



## Lending Support: Modernising the Government's Use of Loans



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## PIU WORKING PAPERS

These papers are referred to in the report and are published independently of the report on the PIU website. The address of our website is: [www.piu.gov.uk](http://www.piu.gov.uk)

Working paper 1: Overseas research

Working paper 2: Modelling and assumptions for case studies and supporting data for administrative proposals

Working paper 3: Focus groups

Working paper 4: Income fluctuations

## FOREWORD BY THE PRIME MINISTER



Over the last 15 years, loans have become an increasingly important way of supporting individuals and businesses. That is why I asked the PIU to undertake a project on modernising government loans. This report – which will form the basis of future government policy in this area – sets out the conclusions of the project, including when loans are an appropriate tool for government intervention and how their administration could be modernised.

Loans have a valuable role to play. They allow public money to go further, they can encourage desirable behaviour and they can help people and businesses cope better with variations in income and expenditure. They are particularly important for those people who do not have access to other forms of support and have difficulty getting finance from existing financial institutions.

This report provides clear guidance and criteria on where government loans will be most appropriate and how they should be used. This guidance will be an important input into the future design of policy and service delivery.

There are some areas of public policy where loans might deliver policy objectives more effectively than the existing tools of intervention. Case studies are used to provide some *illustrative* ideas on where new loans might be used, including loans for home improvements or for assisting those moving from unemployment into self-employment. Equally the report recognises that in many situations, loans will not be a suitable means of providing support either to individuals or businesses.

The administration of government loans can be improved in the context of e-government by simplifying and streamlining procedures and improving the customer experience. The report concludes that changes to the ‘front end’ of the loan administration process – publicity, application and assessment – will be important in improving customer access and streamlining procedures through better use of IT. This will be



an important element in the delivery of better services for all citizens, whether they access those services face-to-face, by phone or on-line.

Looking further into the future, the report also paves the way for a more in-depth study of the way in which financial transactions between government and the citizen are conducted, and debts managed. I look forward to seeing the results of this study, which Ministers will want to consider carefully.

**Tony Blair**  
**Prime Minister**

# 1. EXECUTIVE SUMMARY

## Key points

- Government's use of loans to individuals and businesses has gradually increased over the last 15 years. Notable examples of recent loans include the Social Fund (in 1988) and student loans (in 1990).
- Loans can be a good tool of intervention because they allow public money to go further, they can encourage valuable behaviour and they can help people (particularly those who do not have access to other forms of support) to cope with variations in income and expenditure.
- However, there is no framework to guide policy-makers about when loans are an appropriate tool of government intervention. Criteria have been developed by the project to guide consistent decision-making on when government should intervene and when loans might be appropriate. Departments will be referred to this work by the Treasury as part of the Guidance for the 2002 Spending Review. Most existing government loans fit well with the criteria.
- We have developed some illustrative case studies to demonstrate how the criteria could be used – examples have been worked up on:
  - home improvement;
  - support for those undertaking further education;
  - extended maternity leave;
  - unemployed people who wish to set up in self-employment.
- Over-indebtedness is a serious problem for some households. The Government will review the support given to strategies for preventing over-indebtedness, and the collection and enforcement of debts to government, building on research into the effectiveness of tools for reducing over-indebtedness, and on proposals emerging from the Lord Chancellor's Department's Review of Enforcement.



- The administration of government loans can be improved in the context of e-government by simplifying and streamlining procedures and improving the customer experience. The report recommends changes to the 'front end' of the loan administration process (publicity, application and assessment) to improve customer access and streamline procedures through better use of IT.
- A feasibility study should be undertaken to consider the opportunities, costs/benefits and implications of:
  - centralising the management and recovery of all debts to government (including those arising from government loans where appropriate), in a single organisation;
  - more speculatively, the establishment, in the longer term, of a single citizen's account through which all financial transactions, including tax and benefit payments as well as loans and other debts, between government and citizen could pass.



## Government’s use of loans has increased over the last 15 years

Increasing pressures on public expenditure and a shifting emphasis from government ‘support’ to ‘enabling’ has provided the backdrop to successive governments’

increased use of loans. Table 1(a) below sets out the government loans currently available to individuals and to businesses.<sup>1</sup> These are further detailed in appendix 3 of this report.

**Table 1(a): Existing Government loan schemes**

Loans to individuals	Loans to business
<ul style="list-style-type: none"> <li>• Student loans</li> <li>• Social Fund budgeting and crisis loans</li> <li>• Career Development Loans</li> <li>• Deferred payments secured against property for those entering residential care<sup>2</sup></li> <li>• Loans for home improvement</li> </ul>	<ul style="list-style-type: none"> <li>• Launch Investment</li> <li>• Phoenix Fund grants paid as loans through Community Development Finance Institutions</li> <li>• Small Firms Loan Guarantee Scheme</li> <li>• Small Firms Training Loan Programme</li> <li>• Home Shipbuilding Credit Guarantee Scheme</li> </ul>

*There are some areas of public policy where loans might better deliver policy objectives than existing tools of intervention*

No guidance currently exists to assist departments’ decision-making on when loans might be appropriate (or indeed when they might not be appropriate). Lack of guidelines may have resulted in insufficient consideration being given to loans as opposed to other forms of intervention such as grants or allowances.

*Criteria can encourage consistency when governments are deciding when and how to intervene*

There are four steps to follow in considering whether and how government should intervene:

1. What are government’s objectives?
2. Should government intervene to deliver those objectives?
3. Are loans the most effective tool of government intervention?
4. What type of loan and what administrative arrangements are appropriate?

These are discussed in box 3.2 (page 17).

<sup>1</sup> Both government provided and enabled.

<sup>2</sup> Currently being introduced by local government.

## *Market failure and equity are the two key reasons why a government should intervene*

There are four key sources of market failure:

- **Externalities:** Costs (such as pollution from a factory) or benefits (such as a reduction in youth crime due to an expansion in education) – that are borne by society in general, or a group of people other than those directly providing or using a good or service.
- **Incomplete markets:** Exclusion from markets by certain individuals and/or failure of markets to cover certain events.
- **Imperfect competition:** Where there are relatively few companies in a market which gives them the power to influence the market.
- **Public good and merit goods:** Public goods are goods that are simply not provided by private markets and merit goods are goods that government tends to value more highly than citizens.

There are three reasons why government might want to intervene to promote equity:

- **distributional aims;**
- **prevention of discrimination;**
- to ensure that everyone has **equal access to justice** and is treated fairly under the law.

## *Loans are the appropriate tool of intervention when...*

- they provide an effective way to deliver government objectives;
- they provide an efficient way to target government resources;

- there is a reasonable expectation that the recipient will be able to repay;
- the use of loans promotes 'positive incentives'.

## *Most existing loan schemes score well against the criteria*

Most existing government loan schemes score well against the criteria. Loans for education tend to score well since they allow individuals to increase their future earnings potential. For similar reasons, on the business side the Small Firms Loan Guarantee Scheme and loans to small businesses administered by the Phoenix Fund also score highly. Some existing schemes score less consistently, for example launch investment. The criteria raise questions about whether the government should be intervening. This scheme is currently being evaluated by the Department of Trade and Industry (DTI) as part of a wider review of business support.

## *Examples of loans have been used to demonstrate the use of the criteria*

Some illustrative case studies were developed to demonstrate the use of the criteria. These are not policy proposals. The examples include:

- loans to encourage take up of unpaid maternity leave;
- loans to assist students undertaking further and adult education to pay for their living expenses whilst studying;
- equity loans to assist low-income private home-owners with improvements to their properties, repaid when the property is sold;
- loans for the unemployed wishing to enter self-employment.



### *Future developments are expected in the case study areas...*

- **Further and adult education loans.** The Department for Education and Skills (DfES) is reviewing the financial support arrangements for adult learners and will consider the conclusions of this report in the context of that wider review.
- **Home improvement loans.** The Department of the Environment, Transport and the Regions (DETR) published a consultation paper in 2001, which proposed offering extra flexibility to local authorities to offer loans for home improvements. In the light of this consultation, the Government has laid proposals before Parliament, with the aim of bringing these into force in summer 2002. Guidance is being prepared to coincide with the introduction of these reforms.
- **Loans for self-employment.** These proposals will be considered further by the Department for Work and Pensions (DWP), along with the Small Business Service (SBS) and DfES; if the proposal is supported by more detailed analysis the aim would be to pilot a loan scheme in 2002.
- **Maternity loans.** The DTI, together with the DWP, has considered these ideas. Early in 2001, the Government announced the introduction from 2003 of a number of measures to improve and simplify maternity leave and pay provisions. The ideas for maternity loans in this report are not being taken forward as part of this work, and are not being considered further by the Government at this time.

### *While loans have many advantages over other forms of intervention it is important to minimise the risk of over-indebtedness*

Debt does not equal over-indebtedness. Borrowing can be a useful tool to help households smooth their income over time. Debt only becomes a problem when people cannot afford the repayments. Household debt is rising. Some of this is due to a rise in home ownership and reflects a corresponding increase in wealth. In a climate of rising real incomes, property prices, and low interest rates, this may be affordable. However the evidence points to the existence of a minority of households who are paying significant proportions – sometimes over 90% – of their income on debt repayments. Young households, those on low incomes, large families, and those with a large number of credit commitments are at more risk of over-indebtedness.

Levels of over-indebtedness may also be rising. While some indicators of over-indebtedness such as arrears and county court judgements are stable or falling, others such as enquiries at debt advice centres are rising. Citizens Advice Bureaux report a 39% rise in the number of consumer debt enquiries from over the last four years. It is also thought that the total debt service ratio (the amount households spend on paying off the interest and loan principal) has risen to levels last seen in the early 1990s.

This analysis points to the need for Government to avoid exacerbating over-indebtedness when making government loans available.

Currently much of government intervention is at the bottom of the debt spiral, in the courts and insolvency service: coping with the effects of over-indebtedness rather than focusing on prevention. Little is known about the effectiveness of preventative tools such as financial literacy programmes, money advice and debt advice. The ability to set the right level and pattern of government investment in these tools is hindered by this lack of knowledge.

A cross-cutting review should be undertaken of debt advice, and the collection and enforcement of debts to government, building on research into the effectiveness of tools for reducing over-indebtedness, and on proposals emerging from the Lord Chancellor's Department's Review of Enforcement (see appendix 4).

### *There are some shortcomings in existing arrangements for administering loans*

There are some shortcomings in each of the key steps in the generic process for delivering loans:

- **Publicity:** For some loans there is no clear 'lead' in terms of whom customers should contact for information.
- **Application:** The process of applying for loans is largely paper based and clerically processed and in some cases requires customers to deal with more than one institution.
- **Assessment:** Assessment of loan eligibility is often not well supported by IT and there are few online links between departments. This means that verification of entitlement, e.g. benefit receipt or income, often has to be manually provided and clerically processed.
- **Payment:** For some loans the general government push to reduce costs of payment through moving to automated credit transfer (ACT) has not been rigorously pursued.
- **Loan account management and recovery:** The functions of loan account management and recovery are similar for all departments. However, because the customer groups are often very different, it is difficult to maximise economies of scale. Government is also not always consistent in its approach to debt recovery. Differences in the extent to which debts are pursued are not always based upon an explicit policy rationale.

### *It is recommended that departments consider 'wiring up' the front end of the loans administration process (the steps of publicity, application and assessment)*

This will involve:

- Increasing the information available about loans online, providing the facility for customers to apply for loans online and developing better links to ensure that customers can access government loan services through a variety of portals including UKonline and any private or voluntary sector portals.

The next step is for departments to work with the Office of the e-Envoy, Treasury and the Cabinet Office in considering how this proposal fits into their wider e-agendas and to agree the relevant departmental objectives.



*However, there may be less to be gained from joining up the management and recovery of loans*

There may be advantages of centralising loan account management and debt recovery functions, including:

- Economies of scale in delivering these generic processes (by centralising processes requiring similar IT support, staff skills, contracts to third parties, etc.).
- Improved consistency:
  - avoiding situations where government is separately chasing the same individual for outstanding debts to different government departments;
  - requiring explicit guidelines on the extent to which the public sector pursues outstanding debts.

However, the scope for greater gains from joining up these functions for existing government loans may be limited, simply because there are anyway relatively few schemes, and because they serve very different customer groups. If we were to extend this centralisation to debt recovery across all debts to government (e.g. including unpaid taxes or fines as well as loan repayments), however, the gains may be more significant. And if we were to look at the scope for 'joining up' all financial transactions between government and citizens, additional improvements may result. However, these proposals clearly go much wider than loans and development and implementation would be some years off.

It is therefore proposed that a feasibility study be undertaken to consider whether there would be overall benefits from in the longer term, greater integration of government's debt recovery services and its financial transactions with citizens more generally. The study would be in two stages. The first stage of the study would be an assessment of the full benefits, costs, risks and practicalities of these proposals, to determine whether these proposals should be taken forward. The study will report to the Chief Secretary to the Treasury, involving PSX(E) as necessary, to ensure decisions on whether to proceed to stage two or to finish are collectively agreed. Subject to this, the second stage of the study would consider the longer-term implementation of proposals, and seek Ministerial agreement on conclusions. The scope of the feasibility study is described in full in chapter 6.



Table 1(b) below summarises the actions required to implement this project's proposals.

**Table 1(b): Actions, responsibilities and timing for taking forward this report's proposals**

What?	Whom?	When?
1. The criteria should inform Treasury's Guidance to departments on the conduct of the 2002 Spending Review	Treasury and departments	Ongoing
2. Departments to agree priorities and where appropriate have targets for delivery of online loan services and better links with other departments built into their objectives	Treasury in conjunction with the Cabinet Office (Office of the e-Envoy (OeE)) in agreeing departments' objectives	April 2002
3. Develop strategies and plans for 'wiring up' the front end of loans administration in line with the proposed vision	Each department (in consultation with OeE)	July 2002
4. Detail the new processes, IT support and skills required to move towards the new arrangements	Departments/government bodies responsible for administering loans (in consultation with OeE)	July 2002
5. Implement the proposals	Each department	2003-05
6. Research into effectiveness of strategies to reduce over-indebtedness. Review of government's role in provision of debt advice, financial education and the collection and enforcement of debts to government.	DTI/FSA	December 2002
7. Conduct stage 1 of the feasibility study, and seek Ministerial agreement to conclusions.	Treasury/IR/PIU in conjunction with other interested departments, e.g. DWP and DfES. Stage 1 should report to the Chief Secretary to the Treasury, involving the Ministerial sub-committee on Electronic Service Delivery (PSX(E)) as necessary	Complete stage 1 by September 2002
8. Depending on the outcome of stage 1, undertake stage 2 of the feasibility study, and then seek Ministerial agreement to conclusions on implementation.	Treasury/IR/PIU in conjunction with other interested departments, e.g. DWP and DfES. The Study should report to the Chief Secretary to the Treasury, involving PSX(E) as necessary	March 2003

The Ministerial committee on Economic Affairs, Productivity and Competitiveness (EAPC) should monitor implementation of the project conclusions.

## 2. INTRODUCTION

### 2.1 Government's use of loans is increasing

Increasing pressures on public expenditure and a shifting emphasis from 'support' to 'enabling' have provided the backdrop to successive governments' increased use of loans as a tool of government intervention. Governments' use of loans<sup>1</sup> has gradually increased over the last 15 years. Notable examples where existing allowances have been changed to loans include the move from social security exceptional needs payments to Social Fund loans (in 1988) and the move from student grants to student loans (in 1990). This movement from grants to loans is continuing with the introduction of two new schemes:

- councils with social services responsibilities will be able to offer deferred payments

secured against the value of a property for the costs of residential care for the elderly; and

- change in the legislation enabling local authorities to offer equity loans instead of grants for low-income homeowners.

On the business side too, government is also making greater use of alternatives to grants, including loans. Loans available to business include large-scale support to particular industries such as aerospace, under the Launch Investment scheme. Government also provides support for smaller firms through its Small Firms Training Loan programme and loans for businesses setting up in deprived areas administered through the Phoenix Fund.

Existing government loan schemes are listed in table 2.1 below and detailed in appendix 3 of this report.

**Table 2.1: Existing government loan schemes**

Loans to individuals	Loans to business
<ul style="list-style-type: none"> <li>• Student loans</li> <li>• Social Fund budgeting and crisis loans</li> <li>• Career Development Loans</li> <li>• Deferred payments secured against property for those entering residential care<sup>2</sup></li> <li>• Loans for home improvement</li> </ul>	<ul style="list-style-type: none"> <li>• Launch Investment</li> <li>• Phoenix Fund grants paid as loans through Community Development Finance Institutions</li> <li>• Small Firms Loan Guarantee Scheme</li> <li>• Small Firms Training Loan Programme</li> <li>• Home Shipbuilding Credit Guarantee Scheme</li> </ul>

<sup>1</sup> Included in the definition of loans are guarantees, deferred payments and recoveries from grants. These loans may be publicly or privately funded, subsidised or unsubsidised and may or may not be guaranteed by Government.

<sup>2</sup> Currently being introduced by local government.

## 2.2 There are some areas of public policy where loans might better deliver policy objectives than existing tools of intervention

Loans as a government policy tool have developed in an ad hoc way. There has been no overarching examination of loan use. And there are no cross-governmental agreed principles for guiding departments' decision-making on when loans might be appropriate. Lack of clarity about the circumstances in which loans should be considered might prejudice policy-makers against loans as opposed to other forms of intervention such as grants or allowances. There are also some areas of public policy where existing use of loans might be inappropriate.

## 2.3 The ad hoc growth of loans has resulted in administrative inefficiencies

Ad hoc development of loans as a policy tool has also resulted in the ad hoc development of administrative arrangements for delivering loans policy products. This means that in addition to any existing shortcomings in the administrative arrangements of individual schemes, there may be additional inefficiencies because of a lack of consistency and failure to exploit economies of scale arising from common functions. Most of the key steps in the loans promotion, assessment, payment and recovery process involve the same types of tasks. It therefore makes sense to see if improvements can be made through considering a more joined-up approach to the delivery of government loans.

## 2.4 We aim to develop criteria to improve consistency in policy decision-making on when to use loans and recommendations for improving government loans administration

This PIU project was therefore announced by the Prime Minister on 7 December 2000 with the three aims of:

- developing a clear set of criteria for guiding decision-making on when loans (to individuals and to businesses) are the best form of government intervention. The criteria for guiding decision-making developed by this project will inform the Treasury's Guidance to departments on the conduct of the 2002 Spending Review;
- testing the practicality and completeness of the criteria for guiding decision-making, by using the criteria to evaluate case studies focusing on possible areas of intervention where a loan might replace alternative forms of existing intervention or to fill any existing gaps in provision; and
- making recommendations for any changes required to ensure that government loans are delivered in the most coherent, cost effective and customer friendly way.

The three questions addressed by this project relate to the consistency of government's use of loans and the overall efficiency of the administration of loans:

- Is there a clear set of criteria for guiding decisions on when loans might be the appropriate tool of intervention? If not, what should the criteria be for guiding decisions?
- How well do current government loan schemes fit with the criteria for guiding



decision-making on when loans are appropriate? Can the criteria be used to identify additional areas where government might make greater use of loans?

- Can the administration of government loans be improved? What criteria should we use to evaluate the options for improvement? What are the options for improvement? What is the preferred way forward? What are the barriers to be addressed?

## **2.5 The project was carried out by a multi-disciplinary team, supported by an Advisory Group and sponsored by the Chief Secretary to the Treasury**

The team members undertaking this project came from both the private and public sectors and came from a variety of disciplinary backgrounds. Details are shown in appendix 1.

The project comprised five strands of work:

- developing and agreeing criteria for guiding decision-making on when government intervention is appropriate and when loans are appropriate;
- describing current UK loan activity and evaluating the fit between existing schemes and the criteria;
- describing overseas governments' loan activity and administrative arrangements;
- developing options for possible new loans products; and
- reviewing existing arrangements for administering loans and making recommendations for improvement.

Details of the project methodology are in appendix 2.

In carrying out the project, the team has drawn on the expertise of the project's Advisory Group and two Working Groups, made up of representatives and stakeholders from inside and outside government. The team was also supported by its Sponsor Minister, Andrew Smith, Chief Secretary to the Treasury. There was also extensive input, advice and support from other stakeholders both within and outside government. The team wishes to express its gratitude for this support.

The team consulted closely with the devolved administrations (DAs) when carrying out the analysis. The conclusions of the report apply to England, but may be of relevance to the DAs for their own policy development.

## **2.6 The remainder of this report is structured into four sections**

- Chapter 3 sets out the criteria developed for guiding decision-making on when government should intervene and when loans are appropriate.
- Chapter 4 uses the criteria to evaluate existing loan schemes for individuals and businesses.
- Chapter 5 uses the criteria to identify where new loans products for individuals and businesses might be introduced. The new loans include products to replace existing forms of intervention (e.g. grants and benefits) and products to provide additional financial support.
- Chapter 6 sets out proposals for improving the efficiency and customer service of loans administration.

### 3. PRINCIPLES AND CRITERIA GUIDING THE USE OF LOANS

#### Summary

Making consistent decisions about intervention across a wide range of policy areas is a key challenge for government. This process may be aided by the development of criteria to guide when and how governments should intervene.

The focus of this part of the report is on criteria for when loans might be the most appropriate form of intervention. The main conclusions are that loans should be used when:

- they can **effectively deliver government objectives** at lowest cost (compared with other instruments);
- they can be used to **target resources efficiently**, for example, in providing loans only to those who could not borrow on private markets;
- there is a reasonable expectation that the **borrower will be able to repay** the loan, either because the income reduction or need for expenditure is temporary, or because the loan can be used to generate an increase in future earnings; and
- the use of loans **promotes positive incentives**, such as encouraging people to make best use of the money, rather than acting as a **barrier to uptake**.



### 3.1 Growing demand for public services requires government to consider carefully when and how to intervene

This section of the report examines the role of criteria in giving guidance on whether government should intervene, and on when loans might be an appropriate form of intervention. Loans in this context include both publicly provided loans and privately provided loans, facilitated through government interventions such as guarantees or interest rate subsidies.

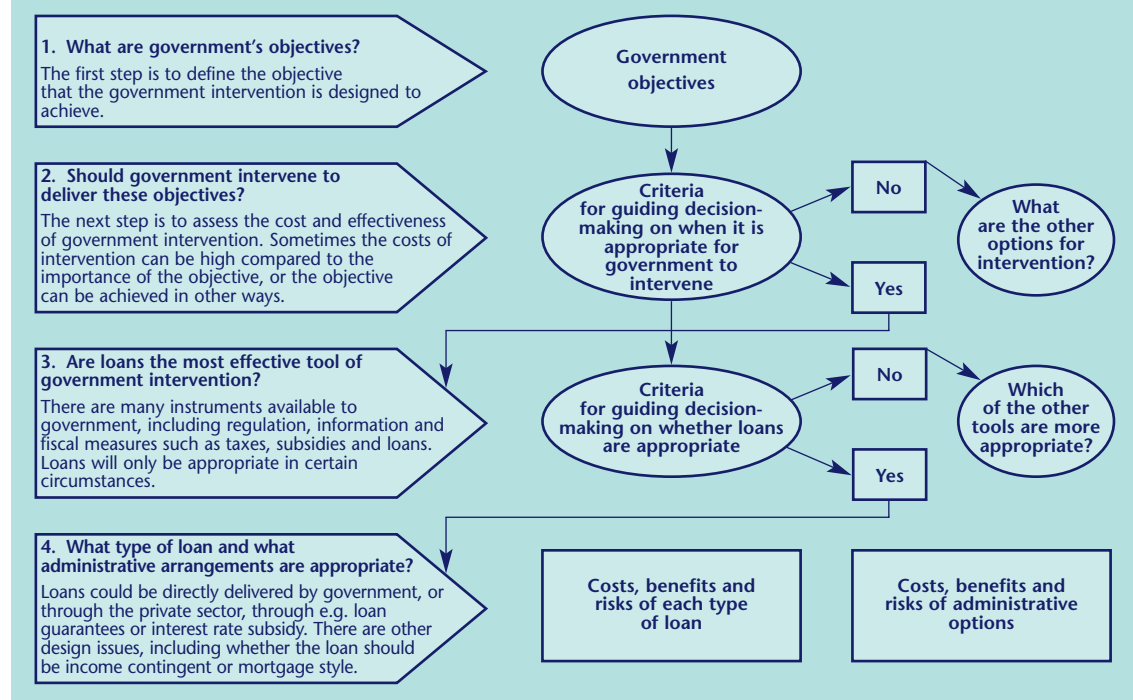
### 3.2 Criteria can encourage consistency when governments are deciding when and how to intervene

In examining when government should intervene, the first step is to define the objective that the Government intervention is designed to achieve, see box 3.2 below.

The second step is to decide whether government intervention is the best way to achieve the objective. Sometimes the costs of intervention are high relative to the benefits of the objective, or the intervention can simply be ineffective. There may also be other routes to achieve the objective. Criteria can be helpful here in identifying the central rationale for why governments should intervene.

Finally, the effectiveness, and the costs and benefits of different instruments of

*Box 3.2: Criteria within a policy process where loans are under consideration*





government intervention need to be assessed. Criteria can also be helpful here, to indicate which policy instrument might be the most appropriate. Box 3.2 shows how criteria might fit within a policy process where loans are under consideration.

The following sections consider each set of criteria in turn.

### 3.3 The first set of criteria looks at whether government should intervene

There is a large amount of economic theory about the rationale for government intervention. Most commentators define two central justifications for intervention:

- **to help correct market failures;** and
- **to promote 'equity'** (for example, to redistribute income or wealth, prevent discrimination, or ensure equal access to justice).

These are explained in more detail below. The reason for intervention is important in

#### *Box 3.3: Criteria for whether government should intervene*

- **Market failure**

There are several possible sources of market failure, including:

- **Externalities.** 'Externalities' are costs (such as pollution from a factory) or benefits (such as a reduction in youth crime due to an expansion in education) – that are borne by society in general, or a group of people other than those directly providing or using a good or service. The existence of externalities might cause governments to intervene because they want more of the external benefits, or less of the external costs, than would result from private markets.
- **Incomplete markets.** Incomplete markets can occur where the legal system doesn't define ownership or responsibility properly. Markets are also incomplete where there are high transaction costs, or information problems, which mean that people simply don't know which goods or services are available. Sometimes the problem can be simple to address, e.g. by marketing to improve information. In other cases, it can be more complicated. This is often the case in insurance or financial markets, where there are difficulties in obtaining information about the risk of a claim or the probability of default on a loan. The result can be that insurers or lenders exclude a whole group of potential customers they consider a bad risk.
- **Imperfect competition.** Sometimes there are relatively few companies in a market. This leads to a situation in which they can influence the market, for example by restricting the supply of a good or service to force up prices and profits, or by colluding with other players in the market to do the same. Often governments intervene in these circumstances to regulate the market to control prices or promote competition (e.g. water, electricity, and gas in the UK), or in some cases to provide the good or service directly.



### *Box 3.3: Criteria for whether government should intervene (continued)*

- **Public goods and merit goods.** Public goods are goods that are simply not provided by private markets because they can't make any profits from selling them. This is usually because once public goods exist, it is impossible to prevent anyone from enjoying the benefits. Examples of public goods include street lighting and defence expenditure. Merit goods are goods that government tends to value more highly than citizens. For example, governments tend to make education compulsory up to a specified age, rather than allow people to make that choice for themselves or their children. Similarly, governments may legislate to make people wear seatbelts or tax cigarettes to discourage smoking.

- **Equity**

Recognising that not every individual starts life with the same resources, and in order to ensure greater equality of opportunity, governments may wish to intervene to promote equity, for example:

- **Distributional aims.** For example, to ensure a more appropriate distribution of income or wealth.
- **Prevention of discrimination.** To prevent discrimination, e.g. on the grounds of gender, race, religion, etc.
- **Equality under the law.** To ensure everyone has equal access to justice and is treated equally under the law.

identifying the most appropriate response and identifying the case for loans compared with other instruments of intervention.

#### **3.3.1 Market failure is a key rationale for government intervention**

Markets usually work well. Markets that are operating freely allow consumers and business to buy the goods and services they value most highly, and allow suppliers to sell at a price that maximises their profit. So suppliers provide what people want, at a price they are prepared to pay. Another way of saying this is that resources are allocated efficiently in the economy.

However, sometimes markets fail. Information deficiencies, externalities such as pollution, market power, and many other problems can arise which provide a rationale for

government intervention. These are set out in box 3.3 above.

#### **3.3.2 Equity is also an important rationale for intervention**

Even if markets are working perfectly, governments may still wish to intervene. Not everyone has an equal allocation of resources to start with, and governments often try to make this initial allocation of income or wealth more equitable. For example, people who earn more are often taxed more highly, and many government benefits are targeted at those on low incomes. Similarly, governments may want to ensure that individuals are not discriminated against, for example on the basis of race or gender, and that the legal system allows for equal treatment for all (see box 3.3 above).

### 3.3.3 But government intervention doesn't always work

Government intervention has costs as well as benefits. Market failure or a desire to improve the distribution of income or wealth provides a rationale for intervention. However, there are risks that the intervention itself may fail. And intervention can often be costly. These risks and costs also need to be weighed up alongside the benefits of intervention.

## 3.4 The second set of criteria look at whether government should intervene in the form of loans

If government has decided that there is a case for intervention, there are a number of possible instruments that can be used. Some instruments may be more effective than others at achieving the objective, and different instruments are likely to have different costs associated with them.

The advantages and disadvantages of all relevant forms of intervention should be explored. Often the type of market failure can give guidance about which type of response is most appropriate. For example, if the failure is an information failure in financial

markets, a first step might be to see if information flows can be improved; if this is not possible, government support for loans may be an appropriate response.

### 3.4.1 Loans have advantages...

- **They can be an effective and efficient way to meet government objectives.**

For example, the Social Fund has made loans worth over £3 billion available since its inception in 1988. But the net cost to government has been £500 million. Loans can allow government resources to be freed up to assist a greater number of people.

- **They can be a 'fair' way to recoup some of the benefits of government intervention from recipients.**

If individuals or businesses receive significant private benefits from government intervention, there is a case that they should contribute to the cost. For example, obtaining a university degree results in an earnings premium of between 10% and 25% to the average student, see box 3.4(a), and it therefore seems fair that they should contribute to the costs of providing that education. Loans also allow other beneficiaries to contribute to the cost, for example, some employers offer partial loan repayment to graduates.

#### Box 3.4(a): Did student loans affect poor students' take up of HE?

People earn more after graduating from university. The increase in lifetime earnings from higher education has been estimated at about 10%–28% for men and 21%–26% for women.\* However, students from lower social classes experience much greater variation in return than students from better-off backgrounds.\*\*

It has been claimed that the recent shift from grants to loans for maintenance, and the imposition of tuition fees, has discouraged poorer students from entering higher education.\*\*\* Possible reasons why this might be the case include greater debt aversion, and higher variation in the expected returns from HE amongst poorer students.

\* Dearden et al. Blundell et al, using the NCDS, find returns for women of 37%, and men of 17%.

\*\* McKnight et al.

\*\*\* Such a claim has been made, for example, by John Knowles in *Pity the Poor Students*, University of Lincolnshire and Humberside, 2000 and *Equal access or elitist entry?*, NUS research paper, 2000.



**Chart 3.4: Participation rates in higher education by social class\***

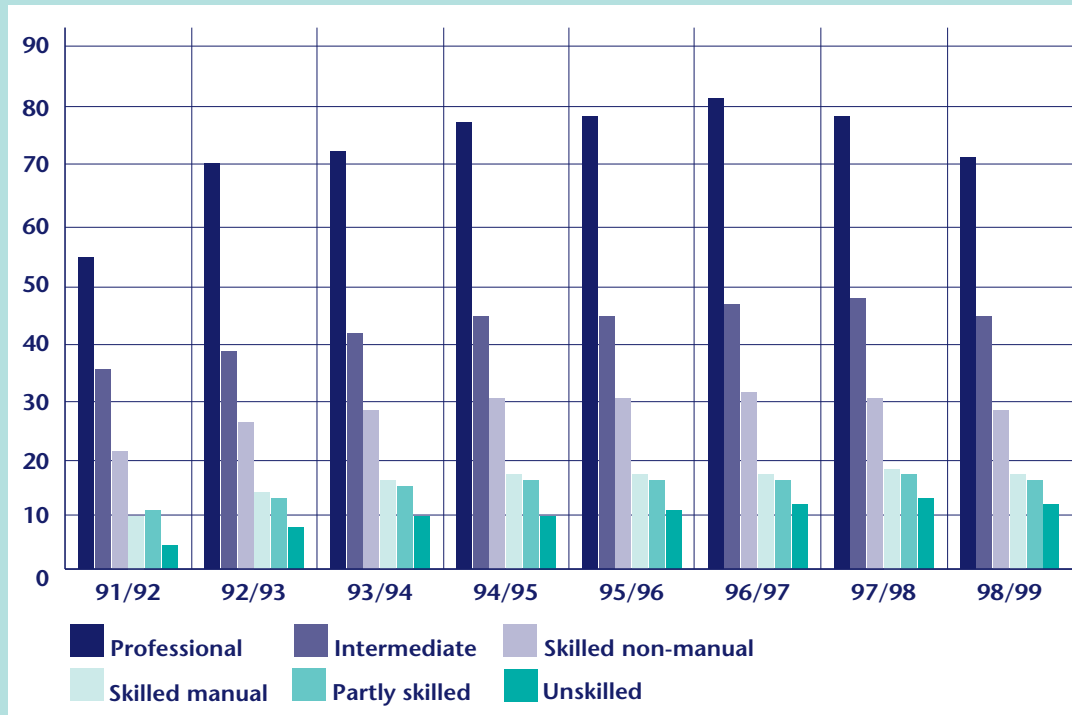


Chart 3.4 shows the participation rates amongst young people aged under 21 in Great Britain. It shows a large rise in participation rates for all social classes during the early 1990s, when student loans were first phased in. There was an increase in the participation index in 1997/98 related partly to changes in the funding arrangements for higher education, with students choosing to enter HE rather than wait until 1998/99. There was a corresponding reduction in 1998/99 before the entry rates started to increase again in 1999/2000. There is little evidence to indicate that participation by students from poorer backgrounds has been relatively worse affected by the shift to student loans, as their participation rates have risen faster than students from higher social classes – albeit from a much lower base. This is supported by a recent study by South Bank University\*\* which found that there was little variation in the likelihood of taking out a loan between students from different social classes, although those from poorer backgrounds tended on average to borrow slightly more. The latest provisional figures for 2000/01 show that participation rates are at the same level as in 1996/97 – 48% for those from better off backgrounds, and 18% for those from less affluent families. ('Better off' covers Professional/Intermediate/ Skilled non-manual – 'Less affluent' covers Skilled manual/Partly-skilled/Unskilled).

However, concerns about debt were more significant amongst students from poorer backgrounds. 48% of the students from social classes IV and V who had not taken out a student loan expressed concerns about borrowing, compared with 34% of those students from social classes I and II.

Financial concerns may therefore be a factor in influencing the choices of those from low-income groups. In recognition of this the Government has recently introduced Opportunity Bursaries (£2,000 for younger students from disadvantaged backgrounds and poorer areas). There will be 7,000 bursaries available in 2001/02; 8,000 in 2002/03; and 10,000 in 2003/04.

\* Data in chart 2 from Social Trends 30, Table 3.13.

\*\* *Changing Student Finances: Income, Expenditure and the take-up of Student Loans among full- and part-time HE students in 1998/99*, Callender and Kemp, 2000, DFEE research report RR213.



- **They can have important incentive effects.** For example loans may:
  - provide incentives to choose value-for-money options, in contrast to grants, which can remove such an incentive;
  - provide incentives for desirable behaviour
    - student loans and career development loans may encourage borrowers to complete a course and make use of their new skills to work and pay back loans.

### 3.4.2 ... and disadvantages

- **They can result in low take-up**, which may jeopardise the achievement of the

objective. There are concerns that individuals on low incomes and small businesses may be particularly concerned about taking on debt, even if the loan increases their expected future earnings (see box 3.4(a)). This may be partly overcome in the design of the loan – for example by making the repayment contingent on income, as for student loans (see appendix 3). A related issue that may lead to low take-up is lack of financial literacy. As table 3.4 below shows, use of credit rapidly declines with the level of qualifications (although this data is not adjusted for the effects of income). One way to address this is to provide money

**Table 3.4: Use of credit by level of education<sup>1</sup>**

Highest educational level	High street credit	Low income credit	Non commercial credit	No credit
Degree/higher degree	92%	–	8%	7%
HE (below degree)	86%	2%	2%	10%
A level or equivalent	74%	1%	6%	19%
O level/GCSE (A–C) or equivalent	81%	1%	6%	11%
GCSE (D–G) or CSE (2–5)	66%	3%	13%	18%
Other	70%	1%	4%	25%
No qualifications	43%	2%	4%	49%

### Box 3.4(b): Islamic banking

The basic principle of Islamic banking is the prohibition of Riba (usury – or interest). According to Islamic law, both the lender and borrower are committing a sin if interest is charged on a loan. A system of Islamic banking exists which aims to overcome some of the religious objections to interest charging. Whether it succeeds in this aim is a matter of controversy in Islamic scholarship.

Imagine, for example, that an individual approaches an Islamic bank having identified a house that he wishes to purchase from a builder. The bank agrees to buy the house from the vendor on behalf of the individual at the market price of, say £100,000. The bank then sells it to the individual for a price of £150,000 to be paid in instalments of £7,500 per year over 20 years. The 'mark-up' of £50,000 represents the bank's profit, not an interest charge, argue the Islamic bankers who practise this technique. The bank acts as a trader, they say, buying the house for £100,000 and selling it for £150,000. The banker will usually take some form of security for repayment of the instalments, such as a charge over the house. This is the familiar process of taking collateral and it allows the bank to sell the house in order to repay any outstanding instalments if the individual defaults.

Source: *The Problem with Interest* [www.islamic-finance.com](http://www.islamic-finance.com)

<sup>1</sup> Source: *Vulnerable Consumers and Financial Services*, appendix 4, OFT 1999.



management advice, perhaps targeted on those taking out loans (see appendix 4). Finally, an additional issue that may result in low take-up is the religious objections of particular groups, such as observant Muslims, to interest-bearing loans. Again, it may be possible to partially address this in the design of the loan, see box 3.4(b).

- **They may lead individuals or businesses into excessive indebtedness.** For example, there are concerns that students can face large debts after graduation which take a considerable time to repay. The risks of over-indebtedness can be felt both at the household level – as people find themselves in increasing

financial difficulty due to unexpected or unsustainable increases in debt – and across the whole economy, as the UK experienced during the early 1990s. Over-indebtedness is therefore a key issue for government loans, and is discussed separately and in detail in appendix 4. Financial literacy programmes, generic financial advice and debt advice can play a role in reducing over-indebtedness and **it was concluded that a review of government’s role in debt advice should be carried out by DTI** (see appendix 4).

These advantages and disadvantages have been reflected in the criteria outlined in box 3.4(c). The criteria have been developed

### *Box 3.4(c): Criteria for government intervention in the form of loans*

#### **Loans are an appropriate form of government intervention, if:**

- **Loans provide an effective way to deliver government objectives**
  - deliver objective at lowest cost to government, compared with alternative forms of intervention such as grants or regulation;
  - directly address any identified market failures or distributional requirements that underlie the rationale for intervention;
  - minimise the barriers to take-up, to achieve the desired result in the target group.
- **Loans provide an efficient way to target government resources**
  - minimise deadweight losses, by:
    - targeting loans on those who could not borrow in private markets;
    - recouping costs/earning a return where a desired outcome is achieved (e.g. Launch Investment).
  - the costs of administering the loan do not outweigh the benefits of repayment.
- **There is a reasonable expectation that the recipient of the loan will be able to repay**
  - recipients able to repay because the reduction in income or need for additional expenditure is temporary;
  - the loan generates substantial private benefit to the recipient, which may enhance future ability to repay (e.g. student loans, business start-up loans);
  - the loan can be secured on an asset.
- **The use of loans promotes ‘positive incentives’**
  - increases incentives for positive behaviours, e.g. to seek value for money in the goods or services purchased with the loan;
  - avoids perverse incentives from income or poverty traps.



### Box 3.5(a): Career Development Loans

Career Development Loans (CDL) are government-backed loans for individuals undertaking vocational and professional education courses, provided by four high-street banks.

Government support is provided by subsidising the interest payments on the loan during the period of study and for up to 17 months afterwards if the individual is unemployed.

In 2000/01, £69 million was lent to students under the CDL scheme. Government expenditure was £13 million.

through discussion with external experts and stakeholders, Treasury and other government departments. They are intended to provide guidance, not be prescriptive, and are not weighted.

## 3.5 There are different options for how government might intervene in the form of loans

### 3.5.1 Both private and public funds can be used to make loans

The decision about whether government or private sector money should be used to provide loans will depend on a number of factors, but two central issues are:

- **The extent to which private sector provision represents an appropriate transfer of risk to the private sector,** and value-for-money in the provision of loans to target groups. In some cases, it may be appropriate for government to transfer some of the risk of default and the responsibility for administering the scheme to the private sector – whilst supporting the loans, if necessary, through guarantees or interest rate subsidies, see box 3.5(a). However, it may be necessary for

government to provide loans directly if the private sector is unwilling to take on the risk at an acceptable cost to government.

- **The extent to which government wishes to influence the design of the loan.** For example, governments may want to control *loan entitlement*, e.g. to provide for automatic entitlement to a loan provided certain criteria are fulfilled, or to target the loan on specific groups. Or governments may wish to influence the structure of the loan repayments, see Section 3.5.2. If so, it may be difficult to deliver this using private sector money, because banks typically want to retain control over who they lend their money to, and how the loan is repaid.

### 3.5.2 There are also different ways in which government or the private sector can structure loans to individuals...

Loans to individuals can be repaid from future streams of income or from the sale of an asset – through placing a charge on the borrower's property (this is usually referred to as an 'equity loan'). If the repayments are paid from future income the repayment schedule can be flat rate, starting at a certain date after the loan has been paid, or income



contingent, with repayments commencing when income reaches a certain level.

- **'Mortgage style' fixed payment loans.** These are the traditional type of loan, where there is a fixed level of repayment and timescale over which this must be repaid. Flexibility may be built in through allowing payments to be deferred in particular circumstances. The fixed nature of mortgage style loans can be unattractive to low income borrowers, but for the lender they tend to have faster repayment schedules. These type of loans can easily be operated by both the public and private sectors.
- **Income contingent loans.** These are loans where repayments are a fixed proportion of an individual's income, so the amount repaid and the duration over which the loan is repaid will depend upon future income. The new student loans are an example of this, with repayments at 9% of any income earned above £10,000 per year. Income contingent loans may be more attractive to low income borrowers. However, they tend to cost more as repayment schedules are longer and more uncertain. In addition, there are concerns that these loans might reduce the incentive to work, since the more an individual earns, the greater their repayment rate.
- **Equity loans.** Loans can be secured on an asset, through placing a statutory charge on the borrower's property. The loan is repaid when the house is sold. This is most appropriate when there is sufficient equity in the house to cover the repayment, but where the borrower cannot meet loan repayments from their income (typically because their income is too low). Where there is a partner living in the house this may affect the length of time before the

loan is repaid and the amount of equity, which can be considered.

### *3.5.3 ... and there are different ways in which government or the private sector can structure loans to business*

There is an even greater range of possible loan instruments for business and other organisations. As well as ordinary loans there are loan guarantees and subsidies, risk capital, equity participation and repayable grants. Different interventions will be appropriate in different circumstances and often a direct loan will not be the most effective. A summary of the options and the potential advantages and disadvantages of each is given in box 3.5(b).

### *3.5.4 Finally, there are choices about the interest rate payable*

There are also choices to be made about the interest rate payable on a loan. Subsidising the interest rate reduces the cost to borrowers, which may fit well with government objectives. But this will also raise government expenditure and unless the scheme is well targeted, may result in some deadweight (i.e. people who do not need subsidised loans taking one out to invest or spend the money).



