

The US college loan system looks odd from down under

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By all accounts there are emerging problems with US College loans. Increases in tuition over the last decade or so have been well above the rate of inflation, and in 2007 tuition levels stood at around \$12,000 and \$25,000 a year for public sector and private colleges, respectively.

US students taking out loans to pay tuition and to help survive may end up with very large debts, even of the order of more than \$100,000. This has the unfortunate implication that for some graduates it is not feasible to take relatively low paid jobs because the size of their student loan repayments makes such employment hard to afford.



As reported by Mark Huffman in ConsumerAffairs.Com (March, 2007), 'Why Does College Cost So Much?', labor economist Ronald Ehrenberg shares that concern and thinks it might unduly influence a student's choice of career. Huffman reports Ehrenberg as saying: "I am very much concerned and worried ... that it may preclude students from entering socially important but low-paying occupations".

The US problem seems odd to outsiders. In Australia, for example, the repayment of loans for tuition does not have this kind of trouble because the loans are repaid not on the basis of a set amount each time period, but instead depend on a graduate's capacity to repay. This is a concept known as "income contingent loans", the intellectual basis of which derived from the related work on graduate taxes from the late influential Chicago economist, Milton Friedman, and whose idea is pretty much ignored in the country of its origin. James Tobin designed a scheme for Yale University in the 1970s, but it ran into trouble because of collection difficulties.

Australia led the world by introducing income contingent loans (ICLs) for higher education in 1989 paid through the income tax system. The system, known as the Higher Education Contribution Scheme (HECS) works as follows: when students enrol in college (in the English tradition, known as university) they may elect to pay their tuition at the point of entry, or they can agree to repay later (with a surcharge) in a way that depends on their future incomes. The system covers all Australian students.

To illustrate how it works, consider what occurs when a student enrolls in a four-year liberal arts degree program and incurs a total debt of approximately \$30,000. After she graduates she is unemployed for a few months and at that time her HECS repayments are zero. Later she gets a job which pays her \$35,000 for the first year and for that period she also repays none of the debt. In the second year she gets a promotion and then earns \$40,000 a year and starts to pay off her debt because \$40,000 is the first income threshold of repayment. She will repay a fixed percentage of her income to reduce the debt until it is completely repaid.

If at any time the student's income falls below \$40,000 a year (for example, by losing her job and becoming unemployed again), she repays none of the debt during that period. The difference for the student in the Australian system compared to the US college loan system is that in the latter she would have to repay a set amount of her loan no matter what her income is in the future.

Like all college loan systems, HECS was designed to remove the financial barrier for students having to find money to pay tuition on enrolment. But the difference between HECS and the US system of loans is that HECS offers protection against adverse circumstances, such as unemployment or low income employment. The problem expressed by Ron Ehrenberg with respect to the US system cannot happen in Australia because if the pay is low there are no or very low repayment obligations for the graduate.

There are other advantages with the Australian ICL system because students face an important default issue. This problem may manifest itself in a student's reluctance to borrow for fear of not being able to meet future repayment obligations and thus being obliged to default on loan repayments. These concerns imply that there will be less borrowing than there would be in the absence of this default apprehension.

A reluctance to borrow due to the uncertainty of repayment constitutes what might be labelled an *ex ante* default problem for prospective students. There is also an *ex post* problem, which is that a proportion of those students who took the credit risk of borrowing for a human capital investment will end up not being able to repay because of low incomes. In these circumstances default imposes a potentially large cost on those unlucky borrowers who do poorly in the labour market. Significantly, research suggests that members of the default group in the US are predominantly those who ultimately experienced relatively high unemployment rates and relatively low earnings.

The critical summary point is that ICL offer students insurance of two forms. One, insurance against the hardships associated with repaying a set amount of a loan even if the hardship occurs at a later stage in the student's future career trajectory. And two, insurance against default.

It is of interest to note that, in 1993, the Clinton Administration introduced broadly based reforms to student loan programs along the lines of an ICL, but these reforms have not worked well. One reason is that the policy design was very complicated and did not have a sensible income contingent basis. The take-up has been very low, and surveys reveal that most students have not heard of the

scheme. In other words, there remains an important need in the US for a change in an ICL direction.

The success of HECS has encouraged a quiet international revolution in college loans, away from the US-style and towards the Australian. An ICL very similar to HECS was introduced in New Zealand in 1991, in South Africa in 1991, in the UK (partially at first in 1997 and now in full swing), in Thailand in 2007 and is planned for Israel in 2008.

It seems from a distance that US college students are being left behind in terms of international reforms of loan arrangements. ICL offers distinct advantages over current US approaches, and given the demonstrated success and fairness of these systems in other countries, the time seems right to debate the issue in the US.

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