Student Loans: A Hungarian Proposal

Part 2: Implementation

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1. A companion paper discusses the design of a student loan strategy set out by the Hungarian Government. The core of the proposal is threefold:

- Student loans have income-contingent repayments, i.e. repayments calculated as 5-6% of a student's subsequent earnings, collected alongside income tax; the scheme is to be administered by a Student Loans Agency.

- The loans attract an interest rate broadly equal to the government's borrowing rate, i.e. there is no interest subsidy.

- Debt sales will be used to bring in an element of private funding.

2. This paper looks at issues of implementation, discussing in successive sections the design of the Student Loans Agency, debt sales and a range of other questions. Since many issues remain to be decided, the paper is, for the most part, couched in terms of questions which will need to be answered.

1 Designing the Student Loans Agency

3. This section discusses a number of strategic issues about the Student Loans Agency:

- Location and structure.
- Disbursing loans.
- What remit?
- Who should own the Agency?

3. *Location and structure*. A central loans agency using modern cash transfer techniques need not be located in Budapest. Office accommodation would be cheaper and staff might be more available elsewhere. In addition, there are potential efficiency gains from locating the Agency in an area which, because of restructuring, has a skilled population but high unemployment. The UK Government chose to locate its Student Loans Company in Glasgow rather than London; and the Student Loans Company has outsourced much of its data input to rural areas.

4. There is no need for the Agency to have local offices. It would have a web site, email contact, and a phone number (perhaps a number which students could phone free or for the cost of a local call).

5. *Disbursing loans*. Paying student support in cash, as currently, is administratively expensive. Sending individual cheques to students, though less costly, is also unnecessarily expensive.

6. Electronic cash transfer is cheaper, particularly since there might well be a demand for loans to be paid monthly in the same way as existing grants. Electronic cash transfers (i.e. automated monthly payment from the Student Loans Agency's bank account to the student's bank account) is potentially highly cost effective. This approach requires each student borrower to open an account with a commercial bank. It can be assumed that commercial banks would be happy to have such contact with students and would compete to attract student accounts. There is a significant role for government to establish the terms on which banks would be eligible to join the student loans 'club', for example free banking for accounts kept in credit, help from banks in publicising and promoting the scheme, etc. Note that what is being asked of commercial banks is that they administer students' bank accounts; they are not being asked to undertake tasks which the British commercial banks refused, such as being the source of individual student loans or the collectors of student loan repayments.

7. It would be possible to build on this approach using 'smart card' technology. This would involve giving students a card which could be loaded each month and used as a conventional cash card.

8. All these methods of payment could be organised by a central agency without branch offices at each campus.

9. Two further issues pose broader-ranging policy choices. What follows is intended to flag up the questions, but not to point towards any particular set of answers.

10. *What remit?* The main administrative tasks of the Student Loans Agency is to process loan applications, set up and maintain individual account records, and reconcile repayment records with the tax collection authorities.

11. The existing student support system includes a number of grants, scholarships, subsidies and benefits in kind (see Appendix 2) administered by higher education institutions (HEIs). Where local knowledge is important and where the law allows local discretion – for

example the allocation of scarce residential accommodation – decisions and administration should take place at local level. This argument, however, does not apply to the basic student grant of 70,000 Ft. per year, which is given to students in 10 monthly payments on the basis of rules which are nationwide and which allow no local discretion. In the latter case there should be significant efficiency gains, for several reasons, if this task is allocated to the new Student Loans Agency. First, there are administrative economies of scale if a standard task is administered by one administration. Second, there are additional economies if the administration of grants and loans are brought together (the UK, which administers the two separately, shows the extent of diseconomies if complex administrative tasks are imposed on local education authorities). Third, as already discussed, a single administration would have the capacity to organise disbursements electronically, avoiding the substantial cost of handling and accounting for cash. For all three reasons, administrative savings at the HEI level could contribute a substantial proportion of the administrative costs of the new Agency, at the same time freeing university administrative resources for core university tasks. Thus it is worth considering – in the future if not now – whether to broaden the Agency's remit to include most student support.

12. If that approach were adopted, there would be presentational advantages in calling the expanded institution the *Student Support Agency*. This would emphasise the point that the loan is an option and that existing student support mechanisms will continue.