### *Box 3.5(b): Different types of instruments for supporting business*

- **Grants** to business are often the most effective means of providing direct subsidy. Advantages are transparency and lower administrative costs. Drawbacks include the deadweight costs, the lack of any direct share for public in successful projects, the costs of targeting and monitoring use, and creation of a dependency culture.
- **Tax incentives or credits** are similar to grants, but in the form of a reduction in corporation tax. These may be more efficient than grants if they encourage better resource allocation. Drawbacks include making the tax system more complex and problems of marketing and deadweight, e.g. firms are often unaware of available tax incentives.
- **Recoverable grants** are a half-way house between a straightforward grant and a risk capital approach. They are repaid if a firm achieves certain profit or revenue goals. These might be used where public subsidy is needed to encourage firms to behave in a specific way, e.g. locate in a deprived area. Recoverable grants can be efficient where the government is less risk averse than firms. They also help reduce the deadweight costs of a grant-based scheme and allow government to benefit from successes. The drawbacks are the administration costs, the need to monitor the scheme and the potential impact on firms' behaviour.
- **Interest rate subsidies** are very similar to grants but are provided over the course of the loan, whereas the 'lump sum' grant is paid at the start of a project. Linking the intervention to the existing system of bank loans may lead to better quality investments, as banks will need to be confident of the viability of a scheme before proceeding. The disadvantage of interest subsidies can be high administration costs associated with monitoring and processing repayments.
- **Government lending** – there is very little direct lending by government to business. The disadvantages include: government not making use of well-developed financial markets; crowding-out of private sector provision; government bearing the risk and up-front financing costs; and the administration costs of monitoring, processing repayments and acting on bad debts.
- **Guarantees** are used in a number of situations, e.g. the Small Firms Loan Guarantee Scheme (SFLGS), and export credit guarantees. These may be particularly suitable where projects have high risks, there is asymmetric information and the small scale of loans outweighs the assessment costs. Guarantees enable government to use its comparative advantage in bearing risk without crowding out private activity by banks. The disadvantages are: guarantees exacerbate the impact of an economic downturn on government finances; may be used as a substitute for rigorous risk assessments by banks; it is very difficult to limit the guarantee only to those firms that are a better risk so it is likely that any scheme will make a loss; and crowding out of equity finance. A partial guarantee provides stronger incentives for banks to carry out rigorous risk assessments and pursue bad debts.



- **Risk capital** as equity or a repayable investment may be suitable where there are high risks and uncertainty over the pattern of future revenues. Government rarely provides direct equity, as the private sector is better placed to run businesses. Ideally the market would provide equity for small and medium-sized enterprises (SMEs), though there is little demand from smaller firms and it may not be profitable for venture capitalists to handle small investments. Policy has been to stimulate the growth of the equity market for SMEs, e.g. through tax credits and the Regional and High Technology venture capital funds. These are privately managed and have used public money to lever in significant amounts of private finance. The Government has used risk capital where the returns are risky and loan financing is not available, for example with launch investment. Risk capital does allow government to benefit from successes and has positive incentives for businesses.

## 4. ASSESSMENT OF EXISTING GOVERNMENT LOAN SCHEMES AGAINST THE CRITERIA

### Summary

- In developing the criteria it is important to test them against existing loan schemes.
- Most existing schemes for individuals score well against the criteria. Loans for education score particularly highly since they allow individuals to increase their future earnings potential.
- Most existing business schemes score well against the criteria. There were lower scores for the Small Firms Training Loan Programme (SFTLP), Launch Investment and Regional Selective Assistance (RSA). The Phoenix fund and the Small Firms Loan Guarantee Scheme (SFLGs) have the best fits with the criteria, reflecting their design to directly address the identified market failures and success in delivering objectives.
- In undertaking their review of industrial support the DTI should use the criteria to assess the case for intervention and the areas where more use might be made of repayable investment.



## 4.1 Existing government loans to individuals have been assessed

### 4.1.1 Existing loan schemes are important in developing our criteria

Existing loan schemes are described in detail in appendix 3. Guidance for when loans are an appropriate form of government intervention has been discussed in chapter 3. This section brings the two together to offer an assessment of existing schemes against the criteria.

Table 4.1(a) below provides a scoring of existing loan schemes to individuals against the criteria. Table 4.1(b) explains the reasoning behind the scoring given.

### 4.1.2 Most existing loan schemes score well against the criteria

Most existing schemes score well against the criteria. Loans for higher education score particularly highly since they also allow individuals to increase their future earnings potential.

The Social Fund scores well on the criteria for government intervention. There is some evidence for market failure, and there is also a distributional rationale for intervention. Although the Social Fund scores less highly on the criteria for whether intervention should be in the form of loans, this partially reflects the fact that the Fund is already a combination of grants and loans (only the loan elements of the Fund were evaluated against the criteria). And it also reflects the

fact that elements of the loan scheme effectively provide a money management service to people who would not be considered acceptable to the mainstream credit market because of their low income (and for whom the alternative may be expensive or inappropriate forms of credit such as loan sharks).

The Department for Work and Pensions is currently looking at the wider aspects of the Social Fund, in the light of the establishment of Jobcentre Plus and the Pension Service and of the Policy Action Team 14 (PAT 14) recommendation on extending loans to people in work. That work will be informed by the criteria set out in chapter 3.



**Table 4.1(a): Existing government<sup>1</sup> loans schemes – how well do they match against the criteria?**

CRITERIA	Student loans	Career Development Loans	Housing loans	Social Fund Loans	Deferred payment residential care
<b>Criteria for government intervention<sup>2</sup></b>					
<b>Market Failure</b> – Externalities – Imperfect information – Public or Merit goods – Imperfect competition	✓✓✓	✓✓✓	✓	✓	✓✓
<b>Distributional impact</b> – Between individuals – Across an individual's life – Between geographical areas	✓	✓✓	✓✓✓	✓✓✓	✓
<b>Criteria for intervention in the form of loans<sup>3</sup></b>					
<b>Assumption made about counterfactual</b>	Return to previous (grant-based) system before loans introduced	Return to previous system (limited grants for post-graduates; nothing for FE/AE)	Grant-based system designed to achieve same level of home ownership	Grant-based system	Grant-based system
<b>Loan provides an effective way to deliver government objective</b> – Delivers objective at lowest cost – Directly addresses any identified market failures or distributional concerns – Does not present a barrier to uptake for particular groups	✓✓	✓✓	✓✓	✓✓	✓✓
<b>Loan provides an efficient way to target government resources</b> – Minimises deadweight losses – The administrative costs do not outweigh the benefits of repayment	✓✓	✓✓	✓✓	✓✓	✓

**Key**

x no fit under the criteria, ✓ acceptable, ✓✓ good, ✓✓✓ very good.

Brackets – subject to uncertainty depending upon interpretation of evidence and weight attached to different aspect of criteria (✓) = from acceptable to good.

<sup>1</sup> Loans offered by central or local government, directly or through an agency.

<sup>2</sup> When considering the criteria for government intervention, the counterfactual is assumed to be no intervention at all from the public sector in this area.

<sup>3</sup> When considering the criteria for intervention in the form of loans, the counterfactual varies according to the individual area. For example, for student loans, the counterfactual is likely to be a return to grants rather than no intervention at all. However, in the case of equity loans for residential care, the counterfactual is unlikely to be a switch to full grants for residential care, but might be a shift back to the previous scheme of enforced residential sales.

**Table 4.1(a): Existing government<sup>1</sup> loans schemes – how well do they match against the criteria? (continued)**

CRITERIA	GOVERNMENT LOAN SCHEMES				
	Student loans	Career Development Loans	Housing loans	Social Fund Loans	Deferred payment residential care
Criteria for intervention in the form of loans <sup>2</sup>					
Assumption made about counterfactual	Return to previous (grant-based) system before loans introduced	Return to previous system (limited grants for post-graduates; nothing for FE/AE)	Grant-based system designed to achieve same level of home ownership	Grant-based system	Grant-based system
Reasonable expectation that borrower can repay: – Income reduction or need for expenditure is temporary – loan generates private financial returns – loan secured on asset	✓✓✓	✓✓	✓✓✓	✓	✓✓✓
Loan promotes positive incentives: – increased incentive to make best use of loan (e.g. finish course) – avoids unemployment/poverty traps	✓✓	✓✓✓	✓✓	✓✓✓	✓

**Key**

x no fit under the criteria, ✓ acceptable, ✓✓ good, ✓✓✓ very good.

Brackets – subject to uncertainty depending upon interpretation of evidence and weight attached to different aspect of criteria (✓) = from acceptable to good.

<sup>1</sup> Loans offered by central or local government, directly or through an agency.

<sup>2</sup> When considering the criteria for intervention in the form of loans, the counterfactual varies according to the individual area. For example, for student loans, the counterfactual is likely to be a return to grants rather than no intervention at all. However, in the case of equity loans for residential care, the counterfactual is unlikely to be a switch to full grants for residential care, but might be a shift back to the previous scheme of enforced residential sales.





**Table 4.1(b): Existing government<sup>1</sup> loans schemes – reasons for their match with the criteria**

CRITERIA	GOVERNMENT LOAN SCHEMES				
	Student loans	Career Development Loans	Housing loans	Social Fund Loans	Deferred payment residential care
<b>Criteria for government intervention<sup>2</sup></b>					
<b>Market Failure</b> <ul style="list-style-type: none"> <li>– Externalities</li> <li>– Imperfect information</li> <li>– Public or Merit goods</li> <li>– Imperfect competition</li> </ul>	<ul style="list-style-type: none"> <li>– External benefits of higher education</li> <li>– Merit good</li> <li>– Imperfect information about returns from HE, leading to (i) under-investment from students and (ii) financial market failure</li> </ul>	<ul style="list-style-type: none"> <li>– External benefits of additional vocational education</li> <li>– Merit good</li> <li>– Imperfect information about returns from FE/AE, leading to (i) under-investment from students and (ii) financial market failure</li> </ul>	<ul style="list-style-type: none"> <li>– External benefits of prevention of housing stock decline (people who own their homes have more incentive to maintain them)</li> <li>– Little evidence of other market failure</li> </ul>	<ul style="list-style-type: none"> <li>– Imperfect information about willingness of individuals to repay means that banks reluctant to lend</li> </ul>	<ul style="list-style-type: none"> <li>– Some evidence of market provision (e.g. private sector equity release schemes; also possible to sell house). However, lack of confidence in equity release market may mean that market not yet fully developed</li> </ul>
<b>Distributional impact</b> <ul style="list-style-type: none"> <li>– Between individuals</li> <li>– Across an individual's life</li> <li>– Between geographical areas</li> </ul>	<ul style="list-style-type: none"> <li>– HE take-up greater amongst higher social class/income (slightly mitigated because 25% of loan is means-tested)</li> <li>– Positive distributional impact across lifetime</li> </ul>	<ul style="list-style-type: none"> <li>– CDL take-up roughly even across social class (except for social class E)</li> <li>– Positive distributional impact across lifetime</li> </ul>	<ul style="list-style-type: none"> <li>– Right-to-buy loans targeted at lower income groups. Homebuy targeted at those on modest incomes who cannot buy a home without help</li> <li>– Homebuy targeted on areas where there is a shortage of social housing</li> </ul>	<ul style="list-style-type: none"> <li>– Social Fund loans highly targeted</li> <li>– Budgeting loans only available to those on IS/JSA for six months</li> <li>– Crisis loans only available to those with no other source of finance</li> <li>– Positive distributional effect over lifetime</li> </ul>	<ul style="list-style-type: none"> <li>– Deferred payment scheme benefits homeowners, who are richer than the general population. However, many people with a property who enter residential care are not income-rich</li> <li>– However, overall policy on residential care has a positive distributional effect, since the costs of care are met for those on low incomes without assets or wealth.</li> </ul>

<sup>1</sup> Loans offered by central or local government, directly or through an agency.

<sup>2</sup> When considering the criteria for government intervention, the counterfactual is assumed to be no intervention at all from the public sector in this area.

**Table 4.1(b): Existing government<sup>1</sup> loans schemes – reasons for their match with the criteria (continued)**

CRITERIA	GOVERNMENT LOAN SCHEMES				
	Student loans	Career Development Loans	Housing loans	Social Fund Loans	Deferred payment residential care
Criteria for intervention in the form of loans <sup>2</sup>					
Assumption made about counterfactual	Return to previous (grant-based) system before loans introduced	Return to previous system (limited grants for post-graduates; nothing for FE/AE)	Grant-based system designed to achieve same level of home ownership	Grant-based system	Grant-based system
<p><b>Loan provides an effective way to deliver government objective</b></p> <ul style="list-style-type: none"> <li>– Delivers objective at lowest cost</li> <li>– Directly addresses any identified market failures or distributional concerns</li> <li>– Does not present a barrier to uptake for particular groups</li> </ul>	<ul style="list-style-type: none"> <li>– Reduces public expenditure costs and deadweight compared with grant-based system</li> <li>– Directly addresses market failure in financial markets</li> <li>– Little evidence that there are barriers to uptake for particular groups, although some, e.g. Asian students, have lower take-up rates than general student population</li> </ul>	<ul style="list-style-type: none"> <li>– Reduces public expenditure costs and deadweight compared with grant-based system</li> <li>– Directly addresses market failure in financial markets</li> <li>– Little evidence that there are barriers to uptake for particular groups</li> </ul>	<ul style="list-style-type: none"> <li>– Likely to be more cost-effective than grant-based scheme</li> <li>– Directly addresses distributional concerns, such as lack of access to housing market for people on low incomes</li> <li>– Little evidence of barriers to uptake for particular groups</li> </ul>	<ul style="list-style-type: none"> <li>– Current scheme cost-effective compared with grant-based scheme</li> <li>– Directly addresses financial market failure</li> <li>– Little evidence of barrier to uptake for particular groups, although pensioners more reluctant to take out loans than other comparable groups</li> </ul>	<ul style="list-style-type: none"> <li>– The deferred payment scheme involves a relatively small increase in public expenditure. It is part of the Government's overall response to the recommendations of the Royal Commission on the funding of long-term care which has involved a significant commitment to those people needing long-term care, matched by significant additional resources</li> <li>– Directly addresses market failure of undeveloped equity release market</li> <li>– Should not prevent uptake of residential care</li> </ul>
<p><b>Loan provides an efficient way to target government resources</b></p> <ul style="list-style-type: none"> <li>– Minimises deadweight losses</li> <li>– The administrative costs do not outweigh the benefits of repayment</li> </ul>	<ul style="list-style-type: none"> <li>– Likely to be significant deadweight, although much less than for grant-based system</li> <li>– Administration costs could be improved, but clearly outweighed by benefits of repayment</li> </ul>	<ul style="list-style-type: none"> <li>– Likely to be significant deadweight, although much less than for grant-based system</li> <li>– Administration costs borne by banks</li> </ul>	<ul style="list-style-type: none"> <li>– Both Right-to-buy and Homebuy use means-testing to minimise deadweight</li> <li>– Homebuy administrative costs appear high relative to loans secured in the private market, although these are expected to fall over time</li> </ul>	<ul style="list-style-type: none"> <li>– Minimises deadweight by means-testing</li> <li>– Administrative costs high compared with other benefits</li> </ul>	<ul style="list-style-type: none"> <li>– Will lead to additional administrative costs, but these can be minimised by integrating the new processes into existing systems</li> </ul>

<sup>1</sup> Loans offered by central or local government, directly or through an agency.

<sup>2</sup> When considering the criteria for intervention in the form of loans, the counterfactual varies according to the individual area. For example, for student loans, the counterfactual is likely to be a return to grants rather than no intervention at all. However, in the case of equity loans for residential care, the counterfactual is unlikely to be a switch to full grants for residential care, but might be a shift back to the previous scheme of enforced residential sales.





**Table 4.1(b): Existing government<sup>1</sup> loans schemes – reasons for their match with the criteria (continued)**

CRITERIA	GOVERNMENT LOAN SCHEMES				
	Student loans	Career Development Loans	Housing loans	Social Fund Loans	Deferred payment residential care
Criteria for intervention in the form of loans <sup>2</sup>					
Assumption made about counterfactual	Return to previous (grant-based) system before loans introduced	Return to previous system (limited grants for post-graduates; nothing for FE/AE)	Grant-based system designed to achieve same level of home ownership	Grant-based system	Grant-based system
<b>Reasonable expectation that borrower can repay:</b> – Income reduction or need for expenditure is temporary – loan generates private financial returns – loan secured on asset	– Income reduction temporary – student likely to find employment after university – HE generates return of about 15%–20% increase in wages – In practice, default rates are low (>5%)	– Income reduction temporary during period of study – However, returns to FE/AE likely to be slightly lower and much more variable than for HE – In practice, default rates are relatively low (<10%)	– Loan can be secured against asset so strong likelihood of repayment – In practice default rates for Right-to-buy loans about 2% (compared with 0.6% for mortgages with commercial lenders)	– Income reduction may be long-term in some cases. Alternative to loans would be expensive home lending/catalogues – Ability to pay considered on an individual basis – Effective recovery mechanism (well over 90%) through benefit recovery	– Loan can be secured against asset
<b>Loan promotes positive incentives:</b> – Increased incentive to make best use of loan (e.g. finish course) – avoids unemployment/poverty traps	– Could encourage students to complete course – Income-contingent aspect of new-style loans might lead to income trap, but design minimises this impact	– Could encourage students to complete course – Have to repay – even if unemployed – after 18 months so strong incentive to find work.	– Likely to be positive behaviour associated with home-ownership (e.g. better care of property, etc.)	– Encourages recipients to choose value-for-money items (compared with grant)	May skew choice between residential and home care.

<sup>1</sup> Loans offered by central or local government, directly or through an agency.

<sup>2</sup> When considering the criteria for intervention in the form of loans, the counterfactual varies according to the individual area. For example, for student loans, the counterfactual is likely to be a return to grants rather than no intervention at all. However, in the case of equity loans for residential care, the counterfactual is unlikely to be a switch to full grants for residential care, but might be a shift back to the previous scheme of enforced residential sales.



## 4.2 We have assessed existing government loans to businesses

### 4.2.1 Government support for business takes a number of different forms

The project has considered both existing loans to business in the UK and areas where further use might be made of government loans. There are few cases of government directly lending or providing investment to businesses. More often intervention is through the use of loan guarantees and occasionally through interest rate subsidies. A general guide to types of support is set out in box 3.5(b) in chapter 3.

### 4.2.2 International comparisons suggest the UK makes relatively little use of loans though this is not surprising

As table 4.2(a)<sup>4</sup> shows the use of grants, interest rate subsidies and tax exemptions are by far the most frequently used form of state aid in the European Community. State aid is selective support to particular businesses or sectors and so is a subset of all government support to business – in particular, support that benefits all businesses, or all businesses undertaking a particular activity (e.g. investing in R&D) is not state aid. The headline figure is that the UK makes much greater use of grants for this specific support to business (94% compared with an EU

**Table 4.2(a): State aid to the manufacturing sector 1996–98, breakdown according to type of aid (%)**

TYPE OF AID	Grants	Tax exemptions	Equity Participation	Soft loans	Tax Deferrals	Guarantees	TOTAL
Austria	76	0	0	19	0	5	100
Belgium	60	28	4	4	1	3	100
Denmark	63	31	0	6	0	1	100
Finland	84	3	1	13	0	1	100
France	28	47	13	9	1	3	100
Germany	56	12	0	23	1	5	100
Greece	97	0	0	3	0	0	100
Ireland	60	29	7	0	0	4	100
Italy	55	37	4	1	0	2	100
Luxembourg	93	6	0	2	0	0	100
Netherlands	66	19	0	5	8	2	100
Portugal	84	7	2	7	0	0	100
Spain	88	<1	3	9	0	0	100
Sweden	60	18	3	18	0	0	100
United Kingdom	94	1	0	2	1	1	100
<b>EUR 15</b>	<b>58</b>	<b>23</b>	<b>4</b>	<b>11</b>	<b>1</b>	<b>3</b>	<b>100</b>

<sup>4</sup> Source: 'Eighth Survey On State Aid In The European Union', Com (2000) 205 Final, European Commission, April 2000. The table covers 1996–98 data and relates to the state aid elements alone. The capital sums involved for loans will be much larger. The UK is now making greater use of tax measures and equity participation through the Enterprise Fund, but this is unlikely to affect the overall conclusions.

average of 58%) and correspondingly less use of loans and other sorts of support. Looking at grants and tax exemptions together, as both represent direct subsidy, the difference is not so great: 96% compared with an EU average of 81%.

These figures needed to be interpreted with care, for example in the years covered by the survey, UK Launch Investment has been providing net receipts to the Government and so does not feature in the table – but in other years, there may be considerable outgoings under Launch Investment depending on the timing of the investments. The UK financial markets are particularly well developed internationally<sup>5</sup> though equity financing for smaller businesses is not as well developed as in the US. Therefore there is likely to be less need for intervention by government in financial markets. Policy makers in the UK may as a consequence be less familiar with forms of intervention such as loans, and more focused on the use of grants.

There are some policy areas where the UK primarily uses grants whereas other countries provide a range of support through loans and risk capital as well as grants (for example Germany provides loans for regional support and Italy and France provide loans for R&D). The UK has recently been making more use of equity-based schemes, through the Enterprise Fund, Regional Venture Capital Funds and the Coalfields Enterprise Fund, with the Community Development Venture Fund and the Community Investment Tax Credit soon to follow.

The DTI and Treasury have announced a review of DTI's support to business.<sup>6</sup> The DTI review will start by considering support to industrial manufacturing. It will be desirable for this review to make use of the criteria in chapter 3 in assessing the case for government intervention, and consider the merits of repayable interventions as well as grants. For example, initial analysis suggests that there is potentially more scope to make use of risk capital for funding R&D and repayable grants where Regional Selective Assistance (RSA) is provided (see appendix 3).

#### 4.2.3 Most existing loans to business score reasonably well against the criteria

As noted earlier, existing loan and repayment schemes provide an important test for our criteria. The main schemes involving an element of repayment are:

- **Launch Investment** which provides risk capital for aerospace projects;
- **the Small Firms Loan Guarantee Scheme** (SFLGs) which provides loan guarantees for firms with good projects that because of limited collateral or track records are regarded as high risk by banks;
- **the Small Firms Training Loan Programme** (SFTLP) which provides a loan holiday to small firms taking out bank loans for training;

<sup>5</sup> *Housing finance in developed countries: An international efficiency comparison*, Journal of Housing Research, 1992, for personal mortgages and *Competition in UK Banking, A Report to the Chancellor of the Exchequer*, Don Cruickshank, March 2000, [www.bankreview.org.uk](http://www.bankreview.org.uk). This concludes that overall SME and personal customers get reasonable value for money from the UK banks with good product innovation. SMEs have low lending rates but face relatively high current account charges.

<sup>6</sup> *Enterprise for all – the challenges for the next Parliament*, Treasury Press Notice, 18 June 2001, [www.hm-treasury.gov.uk/press/2001/p67\\_01.html](http://www.hm-treasury.gov.uk/press/2001/p67_01.html).



- **the Phoenix Fund** – which provides funds to Community Development Finance Institutions (CDFIs) to lend to businesses and social enterprises from disadvantaged groups or areas and loan guarantees to support loans made by CDFIs; and
- **Regional Selective Assistance (RSA)** which is normally provided as grants, but in the past has made use of loans and is exploring recoverable grants.

A full description of the business loan and repayment schemes is set out in appendix 3. A scoring of the existing loan schemes for business against the criteria is given in table 4.2(b). The reasoning behind the scoring is explained in table 4.2(c).

Most existing loan and repayment schemes score reasonably well against the criteria. This is not be surprising as existing interventions will have been subject to a detailed assessment. The SFTLP has a poorer fit given the very low levels of take-up. The assessment of launch investment raises some issues about the extent to which this is addressing capital market failures or is a response to overseas aid, and whether this is the best way of delivering objectives and using resources. The scheme is being evaluated by the DTI as part of a wider review of business support. The RSA scheme's lower scoring reflects the fact that recoverable grants will only be suitable in limited cases as the main objective is to change firms' behaviour, which needs public subsidy. The SFLGs and the Phoenix Fund both score well reflecting the relatively good targeting of these schemes at financial market failures and government objectives.



**Table 4.2(b): Existing government<sup>7</sup> loans schemes – how well do they match against the criteria?**

CRITERIA	GOVERNMENT LOAN SCHEMES				
	Launch Investment (LI)	Small Firms Loan Guarantee Scheme (SFLGS)	Small Firms Training Loan Programme (SFTLP)	Regional Selective Assistance (RSA) <sup>8</sup>	Phoenix Fund/Loans via CDFI
<b>Criteria for government intervention<sup>9</sup></b>					
<b>Market Failure</b> – Externalities – Imperfect information – Public or Merit goods – Imperfect competition	✓(✓)	✓✓	✓✓	✓	✓✓
<b>Distributional impact</b> – Between individuals/businesses – Between geographical areas – Assisting social objectives	(✓)	✓	✓	✓✓✓	✓✓✓
<b>Criteria for intervention in the form of loans<sup>10</sup></b>					
<b>Assumption made about counterfactual</b>	Grant-based system	Grant-based system	Grant-based system	Grant-based system	Grant-based system
<b>Loan provides an effective way to deliver government objective</b> – Delivers objective at lowest cost – Directly addresses any identified market failures or distributional concerns – Does not present a barrier to uptake for particular groups	✓(✓)	✓✓	✓	✓	✓✓

**Key**

x no fit under the criteria, ✓ acceptable, ✓✓ good, ✓✓✓ very good.

Brackets – subject to uncertainty depending upon interpretation of evidence and weight attached to different aspect of criteria (✓) = from acceptable to good.

<sup>7</sup> Loans offered by central or local government, directly or through an agency.

<sup>8</sup> This column relates to RSA paid as recoverable grant. RSA is typically provided as a straightforward grant, but in the past has been provided as loans, and is now occasionally provided in the form of a recoverable grant – so the grant is repaid when certain sales or profit thresholds are reached. Typically if public subsidy is required to get a firm to invest in a deprived rather than a more prosperous region, then it will be most efficient and effective to provide a straightforward grant, as compensation for the higher costs and lower profits from working in this region. The justification for using recoverable grant would be if there are much greater uncertainties and higher risks associated with investing in a deprived region – if firms attach a higher weight to this risk than government then it may be more efficient for government to provide a further grant, but then recover this if high returns are made.

<sup>9</sup> When considering the criteria for government intervention, the counterfactual is assumed to be no intervention at all from the public sector in this area.

<sup>10</sup> The case for intervention through loans is compared with the intervention through grants. The choice of counterfactual is a key consideration here and results should vary if loans were compared with situation where there is no government intervention.

**Table 4.2(b): Existing government<sup>7</sup> loans schemes – how well do they match against the criteria? (continued)**

CRITERIA	GOVERNMENT LOAN SCHEMES				
	Launch Investment (LI)	Small Firms Loan Guarantee Scheme (SFLGS)	Small Firms Training Loan Programme (SFTLP)	Regional Selective Assistance (RSA) <sup>8</sup>	Phoenix Fund/Loans via CDFI
Criteria for intervention in the form of loans <sup>9</sup>					
Assumption made about counterfactual	Grant-based system	Grant-based system	Grant-based system	Grant-based system	Grant-based system
<b>Loan provides an efficient way to target government resources</b> – Minimises deadweight losses – The administrative costs do not outweigh the benefits of repayment	✓(✓)	✓✓	✓	✓✓	✓✓
<b>Reasonable expectation that borrower can repay:</b> – Income reduction or need for expenditure is temporary – loan generates private financial returns – loan secured on asset	✓(✓)	✓✓	✓✓	✓(✓)	✓✓
<b>Loan promotes positive incentives:</b> – increased incentive to make best use of loan (e.g. finish course) – avoids unemployment/poverty traps	✓✓	✓✓	✓✓	✓✓	✓✓(✓)

**Key**

x no fit under the criteria, ✓ acceptable, ✓✓ good, ✓✓✓ very good.

Brackets – subject to uncertainty depending upon interpretation of evidence and weight attached to different aspect of criteria (✓) = from acceptable to good.

<sup>7</sup> Loans offered by central or local government, directly or through an agency.

<sup>8</sup> This column relates to RSA paid as recoverable grant. RSA is typically provided as a straightforward grant, but in the past has been provided as loans, and is now occasionally provided in the form of a recoverable grant – so the grant is repaid when certain sales or profit thresholds are reached. Typically if public subsidy is required to get a firm to invest in a deprived rather than a more prosperous region, then it will be most efficient and effective to provide a straightforward grant, as compensation for the higher costs and lower profits from working in this region. The justification for using recoverable grant would be if there are much greater uncertainties and higher risks associated with investing in a deprived region – if firms attach a higher weight to this risk than government then it may be more efficient for government to provide a further grant, but then recover this if high returns are made.

<sup>9</sup> The case for intervention through loans is compared with the intervention through grants. The choice of counterfactual is a key consideration here and results should vary if loans were compared with situation where there is no government intervention.





**Table 4.2(c): Existing government<sup>7</sup> loans schemes – reasons for their match with the criteria**

CRITERIA	GOVERNMENT LOAN SCHEMES				
	Launch Investment (LI)	Small Firms Loan Guarantee Scheme (SFLGS)	Small Firms Training Loan Programme (SFTLP)	Regional Selective Assistance (RSA) <sup>8</sup>	Phoenix Fund/Loans via CDFI
<b>Criteria for government intervention<sup>9</sup></b>					
<b>Market Failure</b> – Externalities – Imperfect information – Public or Merit goods – Imperfect competition	– Addresses financial market failure – capital markets would not support given size and riskiness of projects (but this is largely a result of foreign governments distorting the market) – Does LI target key weakness? Support for R&D amongst downstream suppliers might be more relevant – Key issues are role of LI in retaining aerospace industry and benefits of retaining R&D and jobs within UK – Could UK aerospace win contracts if commercial return required by capital markets, while foreign competitors are supported by government finance? – probably not – Evaluations of policy and economic effectiveness underway within DTI	– Addresses market failure, in that bank lending will be constrained by lack of information about riskiness of borrowers, so they will ration credit – Size and significance of financing gap is uncertain – Review is being undertaken by DTI	– Firms may not have the resources to invest in training – research suggests finance and time are key constraints on training – May be financial market failures given limited information on the returns to training, which the scheme helps overcome – Evidence of external benefits from training – which government support should help deliver	– Indirectly addresses labour, housing and land market failures with a view to delivering social objectives. – ‘Last resort’ finance for projects that would otherwise not be able to go ahead in Assisted Areas – Government grant may sometimes be needed to influence location decisions of firms. But recoverable grant may be appropriate in cases of high risk, high return investment projects where the return on projects in these areas are higher risk	– Helps tackle financial market weaknesses in face of limited information on borrowers and small and unsecured loans. So provides financial support that would not otherwise be available – Assists with the regeneration of areas and improved life quality – may be some external economic benefits, though some of the benefits are likely to be displacement from other areas

<sup>7</sup> Loans offered by central or local government, directly or through an agency.

<sup>8</sup> This column relates to RSA paid as recoverable grant. RSA is typically provided as a straightforward grant, but in the past has been provided as loans, and is now occasionally provided in the form of a recoverable grant – so the grant is repaid when certain sales or profit thresholds are reached. Typically if public subsidy is required to get a firm to invest in a deprived rather than a more prosperous region, then it will be most efficient and effective to provide a straightforward grant, as compensation for the higher costs and lower profits from working in this region. The justification for using recoverable grant would be if there are much greater uncertainties and higher risks associated with investing in a deprived region – if firms attach a higher weight to this risk than government then it may be more efficient for government to provide a further grant, but then recover this if high returns are made.

<sup>9</sup> When considering the criteria for government intervention, the counterfactual is assumed to be no intervention at all from the public sector in this area.

**Table 4.2(c): Existing government<sup>7</sup> loans schemes – reasons for their match with the criteria (continued)**

CRITERIA	GOVERNMENT LOAN SCHEMES				
	Launch Investment (LI)	Small Firms Loan Guarantee Scheme (SFLGS)	Small Firms Training Loan Programme (SFTLP)	Regional Selective Assistance (RSA) <sup>8</sup>	Phoenix Fund/Loans via CDFI
<b>Criteria for government intervention<sup>9</sup></b>					
<b>Distributional impact</b> – Between individuals/businesses – Between geographical areas – Assisting social objectives	– Arguably large part of justification is job retention/creation in specific areas for social reasons – For businesses, provides support for large-scale industries rather than the smaller firms in supply chain, possibly bearing more R&D risks	– Limited – provides some additional support for small firms, though it is not clear this should be an objective in its own right	– Limited – provides some additional support for small firms	– Mechanism for reducing inequalities between areas and regions. Also around half of RSA supports inward investment projects, so aims to attract mobile investment that would otherwise go to overseas locations – Helps to reduce unemployment or safeguard jobs in depressed regions or areas, with important social benefits	– Important social objectives – helps provide and lever in commercial finance – Provides opportunity for entrepreneurs to access business finance and thereby for businesses in disadvantaged areas to compete equally
<b>Criteria for intervention in the form of loans<sup>10</sup></b>					
<b>Assumption made about counterfactual</b>	<b>Grant-based system</b>	<b>Grant-based system</b>	<b>Grant-based system</b>	<b>Grant-based system</b>	<b>Grant-based system</b>
<b>Loan provides an effective way to deliver government objective</b> – Delivers objective at lowest cost – Directly addresses any identified market failures or distributional concerns – Does not present a barrier to uptake for particular groups	– In principle LI is there because money cannot be raised on capital markets and government wants to retain a high value aerospace industry in UK – Value for money of government intervening to retain UK industry is not clear	– Probably. However this depends on importance of financing gap and benefits of viable schemes	– Possibly, though take-up has been minimal – Government needs to promote the scheme better if it wishes to increase take-up, or consider how it can be linked with general business advice. May need to provide higher subsidies to increase take-up	– Generally direct grant may be easiest way of providing public subsidy to influence location decisions, but may be a role for repayable grants in some cases	– US evidence and recent reviews suggest targeting support at loans distributed via CDFIs helps meet existing financial market failures. Loans help reduce grant dependency in deprived areas – Important to retain the advantages of local knowledge and understanding of disadvantaged areas/groups

<sup>7</sup> Loans offered by central or local government, directly or through an agency.

<sup>8</sup> This column relates to RSA paid as recoverable grant. RSA is typically provided as a straightforward grant, but in the past has been provided as loans, and is now occasionally provided in the form of a recoverable grant – so the grant is repaid when certain sales or profit thresholds are reached. Typically if public subsidy is required to get a firm to invest in a deprived rather than a more prosperous region, then it will be most efficient and effective to provide a straightforward grant, as compensation for the higher costs and lower profits from working in this region. The justification for using recoverable grant would be if there are much greater uncertainties and higher risks associated with investing in a deprived region – if firms attach a higher weight to this risk than government then it may be more efficient for government to provide a further grant, but then recover this if high returns are made.

<sup>9</sup> When considering the criteria for government intervention, the counterfactual is assumed to be no intervention at all from the public sector in this area.

<sup>10</sup> The case for intervention through loans is compared with the intervention through grants. The choice of counterfactual is a key consideration here and results should vary if loans were compared with situation where there is no government intervention.





**Table 4.2(c): Existing government<sup>7</sup> loans schemes – reasons for their match with the criteria (continued)**

CRITERIA	GOVERNMENT LOAN SCHEMES				
	Launch Investment (LI)	Small Firms Loan Guarantee Scheme (SFLGS)	Small Firms Training Loan Programme (SFTLP)	Regional Selective Assistance (RSA) <sup>8</sup>	Phoenix Fund/Loans via CDFI
Criteria for intervention in the form of loans <sup>9</sup>					
Assumption made about counterfactual	Grant-based system	Grant-based system	Grant-based system	Grant-based system	Grant-based system
<b>Loan provides an efficient way to target government resources</b> <ul style="list-style-type: none"> <li>– Minimises deadweight losses</li> <li>– The administrative costs do not outweigh the benefits of repayment</li> </ul>	<ul style="list-style-type: none"> <li>– Likely that risk capital is best way of providing support to large system aggregators, but not clear what effect would be of supporting downstream suppliers engaged in R&amp;D</li> </ul>	<ul style="list-style-type: none"> <li>– Loan guarantees preferable to direct lending. Arguably a scheme to encourage more use of equity finance or mezzanine financing could be more efficient for larger loans, but might not meet requirements of many smaller firms</li> </ul>	<ul style="list-style-type: none"> <li>– Likely to be some deadweight losses, though loan will have much lower deadweight costs than a grant</li> <li>– Given low take-up, administrative costs appear relatively high</li> </ul>	<ul style="list-style-type: none"> <li>– In the case of high risk investment projects it may represent value for money for the risk being borne by government to be reflected in recoverable grants</li> </ul>	<ul style="list-style-type: none"> <li>– Evidence suggests this is an effective way of targeting support</li> <li>– If successful then better value for money than ongoing grant support</li> </ul>
<b>Reasonable expectation that loan will be repaid:</b> <ul style="list-style-type: none"> <li>– Income reduction or need for expenditure is temporary</li> <li>– Loan generates private financial return</li> <li>– Loan secured on asset</li> </ul>	<ul style="list-style-type: none"> <li>– Yes – generally good returns are being made on LI projects</li> <li>– Is a long lag between investment and beginning to earn a return, so a repayable investment is likely to be more effective than a loan and cheaper than a grant</li> </ul>	<ul style="list-style-type: none"> <li>– Yes – will expect most loans to generate income and be repaid.</li> <li>– Cost of scheme from default runs at 18% of value. But unlikely that existing scheme could be self-financing</li> </ul>	<ul style="list-style-type: none"> <li>– Yes – flexible scheme offering repayment holiday and low interest rates</li> <li>– Default rates vary, but generally appear to be low</li> </ul>	<ul style="list-style-type: none"> <li>– For RSA grants this is not relevant. But when recoverable grants are used for high risk, high return investment projects, the grants may be recovered if the project is successful</li> </ul>	<ul style="list-style-type: none"> <li>– Evidence suggests that local assessment and repayment mechanisms are more effective, and borrowers make a greater effort to repay loans to CDFIs. Key issue will be how CDFI schemes subsequently perform</li> </ul>
<b>Loan promotes positive incentives:</b> <ul style="list-style-type: none"> <li>– Increased incentive to make best use of loan (e.g. finish course)</li> <li>– Avoids profits/revenue traps</li> </ul>	<ul style="list-style-type: none"> <li>– Yes – generally beneficial incentives here</li> <li>– Strong incentives for companies to maximise revenue and profits, and so provide return on investment. A guaranteed loan might have weaker incentives</li> <li>– Government financing and covering development and sales risks</li> </ul>	<ul style="list-style-type: none"> <li>– Incentives for firm to make profits and repay. Banks have some incentive (15 or 30% of loan value) to ensure that loans do not default</li> </ul>	<ul style="list-style-type: none"> <li>– Provides opportunities for firms to improve their skill base</li> <li>– Firms will face pressures to repay</li> </ul>	<ul style="list-style-type: none"> <li>– Promotes skilled employment and R&amp;D. Helps businesses in disadvantaged areas to become competitive</li> <li>– Recoverable grants may encourage better business planning and decision-making</li> </ul>	<ul style="list-style-type: none"> <li>– Provides opportunity that would otherwise not be given – encourages self-support and breakout of benefits cycle</li> </ul>

<sup>7</sup> Loans offered by central or local government, directly or through an agency.

<sup>8</sup> This column relates to RSA paid as recoverable grant. RSA is typically provided as a straightforward grant, but in the past has been provided as loans, and is now occasionally provided in the form of a recoverable grant – so the grant is repaid when certain sales or profit thresholds are reached. Typically if public subsidy is required to get a firm to invest in a deprived rather than a more prosperous region, then it will be most efficient and effective to provide a straightforward grant, as compensation for the higher costs and lower profits from working in this region. The justification for using recoverable grant would be if there are much greater uncertainties and higher risks associated with investing in a deprived region – if firms attach a higher weight to this risk than government then it may be more efficient for government to provide a further grant, but then recover this if high returns are made.

<sup>9</sup> The case for intervention through loans is compared with the intervention through grants. The choice of counterfactual is a key consideration here and results should vary if loans were compared with situation where there is no government intervention.

## 5. CASE STUDIES FOR LOANS TO INDIVIDUALS

### Summary

The criteria set out in chapter 3 give some guidance about areas where government could be making more use of loans. The criteria imply that loans may be particularly appropriate:

- when an individual is **expected to be able to repay** at some point in the future – either because the income reduction/call on expenditure is temporary, or because they can use the loan to increase their expected future income, or because the loan is secured on an asset;
- when it is very difficult or expensive for an individual to get **access to credit** on private financial markets.

The case studies discussed in this chapter are examples to illustrate how an extension of loans might work and to demonstrate the use of the criteria. They were identified by looking at points in an individual's life when a temporary reduction in income or increase in expenditure is likely to occur, and examining groups likely to face barriers to accessing credit.

- **Maternity loan.** This would top up flat rate maternity benefits and cover the six-month period of unpaid maternity leave introduced in 2003, as an example of a temporary income reduction.
- **Loan for adult learning.** This would be aimed at encouraging greater take-up of adult learning, typically leading to higher earnings in the medium term.
- **Loans for home improvements.** This is an example of a loan being given to individuals on low incomes, but with relatively valuable assets, on which a loan could be secured.
- **Loans to help the unemployed into self-employment.** This would be aimed at helping people back into work, increasing their independent income.



## 5.1 Case studies help to test the criteria

The criteria set out in chapter 3 provide a framework for determining where loans might be an appropriate form of intervention. This framework has been used to evaluate existing government loans against the criteria (see chapter 4).

This section of the report tests the criteria by using it to assess some examples of loans in new policy areas. These ‘case studies’ are not firm policy proposals; they are examples of how and where loans could be used. There are many other examples, and the criteria clearly have wider application to any potential new loan products.

### *A wide range of case studies to test the criteria were chosen*

As set out in chapter 3, government intervention is most appropriate when:

- there is market failure (e.g. private routes to reduce the impact of income reductions, such as insurance, savings, private loans, overdrafts, etc. are either not available or inappropriate); or
- there is a distributional motive for government intervention.

And intervention in the form of loans is most appropriate when:

- loans provide an effective and efficient way to deliver government objectives;
- loans promote positive incentives; and
- the recipient of the loan is able to repay because the decline in income or additional need for expenditure is temporary, or because they have wealth or assets against which the loan can be secured.

The first and the last of these criteria provide a particularly useful guide to where loans might be appropriate. This is because if there were no temporary income reductions over an individual’s life and no one faced any problems accessing credit from the private sector, there would be little need for government to provide loans, even if the other criteria were met.

### *The case studies were chosen around periods of temporary income reductions or increases in necessary expenditure ...*

So the starting point was to examine:

- the evidence for temporary income reductions across an individual’s life and what events might cause them; and
- the evidence on access to private credit and debt.

This evidence is presented in appendix 4 and working paper 4. The main findings were that individuals do face temporary income reductions across their lifetimes. The most significant causes of such reductions are:

- temporary periods of withdrawal from the labour market, either due to unemployment, or to undertaking education or training;
- demographic events, particularly the birth of a child (this is also associated with withdrawal from the labour market) and family breakdown.

### *... and in circumstances where people find it difficult to access credit*

In addition, the evidence shows that some individuals face barriers to accessing credit. As might be expected, these barriers are most significant when the individual’s income



is low, and when they have little or no savings or assets against which a loan could be secured.

A secondary aim when identifying case studies was to demonstrate the use of the criteria against a good range of different types of loans. Examples of loans for consumption (where the loan is not likely to increase future income) were examined as well as loans for investment (where the loan is expected to increase future income). Similarly, loans secured on assets and unsecured loans were examined.

The case studies chosen for loans to individuals are:

- **Maternity loan.** This would top up flat rate maternity benefits and cover the six-month period of unpaid maternity leave introduced in 2003. This is an example of a loan to cover a period of temporary income reduction and additional expenditure;
- **Loan for adult learning.** This would be aimed at encouraging greater take-up of adult learning, typically leading to higher earnings in the medium term. Again, this is an example of a temporary income reduction and an increase in expenditure, but the loan here is expected to earn the recipient a return in the form of higher expected future income;
- **Loans for home improvements.** Loans for home improvements are aimed at low-income homeowners who are unable to make necessary improvements to their home. In this case a loan could be secured on the property, and would be only repayable when the property is sold, or the owner dies.

