Income Related Loans for Public Policy

1 Background

A major role recently recognised for government[1] involves the management and distribution of risks. This can take many diverse forms, for example, including the application of speed limits for automobiles, national health insurance, disaster relief and social security. One particular genre of intervention of government involvement related to risk concerns what are known as "income related loans" and there are now several well-established Australian examples of policies of this type.

Perhaps the best-known IRL is the Higher Education Contribution Scheme, in which, for the first time with respect to a national intervention, in 1989 the Australian government imposed a charge on university students with the following unique form. Students or graduates were required to pay the charge when and only if their personal incomes exceeded a certain level, which at the time was equivalent to average earnings. This approach to higher education financing has since been adopted in New Zealand (1991), South Africa (1994), the US (1995), Chile (1996) and the UK (2004), and has been recommended by the World Bank or is being implemented in Ethiopia, Rwanda, Malaysia, Mexico, Colombia and Thailand, among others.

Australia also implemented a different form of IRL mechanism in 1987, known as the Child Support Scheme, in which child support payments are collected through the tax system from non-custodial parents contingent in part on their income. Similarly, the AUSTUDY Loans Supplement, introduced in 1993, is an IRL very much in the flavour of HECS and involves eligible higher education students repaying some part of their income support, in a way contingent on future incomes. Australia has been a world leader with respect to this form of public sector risk management.

What follows is a brief explanation of possible additional applications of IRL involving many disparate areas of government social and economic intervention. The exercise is designed to highlight the arguably very significant potential of IRL to improve the operation of, and to make fairer, modern economies. There is thus seen to be the prospect in what follows to change radically the current Australian, and other countries, economic policy landscape.

An important aspect of what follows promotes for the discussion of possible institutional reform concerning the development, operation and monitoring of IRL in what should be seen as quite diverse areas of policy, and such an organisation might be established to help design, provide finance to, and manage income related loans.

2 The Economics of Income Related Loan Reform

What now follows examines briefly the conceptual basis of IRL, to position the later discussion of disparate applications of these forms of policy in a broader analytic framework.

In general IRL can be thought of as a public sector financial instrument designed to address aspects of so-called "market failure". Some of the shortcomings of the operation of the private sector with respect to risk might result in an absence of private sector institutions developing in response to social and/or economic need (such as with respect to the commercial provision of loans for human capital investments), and in this case public sector intervention has the capacity to fill a

[1] See David Moss (2002), *When All Else Fails,* Harvard University Press, Cambridge, Mass.

significant void. In other cases there might well be evolved market responses to particular private sector needs, which could be handled more equitably or in administratively more efficient ways through the use of an IRL mechanism, and this might include financial assistance for drought relief. For each separate possible application it is important to be precise about the nature of a market failure, and/or the alleged advantages of an IRL approach in order that the nature of the problem and the solution are well understood.

Related to the above is that one of the important motivations for income related loans organised through the public sector is that such interventions, compared to commercial bank loans, have the capacity to significantly reduce borrowing risks from private beneficiaries in a way that is both equitable and that benefits society generally. In some cases these arrangements mean also that finance can be made available for projects that would otherwise not have access to loans (such as the Chapman/Simes project). There are other reasons for such interventions, such as to reduce public sector outlays and to make fairer government intervention by transforming government grants into income related loans (such as transforming grants for drought relief into income related loans).

Over the last several years a number of public policy case studies have been developed concerning applications of income related loans. In all applications there has been engagement and involvement with many of Australia's experts in specific areas of policy. There is now a number of completed papers, many presented to conferences and close to publication in refereed journals. As examples I note the following:

(i) Social enterprise financing for economically disadvantaged areas. A proposal to encourage additional community social and regional enterprises. To involve contributions from banks, the enterprise and the government, with some part of the loans to be collected contingent on the enterprise's future profits (Ric Simes (Network Economics Consulting Group) and Bruce Chapman (ANU)). A paper prepared for the Chifley Research Centre.

