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Economics and Policy-making

THE CASE OF THE HIGHER EDUCATION CONTRIBUTION SCHEME

*Bruce Chapman**

There are three main ways in which economists influence the policy process:

- through teaching present and future policy advisers
- by doing relevant research
- through direct involvement in policy-making.

Effective economic policy influence involves a myriad of complex forces. The important political players need to be convinced that a particular policy action is both correct and feasible. "Feasible" can mean different things to those in power, and meant for an Australian Labor Party minister in the late 1980s that it would be possible to persuade members of the Party (and Caucus) that the policy was politically acceptable.

I want to share with you my experience of direct involvement as a consultant to the Wran Committee, which in 1987 was commissioned by the then Labor Government to inquire into options for instituting a form of "user-pays" for higher education.

The experience is an instructive one in the context of the Public Policy Network Conference because it shows that good economic arguments for change must be politically feasible, and must also be deployed with an understanding of bureaucratic processes.

POLITICAL FEASIBILITY

Effective economic policy influence involves a myriad of complex forces. The important political players need to be convinced that a particular policy action is both correct and feasible. "Feasible" can mean different things to those in power, and meant for an Australian Labor Party minister in the late 1980s that it would be possible to persuade members of the Party (and Caucus) that the policy was politically acceptable. There were two relevant and complicated issues at the time, both of which were addressed eventually with the use of economic data and theory.

The first was that the most important Labor Party icon, former Prime Minister Gough Whitlam, had abolished university fees in 1974. It was a popular move within the ALP, given that it was designed to remove financial barriers for the participation of the poor in higher education.

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The second issue was that reinstituting charges for higher education was inconsistent with the Labor Platform. Resolution of both was assisted through reference to economic data.

SUPPORTING THE CASE FOR A CHARGE

The essential arguments offered at the time for having a charge for the use of higher education services reflect fairly straightforward points available in any economics of education textbook. They were fundamental to the Australian policy debate.

Issues of pricing start with an analysis of the incidence of the benefits of higher education. For individuals they take the form of personal, cultural and economic rewards, with there being little doubt that graduates enjoy substantial income advantages over non-graduates. Lifetime incomes are typically much higher, unemployment rates are lower and the expected duration of unemployment is relatively short for those with university degrees.*

It was argued that an obvious method of measuring the private benefits of higher education is to treat the process as an investment and calculate the returns, a technique that has been applied in a plethora of studies both in Australia and abroad. The major cost of full-time study is the personal income foregone, with the benefit taking the form of the eventual receipt of relatively high incomes.

All Australian studies show that on average higher education is associated with high private economic returns (Miller 1982; Chia 1990; Chapman & Salvage 1997). Internal rate of return data available at the time reinforced the issue (as reported in Chapman & Chia 1989). The high average private rates of return strongly implied a case for charging.

The next question was, how much should the charge be? That is, if there are externalities, how big are they?

It is not currently possible to quantify accurately the extent of spillover benefits from higher education, with there being a broad range of opinion concerning the nature and value of higher education externalities. In the Australian debate the setting of the Higher Education Contribution Scheme (HECS) charge at about 20–25 per cent of the public subsidy relied on precedent, not research or argument. That is, the order of magnitude is a rough reflection of the fees charged in public fee-paying institutions in other countries, and about the level that had been previously levied in Australia before fees were abolished in 1974.

Given the existence of spillovers from higher education there is a rationale for some form of government subsidy to ensure that society receives the appropriate level of investment. That is, it seems to be the case that the right charge is less than 100 per cent of the direct cost, but because there are net private benefits it should exist.

* *Financing Higher Education*, Australian Government Publishing Service, Canberra, 1988.

SOCIAL JUSTICE CONSIDERATIONS

The second argument for charging at the time of the introduction of HECS was very influential. Essentially it is about social justice, or "equity": it is the issue of regressivity concerning public sector expenditure.

There was overwhelming evidence that those who gained access to the higher education system come from advantaged socio-economic backgrounds, and certainly as graduates ended up in the upper echelons of the income distribution.† The following data were important in the policy debate.