### *For businesses, accessing finance can be most difficult when starting up*

On the business side, access to credit is most constrained when a business is starting up. Starting a business or entering self-employment can be particularly difficult and risky for the unemployed, although if the business is successful, revenues will be growing and loans could be repaid at a later stage. A lack of start-up finance can therefore be a significant constraint for unemployed people wishing to enter self-employment. A case study looking at loans for self-employment therefore fits well with the criteria outlined in chapter 3.



## Case study 1: Maternity loans

### Summary

- **The Government wishes to encourage family-friendly working practices**

To this end, it will lengthen maternity leave, introduce new entitlements to paternity leave and has already introduced parental leave for families with children under five. The Government will also introduce generous increases to flat rate maternity pay, and introduce a new flat rate paternity benefit in 2003.

- **However, significant sections of leave entitlements will remain unpaid**

Six months of maternity leave will not be covered by any benefit or entitlement. There is some evidence that mothers already do not take up existing maternity leave entitlements because of financial constraints. Many women taking leave will also still face a funding gap when receiving flat rate maternity benefits: the flat rate of maternity pay will be £100 per week from 2003. The 1996 maternity rights survey carried out by the Policy Studies Institute for the Department of Social Security found clear evidence that the amount and type of pay influences the amount of leave taken.

- **One possibility might be a loan scheme for mothers wishing to take unpaid leave or for mothers wishing to top up their flat rate benefits which may improve take-up**

Some of this funding gap may be met through savings and borrowing from the private sector. However, loans may help new parents to take up leave entitlements. The cost of loans is low compared with introducing earnings-related or flat rate benefits to cover unpaid leave entitlements for the 260,000 new mothers in employment.



### 5.1.1 The first case study is a loan for maternity leave

The first case study considered is a loan to assist parents in taking up unpaid maternity leave and to top up flat rate leave benefits and pay.

### 5.1.2 The Government's objective is to maintain a balance between enhancing competitiveness and improving family life

The Government formally expressed its objectives in the Department of Trade and Industry's Green Paper *Work and Parents: Competitiveness and Choice*.

"The Government needs to consider ways to balance improving choice for parents and enhancing competitiveness for business by:

- keeping women's skills and knowledge in the economy and maintaining their attachment to the labour market even when they are not working outside the home;
- enabling business to benefit from a greater contribution from the workforce;
- maximising the contribution that working parents are able to make to their employers;
- safeguarding the health and welfare of the mother and child before and after birth;
- improving the quality of family life; and
- 'thinking small first' in the design of any solutions, to simplify systems so that everyone understands their rights and responsibilities, and introduce any changes in the best way for all."

### Maternity leave helps employers, employees, and their children

Underlying these objectives are several arguments put forward for maternity leave. These include:

- **Health.** Maternity leave is compulsory for two weeks after birth (four weeks if the mother works in a factory) to protect the health of the mother and baby.
- **Family-friendly working.** Leave entitlements are one tool which allow workers to maintain a sensible work/life balance;
- **Staff retention.** At present one third of mothers do not return to work for any employer after maternity leave. There is evidence that the existence of paid maternity leave increases the likelihood that the mother will return to her employer after childbirth.<sup>1</sup> Increased staff retention benefits employers through increasing the returns to training and development, preventing the loss of knowledge to competitors, and reducing recruitment costs. It also may benefit employees to return to the same employer by raising their levels of seniority and tenure – thus increasing their wage levels;<sup>2</sup>
- **Parental contact.** There is some evidence that maternal employment in the first year of a child's life has some association with poorer outcomes later on. In particular reading may be adversely affected;<sup>3</sup> and
- **Reduced sickness absence.** Some research has found a reduction in absences from work following the introduction of family-friendly working practices.<sup>4</sup>

<sup>1</sup> *Maternity Leave Policies and Women's Employment after Childbirth: Evidence from the United States, Britain and Japan*, by Jane Waldfogel, Yoshio Higuchi and Masahiro Abe, Centre for the Analysis of Social Exclusion, 1998.

<sup>2</sup> See Joshi, Heather; Pierella Paci; and Waldfogel, Jane, *The Wages of Motherhood: Better or Worse?*, STICERD Discussion paper WSP 121, London, 1996 and Waldfogel, Jane, 'The Family Gap for Young Women in the United States and Britain: Can Maternity Leave Make a Difference?', *Journal of Labour Economics*, 1997 for a discussion of the positive wage effects of returning to the same employer after childbirth.

<sup>3</sup> *Maternal Employment and Child Outcomes: Analysis of Two Birth Cohort Studies*, Heather Joshi and Georgia Verropoulou, The Smith Institute, 2000.

<sup>4</sup> Dench S. et al, 'Family-Friendly Employment: Its Importance To Small and Medium Enterprises', *Labour Market Trends*, March 2000.



### Box 5.1.2: The post-2003 framework of entitlements and benefits

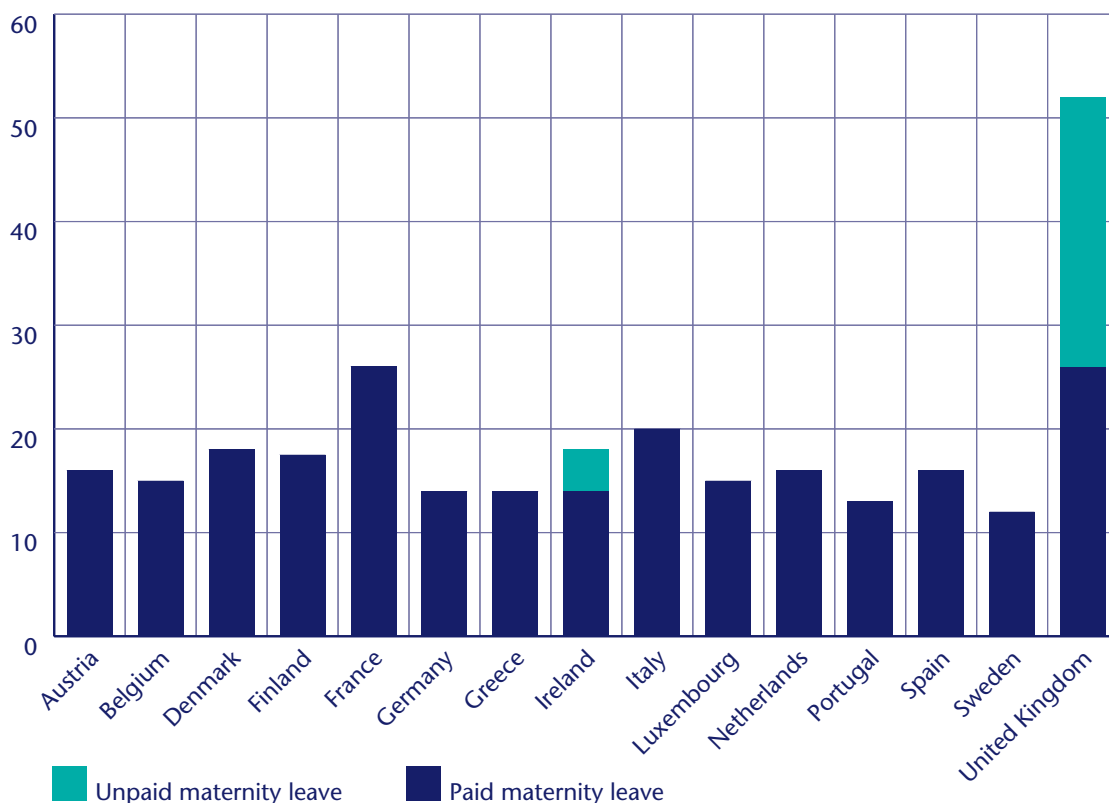
If a woman has worked for her employer for less than 41 weeks before the birth then she will be entitled to 26 weeks' maternity leave. If she has worked for longer than 41 weeks then she will be entitled to maternity leave lasting one year: six months paid; six unpaid.

If a woman qualifies for one year's maternity leave and her average weekly earnings in the previous 26 weeks have been at least equal to the lower earnings limit for National Insurance Contributions (NICs) (currently £72 per week) then she will be eligible for Statutory Maternity Pay (SMP). If the woman is self-employed, newly employed or earns less than the lower earnings limit for NICs then she may be able to claim Maternity Allowance (MA). Finally, a small number of mothers also fail to qualify for MA, in which case they are usually eligible for Incapacity Benefit.

Statutory Maternity Pay provides 90% of the women's average earnings for the first six weeks of maternity leave. After that payments will be made at a standard flat rate of £100 per week (or 90% of average earnings if that is less than £100) until the end of the 26-week period. Payments will be made by the employer and reimbursed by the Government. If the individual is ineligible for SMP, then they may be eligible for MA. Maternity Allowance is a flat rate benefit paid at a standard rate of £100 per week (or 90% of average earnings if that is less than £100), paid directly to the individual by the Benefits Agency for 26 weeks.

In order to achieve the above objectives the Government has increased the amount of maternity leave available and will steeply increase the level of flat rate maternity pay.

Chart 5.1.2(a): Paid and unpaid maternity leave, EU



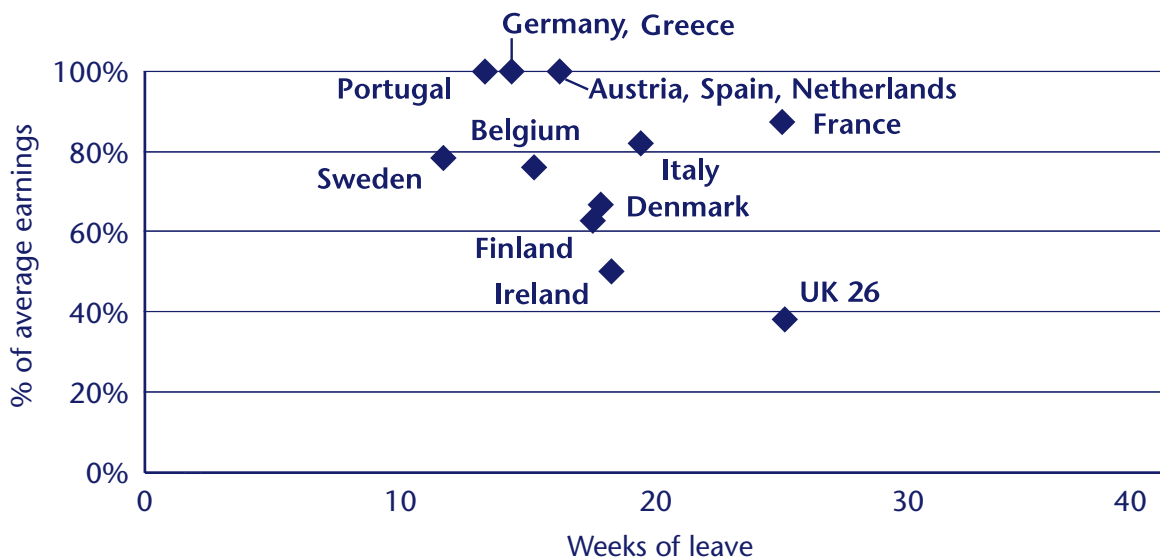


### Compared with Europe the UK offers long leave entitlements but low pay

As can be seen in chart 5.1.2(a) above, from 2003 the UK will have a relatively generous maternity leave entitlement compared with

other EU countries. It will also be unusual in having a long period of unpaid maternity leave. But the amount of maternity benefits paid during leave will be the lowest in the EU relative to average earnings – see chart 5.1.2(b).<sup>5</sup>

Chart 5.1.2(b): Paid maternity leave as % of average earnings by length of earnings, EU member states<sup>6</sup>



### 5.1.3 There are both strengths and weaknesses of existing provision

#### Maternity leave in the UK is long and pay is targeted at those on low incomes

The UK offers a generous length of paid maternity leave entitlement, and is unusual in offering an extra lengthy period of unpaid leave. There is some evidence that the amount of leave offered does influence the actual amount of leave taken by the mother. In a 1996 survey women who were entitled to extended maternity leave took more leave

than those who were entitled to only ordinary maternity leave.

Another strength is that maternity benefits are more progressive than those of other countries – due to the low level of the earnings related element in maternity benefits – allowing resources to be targeted at those on lower incomes. In addition, the new Integrated Child Credit (ICC), which will be paid to the main carer from 2003 whether in work or not, could help pay for some maternity leave costs. The ICC, unlike earnings related maternity benefits, will be targeted at low income families.

<sup>5</sup> This holds true even when the long period of unpaid leave entitlement is removed from the comparative analysis. Chart 5.1.2(b) shows the levels of maternity leave support as a proportion of average earnings replaced, by length of leave. It places the UK's provision when calculated in relation to the 26 weeks of paid leave (shown as UK 26 in the diagram).

<sup>6</sup> Source P. Moss and F. Devens (eds) *Parental Leave: Progress or Pitfall?*, The Hague/Brussels, 1999. Since then Portugal has increased paid maternity leave from 98 to 120 days, and Greece has added entitlement to one week's unpaid leave to the 16 weeks' paid maternity leave.



### Maternity pay levels influence take-up

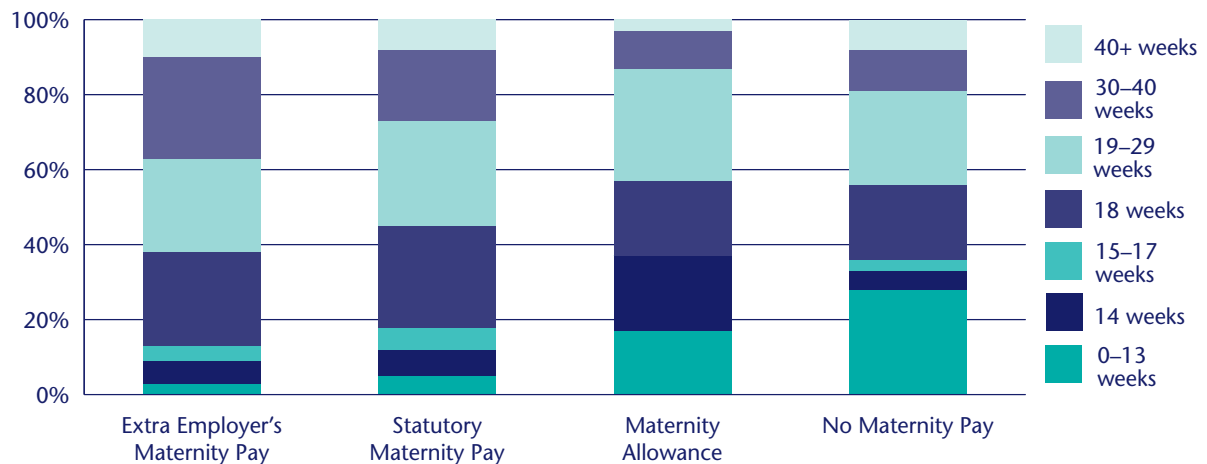
The relatively low level of earnings replacement for some mothers may provide much of the explanation why many do not take their full leave entitlement. The evidence about the amount of maternity leave taken indicates that:

- **The length of maternity leave taken is related to the generosity of maternity pay to which the mother is entitled.** Those who received additional payments from their employer

took more leave than those solely receiving SMP, who in turn took more leave than those who just received Maternity Allowance and those who received no pay. See chart 5.1.3(a) below.

- **Financial constraints are often the reason why mothers often do not take the full amount of leave to which they are entitled.** As chart 5.1.3(b) shows, 30% of mothers return before the 18 weeks to which they are currently entitled. Moreover the DTI survey of working parents found that over a

Chart 5.1.3(a): Amount of maternity leave taken by type of maternity pay received, 1995/96<sup>7</sup>



quarter of mothers could have taken over 40 weeks' leave – i.e. beyond the statutory maximum for any workers, although just 7% did so. The reasons given by mothers for not taking their full leave entitlement were mainly financial: 78% of responses mentioned some form of financial constraint; 12% said they wanted to get back to work; and 6% mentioned work commitments.<sup>8</sup> From 2003 maternity pay will be increased to around 44% of average UK female earnings.

### 5.1.4 Government loans might help improve leave take-up whilst remaining within resource constraints

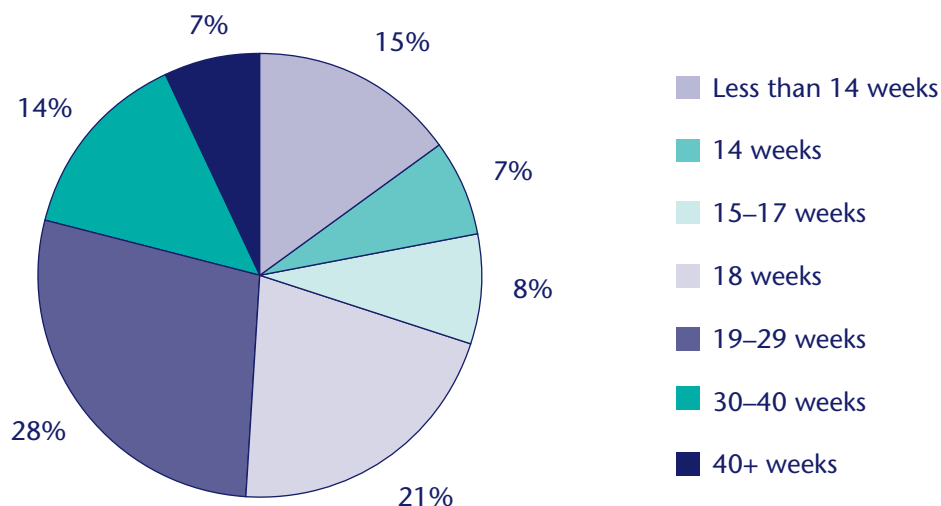
Maternity leave loans might provide a solution to the two problems – resource constraints and incomplete take-up of leave entitlements – identified earlier. But the question remains about the need for government intervention.

<sup>7</sup> Source: 1996 Maternity rights survey, DSS. Base = 1,318.

<sup>8</sup> *Work and Parents Research and Analysis*, DTI, December 2000 page 18. [www.dti.gov.uk/er/research.pdf](http://www.dti.gov.uk/er/research.pdf).



Chart 5.1.3(b): Length of maternity leave taken, GB 2000



Base: All mothers working more than eight hours per week who had taken maternity leave in the previous five years (n = 183). Source: DTI survey of how parents in employment balance work, family and home.

### Some households face difficulties in accessing credit and saving

The use of credit declines by income. This is likely to be partly due to difficulties in accessing credit for low-income households. This may provide a rationale for targeting loans on lower-income households who find it more difficult or expensive to access private sector credit. While saving is a conventional method for many people, some pregnancies are unforeseen and in any case the amount of savings people have also varies by income, see working paper 4.

### Government faces decisions about prioritising public expenditure

By their nature, loan schemes are cheaper than equivalent grant-based interventions. The cost depends largely upon the design

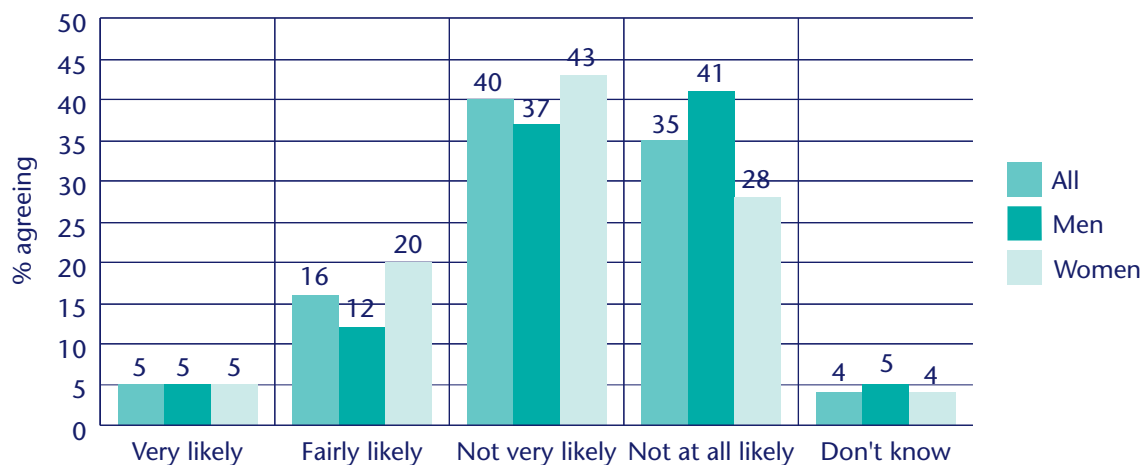
of the scheme. Subsidised interest rates and flexible repayment schedules can increase the real cost of a loan scheme considerably. So, too, can high default rates. Here, however, the Government has an advantage in that it has the ability, if it so chooses, to deduct repayments at source from taxes, tax credits or benefits.

### Loans may increase take-up of leave

There is little evidence available on the possible take-up of a maternity loan. One survey, set out in chart 5.1.4, found that one in four women would be very likely or fairly likely to take up parental leave if it were financed through a loan, with seven in ten women not very likely or not at all likely to take-up leave. This may provide an indication of possible take-up rates.



Chart 5.1.4: Likelihood of taking out a parental leave loan



Source: MORI Omnibus survey, February 1997. Full and part time workers under 40. *Time Out*, Helen Wilkinson, Demos, 1997. Question asked: Assuming that parental leave consists of up to two years' leave funded through a loan system that you would pay back once you went back to work, how likely do you think you would be to take it up?

### Box 5.1.4: Parental leave loans in Austria

All parents are entitled to up to two years' parental leave. A flat rate benefit for those taking leave will be paid at ATS 6,000 (Euro 436) per month from 2002. This is equivalent to 30% of female gross median income and 20% of male gross median income in 1999.

An additional loan is available for benefit recipients – mostly lone mothers and low income couples – taking parental leave. The maximum amount available is ATS 2,500 per month. The repayment structures for this loan have varied over time. From 1996 to 1999, in the case of lone parents, repayment was sought from the other parent, and the lone parent had to name the other partner in order to receive the loan. Loan repayments are now income contingent – commencing as soon as the lone parent's income exceeds ATS 140,000 or the couple's income exceeds ATS 350,000 per annum. The complete loan has to be repaid, including a 'supplemental surcharge' of 15%. The loans are repaid through the tax system and the amount of repayments varies according to household income:

Lone parents' repayments		Couples' repayments	
Gross annual income more than	Tax as % of individual income	Gross annual income more than	Tax as % of joint income
ATS 140,000	3%	ATS 350,000	5%
ATS 175,000	5%	ATS 400,000	7%
ATS 225,000	7%	ATS 450,000	9%
ATS 275,000	9%	–	–

Around 8,000 people took out parental leave loans in 2000. The total number of people taking out parental leave was 77,759 in 2000.

Source: 'Parental Leave in Austria', M. Thenner, in P. Moss and F. Devens (eds.), *Parental Leave: Progress or Pitfall?*, The Hague/Brussels, 1999 and personal communication.

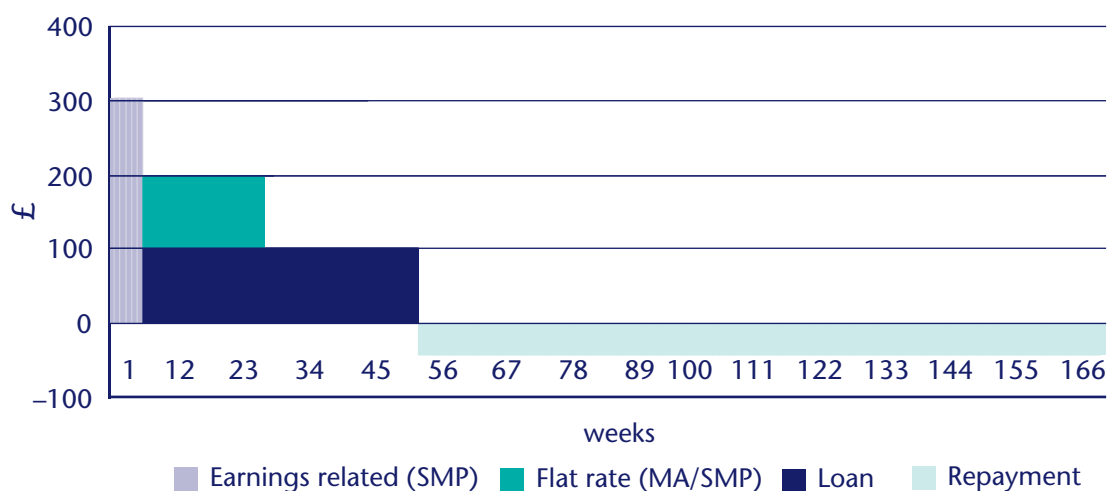


### 5.1.5 There are several options for designing a maternity loan

A loan could provide assistance for people wishing to take those entitlements to leave which are not covered by statutory pay or benefits. A loan could cover either the six

months' unpaid maternity leave or it could top up the 20 or 26 weeks of maternity leave paid at the flat rate – or both. Chart 5.1.5 presents a simplified model of how a loan with flat rate repayments might interact with existing maternity benefits.

Chart 5.1.5: Maternity benefits, loan and flat rate repayments



#### Loans can be designed so that they are appropriate for those on low incomes...

Some families may be debt averse, making them unwilling to take out a maternity loan. Also, low-income households make less use of credit. Focus group research carried out for the PIU found a general unwillingness to get into debt – although among young mothers there was an acceptance that use of credit and consequent indebtedness was often inevitable.

Maternity loan schemes could be designed so that they are more appropriate for low-income households. For example, student loans have income-contingent repayments which do not commence until the borrower's income reaches £10,000. Similarly, although Career Development Loans have flat rate mortgage style repayments, the Government will continue to pay the interest for up to

17 months if the borrower remains unemployed or on benefits after the course ends.

#### ... but the effect on work incentives needs to be assessed

Income contingent loans can be more attractive to those on low incomes but they may have a negative effect on work incentives. The cumulative effect of loan repayments, together with the withdrawal of means-tested benefits and tax credits, could lead to a steep effective marginal deduction rate. As one of the Government's objectives is to maintain women's attachment to the labour market, the possibility of introducing new work disincentives needs to be carefully assessed. We estimate that 17% of eligible women will, if they take out an income-contingent loan, face higher marginal deduction rates which may discourage them from returning to work.<sup>9</sup>

<sup>9</sup> Assuming universal eligibility (260,000 women), income-contingent repayments. Take-up of loan is assumed to be 25%, 33% of women do not presently return to work, for a variety of reasons, and are therefore not influenced by higher marginal deduction rates (MDR) – they already have decided not to return to work. Additional MDR is equal to the percentage of income deducted for loan repayments – in the case of student loans this is 9%.

Another possibility is to have flat rate 'mortgage style' repayments. These may actually operate as an incentive to return to work after taking leave – as earnings from work would be needed to help make the loan

repayments. But mortgage style loans may be less attractive to those on low incomes. We estimate that 8% of eligible women will, if they take out a mortgage style loan, face an increased incentive to return to work.<sup>10</sup>

### Box 5.1.5: Interaction with new tax credits

For those on low incomes, maternity loans and pay will interact with the new tax credits – Child Tax Credit (CTC) and the Working Tax Credit (WTC). The interaction will vary according to family size, employment status and income, and to the responsiveness of the tax credits to short-term changes in family income.

- As the CTC will be paid to the main carer, regardless of whether they are in work or unemployed, it will play a role in part-financing maternity leave.
- If the rules for WTC follow the current Working Families Tax Credit (WFTC), and Disabled Person's Tax Credit (DPTC) rules, the mother will be treated as in work for the purpose of receiving the WTC and WTC entitlement will continue after the end of statutory maternity pay provided the mother returns to qualifying remunerative work.

### 5.1.6 There are costs and benefits associated with maternity loans

There are some benefits of introducing maternity loans, few of which can be expressed easily in monetary terms. Increased take-up of maternity leave, for longer periods, should have a positive impact on certain outcomes later in a child's life. In particular, reading skills should improve.<sup>11</sup> Employers may gain through increased staff retention, and reduced sickness benefits.

There may also be certain second-order effects. In particular, as women take more leave, there is a greater demand for temporary replacement staff. Therefore the reduction in tax receipts from those taking leave may be balanced to some extent by an increase in tax revenue from replacement staff. If the replacement staff were previously unemployed then there may also be savings from reduced benefit payments. There are also (non public expenditure) costs associated with maternity loans. For example,

there will be higher recruitment costs incurred by employers as they employ more temporary staff.

We have modelled the public expenditure costs of four options: universal and targeted income-contingent loans; and universal and targeted mortgage style loans. We have assumed that the loan is paid at £100 per week for either 26 or 52 weeks.

There are two options for the repayment structure:

- **Income-contingent loan.** Repayments commence when household income reaches a threshold of £10,000, the same as that used for student loans.
- **Mortgage style loan.** Flat rate repayments commencing after 12 months of the start of the leave period. Repayment holidays are possible if the household has another child or enters the benefit system.

<sup>10</sup> Assuming universal eligibility (260,000 women), mortgage style repayments. Take-up of loan is assumed to be 25%, 33% of women at present do not return to work. These women would be affected by increased pressure on family finances to return to work.

<sup>11</sup> *Maternal Employment and Child Outcomes: Analysis of Two Birth Cohort Studies*, Heather Joshi and Georgia Verropoulou, The Smith Institute, 2000.



There are also two possibilities for the targeting of the loan. It could be made available to all women in employment just before their baby is born. Alternatively it

could be targeted at those on low incomes. In our modelling we have assumed that it would be available to households earning £234 per week or less.

Option 1 Universal income-contingent loan	Option 2 Targeted income-contingent loan	Option 3 Universal mortgage style loan	Option 4 Targeted mortgage style loan
£100 pw flat rate, with income-contingent repayments – universal	£100 pw flat rate, with income-contingent repayments – targeted	£100 pw flat rate, with mortgage style repayments – universal	£100 pw flat rate, with mortgage style repayments – targeted

Table 5.1.6 presents some of the key findings of the modelling of the public expenditure costs. The loan modelled below is a loan of £5,200, paid as weekly instalments of £100 for the entire 12-month period. If the loan was designed to cover only the six months of unpaid leave the cost would be halved. Universally available mortgage style loans

reach the largest number of women at the lowest cost.

These costs vary according the type of loan introduced – the public expenditure costs of variants of this option can be found in working paper 2, alongside sensitivity analyses.

**Table 5.1.6: Public expenditure costs per annum of introducing maternity loans<sup>12</sup>**

	Value of loans made	Cost per annum, discounted over 15 years (excluding admin costs)	Number of loans per annum	Cost per loan
Option 1 Universal income-contingent loan	£430m	£167m	82,824	£2,016
Option 2 Targeted income-contingent loan	£215m	£110m	41,412	£2,656
Option 3 Universal mortgage style loan	£430m	£82m	82,824	£990
Option 4 Targeted mortgage style loan	£215m	£55m	41,412	£1,328

<sup>12</sup> Key assumptions include: 25% take-up. Full take-up of loan amount i.e. 52 weeks at £100 per week. Targeted loans available to 50% of households. 6% discount rate. 3% real interest rate. Payment holidays apply for mortgage style loans – average duration assumed to be 6 months, with a 50% probability of taking a repayment holiday. Variable default rates of between 3% and 5% depending on the target groups. Sensitivity analysis and modelling of variations can be found in working paper 2.



**This case study is purely for illustrative purposes**

The Department of Trade and Industry, together with the Department for Work and Pensions, have considered these ideas. Early in 2001, the Government announced the introduction from 2003 of a number of measures to improve and simplify maternity leave and pay provisions. The ideas for maternity loans in this report are not being taken forward as part of this work, and are not being considered further by the Government at this time.

## Case study 2: Further and adult education loans

### Summary

A workforce with a relatively high level of skills and education is likely to result in a more productive and richer economy. However, compared with other industrialised countries, the UK has a low skills base. As part of the Government's aim to improve economic growth, it may be necessary to improve the skills of the UK labour force through additional education and training.

There is significant UK Government support for higher education, which has grown rapidly over the past decade. But support for other types of adult education lags some way behind. One way to address this is to:

- create more accessible funding for potential students, including the use of income-contingent loans as for higher education; and
- expose the real costs of investment in education and training, and create a level playing field between public and private learning providers, by providing a contribution towards learning costs via a new Individual Learning Account style scheme.

### *5.2.1 The second case study considered is a loan for further and adult education*

Our second case study focuses on an interest-free loan to cover maintenance and other education-related costs for 19 to 24 year olds in further and adult education and training. It could be combined with other support to waive or subsidise tuition fees.

### *5.2.2 There are significant benefits of further and adult education, both to individuals and the wider economy*

#### **People benefit from education**

There are clear benefits of education and training. A well-educated workforce can

command higher wages and a better standard of living. In addition, people enjoy education for its own sake; it can enhance the quality of lives both during and after the period of study.

#### **There are also wider benefits to employers and society**

As well as private returns to the individual, education and training can confer benefits on society as a whole. Skilled workers are paid more, and so pay more tax, which benefits both current and future taxpayers. And a higher skill level in the economy is linked to other positive outcomes such as higher labour productivity, adaptability and innovation,<sup>13</sup> and higher rates of economic growth.

<sup>13</sup> See for example, Bassanini and Scarpetta (2001), Krueger and Lindahl (2000) and Aghion and Howitt (1998).



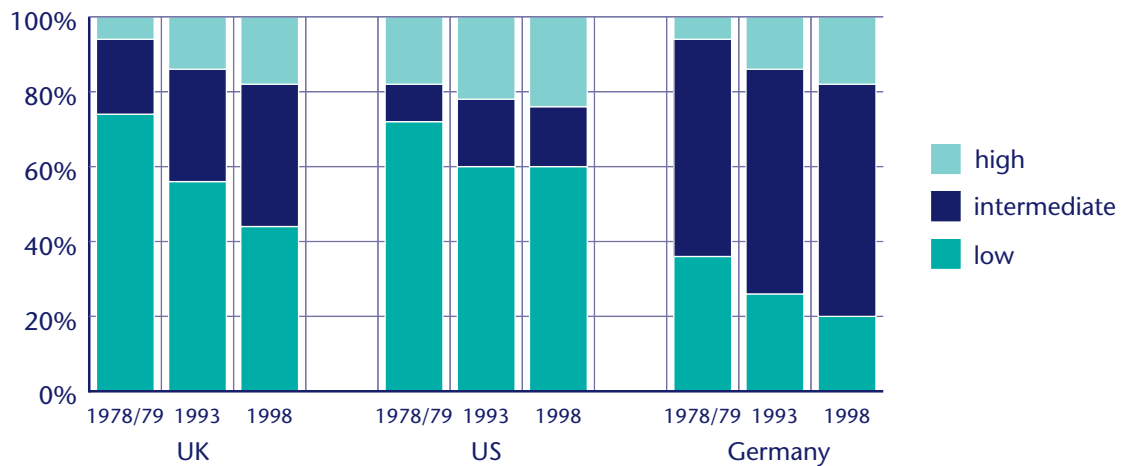
Over the past 50 years, a ‘productivity gap’ has appeared between the UK and other industrialised countries (see box 5.2.2(a)). A major explanation for this may be found in differences in skill levels.

As can be seen in chart 5.2.2(a),<sup>14</sup> in the UK, around 55% of the workforce have low skills, compared with only 23% in Germany, which has far more workers with intermediate skills. The US has a greater proportion of workers with high skill levels than the UK – most recent figures show that around 38% of the

workforce in the US has a degree or higher, compared with only 27% in the UK.

Part of the Government’s response to the productivity gap has been to put in place policies to improve the quality and quantity of skilled workers in the UK. This includes initiatives to affect learning achievement from an early age, such as Sure Start, and new strategies and targets for literacy and numeracy in schools. For higher education, the Government has set an objective that by 2010, 50% of young people will be able to

Chart 5.2.2(a): Employees by skill levels, 1978/79 to 1998



### Box 5.2.2(a): The UK’s ‘productivity gap’

Labour productivity is an important determinant of economic growth. However, evidence indicates that the UK’s productivity lags behind that of our major competitors.

There are different ways to measure labour productivity. The two most common are output per worker (which measures the productivity of each person in employment) and output per hour (which measures the output of each hour worked, and so captures the impact of part time working and time not spent working). On both measures, the UK’s productivity lags behind that of other industrialised countries.

Table 5.2.2(a): Productivity comparisons, 1999

	UK	US	France	Germany
Output per worker	100	145	119	107
Output per hour worked	100	126	123	114

Source: *Productivity in the UK: Progress towards a productive economy*, HM Treasury, 2001.

<sup>14</sup> Source: Crafts and O’Mahony (2000), reproduced in *Productivity in the UK: The evidence and the Government’s approach*, HM Treasury, 2000.



undertake higher education before they are 30.

For further education, the Government has established the Learning and Skills Council to unify funding of post-16 education and training, and improve the quality of provision – and has promoted Modern Apprenticeships. In terms of funding, the Government aims to increase investment in education overall by an average of 17% per year over the next three years.<sup>15</sup> The Government’s manifesto also made a commitment to ‘tackle the financial barriers that prevent adults entering further education’.

### **There is a need to balance public and private contributions**

As outlined above, there are significant benefits to society of education and training. This alone would provide a rationale for Government intervention to encourage take-up. But there are also benefits to the individual, since education and training raise the likelihood of obtaining a better-paid and more interesting job. The existence of these benefits provides a rationale for individuals to make a contribution to the cost of education and training undertaken after the period of compulsory education.

However, many potential students will not be able to afford to contribute to the cost of their period of study. In such circumstances, one possibility is for students to borrow from private lenders (banks and building societies), including through the current system of Career Development Loans, see appendix 3. It would be in their interests to do so if they

expected their future earnings to rise as a result.

But a key issue is that although the expected returns from education are often significant, there is considerable variation, see box 5.2.2(b). This causes uncertainty for students, who may not know in advance their likely return from education. It also causes uncertainty for banks in lending to students, since the banks will be unsure about the likelihood of repayment of the loan, particularly for potential students who already have a poor credit rating. These uncertainties and risks can lead to lower lending, and lower participation in education and training than is optimal for individuals and society. These issues are explored in greater detail in the Performance and Innovation Unit report on Workforce Development.

<sup>15</sup> Source: *Productivity in the UK: Progress towards a productive economy*, HM Treasury, 2001, section 3.



### Box 5.2.2(b): The returns from education and training

Recent work by Dearden et al (2000) has drawn on previous research as well as new analysis to examine the increase in earnings that can be attributed to different qualifications. This is summarised in table 5.2.2(b) below.

**Table 5.2.2(b): Increase in earnings from education and training**

Qualification	Return	
	Men	Women
Lower-level NVQs and C&Gs	Not significant	Not significant
NVQ level 3 to 5	6–9%	1–5%
C&G Craft (NVQ level 2)	4–7%	Not significant
C&G Advanced (NVQ level 3)	7–10%	35% (but small sample)
ONC/OND (NVQ level 3)	7–12%	8%
HNC/HND (NVQ level 4)	6–22%	3–12%
Higher education (level 5)	10–28%	21–26%
Professional qualifications	15–35%	20–40%

NVQ = National Vocational Qualification; C&G = City & Guilds; ONC/OND = Ordinary National Certificate/Diploma; HNC/HND = Higher National Certificate/Diploma. Levels refer to the classification for education and training qualifications. Vocational qualifications at level 2 are equivalent to GCSE/O level pass at grades A–C; level 3 is equivalent a pass at A level. The increased earnings are incremental over the last NVQ or equivalent qualification.

Table 5.2.2(b) needs to be interpreted carefully. Whilst the additional earnings from higher education look to be larger on average than for vocational education, most vocational courses are two years in length rather than three (for HE), and the figures need to be adjusted accordingly. However, the overall message of the figures in the table is that whilst there is considerable variation in the return from different types of qualification, almost all result in a positive effect on future income.

A recent study by McKnight et al uses recent data from Universities Statistical Records (USR) to examine the labour market experience of students after leaving university. They analyse the reasons for variation in earnings premiums experienced by different types of student and degree, and find that students from lower social classes experience much greater variation in return than those from better-off backgrounds.

These results are mirrored in a number of studies (see for example, Smith and Naylor, 2000) which find that students from poorer backgrounds are more likely to drop out of university, and are more likely to fail their exams. In addition, these students are less likely to gain a second class degree or better, and have a higher associated probability of unemployment after graduation.

Sources: Dearden et al, *The returns to Academic, Vocational and Basic Skills in Britain*, Skills Task Force research report 192, 2000; McKnight et al, *Sheer class? The extent and source of variation in the UK graduate earnings premium*, LSE/CASE, 2001; Smith and Naylor, *Determinants of degree performance: evidence for the UK university graduate population from the USR*, 2000.



### 5.2.3 There are several options for designing a loan for further and adult education

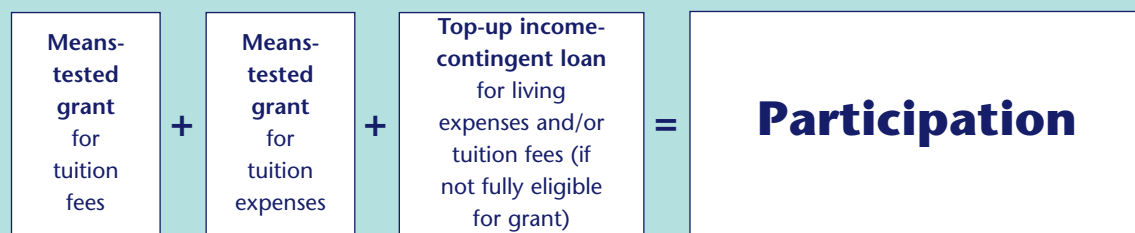
There are a number of options for encouraging greater participation in adult learning. Loans should be looked at as part of a package of measures, and may be additional to the present range of support or might sit alongside new measures on tuition fees or means-tested grants for maintenance and/or learning costs. Different instruments may be appropriate for different types of training or groups of students. The Department for Education and Skills (DfES) is reviewing the financial support arrangements for adult learners and will consider the conclusions of this report in the context of that wider review.

One option is to introduce loans for adult learning, as for higher education, to

encourage greater participation. However, many commentators believe that loans will not be sufficiently attractive to encourage a significant increase in participation. There is a concern that potential students will be put off by loans, fearing saddling themselves with mounting debts at an early point in their working lives. These fears appear to be particularly acute for students from less well-off backgrounds (see box 5.2.2(b)).

It may be possible to mitigate this by the structure of the loan; income-contingent loans, for example, provide a way to shield the student from uncertainty about the future return from education. Another possibility would be to introduce a means-tested grant element. This could stand alone, or be coupled with a top-up loan to support maintenance expenses and/or tuition fees for those who did not fully qualify for a grant. This could also allow for greater integration

#### Box 5.2.3(a): Role of loans for adult learning



#### Box 5.2.3(b): Further education loans in Finland

In Finland, compulsory education is followed by an integrated system of academic ('upper secondary' and higher education) and vocational education.

- Each student is entitled to a study grant, housing supplement and government guaranteed student loan, delivered through commercial banks.
- Loans are available to all students over 17 years of age for full time studies lasting at least eight weeks at upper secondary schools, vocational schools and higher education institutions.
- The terms of the loan, including the interest and period of repayment, are agreed between the individual and the bank.

Source: *Financial Support for Further Education Students in Europe*, Kevin Attfield, The Student Loans Company Ltd, June 2001.



with the current system of support for HE (as is the case in some other countries, see box 5.2.3(b)), building on current delivery mechanisms to minimise administration costs.

### 5.2.4 It is important to assess the costs and risks

The next step is to analyse the costs and risks of this option.

The cost of providing income-contingent loans has been modelled. The results, summarised in table 5.2.4 below, assume that income-contingent loans are taken up by full time and part time students aged 19 to 24 studying qualifications at levels 2 and 3.<sup>16</sup> However, the costs if take-up was extended to those aged up to 30 has also been examined. Restricting the loans to particular age groups is purely indicative; in practice, such loans could be extended to all age groups.

