

# Musing and Memories on the Introduction of HECS and Where to Next on Income Contingent Loans

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## Abstract

*The Higher Education Contribution Scheme (HECS) is a rare example of an important, innovative, and imaginative policy instrument developed and applied within a relatively short time period. Looking back over Australian history, innovative policy instruments, with substantial tax revenue or expenditure implications, and introduced quickly, are rare. The short list would probably include the introduction of the old age pension, unemployment benefits and Medicare, although I am not sure of the length of the pre-introduction phrase associated with each of these innovations. Unlike HECS, however, almost all these policy innovations were introduced a long time ago. The size of the macro financial implications, the innovative nature and the speed of introduction and acceptance, suggest that some comments that extend beyond the usual economic discussions of asymmetric information, market failures and adverse selection might be useful.*

This note discusses two closely interrelated questions about the HECS introduction which seem to be important in understanding the potential for introducing Income Contingent Loan systems (ICLs) into other policy areas:

- (i) Why was the HECS innovation developed and introduced so quickly?
- (ii) Why did HECS fit the policy needs so well?

## 1. Why was HECS developed and introduced so quickly?

### ***Political will. Who initiates policy change?***

The political environment, before the appointment of the Wran Committee that recommended HECS be introduced, was one in which a major change in higher

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education financing was about to occur.<sup>1</sup> There was, more-or-less, a political pre-commitment to collect revenue from students on the part of some senior members within the cabinet. I believed, at the time, and without any documented evidence, that the decision to collect money from students, one way or another, had already been made, at least in the minds of the Minister for Employment, Education and Training (John Dawkins) and the Minister for Finance (Peter Walsh).<sup>2</sup> The key political issue was how to do it and how to get the policy widely accepted, both within the electorate and within a Labour party that had been opposed to university fees. In recognition of these political problems Neville Wran was appointed Chairman of the Committee and, given the nature of his task, this is perhaps why he rarely felt the need to attend meetings. He had a clear political job to do which would occur after the recommendations were made.

My assessment of the environment at the time is summed up by my paraphrasing of the task presented to us as: 'How can the government introduce university fees and collect substantial sums of money without appearing to introduce student fees?'<sup>3</sup>

Of course, at the beginning, this seemed an impossible task and I thought that the process would be one in which lots of ideas were floated by the committee and rejected and finally, student fees would be recommended and introduced on the grounds that there was no alternative. The intellectual and social case for collecting money from students was so strong that I had little doubt that some sort of fee structure would be adopted. A student fee was a widely dispersed tax imposed on individuals of considerable economic and social advantage whose financial and social position in the future would be enhanced by the substantial university education subsidy that they received.

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<sup>1</sup> This discussion is based on my memory of the parts of the process that I was involved in and 'hearsay' at the time, rather than a detailed reading of the documented history. Professor Edwards provides a history from her perspective in *Social Policy, Public Policy: From Problem to Practice*, Meredith Edwards (with Cosmo Howard and Robin Miller), Allen and Unwin, Sydney 2001.

<sup>2</sup> Although Dawkins and Walsh believed that students should pay to attend university they differed considerably in their policy proposals. Walsh always preferred straightforward fees and Dawkins enthusiastically adopted the Wran Committee recommendation and strongly advocated HECS. Of course, both proposals are fee systems. HECS, however, attaches to the fees an income contingent loan repayment scheme which the student can access. HECS does not immediately deliver the fee revenue to the government.

<sup>3</sup> The terms of reference were quite bland and after emphasizing equity and access included the following, 'The committee should develop options and make recommendations for possible schemes of funding which could involve contributions by higher education students, graduates, their parents and employers. In developing options the committee should have regard to the social and education consequences of the schemes under examination'.