In the 1980s, students whose father was in a professional or managerial occupation had four times the chances of experiencing higher education than others. To put this differently, about 22 per cent of university students were from semi-skilled or unskilled backgrounds, but if the composition was instead an accurate reflection of the occupational mix of the Australian labour force the proportion of higher education students from this part of the distribution would have been closer to 50 per cent.

Moreover, evidence from the application of economics of education techniques to Australian data illustrated that university graduates on average did very well in the labour market. The general story, then, seemed to be that a no-charge higher education system (that is, funded entirely by tax revenue) was one in which a disproportionate number of relatively advantaged individuals were being subsidised, after which in general they experienced propitious labour market outcomes. It was hard to believe that this form of public expenditure was not regressive, perhaps considerably so.

It is of policy interest that the facts concerning where higher education students come from in socio-economic terms, and where they end up in terms of relative earnings, were not questioned by the political opponents of the introduction of a charge. This was important to the eventual commitment of the Labor Government to the policy.

In summary, the argument and rhetorical position that seemed to matter for the introduction of charges for higher education was that higher education in a no-charge system is paid for by all taxpayers, but around 85 per cent of contributors have not had access to the private benefits. In short, the Australian higher education financing arrangements in the late 1980s were seen to be regressive. It was a strongly felt issue with key members of the Labor Cabinet at the time.

HOW TO COLLECT THE CHARGE

The next important question addressed in the context of the introduction of HECS was: what is the appropriate way in which the charge is to be collected? For academics interested in the issue this should be uncontroversial given the plethora of economic analyses promoting income-contingent repayment.‡

† *Financing Higher Education*, Australian Government Publishing Service, Canberra, 1988.

‡ For example, see Friedman (1955) and Barr (1989).

It was argued that a significant part of the population faces economic barriers to participating in higher education. Importantly, this means that if fees are imposed without a loans system there will be adverse economic and social outcomes. Charging fees with an inappropriate collection system will mean, for example, that academic talent will be wasted since qualified but poor students will not enrol.

Further, this will mean a reinforcement of what was seen to be the fundamental distributive justice problem. Being born with a poor or ungenerous family becomes a critical determinant of one's eventual professional success.

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The economics of education perspective suggested that an essential economic problem associated with charging up-front fees for higher education is that for those who cannot afford to pay there is only an ineffective capital market available for borrowing. The concern for a bank lending for human capital investments is that, unlike many other purchases, there is not a saleable collateral in the event of default—such as would be the case for the housing capital market—and there is no slavery market in which to sell the human capital.

The problem of lending to students relates to collection costs in the event of default, an issue which assumes greater importance given the absence of collateral. Governments typically address these problems by acting as a guarantor for student loans, and by paying the interest for the period before graduation. However, loans are usually only made available to people from poor families or those who can establish independence through satisfying a complex set of conditions related to age and/or work experience. This suggests that some prospective students who need financial assistance because their families do not provide help will be unable to access the system.

The financial barrier will not be completely removed through means-tested scholarships because this approach presupposes that parents or partners are willing and able to share resources.* However, if that assumption does not hold, the use of family income to determine support is a flawed criterion. In essence, the idea of means-tested loan arrangements to excuse up-front fees for deserving students relies on the assumption of willingness to help within the family, and can thus fail because of it. HECS, like most possible income-contingent repayment arrangements, would considerably diminish these problems because it would make much less relevant the economic situation of the prospective student's family.

The other argument for a HECS-type scheme was not explicitly understood at the time. It lies in the key to understanding the basic problem of the alternative, "mortgage"-style loans. Normal loan arrangements involve the borrower's repayments being made over a specified period of time—for example, the term of a mortgage. Usually little weight is given to the consequences of low future income; when repayments are due the prospect of the borrower not being able to meet the obligation will not be a serious problem for the lender so long as there is a saleable collateral in the event of default.

The essential difference between the two types of loans is that the income-contingent variety serves to protect prospective students from the costs of the exigencies associated with the returns to higher education investment. What HECS offers is a form of "default insurance" such that former students do not have to bear the costs of reneging on their debt as a result of periods of low future incomes. This is quite different to a mortgage-style loan in which the costs of defaulting may be very high in terms of being locked out of other capital markets (most notably for housing) through damage to a person's credit reputation.