**Table 5.2.4: Summary of main modelling results under central assumptions<sup>17</sup>**

	Costs per annum of providing loan (assuming repayment over 15 years)	Number of students taking out loan	Additional cost (of loan write-off if progress to HE)
<b>Option 1</b> Loans for 19–24 year olds (means-tested, exclude current employer-funded courses)	£124m	92,000	£7m
<b>Option 2</b> Loans for 19–24 year olds (non means-tested, include current employer-funded courses)	£144m	104,000	£8m
<b>Option 3</b> Loans for 19–29 year olds (means-tested, exclude current employer-funded courses)	£245m	192,000	£12m
<b>Option 4</b> Loans for 19–29 year olds (non means-tested, include current employer-funded courses)	£270m	207,000	£13m

Note: all costs are discounted at 6% over 15 years, see working paper 2 for details.

<sup>16</sup> It seems unlikely that those studying below level 2 would take out a loan.

<sup>17</sup> Central assumptions set out in section 5.2.4.



These indicative costings assume that students would be offered up to £4,000 per year for full time courses and £2,000 per year for part time courses. All courses are assumed to be two years in length. A zero real rate of interest on the loans is assumed. Loans would be repaid after the period of study has ended, at a rate of 9% of earnings above £10,000 (as for the current HE arrangements, see appendix 3). We have assumed that students studying both vocational and academic qualifications at levels 2 and 3, at private sector and public sector learning providers would be eligible. The assumed take-up rate is 30% of eligible students. This is a DfES mid-point estimate based on the professional judgement of those involved in the field. The additional administration costs associated with providing loans have not been modelled.

### **Sensitivities which affect the results have been modelled**

The modelling includes some variations, such as extending the loans to students aged 25–30. A complication is that there are currently some courses provided by FE institutions which are funded by employers, and there is therefore a question about whether students on such courses would be eligible for loans (provided they fulfilled the other criteria). The results are presented both excluding and including these students. An additional sensitivity is whether the loan is means-tested. The results above consider a case where only 75% of the maximum loan is available to students with income above £30,000. Finally, the costs of writing off 50% of the loan for students going on to complete a higher education course have also been modelled.

Some sensitivities on the assumptions made have also been modelled, such as varying take-up between 20% and 50% of eligible students, and varying the assumption about the number of students with private learning providers (this information is not known). The results are summarised in table 5.2.4 above. The full analysis and sensitivities are set out in working paper 2.

### **Future developments will need to take account of the DfES review**

The current DfES review of the financial support for adult learners is examining the support arrangements for adult learners, and any new proposals will be taken forward in the light of this review.

## Case study 3: Housing improvement loans

### Summary

- Local authorities currently spend nearly £300 million per year on grants to low-income homeowners to improve their homes.
- Proposals to reform the current housing renewal legislation to allow local authorities to make use of different forms of support for low-income homeowners, including equity loans, are currently being considered by Parliament.
- Equity loans would allow low-income homeowners to borrow to make home improvements, with no repayments until the property is sold (so repayments would not reduce their income).
- Preliminary estimates indicate that the shift from grants to loans could make existing resources go twice as far, even if no interest rate is charged on the loan and increased administration costs are taken into account.

#### *5.3.1 The third case study considered is a loan for home improvements*

The third case study considered is an equity loan for low-income homeowners in unfit housing, to allow them to pay for repairs to their home. The loan would be repayable when the property is sold.

#### *5.3.2 Some households in the UK still live in unfit housing, without the means to improve it*

Results from the latest English House Condition Survey (1996) show that nearly three-quarters of a million homeowners were living in unfit housing. Of these, over half have incomes low enough to qualify for a

local authority home improvement grant under the current arrangements, see table 5.3.2 below. This amounts to some 372,000 households, nearly 3% of homeowners in England.

#### **There are high costs to society of unfit housing**

There may be considerable costs associated with the large number of homeowners living in unfit accommodation – including health problems associated with stress and poor conditions (such as damp). Many of the households in such accommodation are vulnerable: 43% are over 65 years of age; 19% are disabled, and 21% have children. Unfit housing also imposes costs on the



wider community; it reduces the incentive for neighbours to improve their properties and can lead to a general decline in the appearance of a local area.

However, there are also significant costs associated with addressing the problem. The cost of a grant to carry out repairs for all eligible households sufficient to bring their properties up to the required standard would

be over £3.5 billion – more than 10 times the amount that local authorities spend annually on grants to tackle this problem. And Government policy is to encourage homeowners to bear responsibility for the upkeep and maintenance of their properties wherever possible; there is a risk that public expenditure would simply displace investment that homeowners might otherwise have made themselves.

**Table 5.3.2: Estimates from the English House Condition Survey of the number of homeowners with low incomes living in unfit accommodation (with income low enough to qualify for grants under current rules)**

All eligible for grant		% of those eligible			
Number	372,000	Outright owner	60%	Aged 16–29	8%
Average grant	£9,526	Owned with mortgage	40%	Aged 30–44	22%
Average cost of work	£11,439			Aged 54–64	27%
Average value of home	£49,818			Aged 65+	43%
Average equity (estimated)	£43,987				
Average income (pa)	£7,748	Total	100%	Total	100%

Table 5.3.2 above summarises information from the 1996 English House Condition Survey. A key finding is that although homeowners in unfit housing have low incomes, many of them own their homes outright or have built up a large equity share. If this equity could be tapped to allow households to pay for repairs, they could gain the benefits of an improved standard of housing, and there could also be spillover benefits to the local neighbourhood.

One way to do this is to allow such households to take out an equity loan. Unlike ordinary loans, equity loans are repayable only on sale of the house, so there would be

no need for regular repayments. In fact, most homeowners – particularly elderly homeowners – would not have to repay within their lifetime (the detail of how equity loans operate in practice is set out in box 5.3.2(a) below). Proposals to allow local authorities to extend the use of equity release loans were made in the Department of the Environment, Transport and the Regions’ (DETR’s) consultation paper on home improvement in the private sector.<sup>18</sup> Further to Parliamentary scrutiny of the proposals, the Government aims to bring these into force in 2002.

<sup>18</sup> *Private sector housing renewal: reform of the Housing Grants, Construction and Regeneration Act 1996, Local Government and Housing Act 1989 and Housing Act 1985 – a consultation paper, DETR, March 2001.*



### *Box 5.3.2(a): The role of the Land Registry and statutory charges*

The safest way to secure a loan on a property is to place a registered charge on the property via the Land Registry. The lender completes a charge form, signed by the lender and borrower. The Land Registry then registers the charge against the property. This means that when a potential buyer requests a Land Registry 'search' on a property (a preliminary stage in the house-buying process), they are notified of the existence of the charge on the property. This charge will then have to be discharged, conventionally by the seller paying off what is owed before the sale takes place. Most properties are bought with the assistance of a mortgage, so a first registered charge will already exist. Any additional loan secured on the property will constitute a secondary charge.

Some preliminary estimates suggest that it costs around £500–£600 to create a statutory charge. This cost includes lawyers' and other professional fees and Land Registry charges (it costs £40 to register a charge up to a value of £100,000 with the Land Registry). This compares with an administrative cost of home improvement grants of about £400 (for renovation grants) and £150 (for home assistance grants).

There are also other ways to secure a loan against a property. One possible route is to enter into an agreement with the lender about the loan. This agreement could specify the circumstances in which, at some future date, the borrower would have to register the lender's formal charge on the property. Alternatively the borrower(s) could agree to a restriction being registered preventing them from making any disposition of the property without the lender's consent. The advantage of these approaches is that some security still remains, but it may be administratively less costly.

### **There may be market failure in the provision of equity loans**

A key question is why government needs to intervene to offer loans. On the surface, the provision of equity loans seems like a good opportunity for private sector markets. One difficulty is that these markets remain fairly undeveloped. A variation on equity loans, known as home income plans, gained a bad reputation in the 1980s (see box 5.3.2(b)) and the market is yet to fully recover.

Another potential source of private sector provision is insurance, but here again, coverage is incomplete. Mortgage providers usually insist on private buildings insurance, which would typically cover damage due to fire, floods or other accidents. However, insurance companies are more reluctant to offer insurance against repairs due to lack of

maintenance, or those over which the homeowner has control, for obvious reasons. It seems unlikely therefore that these households could choose to insure against the deterioration of their properties.

### **The effect on income distribution of moving from grants to loans is unclear**

Arguably, the current system of grants for home improvement (see below) has a positive effect on income distribution, since eligibility for a grant is strictly means-tested. However, homeowners tend to be richer on average than the general population, and whilst the grant certainly helps those on low incomes, it may be also helping some more wealthy households. This can be seen from table 5.3.2, which shows that the average household eligible for a grant has equity in their home worth more than £40,000.



### Box 5.3.2(b): The equity release market

- In the 1980s thousands of homeowners bought equity release products, intending to use the equity that they had built up in their homes for current expenditure or investment. Some of these products used the equity that people owned in their homes to purchase investment bonds. In the subsequent recession, interest rates rose and the value of the bonds fell. In many cases the bonds failed to produce an income, and in some cases did not even cover the interest payments on the mortgage. This led many people to build up large arrears, and some to lose their homes.
- Many equity release products were outlawed in 1990. Despite this, according to the Council of Mortgage Lenders, 'the unfortunate packaging of equity release products in the 1980s continues to be a set-back to the development of the market'.
- So although there are now several types of equity release products on the market, the current market remains small. Safe Home Income Plans (SHIP) report an increase in new business over the past few years, from a low point in 1993 of sales amounting to some £22 million, the market had risen to £70 million by 1997.
- This compares with the estimated £367 billion of unmortgaged housing equity owned by households in the UK.

### Loans may be an appropriate form of intervention where housing is concerned

Home improvements might also be particularly suitable for loans because:

- the home improvement typically confers benefits on the recipient, and could even add to the value of the property; and
- the loan can be secured on an asset, which makes it likely that the loan can be tracked and that repayment can be secured.

### 5.3.3 There are strengths and weaknesses of existing provision

In 1999/2000, local authorities spent £260 million on home improvement grants to low-income homeowners. The bulk of this money – £195 million – went on renovation grants, worth on average £9,726 each. Sixty-five thousand smaller 'home repair assistance' grants – worth on average £988 – were also distributed by local authorities. Private

spending on home improvement currently amounts to between £10 and £15 billion per annum.

1998 research indicates that:

- about half of the grants go to people aged over 60;
- about half of the grants go to people on means-tested benefits;
- about 72% of grant recipients make no contribution to the cost of the work; and
- of the 28% that contribute, the average contribution was £920.

Local authorities are responsible for delivering the current system of home improvement grants, and there are clearly good grounds for maintaining local discretion in delivering this support. DETR recently published a consultation paper setting out the options for allowing local authorities greater discretion in awarding funds for home improvement<sup>19</sup>. If the proposals in the consultation paper are

<sup>19</sup> *Private sector housing renewal: reform of the Housing Grants, Construction and Regeneration Act 1996, Local Government and Housing Act 1989 and Housing Act 1985, a consultation paper*, DETR, March 2001.

accepted, this would allow local authorities to offer loans as well as grants for this purpose.

### *5.3.4 There are two central options for designing loans for home improvements*

There are two central options available for shifting current grant provision to loans: repayment loans or equity loans.

- **Repayment loans.** These are simple loans – typically taken out for a fixed amount, with a given schedule of regular future repayments. Repayment loans may not work well for the group of low-income homeowners eligible for a grant under the current scheme. This is because their incomes are so low, and because of their composition (a high proportion of older and disabled households) means they are unlikely to see significant future increases in income that would allow them to repay the loan. However, repayment loans might be used as an option for those that wanted to repay an equity loan.
- **Equity loans.** Equity loans typically work by the lender placing a statutory charge on the property (see box 5.3.2(a)), which would be repaid when the property was sold. The advantage for low-income households is that repayments do not need to be made until the house is sold (or the homeowner dies). There will be administration costs associated with equity loans (see below), which means that they are particularly appropriate for home improvements that are relatively expensive; for cheaper repairs, grants may be more appropriate.

In the analysis that follows, it is assumed that these loans would be provided directly by local government. This does not need to be

the case. Instead local authorities could encourage private mortgage providers to provide such loans – either through regulation, or by underwriting or subsidising a certain proportion of the loan – until the private market has fully developed.

### *5.3.5 It is important to assess the costs and risks*

The following analysis considers the effects of shifting from a system of home improvement grants to equity loans. Table 5.3.5 summarises the results. The detailed cashflows and assumptions are set out in working paper 2.

For simplicity, a central assumption is that local authorities all make a shift from grants to loans in the same way. Since the proposal is to give greater discretion to local authorities in supporting homeowners in unfit accommodation, the likelihood is that support will vary according to specific local needs and resources.

As table 5.3.5 shows, there are significant expenditure savings associated with the shift from grants to loans that would allow a considerable increase in the number of households assisted for the same amount of public expenditure. The largest saving would accrue if all current grants (renovation and home repair assistance (HRA) grants) were changed to equity loans. This is modelled as Option 1 in table 5.3.5. However, since HRA grants tend to be smaller (average £988) than renovation grants (average £9,726), the second set of results ('Option 2') model the effects if only renovation grants changed to loans, with HRA remaining as a grant.

The next set of results model a policy that shifts both renovation and HRA grants to loans, but allows households to retain a



minimum of £10,000 equity in their property. Given that the average renovation grant in 1999/2000 was almost £10,000, this restricts the shift from grant to loan only to those with equity greater than £20,000 in their property.<sup>20</sup> This is modelled as Option 3 in table 5.3.5. Finally, Option 4 models a shift from grants to loans for renovation grants

only, again allowing households to retain a minimum of £10,000 equity in their homes.

Table 5.3.5 also shows the number of additional households that could be assisted if the current level of expenditure on home improvement grants was kept constant.

**Table 5.3.5: Annual public expenditure implications of shifting from home improvement grants to loans**

	Discounted cost per annum, (including admin costs)	Number of additional households assisted
<b>Status quo</b> Renovation grants and home repair assistance remain as grants	£259m	0
<b>Option 1</b> All renovation grants and home repair assistance changed to loans	£145m	70,000
<b>Option 2</b> Renovation grant only changed to loan (HRA remains grant)	£151m	53,500
<b>Option 3</b> All renovation grants and home repair assistance changed to loans with £10,000 minimum equity	£190m	42,000
<b>Option 4</b> Renovation grant only changed to loan with £10,000 minimum equity retention (HRA remains grant)	£194m	32,500

**Future developments will be taken forward by DTLR in the light of their consultation**

In the light of the consultation initiated by DETR the Government plans to lay reform proposals before Parliament in the autumn, with the aim of bringing these into force in

summer 2002. Guidance is being prepared to coincide with the introduction of these reforms.

<sup>20</sup> Note this is an imperfect proxy, since a household could have a renovation grant of £10,000, and hold £17,000 of equity in their home, in which case it would make sense to ask them to take £7,000 as a loan and £3,000 as a grant – but this was too sophisticated to model using our data.

## Case study 4: Loans to support unemployed people to move into self-employment

### Summary

- A case study was undertaken looking at making use of loans for those moving from unemployment to self-employment.
- The analysis suggests that the existing support may not be totally effective in getting the unemployed (particularly the longer term) to move into self-employment.
- There is evidence of a financing gap for some of the unemployed moving into self-employment. Government loans or government-facilitated loans could boost the take-up and success of the self-employment options and help meet financing problems.
- The case study considered a number of options for using loans, including:
  - loans on top of existing support for working capital and help with bridging income after existing allowances finish;
  - targeting the loan support at the 25+ age group;
  - targeting support at the skill shortages which might involve further linking of training options and support with self-employment.
- The analysis suggests that there is a good case for loans to be made available to those moving from unemployment into self-employment using the New Deal and Work Based Learning for Adults schemes. Targeting the scheme at skills shortages and at the 25+ age group may yield the highest benefits, though other options also look promising.



### 5.4.1 The fourth case study considered a loan for self-employment

The fourth case study, looking at loans to business, considered loans to help the unemployed into self-employment.

### 5.4.2 Self-employment is an important sector of the economy

Self-employment and business start-up may encourage regeneration in deprived areas,

meet social objectives and can provide a route out of unemployment. The Government has recognised this and provides specific help for the unemployed starting a business through the provision of advice, training and in some cases income support.

Self-employment is largely focused on the service sector and this is particularly true of those moving out of unemployment into self-employment. See table 5.4.2 below.

**Table 5.4.2: Self-employment by gender and industry 2000 (percentages)**

	Male	Female	All
Construction	27	1	20
Distribution, hotels and restaurants	18	21	19
Banking, finance and insurance	19	18	19
Public administration, education, health	5	22	10
Manufacturing	7	7	7
Transport and communication	8	3	7
Agriculture and fishing	7	4	6
Other services	9	23	13
All industries	16	7	14
All industries (millions)	2.3	0.8	3.1

The importance of self-employment is indicated by the proportion of businesses with no employees (sole traders or partners without employees) which stood at over 2.3 million in 1999 out of a total of 3.7 million businesses. Currently about 13% of the working population are self-employed and of this just over a quarter are women. There has been some decline in the total number of self-employed (sole traders and those not registered as businesses) from 3.4 million in 1991 to 3.1 million in 2000. This largely reflects growth in other sectors of the economy and reform of tax rules to remove a bias in favour of self-employment.

Self-employment in the UK is generally lower than in other developed countries,<sup>21</sup> which may reflect further barriers within the UK.

### 5.4.3 Government support for the unemployed moving into self-employment is provided through New Deal schemes and Work Based Learning for Adults

The self-employment routes under the main New Deal schemes and Work Based Learning for Adults (WBLA) are described in box 5.4.3.

<sup>21</sup> For example, on the OECD definition in 1999 the UK had 11.7% of working population in self-employment compared with the EU average of 14.5% and the OECD average of 14.6%. See: [www.oecd.org/publications/figures/2001/anglais/018\\_019\\_PartTime.pdf](http://www.oecd.org/publications/figures/2001/anglais/018_019_PartTime.pdf).



The case study has focused upon these schemes because:

- these are the groups (the young and longer-term unemployed) where Government considers it particularly important to target support to help people into work;
- if further support is provided, it is important that it is targeted on areas of greatest benefit. If lower cost loans were too readily available this would have high deadweight costs, crowd out existing private sector support and could create perverse incentives (delaying taking a job in order to access support);
- the evidence (see below) suggests that it is the young and longer-term unemployed where the greatest financing problems and market failures are encountered.

### *Box 5.4.3: Existing support for moving from unemployment into self-employment through the New Deal and WBLA*

A route into self-employment is provided under the main New Deal and WBLA schemes which are:

- New Deal for Young People for 18 to 24 year olds on Jobseeker's Allowance (JSA) or other benefits for six months.
- WBLA for those over 25 on JSA or other benefits for six months, and for those on benefits for over 18 months the New Deal for 25 plus.
- New Deal for 50 plus for the unemployed over 50 claiming benefits for more than six months.
- There are also provisions in the other New Deal programmes, e.g. for the disabled or musicians, for those interested in self-employment.

The New Deal for Young People provides 18 to 24 year olds who have been unemployed for six months with extensive assistance in developing their potential and skills in searching for a job. If an unsubsidised job cannot be obtained there are four main options: a job subsidy for employers; full time education and training; government-provided employment; or voluntary work. The self-employment route will be offered by New Deal Personal Advisers where this appears suitable.

The scheme provides basic training and a mentor to develop a business plan. If a business proposal is considered viable, a period of 'test trading' setting-up and running the business is undertaken for up to 26 weeks, following 4 weeks of training. The client is given advice and support from a personal adviser and there is an opportunity to train towards an approved qualification.

The finance package includes an allowance equivalent to the amount of benefit received plus a grant of £15.38 a week for up to 26 weeks (equivalent to a grant of £400). Any money the business earns during 'test trading' can either be ploughed back into the business or stored in a special bank account. At the end of this, if successful, the business is regarded as fully-fledged and wages can be drawn. If unsuccessful the client returns to signing on and JSA. There is a review after about 13 weeks of test trading to see whether the business is ready to go live or needs more time test trading, i.e. the full 26 weeks. The package does not include access to other financing, though information and advice on some sources may be provided.

For those aged 25+, Work Based Learning for Adults, which can be taken up after six months on benefits, provides a route into self-employment. This provides a paid allowance equivalent to benefits received plus £10 a week for the first 13 weeks of training.

For the unemployed over 25 who have been on benefits for 18 months or more out of the last 21, the New Deal 25 plus is available. This provides the same support for self-employment as the New Deal for Young People.

Under the New Deal for those aged 50+ the self-employment option provides an Employment Credit in the first 12 months when starting a business (up to £60 a week tax free on top of earnings) and a training grant of up to £750.



Of the New Deal schemes only the New Deal for Young People (NDYP) has been established for long enough to allow any useful evaluation. Reviews have suggested that the scheme has had a positive impact on moves into employment and overall shows a positive economic return<sup>22</sup> though there has not yet been an in-depth review of the self-employment route. Two observations can be made on the self-employment routes.

First, take-up of self-employment by those on NDYP is very low. Since its introduction (January 1998–March 2001), 3,652 have entered the self-employment option out of a total of 628,500 who have been on the NDYP programme, of which 149,400 have gone into unsubsidised employment and 230,100 have taken a gateway option. The 0.5% take-up of self-employment by those on NDYP is a small fraction compared with the national proportion of 13% self-employed or the 9% of people who have moved off JSA into self-employment.

Second, the number on NDYP who go on to fully fledged self-employment following the test trading period is particularly low at 22% (though these figures are subject to some recording biases as they may not record all those going on to self-employment; the proportion rises to 31% if only those from confirmed destinations are counted). The WBLA had a much higher success rate with around 62% of those who have gone through the WBLA self-employment route going on to self-employment at the end of 13 weeks. However, this is still less than 1% of those who have gone through WBLA and there are no figures on the subsequent success of those in self-employment.<sup>23</sup>

This suggests that neither the self-employment options under the NDYP nor the WBLA are having the desired impact in terms of take-up or, for the NDYP, success rates. A Bank of England report reached a similar conclusion on the NDYP self-employment route using earlier data.<sup>24</sup> Part of the explanation for low take-up of NDYP figures relates to the 18–24 year old group which nationally has a lower proportion in self-employment. This is partly a result of a ratcheting up of the proportion of the self-employed over time as people move into self-employment and then remain self-employed, but also older people are likely to have more skills and the confidence needed for self-employment. Of course, with self-employment at around 2.4% of all employment for 16 to 24 year olds, it is still much higher than the 0.1% successfully completing the NDYP self-employment route.

It also appears that self-employment may be less actively marketed than other elements of the New Deal. For example, it is not one of the four main New Deal options, but a subset of subsidised employment. New Deal Personal Advisers should generally explore the self-employment route along with other options in discussions with New Deal clients, but clients may still not get sufficient information and advice on this possibility. The lower take-up of the WBLA is partly because the scheme was run on a regional, voluntary basis by the TECs until April 2001 and was not available nationally. Following the transfer of the WBLA to the Employment Service and the introduction of the New Deal for 25 plus there should now be a more systematic and coherent system of support for self-employment. There is evidence that take-up of the New Deal for 50 plus self-employment option is rather higher at

<sup>22</sup> 'No More Skivvy Schemes? Active Labour Market Policies and the British New Deal for the Young Unemployed in Context', John Van Reenen, NBER conference 'Seeking a Premier League Economy', May 2001.

<sup>23</sup> Sources: Employment Service for data on take-up and success of schemes and Labour Force Survey for age breakdown on self-employed in work and unemployed by age and duration.

<sup>24</sup> *Finance for Small Businesses in Deprived Communities*, Bank of England, November 2000.

around the national average, which may reflect the more generous support under this scheme as well as higher take-up of self-employment by this age group.

Self-employment is not for everybody and it may be less appropriate for those who have been unemployed for some months. In areas of high unemployment there may be a greater number of unemployed high skilled workers, but those who have been unemployed for longer may have fewer skills. It would not be desirable to push self-employment on people for whom it is not suited. Furthermore, the self-employed jobs that some of the unemployed are moving into are in low growth, mature markets with high levels of competition and low wages, e.g. taxi drivers. These jobs may have significant displacement, with the new entrants resulting in others in the market moving out of self-employment.

Of those entering self-employment from unemployment around half will cease trading in one year. But for the majority of those who stop the experience has been beneficial (see Kellard and Middleton).<sup>25</sup> Many who leave are doing so to move back into paid employment using skills acquired while in self-employment. For some, however, self-employment may end in business failure, debt and even family breakdown. Overall self-employment can be a valuable and effective route out of unemployment and exclusion for many people.<sup>26</sup>

Other schemes for helping the unemployed into self-employment have shown high success rates. For example, Cowling and Hayward<sup>27</sup> find high success rates for one training provider's self-employment

programmes with 78% of participants going into self-employment. The Prince's Trust provides low interest loans of up to £5,000 for those aged 18–30 and annually makes over 4,000 awards. Half of these are targeted at the unemployed (a greater proportion at the longer-term unemployed). The scheme has success rates of 70–90% after one year and 60% after three years for those going into self-employment. This may in part reflect the selection process with funding targeted at the more enterprising applicants, though the provision of finance and ongoing support from a mentor will also be important. It does show that even for younger adults from disadvantaged groups, self-employment can be successful. There is a commitment from government to support business start-ups through the Prince's Trust. The Department for Work and Pensions (DWP) has made £50 million available over the next seven years on a match-funding basis.

#### 5.4.4 There are three reasons for change

In considering the case for making greater use of loans for the unemployed moving into self-employment or starting a business, there are three key questions.

**Is there a financing gap for the unemployed in accessing funding for starting a business or moving into self-employment?** The size and significance of any financing gap is difficult to determine, but there is a body of evidence that agrees there is a problem for the unemployed, particularly for those from disadvantaged groups and areas. (See Box 5.4.4(a))

<sup>25</sup> *Helping unemployed people into self-employment*, Kellard and Middleton, 1998 and ILO report.

<sup>26</sup> See *From Unemployment to Self-Employment: The Role of Micro-Finance*, Hilary Metcalf et al, National Institute of Economic and Social Research (NIESR) report for the International Labour Organisation (ILO), 2000; *Self-employment and the Unemployed: The Role of Public Policy*, Hilary Metcalf, Policy Studies Institute, 1997; *Small is bankable: Community reinvestment in the UK*, Ed Mayo et al, Joseph Rowntree Foundation (JRF), 1988.

<sup>27</sup> *Out of Unemployment*, Marc Cowling and Rachel Hayward, Research Centre for Industrial Strategy, 2000.



### *Box 5.4.4(a): There is evidence of a financing gap for some of the unemployed starting a business*

There is a large body of literature on the size and significance of financing gaps. There is a general consensus that where banks face limited information and applicants have insufficient collateral there is likely to be credit rationing. Limited or poor credit ratings are typically a key characteristic of unemployed people, particularly those in disadvantaged groups or areas. The lack of savings and security is now less significant as much lending is unsecured. But this has been associated with the growth in use of credit scores, under which the unemployed generally fare badly. Determining the scale of the problem is difficult, but the PAT 3, ILO and JRF<sup>28</sup> reports have all concluded there are problems for the unemployed in accessing finance, particularly for those in disadvantaged areas and groups such as ethnic minorities, women, young people and ex-offenders.

Where financing from banks is not available then support through micro-finance may be possible. A number of micro-finance organisations do target their support at unemployed and disadvantaged groups. However, research for the JRF concluded that Community Development Finance Institutions would only partially meet the financing gap. Similar findings were made by research for the ILO<sup>29</sup> which concluded that the coverage of micro-finance between regions and areas is patchy and schemes are of variable quality. The main gaps in provision are confined to areas of lower unemployment in England (the South East, Eastern England and the Midlands). But in other areas the unemployed may have difficulty accessing finance, for example where fees are charged for advice or other funds are needed (as required with around half of the micro-finance support).

Research for a Bank of England report has suggested a significant latent demand for self-employment in deprived areas which is constrained by lack of finance.<sup>30</sup> The problems with accessing finance for the unemployed moving into self-employment have been given some support by views from

the Employment Service. Focus groups undertaken with NDYP participants for the project also showed strong support for the principle of government loans as a way of accessing finance (See box 5.4.4(b) and working paper 3).

<sup>28</sup> *Enterprise and Social Exclusion, National Strategy for Neighbourhood Renewal, Policy Action Team 3, Treasury, 1999.* See footnote 26 for other references.

<sup>29</sup> *From Unemployment to Self-Employment: The Role of Micro-Finance, Hilary Metcalf et al, NIESR report for the ILO, 2000.*

<sup>30</sup> *Finance for Small Businesses in Deprived Communities, Bank of England, November 2000.*



### *Box 5.4.4(b): Focus group research*

Opinion Leader Research carried out a number of focus groups for the project (see working paper 3). This included a group of people who had started businesses in Newham and two groups of participants on the New Deal or WBLA. One of the latter groups was 18 to 30 year olds and the second 30 to 50 year olds. Key findings were:

- **Business start-ups** – finance was an issue – most had used banking loans and generally had good relationships; very little awareness of government sources of support or advice, e.g. Business Links or alternative sources of micro-finance (one person had been on a Prince's Trust scheme). This group had some concerns about the motivational impact of income-contingent loans, given the weaker incentives than fixed repayments and the scope for fraud.
- **New Deal participants** – most had poor relationships with banks and finance was seen as a constraint, though many were reluctant to go into debt. Not surprisingly the idea of loans in place of the benefits and allowance was not attractive.
- Some evidence that these participants were quite cautious about self-employment and were not as proactive as the business people in Newham. Some of the business plans appeared to be of marginal viability.
- Most were aware of the Prince's Trust via their New Deal Personal Advisers and were exploring finance, though this would not be suitable for everyone – funding would not be given for some purposes.
- Very keen on low cost loans to help provide working capital as finance had been a problem. Income-contingent repayment was attractive.

**Will existing micro-finance initiatives remove this gap?** A further issue is the extent to which initiatives, such as the Phoenix Fund and the proposed Community Investment tax credit, will enable micro-financing to meet all the financing needs of the unemployed. These will certainly be important, particularly if accompanied by further efforts to improve the co-ordination of schemes and the provision of local information on sources of finance. The Small Business Service (SBS) is working on this. However, there may be some problems with comprehensive provision through Community Development Finance Institutions (CDFIs). For example, Aspire in

Northern Ireland estimates there are over 100 soft loan funds in Northern Ireland, but these typically have a default rate of over 30% for loans and many of these loans funds are disappearing as capital funds are quickly exhausted. Recent research has suggested similar findings across the UK and it is unlikely that there will be universal coverage of micro-finance for all areas and all groups in at least the next few years. A report by NEF concluded that while there had been some successes, the performance amongst most soft loan funds had been weak and many had closed down altogether.<sup>31</sup>

<sup>31</sup> 'The Performance and Transformation of Soft Loan Funds in the UK,' Now Economics Foundation, Sam Collins, Thomas Fisher, Ed Mayo, Andy Mullineux and Danyal Sattar, 2001.



Therefore, it may not be possible to meet all the financing needs of the unemployed wishing to start a business through existing and proposed developments in micro-finance.

**Would government support through additional access to loans make self-employment and business start-up programmes more successful?** There are several reasons why government loans may have beneficial impacts on the take-up of schemes and particularly the number who go on to self-employment.

First, as discussed above, government loans may address financial market failures in dealing with higher risk groups such as the longer-term unemployed, who may not obtain financing even where they have viable business plans. Work by Crowley and Bainton for the ILO<sup>32</sup> showed that survival rates for businesses are positively related to the amount of start-up funding, and businesses started by the unemployed are more likely to be underfunded.

Second, for all those embarking on self-employment there are issues around the uncertainty in the early stages and the loss of a regular income, particularly at the end of 'test trading'. The ILO report highlights the need to limit the adverse consequences of serious business failures. It concludes that government should provide loans to counter any remaining discrimination against the unemployed and that greater flexibility on repayment would assist survival. The Social Investment Task Force has also referred to the generally risk averse UK culture and the difficulties around moving from benefits to enterprise.

This all points towards the need to overcome risk aversion but also to mitigate the consequences of failing. Income-contingent

loans could address both these needs. They have lower risks than fixed loans and are more likely to encourage take-up but also limit the adverse consequences of failure. It would be easier for government to provide income-contingent loans than the private or voluntary sectors.

Third, commercial finance will not take account of wider external economic benefits or social benefits of reducing unemployment. In particular if loans are targeted at skills shortages there may be further external benefits to the economy which would not be fully reflected by commercial decisions to provide finance.

Of course, improving the take-up and success of the self-employment routes under the New Deal and WBLA will depend upon a range of factors. In particular better information and marketing from Employment Service advisers will be crucial as well as good advice on business planning early on in the process.

#### ***5.4.5 The loan proposal is to provide a facility for a loan under the self-employment options of the New Deal and WBLA schemes***

Loans for self-employment could be used for two purposes. First, to provide working capital, e.g. for the purchase of equipment, tools or a van. Second, to provide bridging finance to help cover the transitional period of moving off benefit when income from a new venture is not stable.

For small-scale finance for the self-employed, loans are probably the most effective means of intervening compared with the other instruments in Box 3.5(b). If these are on an income-contingent basis they have some similarity to risk capital or repayable grants.

<sup>32</sup> 'Business survival factors: What ensures success of self-employment by the unemployed and low income groups?', T. V. Crowley and C. S. Bainton in *From Unemployment to Self-Employment: The Role of Micro-Finance*, Hilary Metcalf et al, NIESR report for the ILO, 2000.

There are a number of ways of providing loans:

- First, income-contingent loans could be provided. If these were consistent with student loans then they would be repaid at a rate of 9% of income, once income exceeds £10,000 per year. To maximise take-up and success a zero real rate of interest could be provided.
- Second, income-contingent loans could have a real rate of interest, e.g. of 3.5%. This would have advantages in lowering the cost, reducing distortions with the self-employed accessing commercial loans and providing stronger incentives to repay. In this case repayment might start at a much lower income threshold to stop the debt building up.
- Third, fixed repayment loans could be used. This might be required if loans were to be provided and collected by the commercial sector rather than directly by government. This might have advantages in providing stronger incentives for repayment and avoiding any problems with reporting of income. Some flexibility might still be built into the loan by allowing a repayment holiday for the first year of trading and in situations of financial hardship.

Options for change include four (not mutually exclusive) variants of the loan:

- **Additional loans to provide start-up capital and assist income bridging after six months** – larger-sized loans of up to £5,000 payable in flexible instalments after a 12-month period, though average loans should be much lower (typically £500 is the average loan needed for starting a new business). A bridging loan would help cover the period after test trading, and help meet concerns

by some that the test trading period should be extended. For example, overseas the schemes and support are generally extended for longer periods, up to two years in some cases.

- **Targeting loans** – there are a number of ways in which loans might be further targeted:
  - Loans could be directed at specific population groups, where there are problems accessing finance. The most obvious gap here is for those aged between 25 and 50. The New Deal 25 plus option is not available until these adults have been out of work for 18 months and the WBLA provides less support. The Prince's Trust provides financial support for 18–30 year olds, but for those over 30 access to finance can be more difficult as there is no obvious national scheme. For those over 50, finance is less likely to be a constraint (see ILO report) and the New Deal for 50 plus is available. That said, there might still be benefits and administrative advantages from extending any loan to cover everyone from 25 or 30 years old.
  - Target loans at specific disadvantaged areas. These areas may already have good networks of support organisations, though they will also have the greatest problems.
  - The qualifying period for the self-employment routes could be shortened, perhaps to three months. To make self-employment more widely available at an earlier stage, loan finance could be offered instead of the allowances that are provided at six months. Evidence suggests that people are likely to be more motivated at this stage and still have work-related contacts. The major



drawback with this is that it would have high deadweight costs, given the high numbers leaving unemployment into self-employment or other work.

Of the options for targeting, focusing the scheme on those above 24 on WBLA or New Deal 25 plus schemes looks most promising.

- **Link to training** – loans could also be offered to those in unemployment wanting to undertake training in areas of specific skills shortages and then move into self-employment or paid employment. Specific skills gaps have been identified in the National Skills Task Force report such as gas fitters, electricians and IT technicians. To be successful a vocational qualification is needed that is also professionally recognised and a period of supported training typically provided by an existing business is needed. There is some evidence that existing support may not be sufficient to fully meet all these needs for some skills shortages, and in particular that small businesses are reluctant to provide training for free. There could be significant benefits from loans to help bridge these financing difficulties.<sup>33</sup> Returns to individuals undertaking these schemes would be on average much higher so it would be easier to repay a loan. Any scheme should have much lower displacement impacts than other employment support and is likely to have wider external benefits for the economy from removing skills shortages. This might involve looking at the support provided by the New Deal and WBLA training options, though issues are wider ranging than these schemes.

- **Replace existing grants with a loan** – the additional allowances received under the New Deal and WBLA could be replaced with a loan. This would save public resources and provide a strong incentive to ensure that only those people with good prospects of success would take the self-employment route (given the current low success rates of those going onto the scheme). However, this would have a major detrimental impact on take-up and would result in a big fall in the already low numbers taking the self-employment route. This would detract from the wider objectives of encouraging the unemployed into work. It would also tilt the playing field against the self-employment route given the existing support for other employment options. The administrative costs of a loan might make this less attractive than a grant given the relatively small size of the allowances (equivalent to a grant of up to £400).

It is important that any package also provides advice and support on managing the loan. This should be part of the more general business advice and mentoring which is often the most important business requirement. Mentors can help to identify loan repayment problems at an early stage and enable action to be taken to address them.

A key factor will be how any scheme is administered. The administration costs, likely repayment levels and defaults will be highly dependent on what systems are available for administering loans. Possible ways of recovering government loans would be through the self-assessment process, as currently used for paying off student loans by those in self-employment, or under the possible new loans administration system for individuals discussed in chapter 6.

<sup>33</sup> This has links with the transferable training loans scheme (see appendix 3, section A3.3.5) which is being developed in specific sectors such as the gas industry. Transferable loans will be suitable where the loan can be linked to a certification process and there is a well established national training organisation. In many cases this will not be the case and there appears to be a good case for government providing loans.



There are alternatives to government directly providing loans, which include:

- Extension of support through micro-finance. This is already starting to happen through the Phoenix Fund and the proposed tax credit. Further rounds of support under the Phoenix Fund, etc., might have criteria for funding decisions to favour those CDFIs targeting loans on the unemployed moving into self-employment.
- Lowering the minimum size of loan (currently £5,000) covered by the Small Firms Loan Guarantee Scheme (SFLGS) could also enable more commercial lending for those moving into self-employment. There will be benefits through multiple channels for accessing finance, from banks, Prince's Trust and other CDFIs.
- A loan guarantee for the commercial banks, but with lower interest rates and an interest repayment holiday and flexibility over repayments in early years.

A further option would be to explore the scope for Public Private Partnerships, where government-financed loans are combined with private sector infrastructure and possibly use public support to lever in private finance.

There are a number of advantages of commercial channels. First, establishing relationships between the self-employed and commercial lenders early on will facilitate the provision of commercial finance at a later stage. Second, using the commercial sector's risk assessment and repayment systems may be more efficient. If public support can lever in private money this will also reduce the financing cost for the public sector.

The drawbacks may be that there have been difficult relationships between some banks and some groups of unemployed, and problems where commercial pressures may mean that bank lending does not cover all the groups it would be beneficial to support. This might be mitigated through the loan guarantees and using business advisers or mentors to facilitate interaction with banks.

The merits of government loans will depend on whether the Government is able to develop efficient administrative systems (see chapter 6) that can provide income-contingent loans at a low cost to targeted groups. Even if loans and repayment are directly made by government, it would be important for the process to foster good links between self-employed and banks or other financial organisations. If this is some years off then the case for working through existing commercial and voluntary channels is that much stronger. In particular a scheme working with commercial banks providing a loan guarantee and a repayment holiday and flexibility in early years could be explored.

#### ***5.4.6 An assessment suggests there are a number of promising options***

Table 5.4.6(a) shows an assessment of these options against the criteria. This considers the case for intervention through loans compared with the existing New Deal scheme. There would be a very good fit with the first set of criteria on whether government should intervene.



**Table 5.4.6(a): Options for change – how do they fit with the criteria?**

Criteria for intervention in the form of loans <sup>34</sup>				
Criteria	Options			
	Provide further low cost loans	Targeted 25+	Linked to training	In place of grants
Loan provides an effective way to deliver government objective	✓✓ Likely to have a beneficial impact on success of self-employment schemes.	✓✓ Likely to have a beneficial impact on success of schemes.	✓✓✓ Should be effective in meeting skills gaps and reducing unemployment.	X Given negative impact on take-up of self-employment schemes.
Loan provides an efficient way to target government resources	✓✓ Better vfm than grants.	✓✓ Better vfm and potentially loans targeted at major gap.	✓✓✓ Better vfm and potentially loans targeted at most serious gap.	✓✓ Will have better vfm than grants.
Reasonable expectation that borrower can repay	✓✓ If business succeeds then will be able to repay.	✓✓ If business succeeds then will be able to repay.	✓✓✓ Given higher income resulting from professional qualification/skills.	✓✓ Lack of grant may impact upon business success, though should only have strongest business cases.
Loan promotes positive incentives	✓✓ Only those with robust cases and motivation pursue. Incentives to succeed to repay loans.	✓✓ Only those with robust cases and motivation pursue. Incentives to succeed to repay loans.	✓✓ Only those with robust cases and motivation pursue. Incentives to succeed to repay loans.	✓✓✓ Ensures that only those with robust cases and motivation pursue. Incentives to succeed to repay loans.

**Key:** x no fit under the criteria, ✓ acceptable, ✓✓ good, ✓✓✓ very good.

<sup>34</sup> When considering the criteria for intervention in the form of loans, the counterfactual here is intervention through grants under the existing New Deal and Work Based Learning for Adults programmes.



Assessing this scheme against the criteria suggests that some of the options do look attractive. A more general loan for facilitating a move into self-employment performs well and is looked at in more detail. Replacing the allowance with a loan has not been pursued further, given the detrimental impact upon the take-up of any scheme. The option of providing loans to specific vocational training to help fill skills shortages for the unemployed moving into self-employment (or paid employment) might be particularly effective. However, more work is needed on the extent of financing gaps and links with current developments. This option has not been modelled; the Learning and Skills Council (LSC), the DWP and the PIU project on Workforce Development are looking at schemes for providing support for training to fill local and national skills shortages.

More detailed analysis of the costs and benefits is set out in tables 5.4.6(b), 5.4.6(c) and 5.4.6(d). This looks at a loan for different target groups. The benefits in terms of the extra unemployed taking up a self-employment scheme, the number who successfully go on to self-employment and the overall impact on net job creation (allowing for displacement) are difficult to quantify and depend upon some tentative assumptions. The analysis indicates the potential costs and impacts of a loan scheme and identifies the key issues for targeting and designing a loan scheme.

A loan of £2,500 has been used (based upon the average Prince's Trust loan of £2,200) paid back either on an income-contingent or mortgage style basis at a real interest rate of 3.5%. Any loan scheme should be linked with further marketing and advice for self-employment routes, which will all help to boost take-up. Upper and lower estimates have been presented. The upper estimate assumes that the proportion of those from the New Deal for Young People, New Deal 25 plus and WBLA taking the self-employment route would be half the respective national average for these age groups and at the national average for the New Deal 50 plus given their current higher take-up. The lower estimate assumes 1% of those on New Deal for Young People take self-employment, 1.5% of those on the New Deal 25 plus and WBLA and the proportion is unchanged for those on the New Deal 50 plus. It is assumed that the success rate of those going into self-employment following a New Deal or WBLA scheme would be similar to success rates under the Prince's Trust scheme.



