



Stokes Valley Rotary Club

Student Loans

Norman LaRocque
nlarocque@educationforum.org.nz

Avalon Studios
Hutt City, New Zealand

6 September 2005

www.educationforum.org.nz

STUDENT LOANS

Thank you for the opportunity to address the Stokes Valley Rotary Club. Tonight, I want to speak about an issue that has been front and centre in the current election campaign – student loans.

Both of the main political parties – National and Labour – have announced significant policy changes in the area of student loans. For its part, the National Party has proposed making all net interest payments on student loans tax deductible against earned income from 1 April 2006. They have also promised a student loan write-off aimed at attracting and retaining doctors in rural areas. The Labour Party, for its part, has proposed abolishing all interest payments on student loans for graduates who reside in New Zealand from 1 April 2006.

There has been much discussion of the main parties' proposed changes to the student loan scheme – and particularly the Labour Party's proposal to abolish student loan interest. However, much of the discussion to date has centred on the costs of these proposals, rather than whether they represent good policy. I hope to shed some light on this issue with my talk tonight.

I will begin my talk with a brief overview of the New Zealand student loan scheme, including its history and key features. I will then provide a brief assessment – from a policy perspective – of the main parties' proposed student loan scheme changes and address some of the concerns typically raised against the student loan scheme.

The New Zealand student loan scheme was introduced by the National Government in 1992 as part of the comprehensive tertiary education reform plan that included the deregulation of tertiary tuition fees, successive reductions in the level of per-student funding going to tertiary institutions, the targeting of student allowances and measures aimed at promoting the expansion of the private tertiary education sector.

Broadly speaking, there are two kinds of student loan schemes: 'mortgage-type' schemes and 'income contingent' schemes. Under the former, loans

are provided for a defined period (say 10 years) and repayments are made according to a fixed schedule. In contrast, repayments under an 'income contingent' student loan scheme are linked to borrowers' income after graduation. As a result, the length of time it takes to repay a loan under such a scheme is not fixed. Rather, repayment times depend on the size of the student loan and the borrower's income post-graduation.

The New Zealand student loan scheme is an income contingent one (as are those in Australia and England). Its key design features are as follows:

- eligibility is not means-tested and there is no duration limit on receipt;
- students can borrow to cover tuition fees, living costs, course-related costs and student association fees. Entitlement to the living cost component is reduced if the student is entitled to a student allowance;
- full-time/full-year students and part-time and/or part-year students earning less than \$26,799 (2005/06) have all their interest written off while they are studying;
- student loan repayments begin once borrowers' taxable income reaches \$16,588 (2005/06) and is adjusted annually to reflect changes in the Consumer Price Index;
- borrowers repay ten cents for every dollar they earn above the threshold. They can also make voluntary repayments above and beyond their compulsory repayment requirement. Repayments are collected through the tax system;
- interest is written off for borrowers on incomes below \$16,588 (2005/06), though loan principal is adjusted for inflation;
- students who go overseas must set up a repayment schedule;
- the interest rate is currently set at 7 percent; and
- policy responsibility sits with the Ministry of Education, while loan advances and repayments are the responsibility of the Ministry of Social Development and the Inland Revenue Department respectively.

The design of the student loan scheme has been remarkably stable since its establishment in 1992. The scheme underwent few significant design changes under successive governments during the 1990s. While there have been some changes since 2000 (eg. the abolition of interest for

students while they are studying, the freezing of the student loan interest rate and increases in income thresholds for some borrowers), the broad architecture of the scheme remains as it was in 1992.

Let me now discuss some of the concerns I have with the recently announced proposals for changes to the student loan scheme. Although I will discuss both of the main parties' proposals, the focus will be on the abolition of student loan interest as it is likely to have a more significant impact on the design and cost of the scheme.

The first concern I have with the proposed abolition of student loan interest is its cost. With over \$1.1 billion dollars expected to be borrowed this year, and an accumulated debt of \$6.7 billion, the policy would be expensive. According to Westpac economists, the cost of the policy change could be anywhere from \$270 million to \$1.1 billion per year, depending on the loan take-up rate. These costs come on top of the write-down in the value of the loans on the Crown balance sheet as a result of the change. This has been reportedly calculated at \$1.7 billion.