The point is that default protection from income-contingent repayment overcomes the fundamental problem for prospective borrowers inherent in other loan repayment arrangements. With the 1996 HECS repayment rules there will be no concern with the possibility of not being able to repay a loan or only being able to repay it with hardship.

It is relevant to note that some part of an aversion to borrowing for human capital investment is perfectly understandable. After-all, the returns to investment in higher education have a very high variance—many students do not graduate, unemployment exists, and the differences in income between graduates are very high.† But when there is no chance of default the issue disappears.

GETTING IT THROUGH CABINET AND THE BUREAUCRACY

One of the problems for economists who are directly involved in policy-making is that the standard textbooks tell us close to nothing about process. However, successfully managing issues of process is critical to policy change. Indeed, no matter how correct are the ideas, how well researched are the likely impacts, and how on-side are the major direct political players, without the endorsement and support of the bureaucracy significant advances are unlikely.

* It is not just a matter of parents or partners being ungenerous. They may not share the view of the prospective student concerning the value of the investment.

† In the Australian context, Miller and Volker (1993) demonstrate this strongly.

One of the reasons this is true is that different parts and influence of the bureaucracy extend typically well beyond the jurisdiction of a particular minister and his/her agenda. For example, a Minister for Education (or equivalent) wanting to introduce a charge for university students would have to have Cabinet support. Before this happened in the Australian context, each Cabinet minister would be informed by their respective department of the implications for that jurisdiction. This advice would normally be an important input in the conditioning of a Cabinet response.

Before the issue gets to Cabinet there is another challenge. It is that the department or departments directly affected by the policy change have to be consulted. Indeed, not only is consultation important, it matters that the relevant parts of the bureaucracy believe that the change is "feasible", meaning that it can be done without considerable administrative costs. In this context HECS is a particularly interesting case study involving the Australian Tax Office.

IMPLEMENTING HECS: THE AUSTRALIAN TAXATION OFFICE'S INITIAL REACTION

One of my direct roles in this process was to consult with the ATO with respect to the feasibility of introducing HECS. At the time I had not much more experience of how this should be done than would be the case for a typical PhD economics student with no understanding of the policy process. There turned out to be significant lessons.

The first lesson lies in the understanding that a department responsible for the administration of new policy will in general not endorse it without some resistance. This is completely understandable, for two reasons.

The first is that change is difficult. It requires insight into how to do new things, and/or reorganisation concerning how to do old things in a new environment. Neither can be guaranteed to be easy.

Second, and more importantly, it is not in the interests of a department responsible for delivery of a new program to agree to it quickly. The reason is that a new program will take resources, and it is possible that the department will not receive all the extra staff required. And if the extra resources are not forthcoming the individual agents in that department will necessarily find themselves working longer and harder to make it happen.

The ATO resisted the introduction of HECS, possibly for the above reasons. At the time the relevant officers posed the following as challenges to be addressed:

(i) The principle that the Tax Office is not a debt collection agency.

(ii) Graduates can emigrate, so the debt will not be repaid by this group.

(iii) What will be done in the event of a graduate's death, with debt remaining?

(iv) People cheat on their taxes, meaning that some part of a HECS debt will not be repaid.

Because making policy effective requires bureaucratic support, a response was required to each of these potential difficulties.

RESPONSES TO THE ATO'S OBJECTIONS TO HECS

The Tax Office is not a debt collection agency.

While it is true that the ATO had not in the past been a debt collection agency this is not in itself an argument against it becoming one. Indeed, one of the design arguments for HECS is that it could use an administratively efficient mechanism to make income-contingent repayment possible. It also mattered that the ATO was already involved in the collection of monies that were not related to income tax: for the payment of non-custodial child maintenance.

... no matter how correct are the ideas, how well researched are the likely impacts, and how on-side are the major direct political players, without the endorsement and support of the bureaucracy significant advances are unlikely.

It was relevant that Dr Meredith Edwards—who was instrumental in the introduction of the child maintenance collection through the Tax Office—was also on the Wran Committee. This meant that there was an informed and influential player who would question the proposition that the ATO's function was only to collect tax. Dr Edwards' role in this context was significant to the ATO's acceptance of HECS.