**Table 5.4.6(b): Cost and cost-per-job estimates of loan schemes for the unemployed moving into self-employment – loans for New Deal and WBLA**

	Option – loans for New Deal and WBLA			
	ICL <sup>1</sup>		MS <sup>2</sup>	
	Lower	Upper	Lower	Upper
Number taking out loan (000s)	5.8	14.1	5.8	14.1
Number of new participants	1.7	10.0	1.7	10.0
Loan paid out (£m)	14.6	35.3	14.6	35.3
Loan recovered NPV <sup>3</sup> (£m)	13.2	31.8	11.6	28.0
RAB cost <sup>4</sup> (£m)	1.4	3.5	3.0	7.3
Cost per participant (£)	244	244	517	517
Cost per additional job (£)	847	346	1,793	733

Notes:

- <sup>1</sup> ICL = income-contingent loans. Central case assumes £2,500 loan at 3.5% interest rate, with repayment at 9% of income above a £5,000 threshold. A default rate of 1% a year has been used, as defaults are lower with ICLs.
- <sup>2</sup> MS = mortgage style loans – fixed repayment loans over six years, repayable after one year at 3.5% interest rate, with further one year repayment holiday for 10% of recipients. Assumed default rate of 3% per annum. The demand for loans is invariant to the type of loan.
- <sup>3</sup> Net present value of loan repayments, based upon 6% public sector discount rate. Repayments have been modelled using four typical cases, weighted to provide the overall income distribution.
- <sup>4</sup> This is the cost of the loan in terms of subsidy (difference between interest rate and cost of capital) and bad debt (equal to the loan capital minus the discounted value of repayments).



The upper estimate assumes that overall there would be 14,100 people on different self-employment schemes taking out loans, and of these 10,000 would be new participants. The lower estimate assumes around 5,800 participants of which 1,300 would be new. Therefore, the upper estimate involves greater expenditure, but with a lower cost per additional job. Conversely, the lower estimate entails less overall

expenditure, but much higher costs per additional job, reflecting the higher relative deadweight costs of providing funding to the 'existing' participants. Under these scenarios the income-contingent loans have lower costs than mortgage style loans, though this is highly dependent upon the exact design of loan schemes and assumptions on income of the self-employed.

**Table 5.4.6(c): Cost and cost-per-job estimates of loan schemes for the unemployed moving into self-employment – targeted at 25+**

	Option – targeted at 25+			
	ICL		MS	
	Lower	Upper	Lower	Upper
Number taking out loan (000s)	5.4	13.7	5.4	13.7
Loan paid out (£m)	13.6	34.3	13.6	34.3
Loan recovered NPV (£m)	12.3	17.5	10.8	17.5
RAB cost (£m)	1.3	3.1	2.8	3.6
Cost per participant <sup>1</sup> (£)	244	244	517	517
Cost per additional job (£)	983	348	2,082	737

Note:

<sup>1</sup> The cost per participant remains the same across options, as the income distribution and repayment schedules are assumed to be the same across the different New Deal and WBLA groups. The numbers of new participants vary across schemes, which generates the differences in cost per additional job.



Table 5.4.6(c) shows the cost estimates from excluding those below 25 from the scheme. The cost per job rises, as the modelling assumes the scheme would be relatively effective in improving take-up and success of

those in the New Deal for Young People group. Table 5.4.6(d) below shows the costs if the scheme is only available to those between 24 and 49 years old on the New Deal 25 plus or WBLA schemes.

**Table 5.4.6(d): Cost and cost-per-job estimates of loan schemes for the unemployed moving into self-employment – targeted at 25–49 year olds**

	Option – targeted at 25–49			
	ICL		MS	
	Lower	Upper	Lower	Upper
Number taking out loan (000s)	1.7	7.0	1.7	7.0
Loan paid out (£m)	4.4	17.5	4.4	17.5
Loan recovered NPV (£m)	3.9	15.8	3.5	34.3
RAB cost (£m)	0.4	1.7	0.9	7.1
Cost per participant (£)	244	244	517	517
Cost per additional job (£)	380	268	805	568

These results suggest that the scheme has significantly lower costs per additional job where the over 50s are not included. This is because numbers taking up the New Deal 50 plus are already rather higher than for other schemes, so many existing participants would take out a government loan if it was available on attractive terms. Excluding this group reduces these deadweight losses.

There would be extra scheme costs associated with any increase in take-up of the scheme for the additional allowances and training provided on the self-employment option. Therefore, any scheme would need to have resource cover for an increase in

take-up. However, most of these participants would have been receiving benefits and additional support under one of the other WBLA or New Deal schemes, so there may be no net increase in public sector costs. The analysis has not at this stage calculated the spending reductions from benefit savings from any job creation. This would reduce the cost per additional job. Nor has it calculated displacement impacts, where those entering self-employment result in some others moving out of work, which would increase the cost per additional job. Administrative costs have not been included, but are likely to be between 0.6% and 2.5% of the loan value.



Sensitivity analysis has been undertaken looking at different loan designs. Not surprisingly, for income-contingent loans the cost is highly dependent upon the threshold and the repayment rate as well as the income of those in self-employment. For the self-employed reported incomes of a significant proportion are quite low, and a threshold of £5,000 has been used for the base case. For mortgage style loans the assumptions on default rates and the repayment period are important. The modelling and a sensitivity analysis are described further in section A5.4 of working paper 2.

Overall, if the scheme does have a good impact on the take-up and of success rates under the New Deal and WBLA schemes and low administration costs then it is likely that the cost per job will represent good value for money.


#### ***5.4.7 Next steps are for more detailed analysis with the aim of piloting a loan scheme if supported by further work***

We recommend that DWP should consider the proposal of a loan for self-employment further, working with the SBS and DfES. This work would need to consider: the merits of a loan scheme along with other measures to improve the success of the routes from unemployment into self-employment; what form a loan should take and the best way of delivering loans through the public or commercial sectors. If the proposal is supported by more detailed analysis the aim would be for a scheme to be piloted in 2002.

## 6. THE ADMINISTRATION OF GOVERNMENT LOANS

### Summary

- There is scope for improvement in both the customer experience and the efficiency of loan administration:
  - for most government loan schemes, customers do not currently have the option of receiving information on loans or applying for loans online;
  - the process of applying for loans can be time-consuming. For student loans the customer must apply to more than one body;
  - customers must provide paper verification of identity and income, causing inconvenience for customers and slowing down the assessment process; and
  - the cost-effectiveness of government's debt recovery activities is mixed.
- The publicity, application and assessment steps in the loans' administration process should be improved by:
  - allowing customers to receive information and apply for loans online;
  - developing better links to ensure that customers can access government loan services through a variety of media; and
  - developing better IT links between government departments where information is required to verify entitlement. Better links will enable much of the assessment process to be automated, particularly where little discretion is required in deciding on eligibility.
- Where departments are currently considering how to improve existing loan administration (e.g. higher education student loans), this work should be informed by the principles set out in this chapter and by sharing good practice across government.

- 
- It is unlikely that significant benefits would accrue from greater joining-up of the administration of existing loans schemes. There are relatively few schemes, each serving a different purpose and customer group. However, if, in future, government loans were to be used in many different areas, the case for greater integration of loan administration may become stronger. There are likely to be much greater benefits from joining up the recovery of all debts owed to government (this might include, for example, unpaid taxes and fines).
  - A feasibility study should be undertaken to consider whether there would be overall benefits from, in the longer term, greater integration of government's debt recovery services and its financial transactions with citizens more generally. The study would be in two stages. The first stage of the study would be an assessment of the full benefits, costs, risks and practicalities of these proposals, to determine whether these proposals should be taken forward. If this showed that greater centralisation of the administration of debt recovery and/or other activities was worthwhile then, subject to Ministerial agreement, a second stage would look at the key implementation issues.



## 6.1 This chapter proposes improvements to the administration of loans funded by government

This chapter considers whether existing arrangements for administering government loans to individuals are customer friendly and efficient, and sets out a number of proposals for shorter and longer-term improvements to existing arrangements.

The project did not focus in any detail on the arrangements for administering loans to business. The Treasury announced a review of support for business last summer.<sup>1</sup> Large loan schemes, for example Launch Investment, are administered directly by the Department for Trade and Industry, and smaller-scale loans schemes are administered through the private and voluntary sectors, e.g. the Small Firms Loan Guarantee Scheme is administered through banks and the Phoenix Fund is distributed through Community Development Finance Institutions. These arrangements are described in appendix 3.

This chapter makes recommendations about the administration of loans only where government money is being lent and government is responsible for administering the loan. The proposals set out in this chapter do not therefore cover schemes such as Career Development Loans (CDLs) and Small Firms Training Loans, which are administered by private sector banks.

Where new loan products are introduced, the first question to be addressed is whether the administration can be handled most efficiently and effectively by the private sector. But there will be circumstances where government needs to be directly involved in the administration of loans (see section 3.5), either directly or in a partnership arrangement. If so, the administrative arrangements fall within the scope of this chapter.

The remainder of this chapter is divided into five sections:

- the case for change – the strengths and weaknesses of existing loans administration arrangements;
- criteria for evaluating current arrangements and future improvements;
- improvements to the administration of existing loan schemes;
- further ideas for improving administration of financial transactions between government and citizens; and
- next steps and implementation.

## 6.2 There are some shortcomings in existing arrangements for delivering loans to individuals

Many of the steps involved in making and recovering a loan are similar across all loan schemes. The generic process for the administration of loans is shown in box 6.2(a) below.

### Box 6.2(a): The generic process for making and recovering loans



<sup>1</sup> Treasury Press Notice 6701, 18 June 2001.

Appendix 3 describes the variety of government-enabled and government-provided loans currently available, and the many different ways of administering the variations around this generic process. Each of the schemes' administrative arrangements has a number of strengths and weaknesses.

Loan schemes have generally developed independently of each other and, prior to the commissioning of this project, there has been no opportunity to take a cross-departmental view of loan administration. It is therefore not surprising that inefficiencies become apparent when a holistic view is taken of existing arrangements for administering loans.

The rest of this section summarises some of the common shortcomings of current loan administration arrangements. They are also illustrated by the case study of student loan administration set out in box 6.2(b), though the issues raised in this box have already been identified by the Department for Education and Skills (DfES), which is developing plans to improve the administration of the student support system by streamlining the system in line with the Modernising Government agenda.

### *These shortcomings affect each stage of the loan process*

#### *Publicity*

For some loans there is no clear 'lead' in terms of who the customer should contact for information. For example, applicants for student loans may be unclear about whether to contact their local education authority (LEA) or the Student Loans Company (SLC). Local authority One Stop Shops and Call Centres often act as a point of contact for citizens to obtain advice and guidance on government schemes.

#### *Application*

For most loans the option of application through electronic channels is not available. Although student loan application forms are available through the Student Support OnLine Website, they still have to be printed and then returned to the LEA. It is also not possible for an individual immediately to determine their entitlement online.

For some loan schemes, the application process can ask for the same information on two or more occasions. For example, the application for a student loan is a staged process: students go first to their LEA to assess their eligibility and entitlement and then to the SLC to arrange the loan payment.

Applications are generally supported by clerical data entry, rather than by IT-supported data matching and data sharing. For example, completed application forms for Social Fund loans are entered manually by local office staff.

#### *Assessment*

Assessment of loan eligibility is often not well supported by IT. Determining eligibility for loans usually involves some sort of verification of income or benefit receipt requiring:

- applicants to submit information, e.g. student loan applicants must submit proof of parents' earnings; or
- the staff who process applications to move between the loan system and other systems to carry out independent checks. For example, staff processing Social Fund claims must enter data on to the Social Fund system and then come out of the Social Fund system to look at the Income Support system to check whether a claimant has received benefit for



### Box 6.2(b): Key issues raised by current arrangements for administering student loans

- Customers assessed twice by LEA – first for eligibility and then for means-testing. Customers then apply (a third time) to the Student Loans Company (SLC).
- SLC administers account, using returns from Inland Revenue (IR). Information and processes sometimes duplicated.
- SLC recovery procedures apply. These run independently of other government recovery efforts.



- Students obtain information about different elements of the loan process from different sources (LEAs and the SLC).
- Applications all paper-based, cannot be submitted online (applicants for student loans can complete but not submit their application online).
- First payments issued to student by cheque rather than by ACT.
- Deducted from payroll by employer, passed to IR, then SLC to reconcile account at year end. Deduction at source is effective and leads to low default rates, but issues can arise when payroll deductions not passed to IR. Timing mismatch in information flow creates accounting issues.

six months (which is a requirement of the scheme). This issue will be remedied in the next year or so by the rollout of the Early Office Infrastructure project to upgrade IT across the Department for Work and Pensions (DWP).

#### Payment

Currently, payment is made in a variety of ways. There is a general push across government to increase the use of automated credit transfer (ACT), which is more cost efficient than other forms of payment. However, for some loans, the move to ACT has yet to take place, adding to administrative costs. For example, students receive the first loan payment by cheque (when they register for their course) rather than by ACT. This is because under current audit rules there must be proof of registration before the first payment is made. In the absence of electronic links between the SLC and higher education (HE) institutions, meeting these requirements leads to payment by cheque being quicker than by ACT.

The issues set out in box 6.2(b) have already been identified by DfES, and plans are being developed to improve student loan administration by streamlining the system. Indeed, DfES and the SLC are currently developing and implementing a number of initiatives – see section 6.4 below for examples of good practice.

#### Loan account management and collection of repayments

There are variations in the efficiency of the various bodies administering government loans in terms of both cost and the success of loan recovery. This is partly because existing loan schemes are very different in terms of the purpose and the customer group they serve. Comparisons with private sector loan administration may also be misleading. For example, government loan schemes often have little choice about the loan applications they accept (there is typically some element of entitlement according to specified criteria), whilst there is much more discretion for private sector lending – and

this results in very different customer groups. Another difference is that government schemes often have to collect additional information about applicants' characteristics (e.g. gender, country of origin, employment status) to satisfy public spending scrutiny requirements, which can add to administrative costs. Finally, some government loan schemes, such as student loans, have systems of repayment that depend on the income/ability to repay of the recipient. These schemes tend to be more complex and expensive to administer.

Comparison of the administration costs of government loans schemes and those of the private sector does not, however, reveal significant differences. For example, using data for 1999/2000:

- student loan administration costs were equivalent to around 4% of new loans made. This amounts to just over 1% of the total loan book; and
- examination of the administrative expenses of a high street building society's unsecured lending were found to be equivalent to around 1.45% of new loans by value and a similar proportion of the loan book (these loans are typically short term, so new loans are similar in size to the total loan book).

### **Bad debt recovery**

The rate of success in recovering government loans and debt varies significantly between different schemes. For example, the Social Fund has a recovery rate of 97% as loan repayments are netted off against any future benefit repayments. This has proved highly successful, except when someone comes off benefit – then the loan repayments are more difficult to pursue.

There are also differences in the extent to which government pursues different debts. These differences are not always based upon any policy rationale, but are sometimes based upon local custom and practice.

Finally, there is no general guidance about the efforts that should be made to recover debt. In some schemes little effort was made to recover debts of a significant size, while others were effective in collecting even small debts.

## **6.3 Criteria were used to evaluate current arrangements and give guidance about future improvements**

Chapter 3 of this report suggested two criteria for evaluating the administration of government loans:

- customer friendliness; and
- efficiency.

The project team drew on these criteria and worked with the project's Advisory Group, Administrative Working Group and other stakeholders to develop a set of criteria for evaluating the administration of government loans in more detail. These are shown in box 6.3(a) below.

These criteria provide the basis for assessing proposals to improve the administration of existing loan schemes.



### *Box 6.3(a): Criteria for evaluating the administration of government loans*

Maximises value for money, for example:

- optimises trade-off between benefits, in terms of service quality and operational effectiveness, and the capital, running and transitional costs of changing administrative systems.

Feasibility and practicality, for example:

- takes account of existing systems of benefit administrations/tax collection, e.g. student loan repayments;
- maximises benefits of data-sharing whilst protecting privacy;
- takes account of current government strategies, e.g. e-government agenda, development of universal banking;
- considers wider benefits to government of joined-up loans administration, e.g. potential for joining up government debt recovery.

Simplicity, customer-friendliness and fairness, for example:

- customer-friendly;
- administratively simple;
- minimises burden on individuals and businesses;
- balances taxpayers' interests with fairness in approach to loan recovery;
- avoids stigma.

Minimises risks, for example:

- sufficiently flexible to support new IT developments;
- avoids technological lock-in;
- minimises commercial risks;
- minimises political risks;
- retains clear accountability.

## **6.4 There are a number of ways in which the administration of government loans can be improved**

Section 6.2 above sets out some of the shortcomings of existing schemes. Many of these shortcomings can be addressed on an incremental basis. The key issues for each stage of the administration process are set out in table 6.4(a).

Many of these new proposals are based on the wider application of 'best practice' lessons from other loan schemes. There are two key ideas that could usefully be more widely applied: online application facilities; and improved data-sharing between departments.

### ***Providing the facility of online application***

Online application for loans would create additional flexibility about where applications were made from. An interactive system would also enable applicants to get immediate feedback on whether they are likely to be eligible for support.

From spring 2001 a limited Internet application facility (developed with the London Borough of Camden and iMPower) has been in operation. This enables HE students to complete their application for student support online, although they still need to print off the completed form and post it to the LEA. DfES is considering the upgrade of this facility so that it allows students to submit their applications via the



Internet and is linked to other government departments such as Inland Revenue (IR), removing the need for students to provide validating documents such as P60s. DfES is also considering once-only collection, to facilitate the provision of a seamless service to students.

The option of online applications could be extended to other loans. This would be a natural progression in improving the access to government services, given the availability of the Government Gateway.

**Table 6.4(a): Proposals for incremental improvements to current loan schemes**

Process	Incremental improvements
Publicity/application	<ul style="list-style-type: none"> <li>• Continue to develop in line with UK online principles. Where loans are related to the provision of support for a 'life event' (as designated by UK online), information about the loan and the ability to apply for the loan online through the UK online portal (linked to the Government Gateway) should be available. (For further details of UK online, see box 6.4(b) below and working paper 2).<sup>2</sup> Appropriate links should also be maintained with local authority websites, which are often a key information point for citizens.</li> <li>• Departments might also wish to ensure that information and application forms are available through other portals (also linked to the Government Gateway) that might be developed, e.g. Student Support Online Website. Information about higher or further education loans might be provided as part of a wider package of information on education, e.g. through local authority websites.</li> <li>• The necessary links also need to be developed between the portals and the providers to ensure that customers have flexibility in terms of points of access and that information is passed between local authorities, government bodies and other agencies, as appropriate. The aim should be to minimise repetitive data input.</li> </ul>
Assessment	<ul style="list-style-type: none"> <li>• Links should be developed with other departments to collect information that might be required to support the application, subject to privacy requirements. This information might include information held by the Inland Revenue, data on benefit receipt, other government loans and any asset-matching schemes. These links will enable much of the loan assessment to be done automatically (rather like automatic underwriting for insurance). The automatic assessment will identify the exception cases requiring manual input. The movement towards automatic assessment will also provide greater opportunities for private sector involvement in processing loans.</li> </ul>
Payment	<ul style="list-style-type: none"> <li>• Increase the use of ACT, while allowing customers some choice over their preferred method of payment.</li> </ul>

<sup>2</sup> See [www.cabinet-office.gov.uk/innovation/home/home\\_nf.htm](http://www.cabinet-office.gov.uk/innovation/home/home_nf.htm)



A description of UK online is set out in box 6.4(a), and of the Government Gateway in box 6.4(b).

Box 6.4(b) shows the functions the Gateway could support and include:

- authentication of the identity of the applicant using his digital ID; and
- passing on the form to the appropriate department.

### *Improving data-sharing between departments*

The proposed links between the student support system and IR for the verification of income data supplied by applicants for student support could also be applied more generally to other loans. Furthermore the development of direct links between the Social Fund system and the Income Support system would speed up processing time. Key issues to be addressed in moving in this direction are how these proposals might fit

with current programmes to enhance IT, and privacy. Further details of the privacy issues to be addressed are set out in box 6.4(c) below.

‘Wiring up’ in the ways suggested above will deliver improvements to:

- customers, e.g. the availability of online applications will improve access and the links between departments will reduce the amount of paper verification required; and
- departmental efficiency, e.g. improved data-sharing between departments will enable the movement towards greater automated assessment of eligibility.

### *‘Wiring up’ the front end of the loan administration process is in line with Government’s e-strategy*

Some of the incremental changes within government departments and bodies providing loans will result in moves in this direction. Section 6.2 contains an example of

#### *Box 6.4(a): UK online*

The Government has set out a vision of citizens at the centre of service delivery. As part of this vision, Government has launched a campaign to make all its services available online.

Ukonline.gov.uk and the Government Gateway are the two key building blocks for realising this vision. Ukonline.gov.uk is a website that all citizens may access at any time. It is intended to be the primary means of accessing government services, and the place to which people will go to interact with Government. As well as providing general information about government services, the website also allows the citizen to communicate directly with government departments.

The services on offer are organised around key ‘life events’. These include having a baby, getting married and moving house. Other life events are being added, for example services connected with ‘looking after someone’ have been introduced. The portal has been designed to be easy to use, and is secure and confidential.

Ukonline.gov.uk will not be the only portal into Government. The strategy envisages that other portals, such as those established by local authorities, will exist alongside UK online, as Government enters into partnerships to deliver high-quality services.



### *Box 6.4(b): The Government Gateway*

When conducting transactions with Government, citizens should not need to have to understand the intricacies of how Government is organised, or where departments are actually located.

The Government Gateway is designed to act as a routing service, taking requests from a variety of portals or applications, including [ukonline.gov.uk](http://ukonline.gov.uk), and posting them to the right part of Government. It can also do this in reverse, sending departmental communications back to citizens and businesses.

The Gateway's primary role is to authenticate identities to protect the security of Government transactions and ensure privacy for the user. The Gateway performs a vital role in creating an online, citizen-oriented interface with Government, allowing any and every transaction to be completed using a single password or digital certificate.

The Gateway will also facilitate the opening up of other electronic services and make available to the citizen some of the valuable information assets held by Government.

some of the plans of the DfES to streamline and improve the customer experience of student loans. The proposals set out in table 6.4(a) above will require:

- departments buying in to the advantages to be gained from implementing the new arrangements;
- departments agreeing priorities and objectives for moving in this direction, taking into account the strategic joining-up of services;
- the continued rollout of UK online and the Government Gateway;
- for each loan, departments and local authorities will need to work together to develop a clear set of responsibilities and accountabilities for each step in the loan process, i.e. ensuring that there is clarity about roles for publicising loans, providing information to customers to help them with claims, and receiving and assessing claims. Where appropriate, service level agreements will need to be developed and put in place;
- each body responsible for each of the steps in the process will need to ensure that it has developed a clear set of procedures for delivering this function and that its staff have the necessary skills;
- further exploration of privacy issues (set out in box 6.4(d)) to remove (where desirable and feasible) barriers to government joining up data on citizens as and when required to verify a claim – thus reducing the amount of paper verification and manual processing required, so speeding up processing time; and
- working out requirements for any changes in staff numbers or staff skills resulting from the changes.



### **Box 6.4(c): Data-sharing**

#### *What's the issue?*

Legislation restricts the purposes for which information can be used. There are three key areas of legislation:

- Article 8 of the Human Rights Act 1998 gives 'everyone the right to respect for his private and family life, his home and his correspondence' and hence has implications for the collection and use of information concerning an individual;
- The Data Protection Act 1998
  - restricts the way personal data can be collected, handled and disclosed
  - requires there to be a lawful basis for data-sharing; and
- The Freedom of Information Act 2000 will provide the right of access to information held by a public authority.

#### *Does current legislation pose an insurmountable obstacle to this report's proposals?*

The Data Protection Act 1998 does not prohibit data-sharing, provided that it is carried out in accordance with the Act's data protection principles, which include requirements for personal data to be processed fairly and lawfully and in compliance with certain prescribed conditions.

A public authority may not interfere with the right to privacy in article 8 of the Human Rights Act unless the derogation in that article applies, and the intervention is 'proportionate and necessary'. Data-sharing between public authorities is also limited by the administrative powers that public bodies have to collect, hold, share and use personal data. These powers differ for government departments, statutory bodies and organisations based on common law.

The forthcoming PIU report on Privacy and Data-Sharing<sup>3</sup> discusses these issues in more detail and makes recommendations to enhance the existing arrangements for data-sharing by public bodies, subject to certain safeguards.

## **6.5 There may be limited scope for greater joining up of the 'back-end' administration of existing government loan schemes**

So far, our recommendations on improvements to the administration of existing government loan schemes have been focused on the 'front-end' (publicity,

application, assessment and payment). However, there may also be scope for improvement to the 'back-end' of loans administration (management and recovery).

Because loan schemes have developed independently of each other, different government bodies have separate policies on the pursuit of loan repayments and outstanding debts. Although some of these differences result from conscious decisions,

<sup>3</sup> The report has not yet been published.



### Box 6.5: A Single Citizen's Account

Conceptually, a Single Citizen's Account (SCA) is a mechanism for bringing together details of payments to and from Government and other information for each individual. An SCA might enable payments to government to be set off against payments from government.

The possible advantages of an SCA include:

- It might allow a **simplification of administration of taxes and benefits**, improving efficiency and reducing costs.
- It would allow **more coherent information to be given to the individual** about their tax, National Insurance Contributions and loans. Annual statements would be possible, showing annual inflows and outflows from the SCA. This might improve understanding of the tax system and the individual's relationship with state support.
- If the Government were to make more use of loans, then an SCA would allow Government to take a cross-departmental view of the individual's financial position – **preventing over-indebtedness** to government.
- On an operational level, there could be reduced duplication of processes such as debt collection.
- The SCA might allow more flexibility in the design of future policies. More sophisticated control and tracking of payment flows might allow the greater use of loans and asset-based policies, such as so-called 'baby bonds'.

others have arisen due to the lack of a holistic view of debt recovery across government. Clear guidelines need to be developed across departments, setting out the priority with which different government loans and other debts should be recovered.

In order to reduce costs of loan administration, a series of reviews of the administration of each loan scheme could be carried out, identifying best practice for use in other schemes. These reviews would need to take a close look at the processes, systems, staff skills, structures and cultures of those responsible for administering the loans. They should also consider whether some of the services might be more cost-effectively delivered by the private sector (some debt recovery services are already carried out by private contractors).

However, a more far-reaching alternative would be to co-ordinate centrally the administration of account management and loan recovery functions for different loan schemes, either 'virtually' (through establishing electronic links between the different administrative systems) or 'institutionally' by establishing a single organisation. Given the similar processes, staff and skills involved, there could be economies of scale associated with centralisation.

Although attractive in theory, the Performance and Innovation Unit do not believe that, in practice, centralisation would bring significant gains. The difficulty is that the schemes involve very different client groups, and are operating on a small scale. Some economies of scale are possible to



envisage with student loans and Career Development Loans (CDL) (which are loans for a similar purpose collected from similar client groups); however, the involvement of the banks in the administration of CDLs makes this impractical.

For other existing government loans, the client groups and rules governing these schemes are very different and limit the scope for integration. For example, survey evidence indicates that there is no overlap between the group taking out a Social Fund loan, and the group taking out a student loan. There may also be problems of accountability, since policy on loan administration might be spread across a number of departments.

However, if the number of government loan schemes were to be increased, especially if they were extended to groups that already hold other loans, there may be greater gains to be realised. Additionally, it is possible to envisage greater gains if recovery of all types of debts to government held by citizens is considered. This would include, for example, recovery of unpaid fines or taxes, or overpaid benefits, as well as loan repayments. The scale of these total debts to government is clearly much larger than simply unpaid loan repayments, and the potential gains from improving the systems of recovery are therefore proportionately higher.

More speculatively, and in the longer term, there could be further gains from integrating the administration of all financial transactions between government and citizens (which could include taxes and benefits as well as loans) – see box 6.5 above. However, such proposals go beyond the scope of this report, and further work would be necessary before coming to any firm conclusions.

## 6.6 A feasibility study on the gains from joining up is needed

A feasibility study should be commissioned to determine whether there are gains to be realised from joining up and centralising the administration of financial transactions between government and citizen. In the first stage of the study there should be an examination of the costs, benefits and risks of two central proposals:

- the management and recovery of all debts to government (including those arising from government loans) administered by a single organisation; and
- the establishment of a single citizen's account through which all financial transactions (which might include tax and benefit payments as well as loans and other debts) between government and citizen could pass.

The feasibility study should also consider the following issues:

- the priority of repayment afforded to government debt compared with other debts;
- explicit consideration of how far to go in recovering debt, and guidance on 'best practice'. At present some government bodies go further than others in ensuring that debts are recovered;
- what lessons can be learned from how commercial organisations manage customers' debt;
- the opportunities offered by central administration of financial transactions for future policy development and delivery; and

- the policy and practical challenges of bringing together financial and other information about citizens in one place.

An important question the feasibility study will have to consider is how any changes would affect the enforcement of debts. It will need to draw extensively on the Green Paper *Towards effective enforcement*.<sup>4</sup> For most of the potential outcomes of the feasibility study, it is likely that government would still retain a range of different enforcement methods. Here the feasibility study would work closely alongside the Lord Chancellor's Department – particularly in considering the Auld Review of Criminal Courts' recommendation that civil debt enforcement should be removed from criminal courts. It will also need to consider the relationship with court-based enforcement routes for particular types of debt.

Following stage 1, subject to collective agreement by Ministers, the study would either stop or would proceed to stage 2, if it was concluded that there are gains to be made from the centralisation of the administration of financial transactions between Government and the citizen. If the second stage goes ahead then the following issues would need to be considered:

- a central organisation's role in terms of responsibility and accountability (whether a completely new organisation or the arm of an existing department such as IR, Treasury or DWP);
- the boundaries of responsibility and accountability between the relevant government departments or local authorities and any new loan payment/recovery organisation;
- the statutory basis of any data-sharing proposals, which would need to be developed further in line with the

conclusions and strategy set out in the forthcoming PIU Privacy and Data-Sharing report;

- how processes should ensure fair treatment;
- how processes should take account of an individual's overall indebtedness and ability to pay, taking account of work on priority of different debts;
- identification of the functions that would be core to a central organisation and those that would be better performed by third parties;
- defining what any central organisation would look like, for example staff numbers and skills, IT systems, and structure; and
- developing an implementation strategy.

Developing a system for integrating the recovery of government debt and particularly any move towards a single citizen's account would take many years, given the complexity of institutions, financial and IT systems and the legislative issues. In practice, the experience of other major projects suggests this could need a ten year timeframe and this has also highlighted the problems of trying to change major systems too quickly. Ensuring the feasibility study provides robust answers to the above issues will be crucial, both to making the right decisions and, if it is concluded that an integrated system would be beneficial, achieving successful implementation.

## 6.7 Next steps

Tables 6.7(a) and 6.7(b) below set out next steps, including responsibilities and timing for taking this report's conclusions forward over the longer term.

<sup>4</sup> Green Paper, *Towards effective enforcement*, July 2001, [www.lcd.gov.uk/enforcement/enfrev01/index.htm](http://www.lcd.gov.uk/enforcement/enfrev01/index.htm)



**Table 6.7(a): Key steps for implementation of increased wiring-up of loan publicity, application and assessment**

What?	Who?	When?
<ul style="list-style-type: none"> <li>Departments to agree priorities and, where appropriate, have targets for delivery of online loan services and better links with other departments built into their objectives.</li> </ul>	Treasury in conjunction with the Cabinet Office (Office of the e-Envoy (OeE)) in agreeing departments' objectives.	April 2002
<ul style="list-style-type: none"> <li>Develop strategies and plans for 'wiring up' the front-end of loans administration, in line with the proposed vision.</li> </ul>	Each department (in consultation with OeE).	July 2002
<ul style="list-style-type: none"> <li>Detail the new processes, IT support and skills required to move towards the new arrangements.</li> </ul>	Departments/government bodies responsible for administering loans (in consultation with OeE).	July 2002
<ul style="list-style-type: none"> <li>Implement the proposals.</li> </ul>	Each department.	2003–05

**Table 6.7(b): Next steps for reviewing the feasibility of joining up of loan payment, account management and recovery**

What?	Who?	When?
<ul style="list-style-type: none"> <li>Conduct stage 1 of the feasibility study and seek Ministerial agreement to conclusions.</li> </ul>	Treasury/IR/PIU in conjunction with other interested departments, e.g. DWP and DfES. Stage 1 should report to the Chief Secretary to the Treasury, involving PSX(E) as necessary.	Complete stage 1 by September 2002
<ul style="list-style-type: none"> <li>Depending on the outcome of stage 1, undertake stage 2 of the feasibility study, and then seek Ministerial agreement to conclusions on implementation.</li> </ul>	Treasury/IR/PIU in conjunction with other interested departments, e.g. DWP and DfES. The Study should report to the Chief Secretary to the Treasury, involving PSX(E) as necessary.	March 2003

## APPENDIX 1. THE PROJECT TEAM, SPONSOR MINISTER AND ADVISORY GROUP

### A1.1 The team

The project team responsible for preparing this report comprised seven staff drawn from a variety of government departments and from the private sector. The team was guided by a ministerial sponsor and an Advisory Group with government, private sector and voluntary sector representation. Two Working Groups also provided support to the team:

- Patricia Greer – seconded from KPMG
- Joanna Simons – seconded from the Department for Environment, Food and Rural Affairs
- Narmada de Silva – seconded from the Inland Revenue
- Paul O’Sullivan – PIU Core team
- Nick Donovan – seconded from Policy Solutions
- Jane Halestrap – PIU Core team
- Tony Pilch – PIU Core team.

Assistance was provided by Iain Tomlinson, Dolly Begum, Sabeen Choudhary and Mia Rosenblatt from the Performance and Innovation Unit (PIU) Core team.

The team worked closely with the Treasury in the preparation of this report. It would like to thank the Treasury Expenditure Heads who generously provided valuable time and insights. The team would particularly like to thank Adam Sharples and Oliver Robbins.

Thanks also to Andrew Young and Martin Lunnon at Government Actuary’s

Department, Tim O’ Neill at PA Consulting, Jo Semmence and Nicola Sexton at the Office for National Statistics, Derek Jones at the Office of Fair Trading, and Tim Mills and Dianne Beddoes at Opinion Leader Research for their assistance and work on the project.

### A1.2 Sponsor Minister

The Sponsor Minister for this project was the Chief Secretary to the Treasury, Andrew Smith.

### A1.3 Advisory Group

The team benefited from an extensive process of consultation and review with the Advisory Group throughout the project. The Advisory Group was chaired by the Chief Secretary to the Treasury. In his absence, it was jointly chaired by Adam Sharples, Head of Public Expenditure, at the Treasury, and Stephen Aldridge, Chief Economist, PIU.

Other members of the Advisory Group included:

- Stephen Aldridge – Performance and Innovation Unit
- Paul Britton/ William Jordan – Cabinet Office
- Richard Delbridge – former Director and Chief Financial Officer, Nat West Group
- Richard Dudding – Department for Transport, Local Government and the Regions



- Mike Harris – Egg
- Peter Harris – Lord Chancellor’s Department
- Stephen Hickey – Department for Work and Pensions
- Paul Johnson – Department for Education and Skills
- Michael Littlechild – KPMG
- Peter Makeham – Department for Education and Skills
- Mick McAteer – Consumer’s Association
- Steve McManus – Inland Revenue
- Carey Oppenheim – No 10
- Adam Sharples – Treasury
- Anne Steward – Office of the e-Envoy
- Adrian Piper – Department of Trade and Industry
- Colin Ward – Student Loans Company
- Peter Williams – Council of Mortgage Lenders.
- James Foreman-Peck – Treasury
- Tina Haslam – Department for Education and Skills
- Paul Johnson – Department for Education and Skills
- Gavin Kelly – Institute for Public Policy Research
- Carey Oppenheim – No 10
- Sian Owen – Cabinet Office (Women’s Unit)
- Trevor Pendergast – Department for Work and Pensions
- Adrian Piper – Department of Trade and Industry
- Justine Windsor – Department of Health
- Mike Yates – Small Business Service.

The team also acknowledges with thanks the assistance of all whom offered advice, contributed in meetings and participated in working groups.

## A1.4 Working Groups

Members of the two project Working Groups (the Administration and the Policy Working Groups) provided valuable detailed input to the team throughout the project. Working Group membership comprised:

### Policy Working Group

- Prof. George Bulkley – Exeter University
- Tania Burchardt – London School of Economics
- Helen Dent – Families Welfare Association

### Administration Working Group

- Stefan Czerniawski – Office of the e-Envoy
- Bryan Horrocks – Department for Work and Pensions
- Paul Jones – Liverpool John Moores University
- William Jordan – Cabinet Office
- Nigel Leese – Department of Trade and Industry
- Theresa Middleton – Inland Revenue
- Colin Moore – Department for Education and Skills
- Michael Naylor – PriceWaterhouseCoopers
- Michael Swan – Treasury
- Geoff Watkins – Inland Revenue
- Anne Weatherston – Student Loans Company.

## APPENDIX 2. METHODOLOGY

### Summary

The project comprised five strands of work:

- describing overseas governments' loan activity and administrative arrangements;
- developing and agreeing criteria for guiding decision-making on when government intervention is appropriate and when loans are appropriate;
- describing current UK loan activity and evaluating the fit between existing schemes and the criteria;
- developing proposals for new loans products; and
- reviewing existing arrangements for administering loans and making recommendations for improvement.

### A2.1 Describing overseas governments' loan activity and administrative arrangements

In order to see if there were any lessons to be learnt from overseas countries' experiences, the PIU team:

- developed a list of questions on overseas countries' loans schemes including:
  - details of existing loan schemes to individuals and to businesses;
  - details of how the schemes are administered;
- sent out a request to embassies to collect the required information;

- followed up returns from embassies with requests for further detail; and
- visited two of the countries of particular interest, Singapore and Malaysia, to obtain a more detailed understanding of their loan and Central Provident Fund arrangements.

The results from this work are set out in working paper 1.



## A2.2 Developing and agreeing criteria for guiding decision-making on when government intervention is appropriate and when loans are appropriate

In developing and agreeing these criteria, the PIU team:

- reviewed existing Treasury guidance on government intervention set out in the document 'Appraisal and Evaluation in Central Government', commonly known within Whitehall as 'the Green Book';
- sought the views of key stakeholders (both within and outside Whitehall) on what the criteria (for guiding decision-making on when intervention is appropriate and when loans are appropriate) should be;
- developed a 'first cut' of the criteria, for discussion with key stakeholders and the project Advisory and Working Groups;
- revised the criteria in the light of the discussions;
- circulated the revised criteria and took on board comments as appropriate; and
- tested the criteria through using them to evaluate current loan schemes.

The results from this work are set out in chapter 3.

## A2.3 Describing current UK loan activity and evaluating the fit between existing schemes and the criteria

In order to collate a description of current UK loan activity, the project team:

- detailed the proportion of public expenditure currently spent on loans and commissioned the Office for National Statistics (ONS) to map any overlaps between recipients of different types of loans;
- met with departments responsible for administering loans to get a detailed understanding of current loan policies and administrative arrangements;
- visited offices of those administering loans. Staff took the PIU team through each of the key steps in the loans administration process;
- circulated draft papers setting out descriptions of the policy and administrative arrangements for each of the loans to the relevant departments. The team revised and took on board comments as appropriate; and
- evaluated the fit between existing loan schemes and the criteria developed as a part of this project (providing guidance on when it is appropriate for government to intervene and on when loans are the most appropriate tool of intervention).

The results for this work are set out in chapter 4 and appendix 3.

## A2.4 Developing proposals for new loans products

To identify where there may be scope for introducing new interventions in the form of loans, the project team:

- reviewed existing research to identify life events likely to cause temporary mismatches between income and expenditure;
- used the research findings to identify case study areas;

- reviewed packages of support currently available in each of the case study areas;
- considered the likely burden of an increase in use of government loans (through a review of existing literature on patterns of debt and use of different types of credit, and through commissioning some new research on the extent of household debt and household debt as a proportion of household income);
- identified a 'long list' of areas where new loan products might be appropriate (a list comprising areas where loans might replace existing provisions and where they might be an appropriate tool for new interventions);
- commissioned Opinion Leader Research (OLR) to run focus groups to identify the types of loan products that might be appropriate;
- consulted with departments to discuss:
  - the fit between the proposed options and existing and planned packages of support;
  - the practicality and feasibility of each of the options;
- evaluated the options against the criteria (for guiding decision-making on when government intervention is appropriate and when loans are the appropriate tool of intervention);
- used the criteria and the discussions with departments to shortlist the policy options; and
- modelled the public expenditure implications of the top four options.

The results from this work are largely set out in chapter 5. The background papers are included in working paper 2. The paper setting out the research on income

fluctuations is included in working paper 4, the paper setting out the research on patterns of credit and debt is set out in appendix 4 and the report from OLR on the focus groups is set out in working paper 3.

## A2.5 Reviewing existing arrangements for administering loans and making recommendations for improvement

In reviewing loans administration arrangements, the team:

- conducted a series of meetings and visits to identify the strengths and weaknesses of existing arrangements for administering loans;
- developed and agreed, (with the project Advisory Group and Administration Working Group), criteria for guiding the design and evaluation of options for the future;
- consulted with key stakeholders both within and outside government to identify a long list of possible options for the future;
- evaluated the fit with each set of options against the agreed criteria;
- discussed and agreed the evaluation with key stakeholders;
- selected the preferred options for further detailing; and
- detailed the costs, benefits and risks of preferred options and the key steps towards implementation.

The results from this work are set out in chapter 6.

## APPENDIX 3. EXISTING GOVERNMENT PROVIDED AND ENABLED LOANS TO INDIVIDUALS AND TO BUSINESSES

### Introduction

This appendix sets out details of loans paid both directly and through third parties to individuals and businesses as set out in chapter 4. It is divided into three sections:

- Section A3.1 sets out some key facts and figures about expenditure and population coverage of the loan schemes.
- Section A3.2 sets out a factual description of the loans to individuals;
  - A3.2.1: Student Loans
  - A3.2.2: Career Development Loans (CDL)
  - A3.2.3: Social Fund
  - A3.2.4: Housing Loans
  - A3.2.5: Residential Care Deferred Payments.
- Section A3.3 sets out a factual description of the loans to businesses.
  - A3.3.1: Phoenix Fund
  - A3.3.2: Launch Investment
  - A3.3.3: Home Shipbuilding Credit Guarantee Scheme
  - A3.3.4: Small Firms Loan Guarantee Scheme (SFLGS)
  - A3.3.5: Small Firms Training Loan Programme (SFTLP)
  - A3.3.6: Regional Selective Assistance (RSA).



## A3.1 Key facts and figures on government loan schemes

**Table A3.1(a): Expenditure on loans to individuals**

Government loan	Description	No of people taking out loan	Average size of loan
Social Fund			
<ul style="list-style-type: none"> <li>• Crisis loans</li> </ul>	Interest-free loans available in an emergency to those with a risk to their health or safety and without other resources.	939,000 <sup>1</sup>	£66
<ul style="list-style-type: none"> <li>• Budgeting loans</li> </ul>	Interest-free loans available to Income Support/Jobseeker's Allowance (income based) claimants for intermittent expenses that are difficult to budget for from weekly income.	1,017,000 <sup>1</sup>	£389
Education Loans			
<ul style="list-style-type: none"> <li>• Student loans</li> </ul>	Loans available to cover maintenance expenses (and a contribution to tuition fees) for students in higher education, with effectively zero real interest rate.	724,000 <sup>2</sup>	£2,520
<ul style="list-style-type: none"> <li>• Career Development Loans (CDL)</li> </ul>	Loans available for vocational and professional education and training, to cover tuition fees and other course costs. Can also cover maintenance in specific circumstances.	18,363 <sup>3</sup>	£3,761
Housing Loans			
<ul style="list-style-type: none"> <li>• Homebuy</li> </ul>	Equity loan scheme run by Housing Corporation provides 25% equity loan to tenants in social housing or on housing waiting lists.	1,000	£23,000
<ul style="list-style-type: none"> <li>• Starter Home Initiative</li> </ul>	New scheme – offering £250 million of Government money for innovative ways to provide low-cost housing to key public sector workers to enable them to live close to the communities they serve. Likely to include equity loans.	Aims to help 10,000 'key public sector workers'	Aim is average loan ≈ £25,000

<sup>1</sup> Social Fund figures for the financial year 1999/2000.