<sup>4</sup> Meredith's contribution to the adoption of HECS was particularly critical as her earlier work on noncustodial child maintenance scheme set the precedence for the tax department to accept their role as a debt collector. During the initial weeks, when the committee was discussing a variant of HECS, I was not sure that the Taxation Office could collect the fees and was apprehensive that a range of technical collection problems would emerge that we did not anticipate. Meredith's previous experience with the Taxation Office (Child Support collection from the non-custodial parent), and her increasingly enthusiastic advocacy for HECS was important in removing my apprehensions. Unlike other members of the committee I was not strongly opposed to fees and I did not believe that access to universities under a HECS or a fees regime that was likely to evolve (low fees and scholarships) would be that different – but this empirical judgment is difficult. In any event, HECS sent all the right messages about access and was probably the only politically acceptable 'fee' system at that time.

For all practical purposes this is what happened. Student fees were recommended, and introduced, but with a special innovation for their collection. Once I was convinced it would work, I was strongly in favour of the income contingent loan idea, proposed by Bruce Chapman and supported by Meredith Edwards.<sup>4</sup> The concept of income contingent loans had many strong points. But I was still very surprised by the political power of the fee collection innovation and how it made such a significant difference to the political acceptability of student fees. The collection arrangement became the central part of the proposal so that advocates could continually argue that HECS was not a fee system. This scheme was different.<sup>5</sup>

When placing the HECS history against the ICL proposals discussed in this volume the first thing that strikes me is that the way forward to implementing these proposals will be more difficult, for a wide range of reasons quite separate from the intellectual case for their desirability. One overarching problem is that it is not easy to identify the source of the political will needed to introduce the proposals. None of these proposals involve a major addition to government coffers and that immediately removes powerful advocacy from Treasury and Finance departments. The financial need for any proposal is quite small relative to the financial need for university revenue. In the long run university enrolments could extend to about forty per cent of the population. In most cases, the ICL proposals developed here would be, more-or-less, revenue neutral and not extend to a sufficiently large group for that group to mount a committed and effective political campaign in support of the proposals.

Consider the ICL proposal for drought relief refined and developed in this volume – a proposal which I think is particularly strong. On the one hand, there is no substantial savings for government. On the other hand, farmers would be better served trying to get the tax payer to pay for extending, or making more generous, the existing drought relief schemes. Farmers have more of an interest in lobbying to have tax payers pick-up the tabs for drought relief than to support a scheme which involves them paying back loans, even if they are low interest or interest free. If farmers are not the principal political advocates for an ICL, who will be?

Looking back at the process of introducing HECS, I was impressed by the political effort that went into preparing the ground before the policy was developed. I was also impressed by the speed at which policy development and policy introduction was completed. Dawkins produced a paper entitled *The Challenge of Higher Education in Australia* (September, 1987) followed by a Green Paper, *Higher Education and Policy Discussion Paper* (December, 1987) followed by the establishment of the Wran committee in the same month. The committee reported in May 1988 and HECS was introduced in the August 1988 budget and operational in 1989. The speed of change can only be explained by a committed and capable minister who was able to create an environment

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<sup>5</sup> I was, and am still surprised at how much particular interpretation of slogans and words matter in the political process. The Labour Party was strongly against fees. Thus it opposed Peter Walsh's advocacy of university fees in 1986 but was able to accept his recommendation of A Higher Education Administrative Charge (HEAC) of \$250 per student (apparently a charge and not a fee). Meredith Edwards illustrates the hostility to fees and the power of slogans by her book chapter heading on the introduction of HECS 'Paying for a university education; HECS and not fees' (my underlining) (Edwards *et al.*, 2001). The advocates of HECS never described HECS as a fee regime with an optional and innovative loan system attached.

in which it was widely believed by many politicians, and other elites, that there was a university funding crisis about to unfold, and furthermore that the current university funding system was unfair and that a new policy had to be introduced quickly.

### ***Policy Clarity***

Another factor which facilitated the introduction and acceptance of HECS was that the number of policy parameters that mattered was small. The key parameters were the level of fees, the interest rate to be charged, the income levels at which repayments were to begin and the repayment rates. There were no important exemptions, no special arrangements for special groups and no compensation to be negotiated. The key parameters could be settled upon quickly and the process of selling the policy could concentrate on the key idea and not be diverted by detail.