Graduates can emigrate, so the debt will not be repaid by this group.

It is true that graduates can leave Australia, and thus accordingly avoid the repayment of the debt. The question is, however, how significant is this likely to be?

A reality is that most graduate Australians who leave the country also return, and usually after a short time. That is, those who leave for a period of time but return will still repay much of the debt, and while there will be some revenue loss from this, is it likely to be significant enough to deny the net benefits of the policy? The answer seemed to be no.

What will be done in the event of a graduate's death, with debt remaining?

Very little can be done about this unless outstanding debt can be taken from a deceased person's estate and, given that death duties were not part of the policy framework, this is not an answer. But what is relevant is the empirical point: very few graduates are likely to die before a significant part of the HECS debt is repaid. It helped to be able to demonstrate that typical graduates would repay the larger part of their HECS debt within eight to ten years after completing university.

People cheat on their taxes, meaning that some part of a HECS debt will not be repaid.

Certainly it is true that some proportion of true tax obligations are not paid because of unethical practices. However, there is nothing about HECS which makes this more likely. Indeed, for most payers of income tax HECS can be seen as little more than a temporary and small increase in obligations, and certainly not a major incentive to avoid the system.

The only possible additional avoidance issue raised by HECS concerns the size of repayment at the initial income threshold, which is more than $800 (with the 1996 repayment rules). This implies a huge effective marginal tax rate at this point. The matter arises because the scheme requires annual repayment of the debt as an average of income, and not on a marginal basis.

The effective marginal tax rate anomaly exists to ensure that repayments are sufficiently rapid at the same time as there is a relatively high first income threshold. When HECS was first proposed the first repayment in real terms was much less than it is in 1996, which probably explains why the ATO did not raise it is an issue in 1988.

The bottom line is that HECS did not seem to add significantly to the conventional problems of income tax collection for the ATO. What is of interest for students interested in the direct policy process is that, at the time, there was a clear and strong challenge to the institution of HECS from this part of the bureaucracy. Of even greater interest is the change in the ATO's perspective over time.

THE ATO'S CHANGED RESPONSE

Four years after HECS was introduced the ATO was approached with respect to the planned AUSTUDY Loans Supplement. The supplement gives those on student income support the option of trading in a dollar of their grant for two dollars of an income-contingent loan, paid back according to the HECS repayment rules. The collection issues for the supplement were essentially those introduced years earlier with respect to HECS, but in 1992 the bureaucratic response was completely different.

In 1992 the relevant ATO officer sought not to question introduction of the supplement, but instead highlighted the administrative success of HECS and agreed that the mechanism for the supplement would be essentially the same; the impression was given that such a policy change would be straightforward. Indeed, in contradistinction to the 1988 discussion, a range of HECS promotional material (such as pens, balloons, a video, and a board game) were offered as evidence for the ATO's commitment to the scheme.

The lesson to draw from this is that effective input into the direct policy debate can require much more than an understanding of economic theory and data. An understanding of the bureaucratic context, and how it might change, might very often be critical to how change is approached and enacted.

CONCLUSION

There are a myriad of ways that academic economists impact on policy—through teaching, the posing and addressing of research questions, and through the development of technical and methodological instruments. A more direct role is possible also, and there are useful examples of this in Australia. How this can come about, and the forms that it might take, have been illustrated above with respect to the design, development and introduction of the Higher Education Contribution Scheme in the late 1980s.

HECS reflected academic input in ways that should be of comfort to economists who may not always be fully convinced of the value of economic theory and empirical method. The scheme reflects strongly an economics of education framework in which the undertaking of higher education is treated as an investment process. With this approach it was possible to use some fairly basic rate of return and net present value techniques in an understanding of fundamental aspects of the policy and in an illustration of some of its potential effects.

The existence and form of HECS are testament to the potential power of basic economic ideas as direct policy inputs. The notion of income-contingent loan arrangements for higher education had been well established in the literature before Australia adopted the approach, with the contribution here being that it was argued successfully to be workable. Some of the basic tools of the economics student were critical to these developments. ❖

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