<sup>2</sup> Student loan figures for academic year 1999/2000.

<sup>3</sup> Career Development Loan figures are for academic year 2000/01. Note that CDLs are not strictly government loans; they are administered by banks on a commercial basis. Government pays the interest on the loans during the period of study.



**Table A3.1(b): Expenditure on loans to businesses**

Government loan	Description	No of businesses taking out loan	Average size of loan	Total Govt expenditure on loans or scheme
Small Firms Loans Guarantee Scheme	Provides loan guarantees for firms with viable business funds but limited track records and collateral which would not otherwise be funded by banks.	4,312	£55,765	Net cost for 2001 is £25.2m <sup>4</sup>
Small Firms Training Loan Programme	Provides loan interest holiday for small firms financing training through bank loans.	54	£5,000	Net cost for 2001 is £54k <sup>5</sup>
Launch Investment	Provides risk capital to aerospace industry to help capture and keep high value aerospace projects within the UK.	2	Up to £530m	Spending in 2001 ≈ £1bn. Return on investment, so net cost could be zero
Shipbuilding Credit Guarantee Scheme	Provides a loan guarantee and, if required, a fixed interest rate facility of 7.5% to help support shipbuilding projects.	Not available	Not available	Made a profit ≈ £8m in 2001, though in 1980s made losses
Phoenix Fund	Provides fund for Community Development Financial Institutions (CDFIs) to tackle social exclusion. Key elements include: <ul style="list-style-type: none"> <li>● Funds for CDFIs to lend on</li> <li>● Loan Guarantee for CDFIs</li> </ul>	890 <sup>6</sup>	£1,870 <sup>7</sup>	≈ £100m overall (to March 2004) for all elements

<sup>4</sup> This will vary from year to year depending upon the number and value of loans and the default rates, which determine how many loan guarantees need to be paid off.

<sup>5</sup> This is interest costs and cost of guarantee for loan defaults. Excludes £24k of programme costs.

<sup>6</sup> Projected figure for year 1.

<sup>7</sup> Estimated on projected figures for year 1.



### Who receives government loans?

As a proportion of the population, few people receive government loans. Analysis of the Family Expenditure Survey reveals that only a small proportion of households have, or are paying back, a student or Social Fund loan.<sup>8</sup> There is no overlap between receiving or repaying a student loan and a Social Fund loan: no households have both. As might be expected, recipients of student loans tend to

be in younger households while Social Fund borrowers are all low income households.

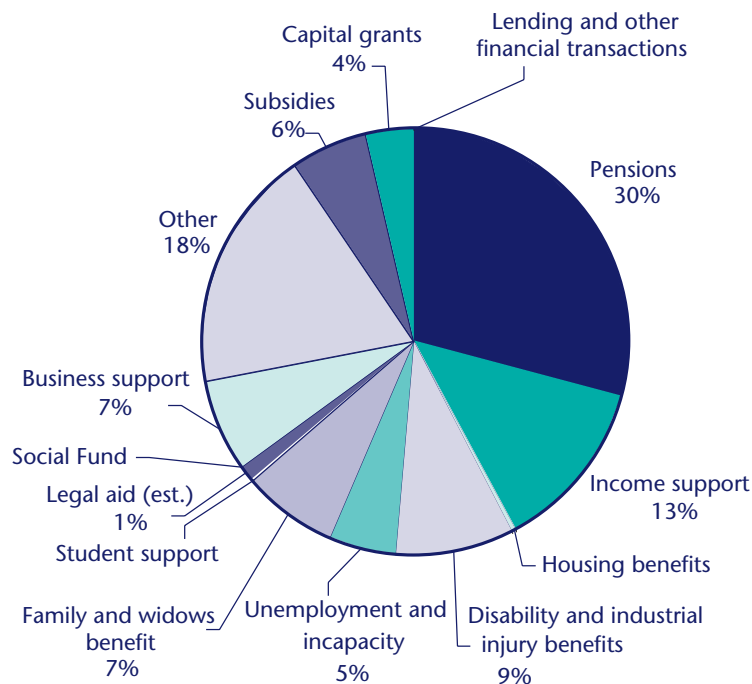
People who borrow from government also tend to have other loans and make use of credit facilities. For example, as can be seen in table A3.1(c), 80% of people borrowing from the Social Fund also use credit, and 17% have another loan. Those with student loans make less use of credit but more have loans – and of a much higher value.

**Table A3.1(c): The private sector borrowing of those with government loans<sup>9</sup>**

Government loans	Proportion with other loan	Average loan amount	Proportion with mortgage	Average mortgage amount left	Proportion with credit
Social Fund loans	17%	£686	4%	£33,705	80%
Student loans	36%	£8,586 <sup>10</sup>	43%	£36,229	73%

Chart A3.1 shows the total expenditure by government in the form of grants, subsidies and loans. Of the £136.8 billion expenditure for 2000/01, less than 1% is in the form of loans.

**Chart A3.1: Proportion of government expenditure on grants and loans 2000/01**



<sup>8</sup> FES, ONS analysis of student loans and Social Fund loan recipients. Existing data sources only allow us to compare student loans and Social Fund loans (not Career Development loans, housing loans).

<sup>9</sup> FES, ONS analysis of student loans and Social Fund loan recipients.

<sup>10</sup> A small number of large loans affect the average and this result should be treated with caution.



## A3.2 Description of current loans to individuals

### A3.2.1 Student loans

#### Aim

Student loans are part of the Government’s student support system, which shares the costs of higher education between students, parents and taxpayers. Student loans have played an important part in the Government’s objective to increase and widen participation in higher education.

#### Key features

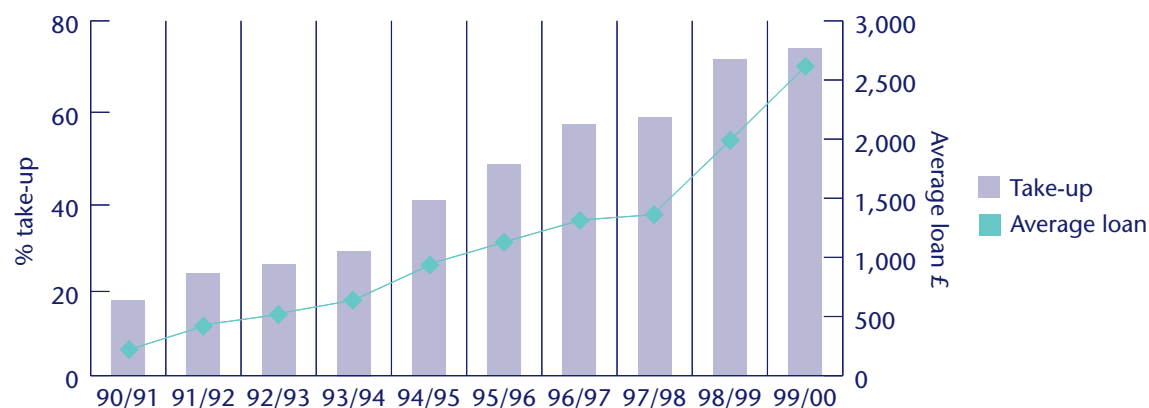
Higher education<sup>11</sup> in the UK is publicly funded through direct government grant; with additional discretionary elements provided by grants from the HE funding councils in England, the National Assembly for Wales, the Scottish Executive and the Department of Education (Northern Ireland). In addition, HE students have been eligible for publicly-funded grants and loans (see below) to cover their maintenance expenses whilst studying.

In 1999/2000, the Government spent £5.9 billion<sup>12</sup> on higher education in England and Wales – £4.1 billion on direct funding of higher education institutions and £1.8 billion on student support (including student loans, mandatory awards for maintenance and fees, access funds and bursaries, and student loans administration).

Student loans were introduced in 1990/91. These loans have a zero real interest rate (i.e. they rise only at the rate of inflation), and students are not required to begin repayments until the April after they have completed their course or left higher education.

The original, mortgage style loans are repaid direct to the Student Loans Company (SLC) as a fixed monthly amount for those earning over a minimum threshold, (set at 85% of national average earnings). However, for most new students from 1998/99, this was replaced by an income-contingent repayment system, where loans are repaid as 9% of any income earned in excess of £10,000 p.a. Details of the repayment process are set out below.

**Chart A3.2.1: Student loans: take-up and average loan, 1990/91 to 1999/2000**



<sup>11</sup> Higher Education (HE) is defined as courses of a standard higher than GCE A level, GNVQ/NVQ level 3 or Edexcel (formerly BTEC), or their Scottish equivalents.

<sup>12</sup> Figures taken from *DfEE and OFSTED – Departmental Report and Main Estimates 2001*, table 4.2, HMSO, 2001.

As chart A3.2.1 above shows, the take-up of student loans is high and rising. In 1999/2000, 74% of students took out a loan, and the average value of the loan was £2,520. There was also significant borrowing from other sources, such as commercial loans and overdrafts, and loans from family and friends. On average, total debt for full-time students in 1998/99 was about £3,300;<sup>13</sup> however, this is reduced to £2,500 on average once savings have been taken into account.

The trend shown in chart A3.2.1 partly reflects the gradual shift from maintenance grants to student loans. In 1998/99, maintenance grants were still available for students with low parental income to cover up to 25% of maintenance costs. From 1999/2000, grants have been phased out for most new students, whilst loans have been extended<sup>14</sup> (except for students in vulnerable groups who are eligible for supplementary grants). Hardship loans have also been introduced for students in serious financial difficulty; they rose from £250 in 1998/99 to £500 in 1999/2000.<sup>15</sup>

Another recent change is in relation to tuition fees. Students entering HE in 1998/99 were required for the first time to make a contribution to their tuition fees. The maximum tuition fee contribution in 2000/01 is £1,050. This represents about a quarter of the average cost of a course. Tuition fees are income assessed. How much, if anything, a student pays depends on their income and that of their family. In 1999/2000, 35% of students paid the required contribution in full; 20% paid part of the contribution, and 45% paid no fees at all<sup>16</sup> (next year this figure is set to rise to 50%).

### Administration

Student loans are administered by the SLC, (in partnership with the local authorities in England, Wales and Northern Ireland, who assess eligibility for a loan). This is a limited company owned by the Government and designated as a non-departmental public body. Funds for the loans (and their administration) are provided by DfES, the Student Awards Agency for Scotland and the Department of Higher and Further Education, Training and Employment (Northern Ireland).

The SLC is based in Glasgow on two sites – a contact centre organised on functional lines (c. 550 staff) and a processing centre (c. 50 staff). It deals with the administration of much of the loans process, including the administration of two tranches of the old mortgage style loan books sold to the private sector (a service provided under contract following a tendering process), using a bespoke IT system. Some of the bad debt recovery work (pursuit of arrears) is contracted out to private debt collection agencies across the country, working with the SLC tracing team.

The repayment of the income-contingent loans is administered by the SLC in conjunction with the Inland Revenue (IR). The graduate's details are passed to IR, which matches these to tax records and instructs the employer to deduct the repayments along with tax and NICs deductions under the operation of PAYE. An annual reconciliation between IR and SLC updates the graduate's loan account balance.

This works well, but does impose an additional administrative cost on employers. For the self-employed, repayments are made

<sup>13</sup> *Changing Student Finances: Income, Expenditure and the take-up of Student Loans among full- and part-time HE students in 1998/9*, Callender and Kemp, 2000, DfEE research report RR213.

<sup>14</sup> Loans now cover 100% of maintenance expenses for those students with parental income below a specific level; with loans available to cover 75% of maintenance expenses for the rest. Means-testing is carried out by the LEAs in England and Wales, the Education and Library Boards in N Ireland, and the Scottish Awards Agency, together with assessment of applicant's eligibility for a loan.

<sup>15</sup> Eligibility for hardship loans is assessed by the student's college or university. Hardship loans are repaid on an income-contingent basis.

<sup>16</sup> Figures taken from Callender and Kemp, 2000, figure 3.2, page 103.



via the self-assessment return. The SLC collects repayments from those not subject to UK tax, and from those repaying mortgage style loans.

The default rate for student loans is relatively low. In 1999/2000, about 5% of borrowers had defaulted on payments (with an additional 1% classified as 'overdue').<sup>17</sup> However, a further 22% were deferring payment – this relates to deferment of the old mortgage style loans, which is possible if the borrower earns less than the lower limit, is unemployed, or suffers from an illness/disability. As the new system of income-contingent loans (ICLs) provides for direct repayment via employers, high repayment rates might be expected to continue, at least for those going into employment.

### A3.2.2 Career Development Loans

#### Aim

The aim of Career Development Loans (CDLs) is to improve people's access to learning to enhance their lives, improve their employability in a changing labour market, and create the skills needed by employers and the economy.

#### Key features

Until April 2001, further education<sup>18</sup> and adult education were funded directly through the FE Funding Councils and the TECs (Training and Enterprise Councils) respectively, in England and Wales. From 1 April 2001, both have come under the Learning and Skills Council (LSC). The aim of this change is to ensure that public provision of further and adult education is more consistent across the country. In addition to

FE colleges and TECs, there is a large range of unsubsidised private provision.

Maintenance grants for further education have been abolished. However, CDLs have been available from 1988 to cover both tuition fees and maintenance (for full time courses) for a range of vocational further and adult education courses. In addition, individual learning accounts (ILAs) were introduced, which provided discounts for those undertaking further and adult education.<sup>19</sup>

The rapid growth of the ILA programme exceeded all expectations, causing the DfES to think again about how best to target public funds in this area and secure value for money. There were also concerns about serious potential fraud and theft, which led to the ILA programme closing earlier than anticipated in November 2001. The Government is committed to introducing a successor scheme, building on the strengths of the ILA programme and learning the lessons from the first scheme.

CDLs are administered by high street banks (see below), which charge commercial interest rates. Government covers the interest costs during the period of study at a rate of interest lower than commercial rates. Loans range from £300 to £8,000, (the average in 2000/01 was £3,761) to cover typically 80% of the course fees. They can also cover the full cost of course-related expenditure and travel and childcare, and living expenses for full time courses.

CDLs must be used for vocational courses – i.e. they must be work-related and give the individual skills needed for an occupation, trade or profession. Chart A3.2.2(a) shows the top course choices for successful CDL

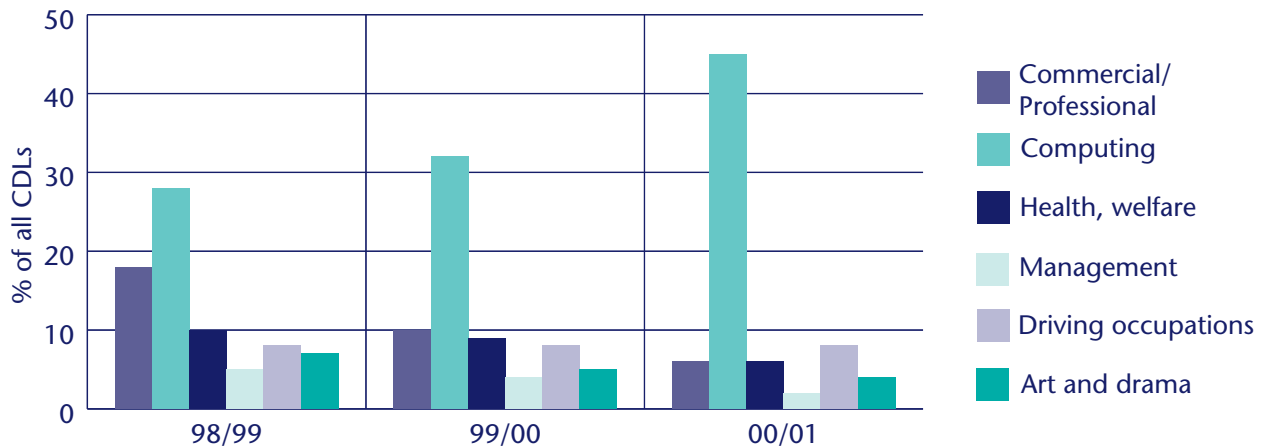
<sup>17</sup> Figures from DfEE Departmental Report 2001, figure 14.1, page 95.

<sup>18</sup> Further Education (FE) is sometimes used to describe all non-advanced courses taken after the period of compulsory education, but more commonly it excludes secondary school and Higher Education courses.

<sup>19</sup> Most courses were eligible for a subsidy via ILAs. However, courses that were essential for the individual's employment and leisure-related courses, such as flying, diving, driving, etc., were excluded.



**Chart A3.2.2(a): Course breakdown for CDLs, 1998/99–2000/01**



applicants.<sup>20</sup> There is a high proportion of commercial and professional qualifications undertaken, and a recent steep increase in IT courses.

DfES has developed guidance on which courses are eligible; if the bank offering the CDL has any doubt, the case is referred to DfES. But even if the course and the applicant are eligible, the banks have discretion to refuse to lend the money – there is no ‘entitlement’ to a loan.

#### Administration

Four high street banks administer CDLs – 80% of loans are offered by Barclays; the remaining 20% come from the Co-op, the Clydesdale and the Royal Bank of Scotland (RBS). The loans are offered at commercial rates to applicants, but DfES underwrite the loans by:

- paying the interest on the loan during the period of study and for one month afterwards (at a rate 2–3% over base rate); and
- continuing to pay the interest for up to a further 17 months if the student remains unemployed or on benefits after the course is finished.

Default rates for CDLs are about 10%, although some banks achieve better than this. Administration costs for CDLs are relatively high compared with other types of unsecured loans. In addition, the time taken to process a CDL application has been longer than for other loans – typically about six weeks compared with between one and three weeks for a commercially-available ‘professional study’ loan. This has recently been reduced to around two weeks by using bespoke processing teams.

Longer administrative timing was due to a number of possible reasons:

- unlike personal loan applications, CDL applications often come from people who are not customers of the bank, so it takes time for the bank to check on credit ratings and management of bank accounts;
- centralising CDL loan applications, as most banks do, may also slow down the process compared with a typical personal loan; and
- because the loans are subsidised by government, it is necessary to collect additional information and undertake cross-checks (e.g. confirmation by the training provider that the student will be undertaking the course).

<sup>20</sup> Research undertaken by Diagnostics Social and Market Research Ltd to examine the characteristics of applicants for Career Development Loans, July 2001.



### A3.2.3 Social Fund: Crisis loans and budgeting loans

The Social Fund is a system of grants, loans and payments, designed to help people meet expenses which are hard to pay for out of regular income. It provides different types of help depending on the circumstances of the people concerned, but most are available only to those on specific qualifying benefits. The different elements of assistance under the Social Fund are summarised in table A3.2.3(a) below.

Since the Social Fund began in 1988, it has made almost 17 million loans, worth over £3 billion, at a net cost of £492 million. There are two types of loans awarded under the Social Fund: budgeting loans and crisis loans. These are described in more detail below.

#### Budgeting loans

Budgeting loans are interest-free loans available to people who have been receiving Income Support or Income-based Jobseekers Allowance for 26 weeks or more.

##### Aim

Budgeting loans are designed to be used for intermittent expenses – such as new clothes

and shoes, or large items of furniture or appliances – that are difficult to budget for from weekly income.

##### Key features

Budgeting loans are awarded at the discretion of local benefit officers, from a cash-limited budget. In 1999/2000, budgeting loans worth £396 million were awarded. The system of budgeting loans was changed in April 1999 to a simplified, speedier and more automated system. Although there is still some individual discretion, the amount available to borrow now increases depending on the length of time on benefit and family size. In the previous system, applicants had to specify in detail the purpose of the loans; this is no longer required.

Chart A3.2.3(a) provides an indication of the purpose of budgeting loan expenditure.

However, the figures relate to the previous (pre-April 1999) system, and represent simply the stated purpose of the loan, since there are no checks on what the money is spent on once the loan has been awarded. The overwhelming majority of expenditure is said to go to large items of furniture or appliances.

**Chart A3.2.3(a): Budgeting loans – expenditure by purpose, 1998/99**

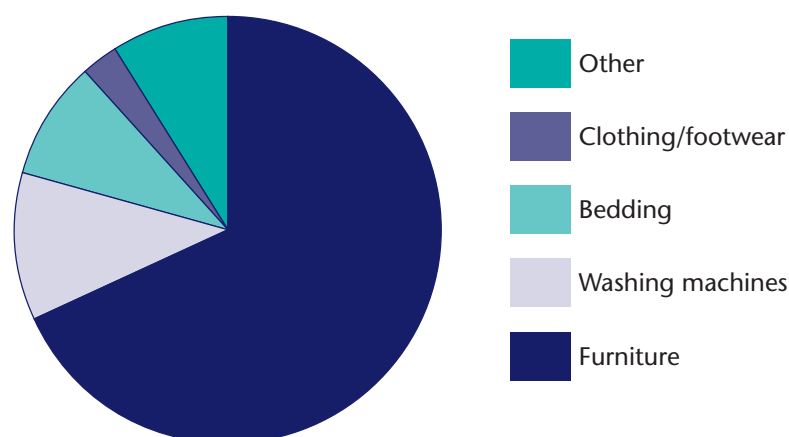
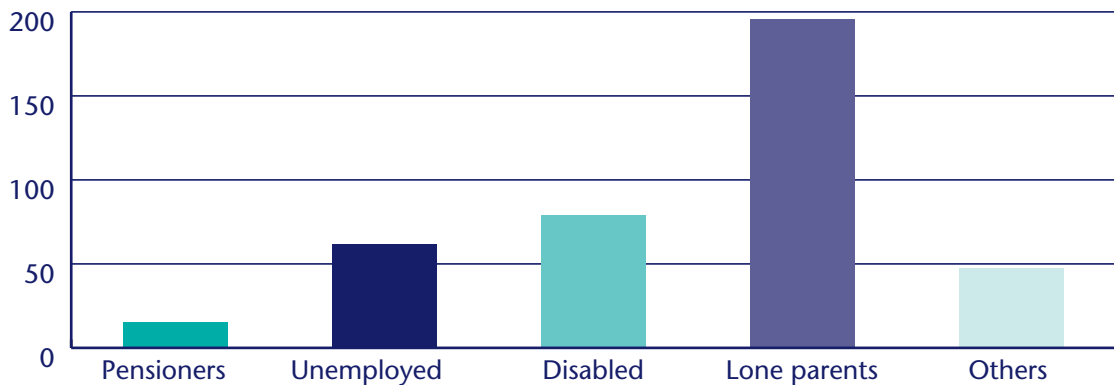




Chart A3.2.3(b) below shows the expenditure on budgeting loans by household type. The majority of expenditure went to unemployed people, lone parents and disabled people,

indicating that expenditure is focused on poorer individuals and families.

**Chart A3.2.3(b): Expenditure on budgeting loans by applicant type (£m, 1999/2000)**



### Crisis loans

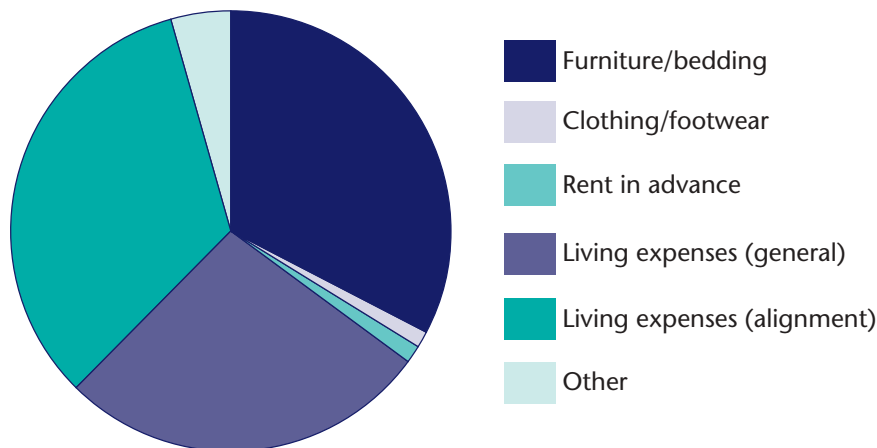
#### Aim

Crisis loans are interest-free loans available in an emergency, where the health and safety of the individual or family is at risk. They are designed to be used for essential items or services.

#### Key features

Crisis loans are used mainly to tide people over emergencies (such as burglary, fire, or family breakdown). They are awarded at the discretion of local benefit officers, from a cash-limited budget. In 1999/2000, crisis loans worth £62 million were awarded. The main purpose of expenditure is set out in

**Chart A3.2.3(c): Crisis loans – expenditure by purpose, 1998/99**



Note: An alignment payment is to cover living expenses up to the first payment of benefit or wages.



**Chart A3.2.3(d): Expenditure on crisis loans by applicant type (£m, 1999/2000)**



chart A3.2.3(c). These figures relate to 1998/99 because data on the purpose of expenditure was not collected after April 1999. Chart A3.2.3(c) shows that crisis loans tend to fund basic living expenses; in about a third of cases, the loan is simply to assist individuals or families until the first payment of benefit or wages.

Chart A3.2.3(d) shows the expenditure on crisis loans. In total, expenditure was just over £60 million in 1999/2000. As for budgeting loans, the majority of expenditure goes to lone parents, or unemployed or disabled people.

#### *Administration of Social Fund loans*

Social Fund loans are administered by the Benefits Agency (Jobcentre Plus from October 2001). Local offices – where applications are received, generally by post – assess each application. The applications are entered on to the computer system and the loan (and repayment terms) calculated. Staff then check and verify information. On receipt of a letter of acceptance from the applicant, the loan is issued, and the repayment structure set up. Each stage of the process can be carried out within a day.

Repayments are generally straightforward, normally by direct deduction from benefit. The repayment system becomes more complex if an applicant comes off benefits, as

this would then require actual repayments to the Department for Work and Pensions (DWP).

The total value of loans awarded under the Social Fund in 1999/2000 was £458 million. The administrative expenditure on loans was £61 million,<sup>21</sup> which is equivalent to an administrative cost of just over 13%.

Table A3.2.3(a) below shows data provided by the DWP, which indicates that Social Fund loans are relatively expensive to administer compared with other benefits. This is partly to be expected given that the administrative costs would cover both the issuing and repayment of the loans.

### **A3.2.4 Housing loans**

#### *Aim*

The aims of public sector loans for housing are:

- to encourage and sustain home-ownership, including through loans for essential maintenance and repair;
- to release social housing for re-letting to people in housing need.

#### *Key features*

There are three existing schemes under which housing loans may be offered by the public sector.

<sup>21</sup> Figures provided by the Department for Work and Pensions.



**Table A3.2.3(a): Administrative costs of representative social security benefits, 1999/2000**

Benefit	Cost as a percentage of benefit expenditure
Retirement pension	0.9
Child benefit	1.5
Income Support	6.1
JSA (contribution-based)	15.6
JSA (income-based)	13.1
Social Fund (both grants and loans)	11.0
<b>Social Fund loans</b>	<b>13.3</b>

**Table A3.2.3(b): Loans and grants under the Social Fund**

	Description	No of people taking out loan/grant <sup>22</sup>	Average size of loan/grant
Crisis loans	Interest-free loans available in an emergency to those with a risk to their health and safety and without other resources.	941,000	£66
Budgeting loans	Interest-free loans available to Income Support (IS) and income-related JSA claimants (on benefits for 26 weeks or more) for intermittent expenses that are difficult to budget for from weekly income.	1,041,000	£380
Community Care	Grants available to IS/JSA(IB) claimants in special circumstances, for example: individuals leaving institutional or residential care or families under exceptional pressure.	219,000	£449
Sure Start Maternity Grant <sup>23</sup>	Maternity payment given at birth if the mother or her partner is claiming.	172,000	£101
Funeral payments	Payment to cover funeral expenses if claimant has good reason to take on funeral expenses of someone who has died, and is claiming IS//JSA(IB)/WFTC/DPTC, Housing Benefit or Council Tax Benefit.	44,000	£866
Cold weather payments	Automatic payment, <sup>24</sup> triggered by average temperatures below 0°C for seven consecutive days, for IS or income-related JSA claimants with a pensioner or disability premium, or a child aged under 5.	114,000	£8.50
Winter fuel payments	Automatic and non means-tested payment to men and women aged 60 or over aimed at helping to meet fuel costs during winter.	11,000,000+	£200

<sup>22</sup> Social Fund figures for the financial year 1999/2000. Winter fuel payments figures for 2000/2001.

<sup>23</sup> SSMGs were introduced 27 March 2000.

<sup>24</sup> Benefit levels are adjusted automatically without having to make a separate claim.

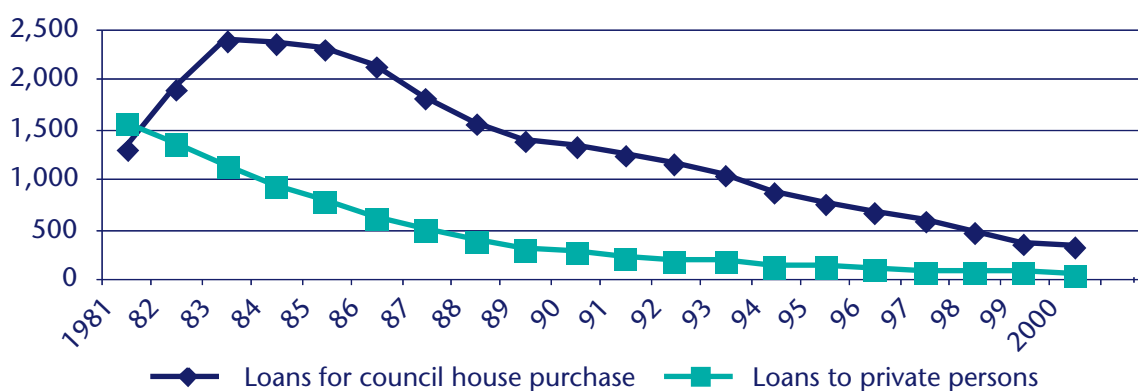


- The 'Homebuy' scheme.** The Homebuy scheme aims to help people on modest incomes who are trying to buy their own home, by offering them an equity loan of 25% of the value of the property. The main objective is to free up existing social housing and reduce waiting lists – so it is open only to existing social housing tenants, or those on a housing waiting list or nominated by the local authority as being in housing need. The scheme is Government funded, and administered by the Housing Corporation through registered social landlords (RSLs). Those taking out an equity loan under the Homebuy scheme simply repay the loan when the property is sold,<sup>25</sup> rather than making monthly repayments as borrowers would typically do for a commercial loan. The rest of the house purchase must be financed in the normal way, i.e. through private mortgage lenders, savings, etc. The Homebuy scheme started in 1999. Expenditure on Homebuy in 1999/2000 was £19.86 million, on 885 loans.
- Right-to-buy loans.** Local authorities have the powers to offer mortgage loans<sup>26</sup>

to those who are unable to use private mortgage providers. In recent years, there have been very few such loans, see chart A3.2.4(a) below. Those that have been made relate mainly to right-to-buy sales (discounted sales of local authority housing to sitting tenants), for which local authorities have had an obligation to act as a lender if the purchaser is unable to secure private finance. In 1999/2000, 19 local authorities made 112 loans, amounting to about £2 million.

- Other housing-related loans made by local authorities.** There are also a few loans made by local authorities<sup>27</sup> for house purchase, improvement, conversion and repair, including any compulsory improvement work by the local authority. The size of such lending is small – in 1999/2000, 13 local authorities made a total of 78 loans, amounting to £627,000. These number of these loans have been decreasing for a number of years, see chart A3.2.4(a) below.

**Chart A3.2.4(a): English local authorities' outstanding housing loans**



<sup>25</sup> The amount paid back is 25% of the value of the property at the time of resale (which may be more or less than the original loan). If the homebuyer chooses to repay the loan before the home is sold, the amount to be repaid is 25% of the value of the home at the time of repayment.

<sup>26</sup> The rates charged for such loans are regulated by a formula established under the Housing Act 1985. The rates tend to be close to commercial mortgage rates.

<sup>27</sup> These loans are made under sections 435 and 456 of the Housing Act 1985.



In addition to these existing schemes, December 2000 saw the launch of the new 'Starter Home Initiative'. This scheme is targeted at key workers, particularly nurses, teachers and the police. It aims to help them buy their own homes in areas where there are demonstrable problems of recruitment and retention associated with high local housing costs. The main aim of the scheme is to provide housing assistance for these workers to allow them to live a reasonable distance from their work.

The Government will provide £250 million over three years to finance the scheme, and has invited bids for these funds from interested organisations, including RSLs and local authorities, who will be responsible for delivering the scheme. The bidding guidance is not prescriptive about how the organisation provides assistance with housing costs, suggesting that direct grants, shared-ownership schemes and equity loans will all be considered provided they demonstrate value for money. The initial round of bidding indicated that a number of RSLs were considering equity loans as an instrument.

Finally, under proposals announced in March 2000,<sup>28</sup> the Government is proposing reforms to the legislation governing private sector housing renewal, which are likely to increase significantly the volume of local authority lending. Under the proposals, authorities will have far more discretion to choose between grants, loans and other forms of assistance. In many cases, loans (or help towards obtaining a commercial loan) are likely to be the preferred option, because they offer scope to make resources go further. Local authorities currently spend over £250 million per year

on grants for housing renewal in the private sector.

#### *Administration*

Public provision of loans clearly has associated administrative costs, although it may be possible to minimise such costs through partnership with private loan providers and other agencies.

#### *Administrative costs of current schemes*

It is difficult to obtain information about the administration costs of the current system of housing loans offered by local authorities (see chart A3.2.4(a) above). These costs are not typically separated from the total administration cost of housing services offered by local authorities.

However, information about default rates for local authority loans is collected centrally. The most recent figures (March 2000)<sup>29</sup> show that 6.4% of loans for council house purchase were in arrears of six months or more. The value of these arrears represents just over 2% of the outstanding debt. Similar figures for other types of local authority housing loans (mainly for home improvement) show that about 12.5% loans are currently in arrears of six months or more, representing just under 9% of the outstanding debt. Perhaps unsurprisingly, these figures do not compare well with private mortgage default rates. The Council of Mortgage Lenders estimate that about 0.6% of house purchasers were in arrears of six months of more with their mortgage payments in June 2000. The difference between private mortgage default rates and local authority mortgage default rates is probably due to the

<sup>28</sup> *Private sector housing renewal: reform of the Housing Grants, Construction and Regeneration Act 1996, Local Government and Housing Act 1989 and Housing Act 1985* – a consultation paper, Department of the Environment, Transport and the Regions, March 2001.

<sup>29</sup> Figures supplied by the Department of the Environment, Transport and the Regions, Housing Data and Statistics Division.



worse financial position of those receiving local authority loans, but also because most of these borrowers are first-time borrowers, who tend to have a higher risk of arrears.

With the existing Homebuy scheme, the RSLs have responsibility for publicising and marketing the scheme, and for administering the application process (including vetting applicants to check their capacity to sustain home ownership). These administration costs are covered by a grant from government, set at 3% of the price of the properties. The average property price in England for the Homebuy scheme in 1999/2000 was about £79,000 (for London the average was £95,000). The administrative costs in 1999/2000 therefore amounted to some £2.1 million, or about £2,370 per property (£2,850 for London).

Once an application for a Homebuy loan has been accepted, the RSL secures the loan through a second charge on the property. The Land Registry holds a register of the outstanding charges on a property so that when the Homebuy purchaser wishes to sell, their solicitor or legal representative must first inform the RSL. If the Homebuy purchaser wishes to repay the loan before the home is sold, the RSL must obtain an open market valuation (disregarding the value of any improvements carried out by the vendor), by an independent qualified valuer acceptable to both parties. The cost of the valuation is the responsibility of the owner-occupier. Because the Homebuy scheme does not require repayment of the loan until the property is sold, default is not really a relevant issue.

### *A3.2.5 Residential care deferred payment scheme*

When adults move into residential care they are means tested to assess their ability to contribute to their accommodation and care costs. The means test includes both income and assets (including property). Some have expressed concern that elderly or vulnerable people have to sell their homes to pay for residential care, and have suggested that local councils should cover residential care costs to prevent this happening.

#### *Aim*

The aim of the deferred payment scheme is to help ensure no adult will be forced to sell their home against their will on admission to permanent residential care, and to give residents a further option in deciding how to pay for their care.

#### *Key features*

Those entering permanent residential care and who are unwilling or unable to sell their home are eligible for deferred payment of their residential care charges. If a resident of a care home has property which has been taken into account in the means test, the council has the legal power to place a charge on the property and recover the debt when the property is sold, usually following the resident's death. If the resident has income and/or other assets sufficient to meet the costs of care, they are not eligible for a deferred payment agreement.

The deferred payment scheme is not a loan in the traditional sense of the term. The resident does not receive the money directly. The advanced funds are secured against collateral.



The scheme is discretionary: there is no entitlement to a deferred payment for an individual nor any requirement for the local authority to provide the scheme. The discretionary nature of the scheme may lead to local variations in access and take-up. Central government does not operate the deferred payments scheme. A pump priming grant has been made available to councils with social services responsibilities for 2.5 years from October 2001. These grants total £85 million.

The deferred payment scheme is distinct from the existing power that local councils have to make a charge on a property (under fairly extreme circumstances such as a resident's refusal to reimburse for care costs incurred). Under section 22 of the Health and Social Services and Social Security Adjudications Act (1983) (HASSASSA), councils already have the power to place charges on property where debt has arisen with respect to the payment of residential care charges. In these situations, residents have no choices in whether a charge is placed or not, and interest can be charged immediately following the resident's death. The deferred payment scheme does not replace the HASSASSA charge and differs in a number of important details: where the resident dies, interest does not become payable until the 57th day after the date of death; and the payment must be agreed between the resident and the council.

The process for obtaining deferred payment (from October 2001, and subject to Parliamentary approval) is as follows:

- **Step 1.** When people are means tested on entering residential care the value of their home will be taken into account, except in certain circumstances – for example where

the spouse or partner still lives in the property. Councils have discretion in deciding whether to assess the property 'in-house' or whether to appoint external valuers.

- **Step 2.** Someone going into residential care who doesn't want to sell their house or has trouble selling it can apply for a deferred payment, provided that their income and other assets are not sufficient to cover the cost of their care.
- **Step 3.** If approved, the council places a charge on the property through the Land Registry. Interest will not accrue on the debt until after the day after the deferred payment agreement ends or, where the resident dies, 57 days after the date of death.
- **Step 4.** When the property is sold, usually when the borrower dies, the council recovers the debt.

Figures on expenditure under this scheme are not yet available as the scheme has only just come into operation.

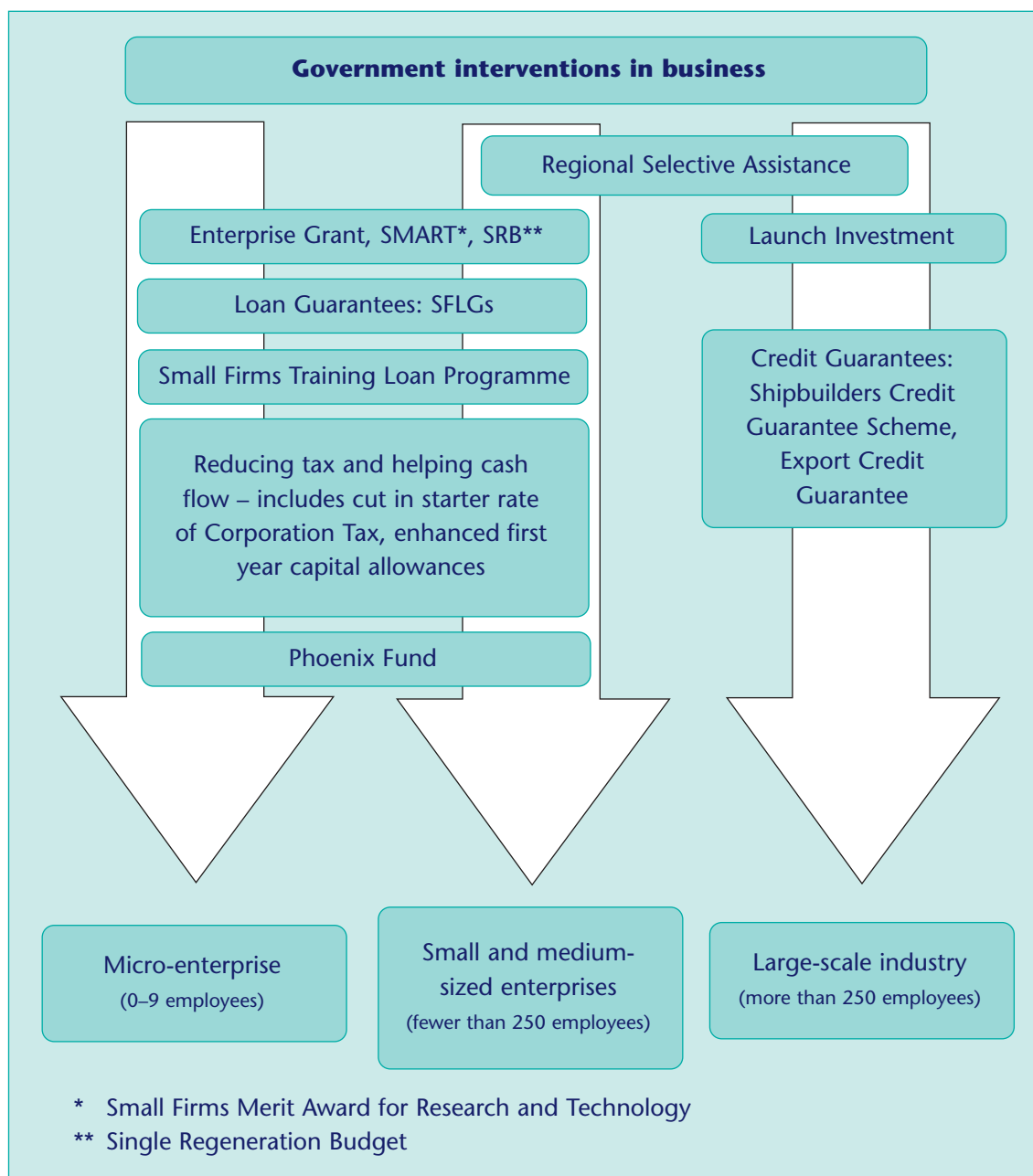


### A3.3 Description of current government loans to business

Government support for business takes many different forms. There are few cases of government directly lending or providing

investment to business. More often, intervention is through the use of loan guarantees and occasionally through interest rate subsidies as well as grants and tax measures. A general guide to types of support is given in chart A3.3(a).

Chart A3.3(a): Government intervention in business



The main loan schemes and other repayable interventions are described below.

### A3.3.1 Phoenix Fund

#### Aim

To tackle social exclusion by encouraging entrepreneurship in disadvantaged areas and groups under-represented in business ownership.

#### Key features

The Phoenix Fund was announced in November 1999 as part of the Government initiative to encourage entrepreneurship as a means of tackling social exclusion. It is recognised that entrepreneurs and social enterprises amongst disadvantaged communities<sup>30</sup> often experience great difficulties launching their ideas, due to lack of support, advice and access to finance. The Phoenix Fund aims to put businesses in a position where they can obtain commercial funding. The Fund was started with a budget of £30 million for a three-year period (2000–03) and then trebled by the Chancellor in the July 2000 Spending Review and extended to cover a four-year period (2000–04).

The Fund currently has four elements:<sup>31</sup>

- Challenge Fund to resource Community Development Financial Institutions (CDFIs);
- Loan Guarantee to encourage commercial and charitable lending to CDFIs;
- Development Fund to promote innovative business support projects; and

- National network of mentors (Business Volunteers Mentoring Association) for business start-ups.

The aim of the Community Finance Initiative element of the Phoenix Fund is to develop the CDFI market. The CDFIs<sup>32</sup> are an outlet for providing loans to the local community for social and business enterprise, and start-ups. They aim to increase the availability of finance and support for entrepreneurs, and address problems around job shortages and lack of local services to aid regeneration in disadvantaged communities. The focus is on business start-ups, but the fund may also support existing businesses and social enterprises (though they must be SMEs<sup>33</sup>). CDFIs are being used to channel two sources of funding: the Challenge Fund and Loan Guarantees.