The abolition of interest will significantly lift the 'economic cost' of the scheme to the Crown – which takes into account factors such as loan write-offs, doubtful debts and the timing of repayments. Throughout the 1990s, the economic cost of the scheme was estimated at 11 cents per dollar of loans drawn down. The decision in 2000 to write off the interest of students while studying more than doubled the economic cost of the scheme from 11 cents to 23 cents per dollar of loans drawn down. No doubt the full write off of interest will increase the economic cost of the scheme by a lot more given its magnitude.

The second concern I have – and this applies to both the Labour Party and National Party proposals – is that the proposed changes will do little to help the government achieve its policy objectives. Neither will do much to increase or broaden tertiary education participation, lift the quality of teaching, pay top performing staff more, help build New Zealand's research infrastructure or encourage more on-the-job training. Further subsidising borrowing under the loan scheme will also mean there is less money available for priority areas such as schools, hospitals, police and tax cuts.

Thirdly, the proposed changes cannot be justified on equity grounds. Both the Labour Party's proposed abolition of student interest and the National Party's proposed tax deduction would, for the most part, benefit borrowers from relatively well-off families and those who have borrowed the most under the scheme. Neither would do much to widen opportunities for students from disadvantaged backgrounds. How will the scrapping of interest for some graduates or allowing a tax deduction help those who leave school without a qualification?

It is also worth highlighting that neither policy will provide additional resources to students. They will only help those who have left tertiary education. And because of the design of the loan scheme, the abolition of interest will only be felt by graduates in mid-career. This is because its effect will be to reduce the period over which a graduate repays their student loan, rather than their annual student loan repayment (which is based on their income).

Fourthly, it is unclear how much of an impact the proposed abolition of interest will have in reducing repayment times or shrinking the amount of student debt outstanding. While the change will have a 'first round' impact on both, some of this will be offset as more students are likely to borrow (and borrow more) given that it is 'free' money to them (indeed better than 'free' given that the real value of an individual's loan will decline with inflation).

The government's decision in 2000 to write off interest for students – a much smaller policy change than is now being contemplated – shows that these concerns are valid. For example:

- the number of student loan scheme borrowers grew by more than 30,000 between 1999 and 2001 (from 115,142 to 148,174) – broadly in line with Ministry of Education estimates that the change would result in a 30 percent (40,000) increase in the number of borrowers;
- according to the Tertiary Education Advisory Commission (TEAC), the student loan take-up rate (the proportion of eligible borrowers who

took out a loan) rose from 49 percent to 64 percent following the policy change in 2000;

- estimates done at the time of the policy change indicated that borrowing would increase by over \$300 million per year within two years of the change being introduced;
- student loan interest write-offs rose from around \$20 million in 2000 to \$192 million in 2001; and
- the government's own estimates at the time were that the abolition of interest would increase the amount of debt outstanding by 33 percent by 2020 (from around \$15 billion to around \$20 billion).

In addition, the abolition of interest will mean that graduates will have little incentive to make voluntary repayments under the loan scheme. This is a significant issue given that nearly half of all repayments (over \$1 billion) made since the scheme began have come directly from borrowers, rather than through employer compulsory deductions. In 2004 alone, over \$210 million was repaid through voluntary repayments.

Finally, a concern with both the Labour and National Party student loan policies is that they both involve channeling additional subsidies to tertiary students. There has been little evidence presented to justify additional public subsidies for tertiary education. Taxpayers already subsidise tertiary education through a variety of means – tuition subsidies, student loans and allowances, industry training and other programmes. These subsidies are significant, with the total tertiary education budget amounting to \$2.8 billion in 2005/06 – more than \$10,800 per Equivalent Full Time Student per year. It is estimated that the government funds around 70 percent of the costs of tuition at the tertiary education level.

Even if further subsidies are justified, the loan scheme is a poor mechanism for delivering these subsidies. Student loans are usually justified on the grounds that capital market imperfections mean that the private sector will provide less than the 'right' amount of lending to students to finance investment in tertiary education. As a result, there will be 'too little'

investment in tertiary education because some students will be prevented from pursuing a tertiary education.