(ii) Transforming drought relief into top-up income related loans. An alternative to grants-based drought assistance, involving both banks and the government in the provision of loans to farm businesses in times of exceptional circumstances (Linda Botterill (ANU) and Bruce Chapman). A submission prepared for the Drought Review, a version of which is under consideration with the *Australian Journal of Public Administration.*

(iii) Income related loans for elite athletes. A scheme designed to reduce taxpayer grants to sportspeople (such as through the AIS), a significant number of whom earn extremely high future incomes. The proposal could involve the most successful athletes repaying more than is provided in their scholarships, with the funds being used to reduce subsidies to sportspeople. (Richard Denniss (Australia Institute), Miguel Palacios (University of Virginia) and Bruce Chapman).

(iv) Income related support for the maintenance of housing. A suggestion to allow individuals and families to access income related loans in periods of adversity to maintain housing. (Joshua Gans and Steven King, the University of Melbourne).

(v) The use of income the income tax system as a substitute for fines imposed on low-level criminal activity, such as assault, theft and drunken driving. Allows the substitution of current practices (which are characterised by high social costs and low enforcement), with income related fines, ensuring low defaults and likely much higher collections). (John Quiggin (University of Queensland), David Tait (University of Canberra), Arie Freiberg (University of Melbourne) and Bruce Chapman). This has been presented at conferences and is very likely to be published soon in the *Australian Journal of Public Administration.*

(vi) Using the tax system to collect fines (from profits and incomes) from collusion and insider trading offences. An alternative to fines with the capacity to collect high fine levels, reward whistle blowers and diminish significantly defaults (Richard Denniss and Bruce Chapman). Under review, *Australian and New Zealand Journal of Criminology*.

(vii) The part replacement of R & D subsidies with profit related loans. In this proposal firms benefiting from R & D grants would be required to repay a proportion of the subsidy as a small proportion of future profits (Amanda Dadd (Productivity Commission), Glenn Withers (ANU) and Bruce Chapman)

If designed properly schemes such as the above involve to some extent: increased progressivity in a lifecycle sense; improvements in both social and economic outcomes; useful financing partnerships with commercial banks; and decreases in taxpayer subsidies. Overall, the proposals arguably mean increased equity, more efficient financing systems, and lower taxpayer outlays.

3 Institutional Change

The policy reform would likely entail the creation of a new public sector institution. Its aim would involve the application of income related loan mechanisms to a host of policy areas, including some of those outlined above.

It is important to recognise that for specific proposals the operational parameters of the basic idea will necessarily be different and conditional on the nature of the activity targeted. The particular arrangements would be determined by the new institution, with examples of the importance of treatment differentiation being illustrated by the following, and much more:

(i) Social enterprise financing would require contributions from individuals or groups, as well as a commercial bank and the government, but this would not necessarily be the case with other applications.

(ii) The repayment of HECS depends on individual taxable income but the recovery of social enterprise loans and drought relief support would require a different basis because the policy concerns businesses not individuals;

(iii) Requiring some form of grant recovery from elite athletes who receive their training from government financing might well involve the most successful (eg elite tennis players or members of the Australian cricket team) repaying a bit more than they actually receive when their personal circumstances are very propitious, which essentially treats the debt as equity;

(iv) The repayment rules associated with insider-trading fraud might have to consider company as well as individual obligations; and

(v) The use of such a system for the repayment of low level criminal fines would need to consider State legislative jurisdiction with respect to legal issues.

4 Where the Discussion Currently Lies

While there has been considerable research into the application of IRL, there is much to be done with respect to academic and policy development. For example, the connections between the various areas needs to be examined and developed with more precision and analytic rigour, and this will likely involve theoretical work focussing on the role of public sector risk management. It is a new area of public sector economics with significant potential for our understanding of policy and governance. As well, the discussion of the nature and form of a potential new IRL institution is so far embryonic.

Further, most of the research and policy activity has come from Australian applications and perspectives, and there is a significant need to consider IRL in other institutional environments. It is hoped that this would lead to the development of general IRL principles.

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