#### Challenge Fund

The Challenge Fund resources CDFIs in England<sup>34</sup> through grants, which the CDFIs then on-lend to entrepreneurs. This usually takes the form of loans, but may also be equity finance. The CDFIs are seen as a provider of 'last resort' finance and are expected to receive a 'reasonably commercial' rate of return from their customers. The Challenge Fund also makes some revenue grant awards to supported CDFIs.

<sup>30</sup> This can be a geographically-based community or a group defined by a common characteristic – women, ethnic minorities, disabled people, etc.

<sup>31</sup> The loan guarantee to CDFIs operates across the UK. The other elements apply in England only. The devolved administrations are responsible for business support in their own territories.

<sup>32</sup> CDFIs typically take the form of Credit Unions, Mutual Guarantee Societies, Micro Loan Funds, Community Loan Funds, Community Development Venture Funds and Social Banks. They are organisations providing finance and access to business support for enterprises in disadvantaged communities, or groups with a strong social purpose that are unable to access funds from traditional sources.

<sup>33</sup> Fewer than 250 staff.

<sup>34</sup> Scotland, Wales and Northern Ireland have their own share of the Phoenix Fund to use as appropriate, though the loan guarantee element applies UK-wide.



The type of projects that have received funding (see boxes A3.3.1(a) and A3.3.1(b)) have enabled groups which generally find it

difficult to get loans to obtain funding and so develop the enterprise culture in their community.

### *Box A3.3.1(a): Examples of how grants from the Challenge Fund are used to set up loan funds*

- *West Yorkshire Enterprise Agency (Huddersfield)* – creation of a loan fund to support hard-to-reach groups in start-up and micro businesses;
- *North London Chamber and Enterprise Credit Union* – establishing a new loan fund to assist the African-Caribbean Community to set up businesses; and
- *Bristol Enterprise Development Fund* – providing a loan fund for deprived wards within the former Avon region and offering leverage for negotiations with commercial lenders.

#### *Loan Guarantee*

The Loan Guarantee element of the Phoenix Fund applies across the whole of the UK and is there to encourage commercial and charitable lending to CDFIs by assisting CDFIs to demonstrate that they are viable businesses.

The Loan Guarantee has allowed CDFIs to lever in commercial funding and so boost their existing loan funds.

### *Box A3.3.1(b): Examples of how the Loan Guarantee is being used*

- *Developing Strathclyde* – lends to businesses and individuals in disadvantaged areas. The Guarantee will be used to lever in funds from the commercial sector to increase funds for on-lending, particularly in deprived areas; and
- *Aston Reinvestment Trust (ART)* – lends for social and economic purposes in the inner wards of Birmingham. The Guarantee will be used to lever in borrowing from commercial sources to increase funds and extend their area of operation.

The first round of bidding for CDFI support through the Phoenix Fund has resulted in awards to 16 organisations, amounting to total funding of £6 million.

#### *Development Fund*

The Development Fund provides grants to encourage innovative ideas and promote enterprise in disadvantaged areas and among groups under-represented in business ownership. It aims to promote best practice by supporting a limited number of high-quality projects targeting areas/groups that usually find it difficult to be involved in

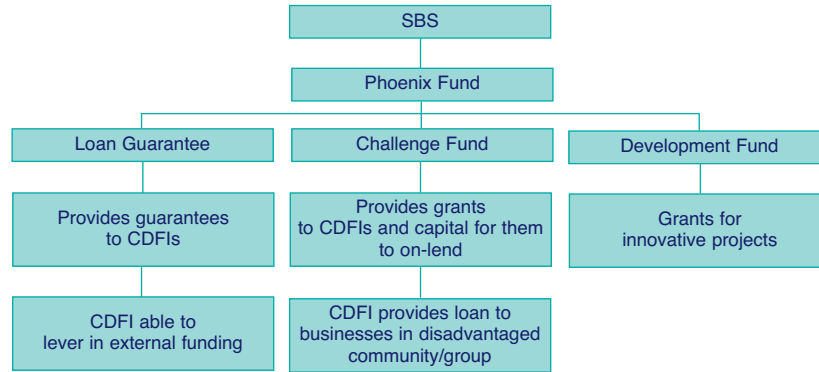
enterprise. The scheme has funding of around £35 million over four years.

Funding can be one-off or for staged projects running up to three years. It can be used for delivery costs (salaries), promotional literature, printing, stationery and premises (rent or alterations). The Fund will also contribute to feasibility studies.

Under the first round of the Fund, 50 projects are being supported at a cost of £15.2 million. Types of activities being undertaken include funding outreach workers



### The Phoenix Fund administrative structure



to work in and with specific communities, supporting business incubators, promoting network opportunities, the use of ICT and support for social and community enterprises.

#### *Business Volunteer Mentoring Association (BVMA)*

A national network of volunteer business mentors providing support to pre and early start-up businesses – including those from disadvantaged groups and areas – has been successfully piloted by the National Federation of Enterprise Agencies (NFEA). The initiative is now being rolled out into a fully-fledged service available within the business support infrastructure. In the roll-out, NFEA will continue to oversee the co-ordination of the initiative for delivery at local level through local enterprise agencies and other Business Link local partners.

#### *Challenge Fund and Loan Guarantees*

The Small Business Service (SBS) is responsible for the overall co-ordination of the fund, both in making the awards and putting award winners in contact with their Regional Development Agency (RDA) and Business Link.

The criteria for awarding grants (and guarantees) are that the project must have a clear objective of promoting social inclusion

and be targeted at a defined disadvantaged community or group. There must be a clear need for Phoenix Fund support, a business case setting out how the money will be used and the CDFI needs to have adequate loan management facilities and experience. In making their application, CDFIs are also required to provide information about their finance requirements, the terms under which they make loans and history, including default rates and details of past loans.

SBS are considering part funding the set-up of a trade association for CDFIs to provide support and cohesion. This was a recommendation of the Social Investment Task Force (SITF).<sup>35</sup> The trade association will provide advice on areas for funding, publish performance indicators, offer best practice guidance and monitor and evaluate the performance of CDFIs.

#### *Development Fund*

The Development Fund is administered by the SBS. Applications are reviewed by the Social Inclusion Unit (part of SBS) and Government Offices. An independent assessment panel then advises SBS on final awards. Successful projects are encouraged to develop close links with their local Business Link operators to promote the exchange of experience and the dissemination of good practice.

<sup>35</sup> *Wealth Beyond Welfare*, Final report of Social Investment Task Force, 2000.



### A3.3.2 Launch Investment

#### *Aim*

Launch Investment aims to assist the design and development of high-value aerospace projects, which would otherwise be lost to the UK economy.

#### *Key features*

Launch Investment is a risk and revenue-sharing Government investment in the design and development of specific civil aerospace projects in the UK. It has been used to support developments of airframes (or parts such as wings), helicopters and aero engines. It is available only to the aerospace sector under the Civil Aviation Act 1982.

The Investment is not a grant and is repayable to the Government at a real rate of return which seeks to reflect the nature of the risk borne by HMG, usually via levies on sales of the product developed. The Government incurs the risk that the company may not achieve sales at the level or price forecast. Launch Investment therefore means the company and the Government share the typically very high level of risk in aerospace projects, characterised by high costs and long payback periods.

Launch Investment is given in part because other international governments provide financial assistance to their aerospace industries, while the projects are thought to be highly internationally mobile so it may enable the UK to capture valuable projects that might otherwise be carried out abroad. The provision of Launch Investment is entirely discretionary.

There are analogous schemes operating in several other European countries (including France, Germany and Spain). The US supports its industry by indirect measures, in particular the very large R&D programmes

run by NASA and the Department of Defence. A range of international agreements exists to regulate financial support given to industry by governments. Any offer of launch investment must be consistent with the UK's international obligations. Principally, these are the European Union's State Aid rules, the 1992 EC/US Agreement on support for large civil aircraft and World Trade Organization (WTO) rules (which would cover engines).

#### *Supported projects*

Significant projects supported in the past include the Airbus A320 and A330/340 programmes. The A320 investment has already been repaid to government, and continues to provide a return. The A330/340 is contributing a steady stream of funds to the Exchequer, and is expected to pay for itself in the medium term. In November 1997, the Government reached agreement with Rolls-Royce to support the development of three new engines in the Trent family, for the Airbus A340–500/600, and for stretched and longer-range versions of the A340.

In March 2000 the Government announced a further Launch Investment partnership for BAE Systems, to support their participation in the Airbus A380 'super-jumbo', on which BAE Systems are manufacturing the wings. The investment of around £530 million is the largest Launch Investment announced to date. The most recent provision has been a £250 million investment for Rolls-Royce, to develop engines for new Airbus and Boeing aircraft.

#### *Administration*

There is no formal scheme for applying for Launch Investment. In practice, an applicant invariably starts by meeting with the Department for Trade and Industry (DTI) officials. There is no guidance for the scheme, nor any formal budget, but DTI have



provided a number of criteria against which applications will be judged.

Applicants have to submit a business case setting out:

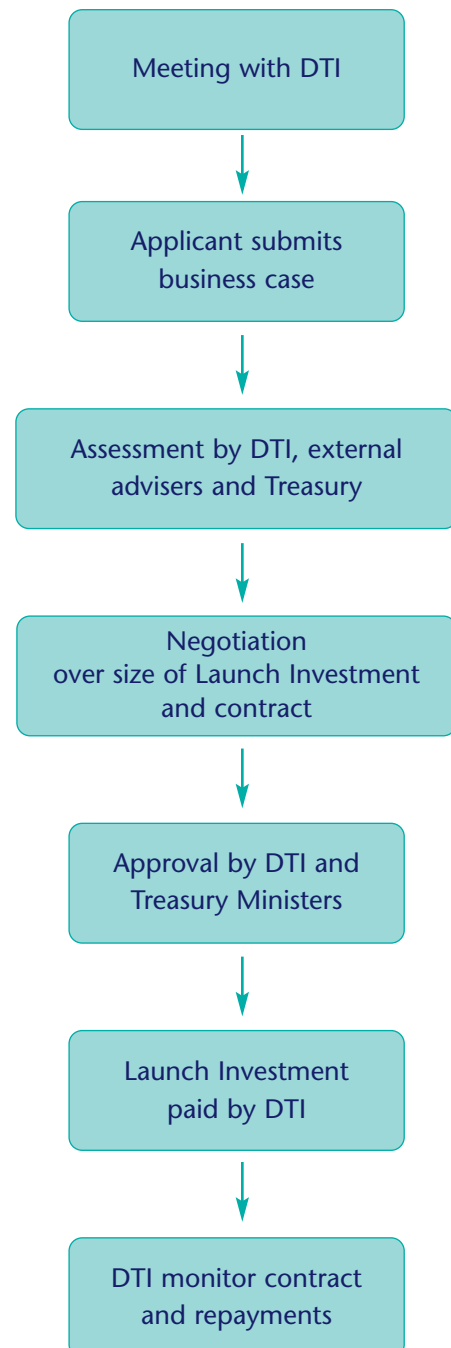
- commercial, market and technical feasibility – projected sales, rates of return, the range of projected outcomes and associated risks;
- why the investment is needed – and cannot be funded via the capital markets;
- why the project would not go ahead within the UK if a loan was not given; and
- what wider benefits the scheme would bring to the UK.

DTI officials then undertake a detailed assessment of the company's business case. This covers claims that the project cannot be funded by alternative means; the technical viability; the market; and the wider benefits of the project to the economy beyond the company itself (e.g. spin-off of new technologies, production methods or transferable improvements to the skill base).

Following detailed assessment of the business case there will then be a period of negotiation. If the application is approved, the Government provides the minimum support it believes is required for the project to go ahead.

For a successful application, Launch Investment is paid out by DTI to the company. DTI will stay closely involved, with a role in subsequently monitoring the contract: ensuring contract conditions are met and payments are made to timescale; forecasting the stream of future revenue, particularly where these are sales or output contingent; and writing off any bad debts.

### The Launch Investment administration process





### *Administration costs*

The administration costs include a full team working on individual negotiations (up to six people) plus the financial costs of external advice from accountants and commercial lawyers who draft the contract. In the latter case, the applicant company refunds these.

Overall costs to departments will vary from loan to loan depending upon input, but might be around £200,000 for a single Launch Investment (assuming a team of six working for six months, plus other inputs). For the Rolls-Royce Launch Investment, administration costs would be less than 0.1% of the value of the investment. This may not be a particularly good indicator of administrative efficiency, as the design of the contracts, risk, and return that Government makes are all highly dependent on the administrative input. In practice, loans may involve more in-depth analysis of business cases and a lot more negotiating than a grant, so costs may be higher, but this should be reflected in a better return and higher value for money from the investment.

Launch Investment is being reviewed as part of DTI's wider review of business support.

### **A3.3.3 Home Shipbuilding Credit Guarantee Scheme**

#### *Aim*

Providing guarantees to secure commercial financing and low-cost loans for the financing of shipbuilding, to help support valuable projects.

#### *Key features*

The Home Shipbuilding Credit Guarantee Scheme provides loan guarantees and interest rate guarantees (and subsidies) for the purpose of financing the construction, completion or radical alteration of ships and

mobile offshore installations (MOIs) in yards approved by the Secretary of State for Trade and Industry (currently four yards remain). MOIs are essentially rigs and certain floating production storage and offloading vessels. The Scheme is operated for the Department of Trade and Industry (DTI) by Ship Mortgage Finance Company plc, a subsidiary of 3i plc.

There are two components to the scheme:

- Loan guarantee – guaranteed loans are available for up to 80% of contract value for ships and up to 85% of contract value for MOIs. This guarantee is provided by DTI to the banks. DTI will secure this loan against assets owned by the shipowner.
- Interest rate guarantee and subsidy element with loans offered at a fixed rate of 7.5%. If market interest rates (London banking rate) exceed this, then DTI will subsidise the difference to the shipping owner's banks, whereas when the market rate falls below this level, the banks will provide income to the DTI (this has been happening on existing schemes in recent years).

Charges are levied for provision of the finance and guarantee, currently these are 2–3% of the amount of a loan for periods of 8 years or less, 4–5% for periods of between 8 years and 10 years, and 1% for periods of more than 10 years, up to the present maximum loan period of 12 years from delivery or redelivery. These charges are low by commercial standards.

The guarantee is secured against the shipowner's assets. Security depends on a variety of factors, such as type of vessel involved, the credit standing of the borrower and any holding company, the project involved and the market in which the vessel is to operate. Purely as a guide, vessels for

which there is an established and not too volatile market for sale are normally considered good security for loans up to 60%. Under such circumstances further security may be sought for the balance up to 80% (ships) or 85% (MOIs), depending on the credit standing of the borrower.

Interest rate subsidies/guarantees mean that the fixed rate of 7.5% is generally lower than rates that can be obtained commercially.

In recent years, the 7.5% fixed rate has been quite high relative to commercial rates, so investors have been less interested in pursuing this element. The DTI has been operating a variant of the scheme since 1999 that allows shipowners to get a loan guarantee but without the fixed interest rate element.

#### *Administration*

The administration is by Ship Mortgage Finance Company plc (SMFC), a subsidiary of 3i plc, on behalf of the DTI. SMFC evaluate a scheme against criteria, and suggest what terms should apply to loans and guarantees, including the level of guarantee and the required securitisation.

Eligibility criteria allow any person or company incorporated in the UK, Isle of Man or Channel Islands to apply for a loan for the purpose of financing the construction, completion or alteration of ships and MOIs at an approved yard.

The 7.5% is set in relation to an 8% allowed in an Organization for Economic Cooperation and Development (OECD) and EU agreement on allowed support to shipbuilding. The scheme is fixed under international rules with the overall Government cap of £1.5 billion. Financing peaked in the mid-1980s at about £1 billion, but has been in decline ever since.

£200 million is currently loaned under this scheme. In the UK the scheme is used for financing 10–30% of shipbuilding.

#### *A.3.3.4 Small Firms Loan Guarantee Scheme*

##### *Aim*

The Small Firms Loan Guarantee Scheme (SFLGS) aims to assist viable small businesses access loans where conventional finance is unavailable because of a lack of security.

##### *Key features*

The Scheme guarantees loans from banks and other financial institutions for small businesses with viable business proposals that have tried and failed to obtain a conventional loan because of a lack of security. Loans are available for periods of between two and ten years on sums from £5,000 to £100,000 (£250,000 in the case of businesses which have been trading for two years or more). The Department of Trade and Industry (DTI) guarantees 70% of the loan for businesses trading for less than two years, rising to 85% for businesses trading for two years or more. In return for the guarantee, the borrower pays the Small Business Service (SBS) a premium of either 0.5% or 1.5% per year on the outstanding amount of the loan. The commercial aspects of the loan are matters between the borrower and the lender. Typically rates are 2–3% above the base rate.

To be eligible, a firm must have an annual turnover of no more than £1.5 million (£5 million for a manufacturer). There are a number of exclusions, including retail. Until November 1998 agriculture was not covered by the Scheme, given EU State aid constraints, but a variant of the Scheme is now available in this sector. Loans are available for most business purposes



(including provision of working capital), although there are some restrictions.

In April 2001 the Scheme was temporarily extended to assist businesses affected by the foot-and-mouth outbreak. For businesses affected there are additional flexibilities to alter the terms of existing SFLGS loans and for new loans the Scheme has been extended to include some previously excluded sectors (principally retail, catering and other local services).

#### *Two key features of the Scheme*

- Take-up of SFLGS is demand led. There is no overall limit on the extent of lending that banks may make under the Scheme, although there are some individual limits. The aim is for the Scheme to be used where other sources of finance are not available. Accordingly, the Government wants financial intermediaries such as accountants, small business advisers in banks and Business Links advisers to be aware of the Scheme as well as businesses, but is not actively marketing the Scheme. If take-up becomes too high, DTI could adjust Scheme parameters (premium, eligibility, size of guarantee, etc to manage demand) or put a direct cap on the value of loans that will be guaranteed, as happens with the Career Development Loans scheme operated by DfES with the banks. One issue is the extent to which demand and take-up would increase if banks and advisers more actively pushed the Scheme.
- DTI is liable to pay out all legitimate calls on the guarantee for defaulting loans. The full contingent liability is currently around £400 million.

The Government gets revenue from the Scheme from (i) premium payments on guaranteed loans and (ii) where loans default and some of the capital is subsequently

recovered by banks (and would be split between SBS and banks 70:30 or 85:15).

Chart A3.3.4(a) shows the annual number of loans made under the Scheme. It can be seen that there have been significant variations in the use of the Scheme. A number of factors are at play here. Changes in Scheme parameters have a strong impact on take-up, e.g. increase in the premium in 1984 led to a sharp fall in demand. External factors also help determine SFLGS demand, e.g. overall state of the economy, real interest rates and house prices.

#### *Administration*

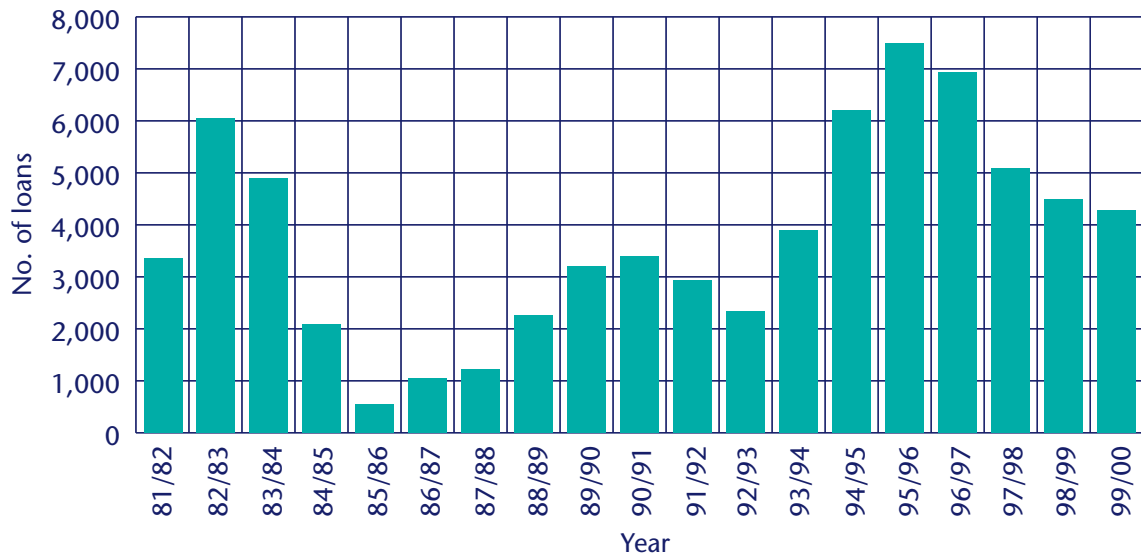
Information on the Scheme is provided by SBS and Business Links and small business advisers in banks. There is evidence that knowledge about the Scheme, and marketing or advice, varies across banks and across different areas of a bank's network. Administration is primarily by banks, which decide upon the business case and then whether the SFLGS can be used, if they would not normally lend, given the lack of collateral or credit assessment. For loans over £30,000 the SBS's approval is required, with most banks able to operate the Scheme independently for smaller loans. The Scheme is operated by 19 banks and other financial organisations. Most of these have a central unit for processing SFLGS applications.

#### *Administration costs*

It is estimated that SBS/DTI's costs are £300,000–400,000 p.a. This covers the direct costs of Scheme administration, but excludes building costs and other central overheads. It is estimated that this is around 10% of full administration costs. So the full costs of the Scheme, including the cost for banks, would be £3 million to £4 million, i.e. around 2% of loan value.



**Chart A3.3.4(a): Number of guaranteed loans each year**



### A3.3.5 Small Firms Training Loan Programme

#### Aim

The Programme aims to encourage more vocational education and training to take place in the small firms sector, to increase productivity and growth. It is administered via the Department for Education and Skills (DfES) in partnership with eight high street banks, to help small firms access funds for training.

#### Key features

The Small Firms Training Loan Programme (SFTLP) was introduced throughout Great Britain in 1994. The Programme provides assistance to small firms in developing and financing their training plans through borrowing, by offering loans which include a repayment holiday and preferential rates of interest. The intention is that this will overcome the resistance of many small businesses to invest in training.

Key features of the SFTLP are:

- Training loans are deferred repayment bank loans. They are available to sole traders, partnerships, limited companies, franchises and co-operatives with 50 or less permanent staff. Small firms can borrow between £500 and £125,000 for vocational training, which can be full-time, part-time, distance learning or in-house training.
- Loans can cover up to 90% of course fees plus the cost of books, materials and other related expenses, subject to a maximum of £10,000 per trainee and not more than £5,000 average per trainee. Loans can also cover up to 90% of the costs of training-related consultancy advice, subject to a maximum of £5,000.
- Firms make no repayments for 6–12 months of training time, according to the amount borrowed. DfES pays the interest on the loan during this holiday period.
- The borrower can repay the loan over a period of one to seven years. The borrower negotiates this with their bank. Monthly repayments normally start within one month after the holiday period.



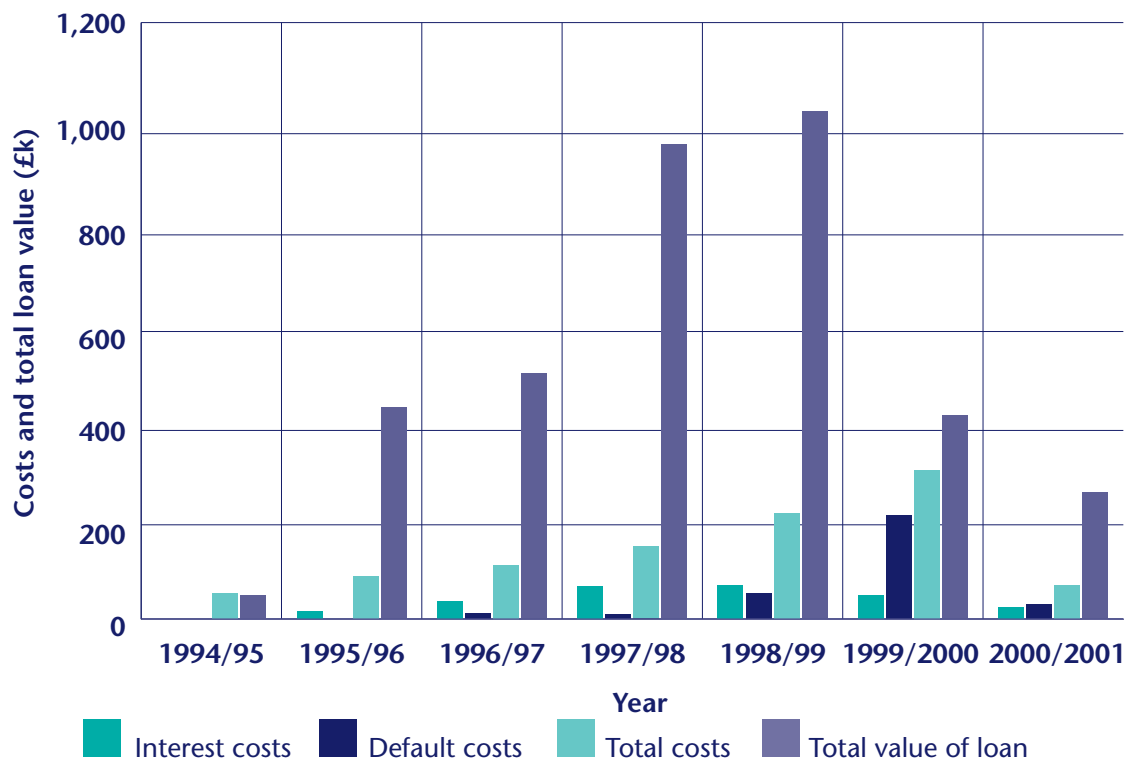
Chart A3.3.5(a) shows the annual costs of the scheme and the total value of loans made in any year. The default costs vary quite a bit from year to year, and the 1999/2000 figure contains one payment for a loan of £122,000 made in 1999. We would need further information to determine the average default rates for loans, but this does indicate the relatively low default costs of the scheme. It is also notable that the administration costs (particularly the programme support costs) are quite high relative to the value of loans, though this is largely a product of low take-up in most years.

loan product. On loans of up to £25,000 there is a six-month capital and interest holiday and on loans over £25,000 a 12-month capital holiday. DfES does not pay any interest to the bank during the holiday period. Instead it pays cashback to the small firm at the end of the holiday period. The pilot has been extended to run for the current year. So far only five loans have been taken up under this scheme. However, the scheme is still attractive to banks, as it can be handled in the same way as existing deferred interest bank loan products (with DfES paying the deferred interest) so it substantially reduces the administrative burden, and other banks have expressed tentative interest in adopting the same scheme.

### Pilot with Barclays

From 1 March 2000, the benefits of a SFTL have been offered through a Barclays business

**Chart A3.3.5(a): Total lending and costs of Programme per year (£m cash prices)**





### Administration

The banks, taking account of DfES's criteria and their own commercial lending criteria, make all loan decisions. Applications are made to participating banks, which are: Barclays, Bank of Scotland, Clydesdale, The Co-operative, HSBC, Lloyds TSB, NatWest and The Royal Bank of Scotland. The banks do find the process quite cumbersome, given the information they need to provide to DfES for the scheme. DfES's own programme support costs are shown in table A3.3.5(a) – which average around £70,000 a year, which appears relatively high given the number of loans made under the scheme.

### A3.3.6 Regional Selective Assistance

There are two elements to regional industrial financial support offered by Department of Trade and Industry (DTI), Regional Selective Assistance (RSA) and the Enterprise Grant. RSA is normally paid as grant, but it has been considered here, as in the past it has been provided as loans and recently DTI have been exploring repayable grants.

#### Aim

The aim of RSA is to help all regions to compete successfully and maximise their contribution to the UK economy and employment. This is done through influencing the location of business by

**Table A3.3.5(a): SFTLP payments and defaults 1994/95 to 2000/01**

£k	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01
Interest	1	15	34	62	75	54	23
Default	0	0	11	9	57	224	31
Programme support	50	50	50	50	67	45	24
TEC	0	15	15	15	14	5	0
<b>Net</b>	<b>51</b>	<b>80</b>	<b>110</b>	<b>136</b>	<b>213</b>	<b>328</b>	<b>78</b>
Total loan value for year	47	461	512	945	1,064	431	276
Number of loans	8	49	102	149	138	66	54 <sup>36</sup>
Average value of loans	5.9	9.4	5.0	6.3	7.7	6.5	5.1

Notes:

- 1 The Programme was launched in June 1994, so the figures for 1994/95 only cover 10 months.
- 2 The large default for 1999/2000 includes one very large loan default of £122,876, for a loan that had been taken out in 1998/99.
- 3 The programme support cost are evaluation and research costs, printing costs for scheme literature, contract with mailing house (Intelmark) to provide a call centre, and to despatch application packs, publicity and marketing.
- 4 The TEC costs were for a fee that the TECs were paid for endorsing SFTL applications, £500 for each approved loan. The rules concerning the endorsement changed to only being needed when the loan was for more than £15,000 and was not with the firm's normal bank. Since 1.4.2001 there is no longer any endorsement process.
- 5 Costs are cash prices, with no adjustment for inflation.
- 6 This implies an overall crude default rate of less than 9%. This would be higher once account is taken of outstanding loans that would continue to default, but is inflated by the default of the £123,000 loan in 1999/2000, which was atypical.

<sup>36</sup> This figure consists of 49 standard loans at a total value of £246,000 and five under the Barclays pilot at a total value of £30,000.



targeting support to businesses moving to or expanding in Assisted Areas.

#### *Key features*

RSA is a discretionary scheme (GB wide) and is available for both domestic and international investors involved in the Assisted Areas.<sup>37</sup> The Statutory provision for RSA<sup>38</sup> allows the scheme to use loans and guarantees as well as grants (currently all RSA is offered as grant).

RSA was originally aimed at the manufacturing industry, but is now available to service sector businesses as well, excluding retail and some other categories of business. RSA provides assistance towards projects with capital expenditure of over £500,000 (in England only). The scheme has traditionally focused on:

- safeguarding or creating employment;
- attracting and retaining international mobile investment; and
- contributing to the competitiveness of disadvantaged areas.

The assistance generally covers establishing a new business, expanding an existing

business, setting up R&D facilities and enabling businesses to move from the development stage to production. The 1998 Competitiveness White Paper announced new measures to improve competitiveness. As a result RSA has been focused on knowledge-based projects, creating skilled jobs, and developing measures to support the growth of small businesses.

RSA is usually provided as grants. There has been some use of loans and guarantees in the past, though these were not wholly successful given risks and problems with recovery. Recently some use has been made of recoverable grants with the intention of allowing government to share in the success of projects by linking repayments to levels of turnover/productivity, e.g. motor vehicles and electronic sectors. It will be some years before this policy can be evaluated.

#### *Box A3.3.6(a): Projects receiving RSA*

- Pfizer Ltd will create 400 high quality jobs in a new Pharmaceutical Sciences Centre for developmental research in Sandwich, East Kent. They received £5 million in RSA assistance towards a £134 million investment.
- Nissan will safeguard jobs manufacturing replacement models for the Micra and Primera cars in Sunderland, Tyne and Wear. They have received an offer of £45 million in RSA towards an investment of £383 million.
- TRW Lucas Varity will create 536 jobs to manufacture electric power assisted steering in Birmingham, with an offer of £6 million RSA towards investment of £30 million.

<sup>37</sup> Those approved by the European Commission. They are generally reviewed every six years. The new Assisted Areas map for Great Britain was agreed by the European Commission in July 2000 and will run to 31 December 2006. These areas can be granted aid under Articles 87(3)(a) and (c) of the EC Treaty. See map of Assisted Areas at [www.dti.gov.uk/regional/assistedareas/annex\\_e.htm](http://www.dti.gov.uk/regional/assistedareas/annex_e.htm)

<sup>38</sup> Section 7 of the Industrial Development Act 1982.



The Government has introduced the Enterprise Grant for fostering the growth of SMEs<sup>39</sup> in the Enterprise Grant areas of England.<sup>40</sup> Enterprise Grant areas extend outside of the Assisted Areas. The scheme provides grants to companies investing up to £500,000 capital expenditure in projects. The grants are up to 15% of fixed capital costs (to a maximum of £75,000) for quality projects that would not otherwise be able to go ahead.

#### *Supported Projects*

Box A3.3.6(a) provides examples of the types of projects RSA can support, and the value and job creation it can bring to regional economies in England.

#### *Administration*

The Government Offices (GO) have been responsible in the English regions for putting into practice RSA policies. Their role in administering RSA involved appraising applications and the awarding of grants up to £2 million. Following the DTI review of priorities and structures the RDAs will, in future, be carrying out the administration of RSA awards of up to £2 million in the English regions. Scotland, Wales and Northern Ireland operate their own schemes working to similar guidelines as those used in England.

Applications for RSA must include:

- a description of the business;
- project details, including rationale, estimate of required finance and an indication of the minimum amount needed; and

- why RSA is needed for the project to proceed, how it could influence location and consequences if RSA is not granted.

Where assistance of over £2 million is requested a fuller economic appraisal is carried out. The grants are paid in instalments against an established criteria and are based on agreed fixed capital expenditure and job targets (based on the minimum amount needed for the project to go ahead). The criteria's coverage includes the need for the project to be in an Assisted Area in which the need for the grant and viability of the project can be demonstrated. Eligible investments must be over £500,000 in England, preserve or create jobs and contribute positively to the national and regional economy.

There are European Commission restrictions on State Aids for sectors where there is over capacity, i.e. in iron and steel, fishery, coal and agricultural products. Within the UK there are also market restrictions to ensure projects are not displacing or reducing existing jobs. This forms part of the project appraisal.

Following the adoption of the new Assisted Areas map in July 2000, there has been a drop in the number of applications in England for RSA from 1,200 over the year to about 800. This is likely to be temporary, reflecting a jump in applications before July 2000, to take advantage of the old Assisted Areas map while this was still in use.

The administration process for Enterprise Grant is similar to RSA except that each of the GOs was given an indicative budget and decides on the selection criteria and processes to use in allocating the budget. In future this will be carried out by the SBS.

<sup>39</sup> Employing fewer than 250 staff.

<sup>40</sup> Areas within the North West, North East, Yorkshire & Humberside, East Midlands, West Midlands, South East, South West and London (see map at [www.dti.gov.uk/regional/assistedareas/annex\\_e.htm](http://www.dti.gov.uk/regional/assistedareas/annex_e.htm)). These areas are those where there are labour market weaknesses, rural development areas and ex-coal field areas, which can be awarded an Enterprise Grant under European Commission rules.

## APPENDIX 4. CREDIT AND DEBT

### Summary

Before government intervenes to provide a loan it needs to satisfy itself that distributional objectives or the existence of market failure justifies government intervention (and that the benefits of that intervention outweigh the costs and risks of doing so). This appendix summarises the available evidence about the availability of credit and other financial services, and the extent of indebtedness, particularly for those on low incomes. The main findings are:

- There are significant numbers of people who do not use credit, do not save and do not insure themselves. Credit use is particularly low amongst poor households, and the types of credit which are used tend to be relatively expensive.
- There are both market failure and distributional reasons why people do not borrow, insure or save. The effect of these market failures is to make borrowing or insurance more expensive – exacerbating distributional concerns.
- Debt is not the same as over-indebtedness. Borrowing can be a useful tool to help households smooth their income over time. Debt only becomes a problem when people cannot afford the repayments. Household debt is rising. Some of this is due to a rise in home ownership and reflects a corresponding increase in wealth. In a climate of rising real incomes, property prices, and low interest rates, this may be affordable. However, the evidence points to the existence of a minority of households who are paying significant proportions – sometimes over 90% – of their income on debt repayments. Young



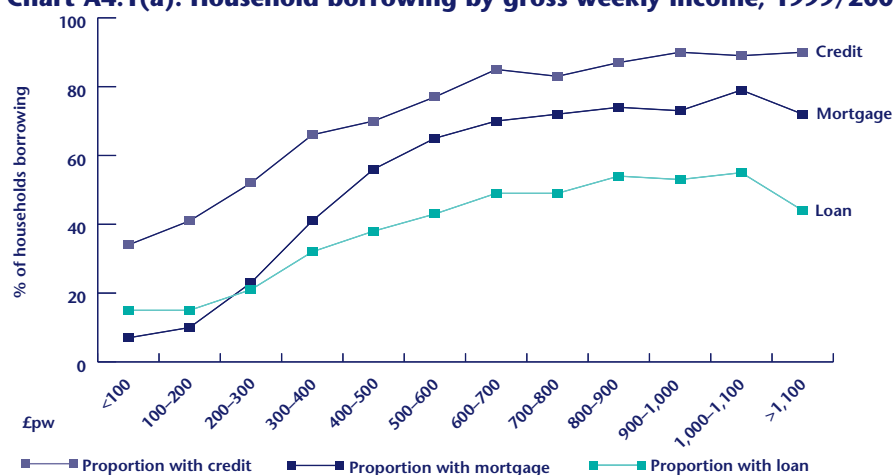
households, those on low incomes, large families, and those with a large number of credit commitments are at more risk of over-indebtedness.

- Levels of over-indebtedness may also be rising. While some indicators of over-indebtedness, such as arrears and county court judgments, are stable or falling, others, such as enquiries at debt advice centres, are rising. Citizens Advice Bureaux report a 39% rise in the number of consumer debt enquiries over the last four years. It is also thought that the total debt service ratio (the amount households spend on paying off the interest and loan principal) has risen to levels last seen in the early 1990s.
- This analysis points to the need for Government to avoid exacerbating over-indebtedness when making government loans available.
- Currently much of government intervention is at the bottom of the debt spiral, in the courts and insolvency service: coping with the effects of over-indebtedness rather than focusing on prevention. Little is known about the effectiveness of preventative tools such as financial literacy programmes, money advice and debt advice. The ability to set the right level and pattern of government investment in these tools is hindered by this lack of knowledge.
- We therefore recommend a cross-cutting review of debt advice, and the collection and enforcement of debts to Government, building on research into the effectiveness of tools for reducing over-indebtedness, and on proposals emerging from the Review of Enforcement by the Lord Chancellor's Department.



## A4.1 Credit and borrowing

**Chart A4.1(a): Household borrowing by gross weekly income, 1999/2000<sup>1</sup>**



As can be seen from chart A4.1(a), the use of credit, mortgages and loans declines with income. The type of credit used by those on low incomes also differs from that of better-off households, with much more use of

moneylenders, pawnbrokers, the Social Fund and friends and family. Table A4.1(a) provides some detail about the types of credit used by households on different incomes.

**Table A4.1(a): Household's use of credit, by income<sup>2</sup>**

	High st credit <sup>3</sup>	Low income credit <sup>4</sup>	Non commercial credit <sup>5</sup>	No credit
All households	66	2	5	27
Very low income	25	5	15	53
Low income	32	3	8	55
Not low income	82	1	3	15
Volatile income – rise	84	2	8	9
Volatile income – fall	75	2	7	19
Volatile income – rise and fall	86	2	11	6

<sup>1</sup> ONS, Family Expenditure Survey 1999-2000, © Crown copyright 2001.

<sup>2</sup> OFT Survey, Vulnerable Consumers and Financial Services. In the OFT analysis, 'very low' and 'low' income are defined according to different household types (crude equivalisation):

	Very low	Low
Single non-pensioners	<£4k	£4k-£6k
Lone parents	<£5k	£5k-£7k
Non pensioner couple, no kids	<£6k	£6k-£9k
Couple with kids	<£7k	£7k-£12k
Pensioners single	<£4k	£4k-£7k
Pensioners couple	<£6k	£6k-£9k
Other	<£7k	£7k-£8k

<sup>3</sup> 'High street credit' includes: mortgage, bank or building society loan, loan from another financial institution, overdraft facility, credit card, store card, credit arranged from retailer.

<sup>4</sup> 'Low income credit' includes: credit weekly from the home, pawnbroker, other e.g. loan sharks.

<sup>5</sup> 'Non commercial credit' includes: family and friends, credit union, Social Fund.

There are several reasons for the lower levels and different patterns of usage amongst those on lower incomes.

Individuals living on a low income may be less able to afford repayments on a loan. If the household income is near the minimum level of consumption needed to clothe, feed and house the family then it is not possible to increase expenditure in order to meet loan repayments. This may make a household reluctant to borrow.

There are also two specific information problems which mean that credit markets may not function efficiently:

- **Adverse selection.** In credit markets lenders may not be able to tell which potential borrowers are likely to repay their loans. If the lender increases the interest rate to reflect the fact that many loans are not repaid, then it is possible that the default rates actually rise: the good risks refuse to pay at that price, while the bad risks are indifferent to the price (as they were never going to repay in the first place). Here the market failure is that good risks do not receive credit at an optimal price. The distributional problem is that interest rates may be too high for those on low incomes.
- **Moral hazard.** After receiving a loan a borrower may change their behaviour in such a way as to lessen the likelihood of repayment. This imposes monitoring costs upon the lender – who need to monitor the behaviour of the borrower. These monitoring costs are reflected in higher interest rates.

The methods which mainstream lenders use to address these information asymmetries can also contribute to the problems faced by low

income households seeking to borrow. One method is credit scoring. Credit scoring uses statistical records to analyse the characteristics of those who have defaulted in the past. This data is then used to assess the likelihood of future borrowers repaying their loans. Many of the characteristics associated with default, such as frequent changes of address, no entry on the electoral role and lack of a previous credit history, are also characteristics which are disproportionately represented in lower income households. Another method is the use of collateral to secure the loan. However, 34% of households do not own their own home, and 28% do not own a car.<sup>6</sup> Again, low income households are over-represented amongst those without assets which can be used as collateral.

## A4.2 Savings and insurance

Other financial services which assist people in smoothing their income include savings and various types of insurance. The evidence here is similar: the existence of savings, and ownership of home contents insurance declines with income.

There are a number of reasons for this. Again, when on a low income, a household may find it difficult to defer consumption in order to save or pay into an insurance policy. There is also evidence that different social groups may take a different attitude towards forward planning and may have differing capacities for estimating risks which may lay some way off in the future. In particular, individuals living on low incomes may have shorter horizons than the more affluent.<sup>7</sup>

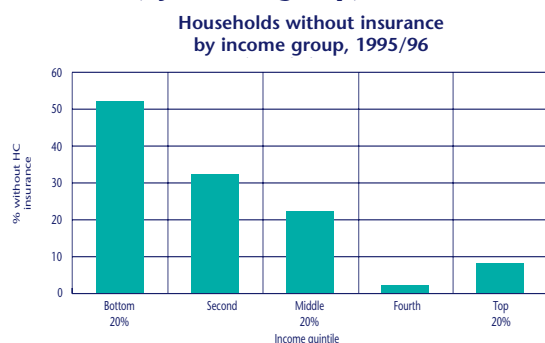
There are also several failures in the market for insurance, and these are outlined in box A4.2(a).

<sup>6</sup> Source ONS, Social Trends and IFS.

<sup>7</sup> Rowlingson, Joseph Rowntree Foundation, 2001.



**Chart A4.2(a): Households without insurance (by income group)<sup>8</sup>**



**Chart A4.2(b): No savings (% households)<sup>9</sup>**



### Box A4.2(a): Failures in the market for insurance

- **Unquantifiable risks.** Insurance can cope with risk, but not uncertainty. In order to set premiums insurers must be able to estimate the probability of a claim. Where risk cannot be estimated then insurers may set very high premiums in order to limit their own exposure. This applies particularly to insurance of far-off events such as long-term care.
- **Certainty.** Insurance is also not appropriate for events which are certain to happen. Thus congenital conditions are excluded from health insurance, as are ailments which exist at the time of insurance purchase.
- **Co-dependent risks.** Insurance pools independent risks. Where risks are linked then when an event occurs, claims would be made all at once and the insurance scheme would collapse. Thus unemployment insurance is problematic (where unemployment is caused by macroeconomic changes), except over a very short period.
- **Adverse selection.** This is a problem of information asymmetry – before the insurance contract is signed, the insurer knows less than the customer. The insurer sets premiums based on the average risk. However, customers have a better knowledge about the likelihood of that event happening to them. Thus those with low risks do not take out cover, while those who know they are risky are more likely to join the insurance scheme. As the insured population is riskier than average, claims will be higher and the insurer has to raise premiums. The market failure is that those who are relatively low risks do not get cover at a rate which reflects their own risk profile. The distributional problem is that those on low incomes may find the premiums unaffordable.
- **Moral hazard.** This is also a problem of information asymmetry – in this case the problem occurs after the insurance contract is entered into. Where the behaviour of those with insurance differs from the uninsured, this is termed 'moral hazard'. For example, car drivers may drive less carefully when they are insured. Also many events are deemed uninsurable because of this problem – suicide, divorce, pregnancy. Moral hazard, like adverse selection, raises the numbers of claims. Therefore premiums will also rise.