Thus, the role of the student loan scheme is to act as a finance mechanism. It allows students to meet the up-front cost of their contribution by spreading the cost over time. Its role is not to provide subsidies. What is the rationale for providing a further subsidy to those who decide to finance their education through borrowing? If a further subsidy is desirable, and can be afforded, it should be done transparently by increasing the per-student subsidy. Interest subsidies are a poorly targeted and non-transparent method of achieving public policy objectives.

Overall, neither of the student loan proposals put forward by the major parties has merit. The student loan scheme served the country well during the 1990s and doubtless played an important role in helping to lift tertiary participation and foster growth in the private tertiary education sector in New Zealand. A number of commentators, including Prof Nicholas Barr of the London School of Economics have described the scheme as a world leader.

The write-off of interest introduced in 2000 had no policy basis and has been criticised by the Organisation for Economic Co-operation and Development (OECD), which argued that “the costly expansion of the student-loan programme is poorly targeted and will not necessarily improve access”. Even the government appointed TEAC came out against the change in 2001, arguing that it “does not represent an efficient allocation of public resources and is not in the best interests of either students or the government”. TEAC recommended the policy be amended.

Since its inception, the student loan scheme has been subject to an ongoing barrage of criticism – the bulk of it uninformed.

Critics have argued that the amount of debt outstanding makes the loan scheme unsustainable – ignoring the fact that that the amount of student loan debt outstanding is but a fraction of the \$70 billion plus in outstanding mortgage and credit card debt. If \$6.7 billion is unsustainable, shouldn't \$70 billion mean a banking sector meltdown?

Others have accused the scheme of driving people overseas – ignoring the fact that emigration rates for New Zealand citizens were higher in the years before the scheme was introduced than in the years following its introduction. As one recent Ministry of Education report argued:

It is clear there is an association between the size of student loan debt and the likelihood of traveling overseas. The patterns observed above, however, make it clear that the Student Loan Scheme is not a major factor influencing the rate of emigration.

It has always intrigued me why some can argue that a 10 percent student loan repayment can allegedly drive graduates overseas, yet a 39 percent top tax rate on incomes does not?

Still others have criticised the scheme as ‘harsh’. It is beyond me how anyone can describe as harsh a scheme that provides assistance to students on terms that are the envy of farmers, small business owners and entrepreneurs. Where can anyone in any other sector get a loan with repayments linked to income, no risk of bankruptcy if the loan cannot be repaid, an effective interest rate of 3.5 percent, no income/asset test, interest write-offs while the investment is being undertaken and for low-income borrowers. Not even Kiwibank can offer such terms!

One has to wonder where the political impetus is for changing the student loan scheme. A recent *New Zealand Herald* poll found that only 1.2 percent of survey respondents saw the ‘student loan’ issue as the most important election issue, placing it twelfth among 17 issues – well behind health (18.8 percent), tax cuts (14.9 percent) and education (14.7 percent). Furthermore, a survey carried out by the New Zealand University Students’ Association in late 2004 showed that only 8 percent of respondents disagreed with the statement that “government policy treats students fairly”.

To conclude, we should be careful before we make significant policy moves in the wrong direction with the student loan scheme. These schemes are notoriously difficult to get right. Many countries – in both developing and developed countries – have tried them and failed. Poorly thought through

reforms can have significant unintended consequences and imperil the viability of the scheme. The New Zealand scheme is, in my view, unique in the world and must be seen as a whole package. It is comprehensive, generous and cheap to operate.

While other schemes may have particular elements that are more generous than the New Zealand scheme, few, if any, offer such comprehensive assistance on such generous terms. For example, the interest rate is lower and repayment thresholds are higher in Australia. But the Australian scheme does not allow students to borrow to cover living costs. Loan schemes in Canada are far more targeted than the New Zealand scheme. They are also 'mortgage-type' schemes, where loan default means graduates must declare bankruptcy – which cannot be discharged for ten years.

No other scheme provides the full package the way the New Zealand scheme does. It is well worth preserving.