13. *Who should own the Agency?* In the short term the Agency should be publicly owned. Appendix 3 discusses a possible future option under which universities own the Student Loans Agency, either directly or through a trust mechanism.

- In order to satisfy IMF rules on public/private expenditure classification (Box 1 in the companion paper), it might be better if the Agency is not directly owned by government.

- Universities face uniquely beneficial incentives: they want to get the best possible deal for students, who are their main customers; but in order to do this, they need to maximise their credibility in financial markets.

- Universities have a vested interest in keeping operating costs low, since costs come from the higher education budget. Any operating surplus could be used to increase resources for higher education.

14. Although the Agency should be publicly owned initially, there is a case, even in the short run, for establishing a consultative board on which all stakeholders are represented, both for educational reasons and to keep open longer-term options.

2 Debt sales

15. *What are the Agency's tasks in relation to debt sales?* Consideration should be given to whether or not the Student Loans Agency should be directly responsible for selling the debt to the private sector. If that task is carried out by the Agency, senior management with appropriate financial market experience will be needed.

16. *Timing of debt sales*. The Minister and officials emphasised the importance of keeping budgetary pressure to a minimum. For this reason it would be desirable to structure the timing of loan floatation to bring in funds at a rate which matches the flow of payments to students.

17. *What guarantee regime?* As discussed in section 3.1 of the companion paper, there is a tradeoff between a minimal guarantee to private lenders (which is helpful in ensuring compliance with IMF rules) and a generous guarantee, which enables government to charge a higher price for student debt.

18. *To whom should debt be sold?* Should student loan stock be sold on the international market or restricted to Hungarian financial institutions? International competition, at least in the early years of the scheme, might allow the Student Loans Agency to borrow on the best possible terms. Hungarian government bonds are currently attractive to investors, partly because they carry a high yield (though in part this is a risk premium) and partly through anticipation that Hungarian accession to the EU will lead to high growth rates. Certainly, the Hungarian bond market is stable.

19. In principle, the attractiveness of government bonds should carry through to student debt *provided* that the repayment mechanism is sound. Since the flow of income-contingent repayments is highly sensitive to the growth of real income, higher-than-normal growth rates in the early years of EU membership (a likely outcome) would generate a particularly strong flow of repayments from early student borrowers. However, international investors are not usually interested in small bond issues – in major markets packages of €1 billion are normal. Student lending would not be on that scale: possibly student debt could be rolled up with other debt.

20. It may be, however, that in the short term, student debt sales remain a domestic matter.

3 Other questions

3.1 The design of loans

21. *A ceiling on loans?* Will there be a ceiling on loans for any one student, either in terms of the maximum amount he or she can borrow or in terms of the maximum number of years he or she can take out a loan?

22. *An annual loan application?* Should a student apply for a loan annually, or make one application which covers the duration of a normal degree? The UK student loan system was originally designed on the assumption that the banks would run the scheme. For that reason the scheme had to be compatible with the Consumer Credit Act, which requires that an application for debt is for a specific amount; since the maximum loan increased each year (e.g because of inflation) it followed that a new application was needed. This process creates large amounts of costly and unnecessary administration. If a student can make an application for the normal duration of a degree, administrative action is needed only for non-standard cases, e.g. a student who decides to take a year away from her studies, or inherits a large sum of money and no longer needs a loan. Thus administrative action is needed only for a minority of students, not for the entire student population.

23. *What threshold for repayments?* At what threshold will loan repayments start, e.g. will a student start to make repayments only when his/her earnings reach average earnings, or will repayments start earlier, e.g. at the threshold at which income tax starts? The great advantage of a lower threshold is that it greatly strengthens the flow of repayments. The reason is straightforward: if the threshold is lowered from 200 to 100, people with incomes between 100 and 200 make repayments; *in addition* people with earnings above 200 make larger repayments than previously. Note that since repayment are income-contingent, a high threshold is not necessary to protect poor borrowers, who are automatically protected by income contingency. Thus there is a strong case for the lowest threshold compatible with (a) political realities and (b) the administrative needs of the tax system. There is a very strong case for arguing that the threshold should be no higher than the starting point for income tax.