The power of this point struck me when I was reading the Paid Parental Leave proposal by Tim Higgins and Bruce Chapman. The simplicity of the eligibility rules and administration are noticeable strengths of HECS. The Paid Parental Leave proposal seems to impose too high a degree of complexity for the potential benefits that it might deliver. The authors list many of the obvious problems that will necessarily make an ICL scheme complex and describe how these problems might be met – but one wonders whether the need to add a different parental leave option to the existing six month entitlement will deliver sufficient benefits. There are concerns about the sharing of responsibilities for the repayments: issues that arise when using family income, the allocation of responsibility for the debt, the response to family break-ups, and interactions with the claw-backs of Family Tax Benefit (FTB) A and B. None of these complexities make the scheme unworkable and many of these problems have to be faced with existing schemes. It is just that the proposal is not as clean as HECS and consequently the enthusiasm for the add-on policy can be expected to be a little less.

Another aspect of the simplicity of HECS is the ease at which income can be identified. In general, degree holders are wage and salary earners and they report a relatively high income – and hence HECS payments are triggered – even where there may be a substantial gap between real income and taxable income. In some of these proposals however, the measurement of income is more difficult and not so straight forward. Farmers, for example, are well known for their very low taxable incomes and if taxable income is the repayment trigger there may be many non-payers in the drought relief program. The solution proposed by Botterill and Chapman is for the scheme to be based on gross farm revenue which is difficult to hide from the Tax Office. This provides a reasonable solution to the measurement problem, but gross farm revenue is probably not closely related to ‘true’ profits and income in a simple fashion. As a result there may be differential and undesirable resource allocation and income distribution implications for various agricultural activities depending on their underlying cost structures.

### ***Integration Issues***

It was also important for the introduction of HECS that, apart from the Higher Education Administrative Charge, there was no entrenched university financing policy framework into which the HECS proposals had to be integrated. Essentially there was a Greenfield

policy site which accelerated the introduction process and kept the policy analysis, and the selling of the idea, simple. If a complex fund raising scheme had already existed for financing universities issues of integration, and conflicting objectives inherent in the new and old policy frameworks, would arise and divert the introduction process. Furthermore, the option of tinkering with the status quo policy framework, rather than adopt a completely new framework, might have evolved as an option.

HECS was a clear policy of additional taxation of a particular advantaged group imposed on a Greenfield policy site. Some of the proposals in this volume would be imposed on policy areas where existing programs deliver a substantial subsidy. The calculation of the exact size of the subsidies delivered can be complex and a new ICL scheme in some of these policy areas could be seen, possibly incorrectly, as the introduction of additional taxation on a disadvantaged group and the beginning of a process of subsidy withdrawal. I am thinking here of the introduction of an ICL drought relief proposal – a proposal that I generally favour.

### ***Feasibility***

To my mind, it was particularly important that there was a precedent for the involvement of the Taxation Office in the collection of income contingent debts. Dr Meredith Edwards, a member of the committee, had been involved in the development and introduction of income contingent child support payments collected by the taxation department from non-custodial parents. The key elements of the HECS financing scheme had already been trialed and shown to be effective and efficient. This experience could be used to offset opposition from the tax department and allay the worries of those who were unsettled by the radical nature of the proposal and questioned whether it was technically feasible (I was in this group early in the deliberations of the committee). All the proposals put forward in this volume, however, have the advantage that it is now known at a technical level that ICL schemes can work.

## **2. Why did HECS fit the policy needs so well?**

First, it was easy to argue that HECS was fair and that the previous system of university funding was not. HECS obligations were to be placed on a social, economic and intellectually advantaged group and, even after HECS the group would still be receiving a substantial subsidy for their education investment. The proposals in this volume seem to me to be concerned more with providing an opportunity to extend a direct subsidy to particular groups and extend the possibilities for inter-temporal smoothing of consumption – but the fairness case does not seem to be particularly striking, especially when placed against the policy that the ICL may replace. For example, fairness is not an issue in the ICL for innovations which is more concerned with efficiency and income smoothing.