24. *Marginal or total income?* Suppose the threshold for income tax and for loan repayments is 100, and a student earns 180. Will repayments be levied at (say) 5% on *marginal* income, i.e. 5% x 80 = 4, or on *total* income, i.e. 5% x 180 = 9? Using total income as the repayment base (as in Australia) has the great advantage of strengthening the flow of repayments. There are two disadvantages. As a person's income crosses 100, their tax payments take a discrete jump of 5 (though note that the lower the threshold, the smaller the

jump). Second, there is administrative complication if the repayment base (180) is different from the tax base (80). Using marginal income as the repayment base (as in New Zealand and the UK) avoids these disadvantages, but at the cost of a significantly smaller repayment flow.

25. Though loan repayments will not be collected until year 3 or 4 of the scheme, giving time to put administrative mechanisms into place, the loan *contract* needs to be specified in advance. Thus it is necessary to think now about the full range of repayment mechanisms. For example, the UK loan agreement is for income-contingent repayments so long as the borrower remains within the ambit of the UK income tax system. Under the agreement, however, the loan reverts to mortgage repayments if the student works outside the UK income tax system.

3.2 Design of the tax system

26. The UK income tax system collects a person's tax payments weekly or monthly. However, it is only at the end of the tax year that the tax authorities work out how much tax each individual has paid. It follows that, though the tax authorities can pass loan repayments on to the Student Loans Company on a monthly basis, they can tell the Student Loans Company which borrower has paid how much only after the end of the tax year. This lag in identifying individual repayers creates a major job for the Student Loans Company of reconciling receipts from the tax authorities with individual student accounts.

27. The UK is unusual in identifying individuals only at the end of the tax year. There are considerable advantages for effective administration of student loans if the Hungarian income tax system kept track monthly of individual's tax payments.

Appendix 2: The student support system

[* Can Erika supply text]

Appendix 3: Ownership of the Student Loans Agency

This Appendix poses the question of who should own the Student Loans Agency (SLA) in the medium term.

It is clear who should *not* own the Agency. If it were sold to (say) a Hungarian merchant bank, its owner would put shareholder interests ahead of the interests of students, i.e. it would load the terms of student loans in favour of the lender. This would be all the more true if the owner were (say) an American insurance company.

An interesting option is for the Hungarian universities to own the SLA. They would elect a Board of Directors which would (and should) include some Vice-Chancellors, but could (and should) include others. Given the Ministry of Finance's role in debt sales, the Board of Directors should almost certainly include both Department of Education and Ministry of Finance representation. It would also be possible for the National Union of Students to have a fairly small shareholding and possibly also a seat on the Board. Suppose the company is called the Universities' Student Loans Agency (USLA).

This arrangement has unique advantages. First, and by far the most important, universities, uniquely, face exactly the right incentives.

- They face a *financial market test* so far as the supply of funds is concerned, in that the price the USLA can obtain per 1 billion Ft. of student debt will be higher the more credible the repayment mechanism, etc. Thus universities are motivated to arrange loans so as to get the best possible deal in financial markets.

- Simultaneously, on the demand side, they face an *academic market test*. Thus universities are motivated to offer loans as advantageous as possible to students -- who represent their major long run business.

Only the universities face *both* sides of the market, maximising the likelihood that loans will be structured in the interests both of students and of private lenders.

There are other advantages.

- A private institution would be less subject to government interference.

- There might be advantages in terms of public expenditure classification. As discussed in Box 1 in the companion paper, student debt, if inappropriately securitised, might still be counted as public spending under international statistical conventions.

- Since the universities own the USLA, any profits on its operations would go back into the higher education system. For example, a list of names and addresses of current and past graduates is immensely valuable. The list should be safeguarded in two ways: it should be used only in appropriate ways; and the benefits from its use should accrue to present and former students, for example through reduced charges for administering student loans. If universities own the USLA they are, again, uniquely placed on both accounts in terms of the incentives they face.

- Given the ownership of the USLA, student loans would be attractive to lenders who want an ethical portfolio.

- For similar reasons, people might wish to leave bequests to the USLA in the form of a named account to benefit their (say) grandchild, thus assisting him/her but tying the assistance to education.

- The approach is consistent both with a stakeholder model and with the idea of a learning bank.