Second, few university graduates would fail to gain financially from the degree, All indications were that almost everyone would either pay up front (fees) or be able to repay the loan. HECS seemed a ‘sure bet’ and the only serious loss to the Finance Department would be the interest on the debt and a waiting period between incurring the debt and repayment. Some of the proposals here do not have this ‘sure bet’ property, at least to the same degree.

Consider, for example, the mature age student loans scheme. The difficulties here are that the individual has less time to repay the loan, the income increment from the additional education is likely to be less and the foregone income during the training period may generate the need for quite a substantial loan. It is much more difficult to make judgments as to likely non-payment rates and who is likely to take-up the loan. Hence it is possible to feel more uncertain about the social optimality of the proposal. It is just not as straight forward as HECS and hence policy makers will feel a little less enthusiastic.

The lack of a 'sure bet' is also more of a problem for the ICL for business R & D which is inherently more risky than HECS.

Third, there were very few ways to avoid HECS charges and the incentives to seek avoidance were not that great. Individuals were unlikely to change their behavior to avoid payment because the collection levels were so low. The lack of a behavioral response is a desirable characteristic from an optimal tax viewpoint. The situation is very different for business where there are more opportunities to reallocate costs and revenues to different parts of the enterprise to seek maximum advantage of any particular scheme. I can remember, for example, the sudden and large increase in business Research and Development (R & D) expenditure following the introduction of the large R & D tax concession. As far as I could tell at the time, the sudden increase in R & D arose primarily from reallocation to R & D expenditure of a range of costs incurred elsewhere in the business. In this way R & D expenditure was measured to increase and additional costs were made eligible for the tax concession. This reallocation effect seemed more important than the increase in the actual amount of R & D undertaken. This is an example of the moral hazard problem that is given so much attention in each of the papers. All proposals imaginatively discuss how to design policy to avoid moral hazard and, in this way, they deepen our understanding of their potential policy initiatives but often the moral hazard reducing restrictions suggested lead to greater and undesirable complexity.

### 3. Concluding Comments

A particularly pleasing feature of the papers in this volume is that they develop very clearly the analytical and economic theory underpinning ICL schemes. All papers describe well the nature of existing government policies in their area of interest and it is illuminating to see the analysis of different policy needs placed in an ICL framework.

My comments have tended to focus on the disadvantages, problems and feasibility of introduction of a suite of ICLs relative to HECS. Since income contingent loans for university students, in my view, is the model of an ideal policy for this group it is inevitable that the assessments of other proposals may sound a bit less enthusiastic. But it should be remembered, in almost each instance, that ICLs are being proposed in areas where the existing policies are quite clearly not good. The existing drought relief programs are of poor policy examples. The right comparison is the policy we have relative to what we could have with an ICL policy rather than a comparison with HECS or an unachievable ideal.

One final remark. One of my initial responses to the volume, from a public

policy viewpoint, was that it was not a good idea to have the taxation department involved in the delivery of too many economic and social policies that involve a wide range of income contingent loans. I thought that the ICL instrument should be confined to a narrow range of policies that involve large revenue flows and for which the need is exceptional and the administrative rules simple. But now, I am not sure that this initial response is right. After all, Centrelink is involved in an enormous range of policies, many of which are quite small so why not the taxation department? Indeed, all the various tax concessions built into the income tax and welfare system are examples of the taxation department delivering policy. So it would not be too difficult in principle to have 'the People Bank of ICLs' as a taxation department offshoot. After more thought it seemed that the role of the taxation department was not the source of my initial concern. The edginess was being generated more by the possibility that there might be too many income contingent policies which will introduce a large range of overlaying interactions of claw-backs as income increases. The interactions with the tax schedules and a suite of ICL policies might increasingly become like the welfare and taxation system interactions and generate a confusingly large range of high marginal effective tax rates. Perhaps this is a misplaced worry but, in general terms, there is a need to make the tax system simpler and to reduce the complexity of interactions – rather than move in the other direction and add to the complexity of the tax system.

## Reference

Edwards, Meredith (with Cosmo Howard and Robin Miller) (2001), *Social Policy, Public Policy: From Problem to Practice*, Allen and Unwin, Sydney.