<sup>8</sup> Association of British Insurers.

<sup>9</sup> Family Resources Survey, 1999–2000 data.

### A4.3 Some households have no financial products at all

The evidence points to a hard core of people with no financial products and no assets, together with a wider circle of people who have access to one or two products, and/or one or two assets.

Data from the Family Resources Survey suggests that 7% of households have no financial products at all. A further 19% have one or two financial products. There are

certain groups with a much higher proportion with no financial products (income support recipients: 35%, lone parents: 23%, young families with head aged between 16 and 19: 26%, the sick or disabled: 19%).<sup>10</sup>

Table A4.3(a) provides a summary of the coverage of financial products and ownership of assets. It shows that there are groups of people who are not using financial services, and that households with low income are particularly likely to be non-users.

**Table A4.3(a): Coverage of financial products and assets**

Product/asset	Lack of coverage	Lack of coverage at bottom of income distribution (where available)
Any account	Between 6–9% of adults have no bank or building society of any kind <sup>11</sup>	17% in bottom quintile with no account
Current account	Between 15–23% of adults lack a current account <sup>12</sup>	31% of those with incomes below £100 per week
Savings and investment	Between 31–37% of households have no savings or investment products <sup>13</sup>	41% of those with incomes below £100 per week have no savings
Pension	Between 27%–38% of employees have no occupational or private pension <sup>14</sup>	–
Home contents insurance	Between 19–26% of households have no home contents insurance cover <sup>15</sup>	52% of households in bottom quintile
Life insurance	45% of households have no life insurance cover <sup>16</sup>	81% of those defined as very low income in OFT survey
Credit – mainstream	29% have no access to credit from a mainstream provider <sup>17</sup>	75% of those defined as very low income in OFT survey use no high street credit
Assets – property	34% of households do not own their home <sup>18</sup>	–
Assets – car	28% do not own a car <sup>19</sup>	–

<sup>10</sup> Kempson, Whyley, Caskey and Collard, 2000.

<sup>11</sup> Kempson & Whyley, 1998.

<sup>12</sup> Kempson & Whyley, 1998.

<sup>13</sup> Kempson 1998; OFT, 1999; Rowlingson et al, 1999.

<sup>14</sup> Budd and Campbell, HMT, 1998; DSS, 1999.

<sup>15</sup> Whyley et al 1998; HM Treasury, 1999; OFT, 1999.

<sup>16</sup> OFT, 1999.

<sup>17</sup> OFT, 1999.

<sup>18</sup> Banks, Blundell and Smith, 2000.

<sup>19</sup> ONS Social Trends, 1999.



## A4.4 Borrowing can be useful, but over-indebtedness causes real problems

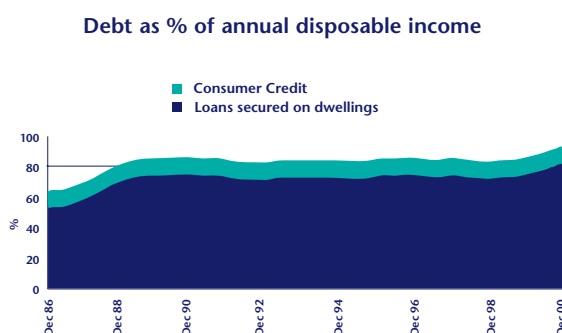
Borrowing can be a useful tool to help households smooth their income over time. But debt becomes a problem when people cannot afford the repayments. The consequences can be arrears, defaults, the repossession of homes and cars, and bankruptcy – all of which have costs for both the creditor and the debtor.

## A4.5 Levels of debt are rising...

In 2000 outstanding credit and loans secured on dwellings totalled some £649 billion. This equates to approximately £27,000 per household.

Over time levels of debt have been increasing. Chart A4.5(a) shows how debt has increased over time – there was a significant rise in the late 1980s, then a period of stability, followed by further rises in the late 1990s as debt reached over 90% of annual disposable income. Chart A4.5(b), based on the same data, brings out the longer-term shift in secured lending and the more cyclical nature of consumer credit.

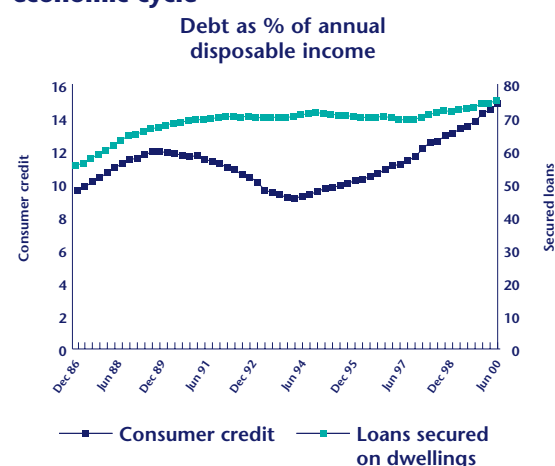
**Chart A4.5(a): Aggregate debt, long-term trend**



The growth in household debt has been encouraged on the demand side by a benign economic environment including low inflation and low nominal interest rates, a steady fall in unemployment, rising wealth and growing confidence in the stability of the macroeconomic policy regime. Also the deregulation of financial services in the 1980s made cheaper credit more widely available.

The evidence outlined in charts A4.5(a) and (b) is drawn from aggregated national statistics. This picture is supported by household-level analyses of debt. Chart A4.5(c) shows the average level of outstanding mortgage for borrowers in different household groups. The evidence here is mixed. Most groups have increased the sizes of their mortgage over the last five years, but others, notably young single households, have lower levels of mortgage debt. Chart A4.5(d) provides similar information for loans.<sup>21</sup> In general, the outstanding value of loans has increased. This is due partly to a longer-term increase in the level of household borrowing and also reflects that the 1999/2000 statistics were collected near the peak of an economic cycle.

**Chart A4.5(b): Credit and secured debt, economic cycle<sup>20</sup>**

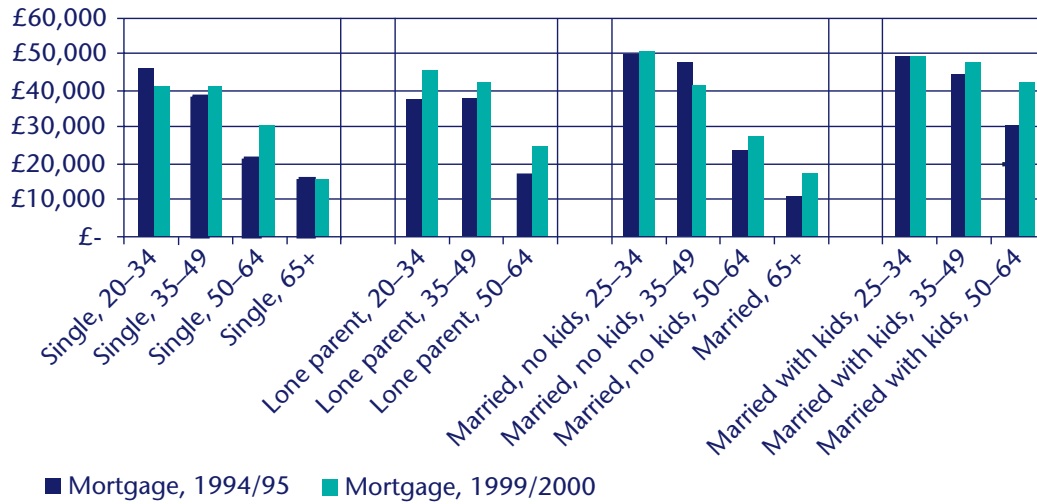


<sup>20</sup> Bank of England and Office for National Statistics.

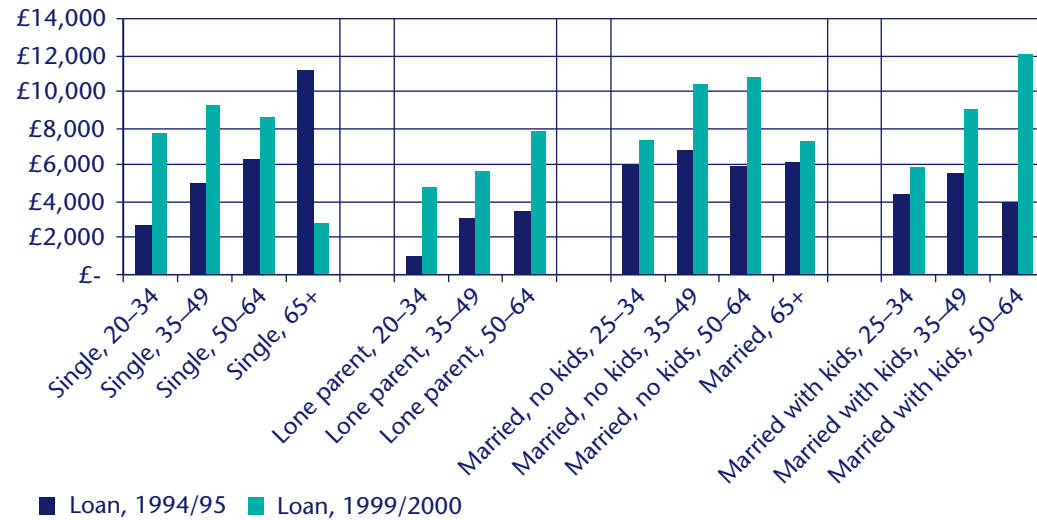
<sup>21</sup> Loans are defined as being from a finance house, credit union, second mortgage, bank personal loan, building society personal loan, or an employer.



**Chart A4.5(c): Mortgage amount left by demographic group, 1999 prices<sup>22</sup>**



**Chart A4.5(d): Loan amount left by demographic group, 1999 prices<sup>23</sup>**



<sup>22</sup> ONS, Family Expenditure Survey 1999-2000.

<sup>23</sup> ONS, Family Expenditure Survey 1999-2000.

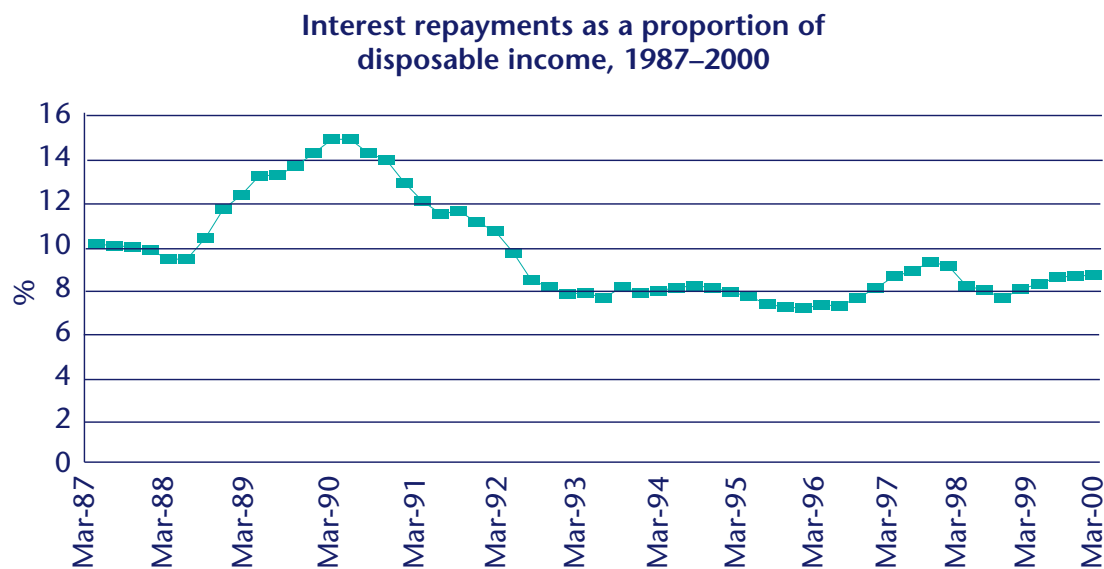


## A4.6 ... but debt repayments may be affordable

While the 'stock' of debt in the economy has been rising in recent years, the proportion of disposable income going to pay off either the interest or the loan principal has varied over

time. The current climate of low interest rates has made the increase in household debt in recent years more affordable. Chart A4.6(a) shows how repayment of the interest on debt varies with the prevailing interest rate: reaching a peak in the early 1990s, when interest rates hit 15%, and falling with the low interest rates prevalent since then.

**Chart A4.6(a): Income gearing has declined since the early 1990s<sup>24</sup>**



As a guide to the overall affordability of debt this may be misleading, as it is thought that total debt service ratios (including payments to pay off the loan principal) have increased to the level of the early 1990s – possibly due to the rise in consumer credit.

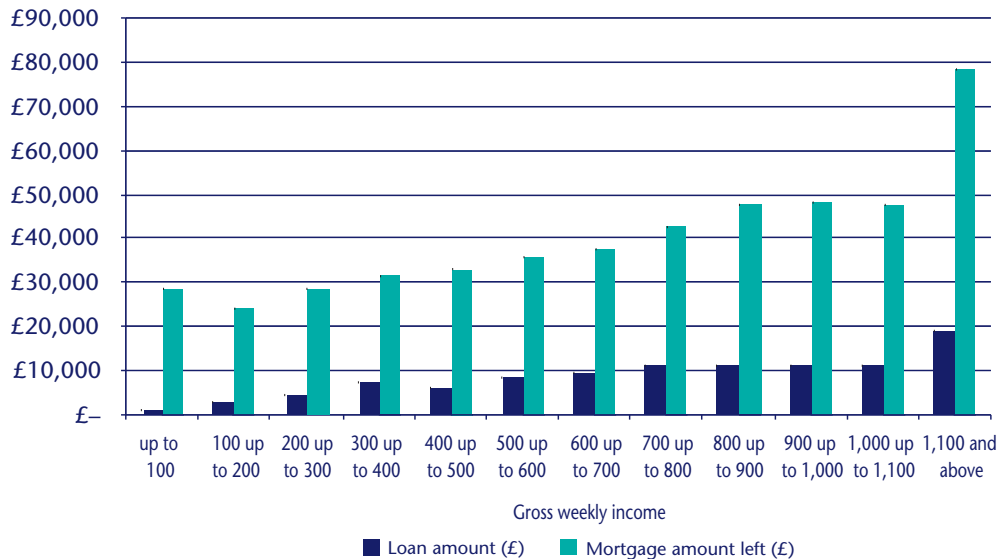
## A4.7 Over-indebtedness affects poor families and young households

Levels of debt vary by age. Mortgages are paid off over the person's life cycle and so decrease with age. The average amount of non-mortgage debt outstanding, on the other hand, generally increases with age. (See charts A4.5(c) and A4.5(d).) As one might expect, the actual levels of debt vary by income. The richer a household, the more debt they have (see chart A4.7(a)). However, generally this debt is more affordable in relation to their disposable income.

<sup>24</sup> Bank of England and Office for National Statistics income gearing refers to the ratio of interest payments to disposable income.



**Chart A4.7(a): Debt by income bands<sup>25</sup>**



By contrast, over-indebtedness affects mostly younger households and those living on low incomes. The 1989 PSI (Policy Studies

Institute) survey of credit and debt<sup>26</sup> identified five characteristics – outlined in box A4.7(a) – which correlated with a high risk of over-indebtedness:

*Box A4.7(a): Some characteristics of households at risk of over-indebtedness*

- **Age.** The younger the householder the greater the risk of debt. Pensioners had hardly any problems.
- **Family type.** Households with children had a higher risk than those with none, and the more children there were, the greater the risk.
- **Income.** Debts were strongly related to income. Non-pensioners who had net incomes below £100 a week represented 11 per cent of all households, but accounted for 37 per cent of all debts. People who had faced a sudden drop in income were especially likely to have got into debt.
- **Commitments.** For householders on moderate incomes, substantial mortgage repayments and having a number of consumer credit commitments influenced the risk of debt. Over-commitment often stemmed from a sudden drop in income.
- **Priority on payments.** Most people placed a strong priority on paying their household bills and credit commitments. But the incidence of debt was substantially higher among the minority who felt that payments could be delayed.

<sup>25</sup> ONS, Family Expenditure Survey 1999–2000.

<sup>26</sup> Richard Berthoud and Elaine Kempson., Credit and Debt, 1991, PSI.

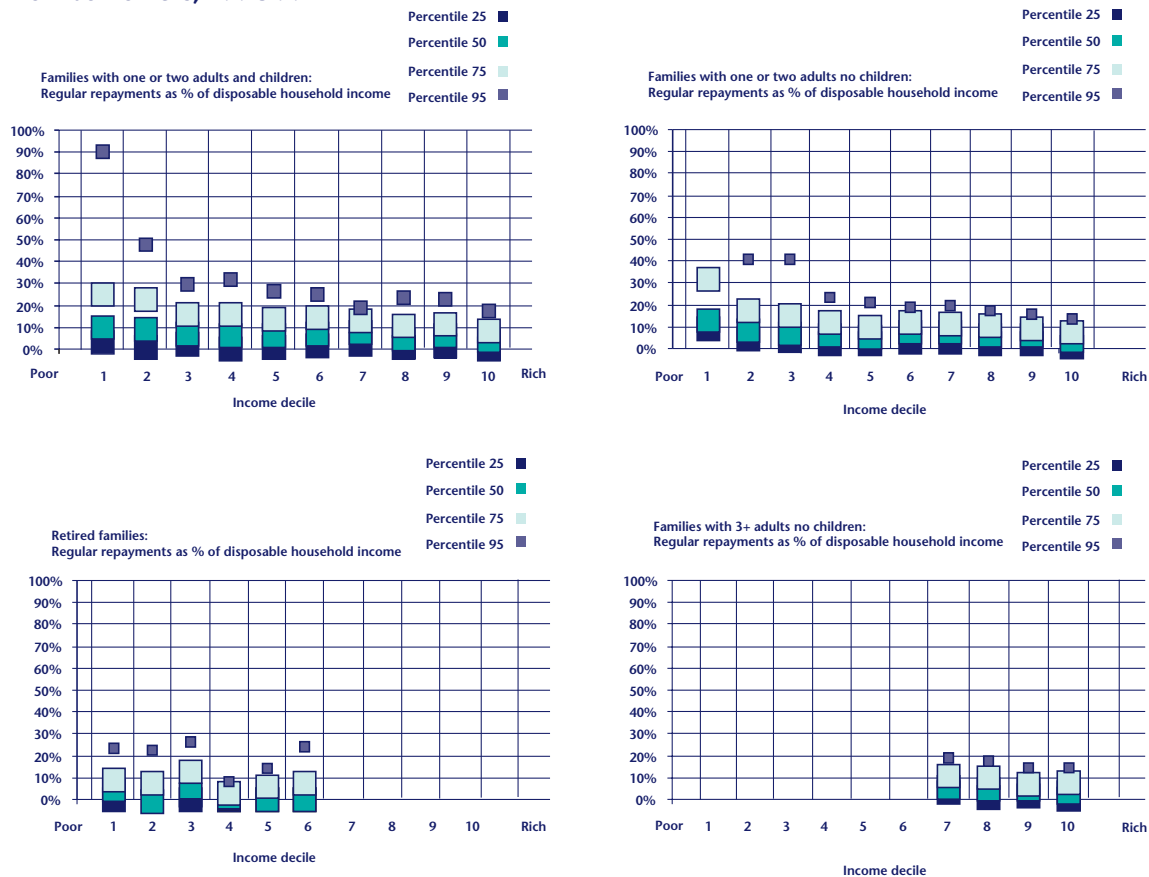


## A4.7.1 Poor households often spend proportionately more on repaying loans

Statistics showing the average amount of gearing can hide wide variations in the amount individual households spend on paying off their debts. Poorer households spend proportionately more paying off their debt than better-off families. Chart A4.7.1(a) shows the number of households spending certain proportions of their income on consumer credit repayments, broken down by different income groups. Each chart provides information about a different demographic group.

The charts show that the majority of families have debt repayments (for consumer credit only) which are generally manageable. The average family (represented by percentile 50) has debt repayments of less than 10% of disposable income: this is true whether the family is rich or poor. Retired households and families with multiple wage earners are particularly cautious borrowers. However, a small minority of working-age families (represented by percentile 95) have levels of debt repayment which are much higher. The problem becomes particularly acute for the poorest families. Here debt repayments rise, with some households spending more than 90% of their disposable income. This indicates that some families are deeply over-indebted and are consequently suffering a reduced standard of living.

**Chart A4.7.1(a): Consumer credit debt repayments by disposable income, data excludes non-borrowers, 1998-99<sup>27</sup>**



<sup>27</sup> OFT analysis of FES.



## A4.8 Over-indebtedness can lead to...

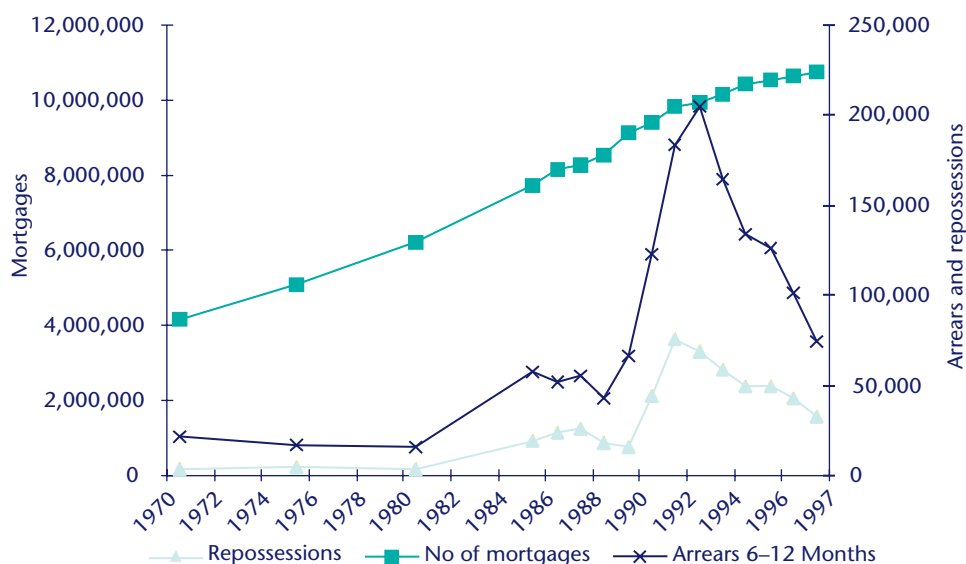
Not all households with high levels of debt and debt repayments will regard this as a problem. Indicators of which debts have become 'problem debts' can be gleaned from administrative data which shows the numbers of people in arrears with their loans or housing payments, the numbers of people defaulting on their mortgages and household bills and the numbers of court proceedings started by creditors seeking to collect debts.

### A4.8.1 ... arrears

When someone is late paying their rent, mortgage or making their loan repayments then this is generally recorded by lending institutions and landlords. The latest data

shows that at the end of 2000 there were 156,140 mortgages in more than three months of arrears (18,830 over 12 months). In 1998/99, 5% of households renting privately and 11% of those in rented social housing were at least two weeks in arrears. Chart A4.8.1(a) shows how the numbers of mortgages in arrears rose in the late 1980s and early 1990s – they have been falling steadily since then. The large increases in arrears seen in the early 1990s were due to economic downturn coupled with large interest rate rises. Interestingly, arrears have not yet fallen to their pre-recession level in spite of favourable economic conditions; this may in part be due to the increase in homeownership levels, but may reflect a more worrying trend of an increase in unsustainable homeownership.

**Chart A4.8.1(a): Mortgages, arrears and repossessions, 1970–97<sup>28</sup>**



<sup>28</sup> Council of Mortgage Lenders.



### A4.8.2 ... defaults

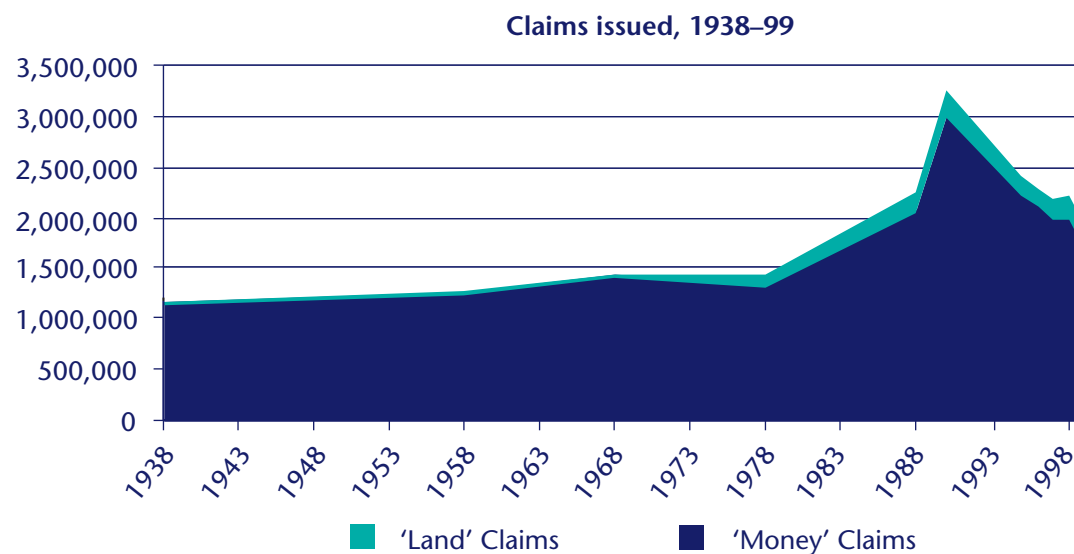
If the individual eventually defaults on their loan or completely fails to keep up payments for household bills, then this is reflected in statistics on house repossessions and utility disconnections:

- In 2000, 22,610 properties were repossessed by lenders.<sup>29</sup>
- In 1998/99, 29,500 households were disconnected by their gas supplier, compared with 4,000 households who were disconnected from their electricity and 1,129 from their water supply.<sup>30</sup>

### A4.8.3 ... court proceedings and bankruptcy

There are a large number of court processes which are associated with debt, arrears, repossessions and bankruptcies. In 1999 1.76 million summonses for money judgments were issued, 1.71 million of which were default actions.<sup>31</sup>

**Chart A4.8.3(a): Claims issued at county courts, 1938–99<sup>32</sup>**



The number of proceedings which result in county court judgments are listed in table A4.8.3(a). This shows a decline in recent years, reflecting a benign economic climate.

**Table A4.8.3(a): County court judgments**

1995	1996	1997	1998	1999	2000	% change 1999/2000
1,390,140	1,245,380	1,185,367	1,123,568	1,077,499	1,013,044	-6%

<sup>29</sup> Council of Mortgage Lenders.

<sup>30</sup> Ofgem and Ofwat.

<sup>31</sup> Judicial Statistics, 1999.

<sup>32</sup> Chart F, Judicial Statistics.



## A4.9 The numbers of people seeking debt advice are rising

Self-reported debt statistics are also useful in ascertaining trends in debt problems over time. Advice centres keep records on the number and type of enquiries they receive. In 2000, 1.4 million enquiries were dealt with by free money advice agencies, with an estimated further 260,000 users of fee-charging debt management services.

The last few years have seen a rapid rise in the numbers of people visiting Citizens Advice Bureaux to discuss consumer debts. The National Association of Citizens Advice Bureaux (NACAB) reports a 39% rise in the number of consumer debt enquiries over the last four years – to nearly one million debt enquiries in 2000/01.<sup>33</sup>

**Table A4.9(a): Citizens Advice Bureaux debt enquiries<sup>34</sup>**

Category	1996/97	1997/98	1998/99	1999/2000	Change 1998/99– 1999/2000
Consumer debt	405,826	433,385	510,938	592,423	16%
Housing debt	132,544	131,287	136,905	132,622	–3%
Utilities debt	90,696	89,857	95,619	97,241	2%
Tax debt	75,664	68,007	66,454	66,889	1%
Benefits debt	24,671	27,430	31,855	33,768	6%
Legal debt	26,518	24,119	23,339	23,267	–
Employment debt	15,869	15,922	15,869	17,216	8%
Relationships debt	18,136	16,091	15,372	13,990	–9%
<b>Total</b>	<b>789,924</b>	<b>806,098</b>	<b>896,351</b>	<b>977,416</b>	<b>9%</b>

## A4.10 There may be a case for earlier intervention to prevent over-indebtedness

Over-indebtedness imposes costs on debtors, creditors and taxpayers. Government intervention is mostly concentrated at the end of the debt spiral – more resources are concentrated on the courts and the Insolvency Service than on debt advice, generic money advice or financial literacy programmes. There may be a case for more resources being targeted at the beginning of

the debt spiral – to prevent over-indebtedness and resort to the court system. However, little is currently known about the effectiveness of interventions to prevent or mitigate over-indebtedness (debt advice, financial literacy programmes and generic money advice). **The Performance and Innovation Unit (PIU) concluded that a study should be commissioned to investigate the comparative effectiveness of strategies to reduce over-indebtedness.**

<sup>33</sup> Citizens Advice Bureaux help with £1.2 billion worth of debt. NACAB press release 06/09/01.

<sup>34</sup> NACAB.



## A4.11 Over-indebtedness, arrears and bankruptcy have a range of adverse impacts on creditors, debtors and the Government

Over-indebtedness imposes both private costs on the debtor and also external costs for the creditor and taxpayer.

- Over-indebtedness can lead to a reduced standard of living for individuals. Some poor families spend over 90% of their disposable income on paying their debts.<sup>35</sup>
- Defaults and bankruptcies reduce the income of creditors. It is estimated that creditors lose at least £600 million a year through unpaid civil judgment debts.<sup>36</sup>
- There are a large number of court processes which are associated with debt, arrears, repossessions and bankruptcies. In 1999, 1.76 million summonses for money judgments were issued, 1.71 million of which were default actions.<sup>37</sup> Most of the costs of the court system are recovered through the use of fees. Some court users receive public funds for civil cases – totalling around £60 million per annum.<sup>38</sup>

Reducing the numbers of people who are over-indebted could therefore have both private and wider public benefits.

## A4.12 The Government currently intervenes at several stages of the debt spiral

### *Regulation and education*

As chart A4.12(a) illustrates, the process of becoming over-indebted takes place over several stages. People often find that a change of circumstance, perhaps divorce, unemployment, or a delay in benefit payment, can lead to problems in meeting even regular commitments such as rent and taxes. Other households overextend themselves when borrowing. The impact of these two situations can be exacerbated when the household is living on a low income.

The Government currently intervenes at this stage through stabilising the macroeconomic climate, providing benefit payments, and regulating the credit industry. It intervenes to a lesser degree in supporting financial literacy programmes and there are proposals to support the provision of generic financial advice.

### *Debt advice, enforcement and collection*

If people fall behind in their payments (arrears), then there are several possible responses. They can negotiate reduced payments with their creditors, they can seek debt advice, or they can enter debt management programmes. Some government debts can be collected at source by deducting from benefits or, in the case of student loans, additions to taxation.

<sup>35</sup> See chart A4.7.1(a).

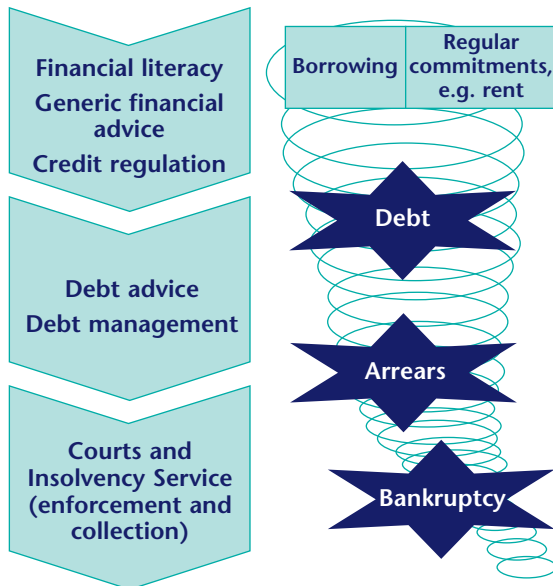
<sup>36</sup> ISB Bid, No 88. Piloting the provision of electronic debt advice centres.

<sup>37</sup> Judicial Statistics, 1999.

<sup>38</sup> The proportion of debt cases is not broken down separately. This figure includes £17 million payment for exemptions and remissions from court fees in 2000/01. People are automatically exempt when they receive Income Support, Jobseeker's Allowance (income-based), Working Families Tax Credit and Disabled Persons Tax Credit. They can also apply to the court for exemptions from fees if they can prove it will lead to hardship. Also approximately £40 million is paid but not recovered from the Community Legal Service Fund for civil cases.



**Chart A4.12(a): Interventions in the debt spiral**



If the debtor continues to fail to meet their payments, court proceedings may be invoked, and, following judgment, various methods of recovery may be triggered. The Government intervenes at this stage by supporting the provision of debt advice and through provision of a court-based system for debt collection and enforcement, and through direct deduction of certain payments from benefits.

*Court involvement*

If a debt problem enters the court system, then the outcomes can include court-negotiated payments, the direct administration of an individual’s financial affairs, or bankruptcy. If a person enters bankruptcy then the Insolvency Service or an insolvency practitioner liquidates their assets and uses any available income stream to pay off debts as far as possible. Any remaining debts are then written off.

At this stage, the Government runs the court system. The criminal justice system is funded

entirely by the taxpayer. Civil business is self-funding through court fees, save for taxpayers’ subsidies:

- for fees where payment has been automatically exempted because the litigant is in receipt of a qualifying means-tested benefit/tax credit or payment has been remitted because of undue hardship;
- where fees have been paid from the Community Service Legal Fund and cannot be recovered from the losing party; and
- for certain Family Proceedings.

The Government also runs the Insolvency Service (which is self-financing). At present, the Government takes first call on assets liquidated during bankruptcy. Some government loans are also exempt from being written off in bankruptcy.

**A4.13 Several issues have emerged about the level and pattern of government involvement**

The following sections outline existing or proposed government interventions in the provision of financial literacy, money advice, regulation of credit, debt advice, debt management, enforcement and collection, and bankruptcy. In each case possible issues with the pattern and level of government involvement are raised. **The PIU concluded that a review of the government’s approach to debt advice, collection and enforcement should be carried out.**

The Government is already reviewing the enforcement of civil court judgments as part of its wider commitment to improving access to, and increasing the efficiency of, civil justice in England and Wales. The Lord



Chancellor's Department's Enforcement Review has been ongoing since March 1998 and will inform the work of the review into debt advice, collection and enforcement.

### *Financial literacy*

Financial literacy is defined as 'The ability to make informed judgements and to take effective decisions regarding the use and management of money.'<sup>39</sup> One survey found that only 52% of single parents were aware that 10% of £300 was worth more than £25.<sup>40</sup> National surveys of adults' attainment in literacy and numeracy show that about 20% of the adult population have less than functional literacy, and about 20% have poor numeracy.<sup>41</sup>

Two issues which need to be resolved are, first, the level of investment in financial literacy programmes, and, second, which agency takes the lead in promoting financial literacy. The research project described in box A4.14(a) will assist government in deciding the appropriate amount of resources to place into financial literacy programmes. There is a lack of clarity of roles and responsibility between the Basic Skills Agency and NIACE (the National Institute of Adult Continuing Education), the Financial Services Authority (given their statutory obligation to promote understanding of the financial system) and the Department for Education and Skills, which now includes the Basic Skills Unit.

### *Box A4.13(a): Financial literacy: existing and proposed government intervention*

- **Children.** DfES, in collaboration with the Financial Services Authority (FSA), have published guidance for schools for introducing financial capability skills into the Personal, Social and Health Education curriculum. Teaching of these skills is not compulsory but is recommended as good practice. In addition, the Personal Financial Education Group (PFEG) promotes the teaching of financial literacy in schools. PFEG is a charity supported by the FSA and funded by the financial services industry.
- **Adults.** The Adult Financial Literacy Advisory Group (AdFLAG), chaired by Derek Wanless, reported to DfEE in December 2000. AdFLAG made a series of recommendations. Key recommendations include:
  - DfES should work with FSA and others to ensure that adult financial literacy is clearly defined;
  - developing local partnerships in deprived wards, facilitated by the Learning and Skills Council, to provide basic financial literacy programmes;
  - the Basic Skills Agency together with NIACE (the National Institute of Adult Continuing Education) should draw up a financial literacy programme and blend financial literacy work in with other basic skills learning. The DTI's over-indebtedness taskforce recommended that FSA should take the lead in promotion and co-ordination of adult financial education.

<sup>39</sup> National Foundation for Educational Research. Cited in Adult Financial Literacy Advisory Group report, p.10.

<sup>40</sup> *Financial Literacy in Adult Life*, Sandie Schagen and Anne Lines, NFER, 1996.

<sup>41</sup> *Assembling the Fragments: A Review of Research on Adult Basic Skills*, Greg Brooks, Kerry Giles, John Harman, Sally Kendall, Felicity Rees, Sara Whittaker, National Foundation for Educational Research, 2001.



### *Generic financial and budgeting advice*

'Generic financial and budgeting advice' is used here to indicate tools which help people manage their money. This can include budgeting aids and generic financial advice (i.e. someone earning under £10,500 p.a. might be advised to save in a Stakeholder Pension unless they thought that they might

need access to their savings before retirement, in which case they would be best advised to save in a CAT marked mini-cash ISA) provided by consumer or financial advisers.<sup>42</sup> The term does not refer to specific advice on specific companies and their products, nor to advice on what to do once someone has become indebted.

### *Box A4.13(b): Generic financial and budgeting advice: existing and proposed Government intervention*

- The Office of Fair Trading (OFT) provide generic budgeting advice on their website.
- Consumer Support Networks are local groupings of trading standards officers, Citizens Advice Bureaux and independent advice agencies set up under the auspices of the DTI.
- The DfES is piloting a Community Finance and Learning Initiative, providing advice about basic financial products, targeted at those with least experience of financial products.
- The Adult Financial Literacy Advisory Group (AdFLAG) also suggested (but did not formally recommend) that there is an important role for 'community finance helpers' who would provide free generic advice. This would be a different role from that traditionally provided by debt advice organisations – which traditionally focus on the 'cure' rather than 'prevention' of financial difficulties. The DTI's over-indebtedness taskforce recommended that Consumer Support Networks be utilised to provide a national infrastructure of financial information and advice.
- The FSA provide a free interactive financial planning tool for consumers.

Generic financial and budgeting advice has not traditionally been provided by government, the voluntary sector or the private sector. Such advice may be effective in reducing over-indebtedness and enabling people to make choices about their financial provision. In theory, as individuals are encouraged to make more decisions about their financial security as we move towards more private provision of pensions, there may be an increased need for generic advice. However, it is not certain that there will be a demand for such services, nor is it clear how advice services should be funded.

### *Regulation*

The Government regulates the sale of financial products and credit. The sale of financial products such as pensions and most mortgages is regulated by the Financial Services Authority. Second charge mortgages and unsecured loans are regulated under the Consumer Credit Act (CCA) by the OFT. Recently, much work on the regulation of credit has been carried out, in particular by the DTI taskforce on over-indebtedness.

<sup>42</sup> [www.pensionguide.gov.uk](http://www.pensionguide.gov.uk)



### *Box A4.13(c): Credit regulation: existing and proposed government intervention*

The CCA lays down rules covering:

- a common method of calculating the Annual Percentage Rate of credit;
- the form and content of regulated agreements;
- the advertising of credit;
- the procedures to be adopted in the event of default, termination or early settlement;
- the licensing of providers of regulated credit.

The recent DTI Over-Indebtedness Taskforce recommended the following changes to the way loans are made:

- a voluntary code of practice on the marketing of credit;
- better, clearer and more transparent information should be provided to consumers at the point of sale;
- consumers should be encouraged, where appropriate, to use payment protection insurance;
- more sophisticated methods of credit scoring which take into account income and existing commitments should be used to assess ability to repay;
- more data-sharing between creditor organisations should be encouraged so as to identify over-commitment;
- lenders should voluntarily ban unchecked instant credit.

#### *Debt advice*

There are a range of agencies which can provide advice for those in debt. Some charge users fees, while others are free at the point of use. Some provide advice and representation, while others provide debt repayment disbursement facilities.

- **Free advice services.** Local Citizens Advice Bureaux and independent debt advice agencies exist to provide independent debt advice, mainly through face-to-face provision. There is also a telephone advice service called National Debtline. It is run

by Birmingham Settlement – a voluntary debt advice organisation. In 1999 it was only able to answer 17% of the 140,000 calls it received. The Money Advice Trust is the umbrella body for many of these organisations, providing centralised fundraising and training and development programmes.<sup>43</sup>

- **Consumer Credit Counselling Services.** Consumer Credit Counselling Services (CCCS) are also free at the point of use. However, CCCS offer a debt management programme – allowing clients owing more

<sup>43</sup> The national body for Citizens Advice Bureaux is the National Association of Citizens Advice Bureaux (NACAB). The national body for independent debt and consumer advice centres is the Federation of Information and Advice Centres (FIAC). The professional organisation for money advisers is the Money Advice Association (MAA)/Money Advice Scotland (MAS). The Money Advice Trust is the umbrella fundraising body. It distributes funds to NACAB, FIAC, MAA, and MAS.

than one creditor to make a single payment to a disbursement agent. Individual payments are then disbursed to each creditor. CCCS ask creditors to contribute some of their repayments received through CCCS back as a contribution to running costs.

- **Fee charging for-profit disbursement organisations.** Several for-profit companies offer fee-charging debt management programmes. For example, Baines and Ernst is a for-profit debt management company which employs 700 staff dealing with 100,000 clients with £0.5 billion debt between them.

There are several different levels of intervention which are given by debt advice agencies and companies. In a rough order of complexity intervention can include: information and referrals; self-help packs; advice on how to maximise income and minimise expenditure; checking the legality of the credit agreement, debt repayment and prioritisation; negotiation with creditors; a centralised payment disbursement system; assistance with filing for bankruptcy; and representation of clients in court.

Not all agencies or companies provide all of these services. There are two concerns which have been expressed about the **type** and **quality** of debt advice which is given. The first concern is that the quality of debt advice can be variable.<sup>44</sup> The second is that some companies encourage those in debt to move directly to a centralised disbursement programme without first maximising the clients' income, minimising their expenditure, checking the legality of their credit agreements, and prioritising their debts.<sup>45</sup>

There are also concerns about the **quantity** of advice provided. There seems to be reasonable circumstantial evidence of an unmet demand for debt advice. The Money Advice Trust estimate that on top of existing provision there are another one million people who need, but do not receive, financial advice. If there are external benefits to debt advice then there may be a case for providing more debt advice to meet this demand. Also, it is not clear that the supply of advice at different levels of complexity matches demand. Often Citizens Advice Bureaux (CABx) (some of which rely on

### *Box A4.13(d): Debt advice: existing and proposed government intervention*

The Government provides support in the following areas:

- Local authorities provide financial support for local Citizens Advice Bureaux and independent advice centres;
- DTI provide a block grant (£15 million p.a.) for National Association of Citizens Advice Bureaux (NACAB);
- DTI, in partnership with the Lord Chancellor's Department, the Scottish Executive, the Money Advice Trust and creditor organisation is supporting three Electronic Debt Advice pilot schemes. The Government is contributing half of the £2 million cost of these pilots.

<sup>44</sup> *Quality Assured? An Assessment of the Quality of Independent Money Advice*, Sharon Collard, Jane Steele, Elaine Kempson, Money Advice Trust, 2000.

<sup>45</sup> *Fee or Free? The role of fee-charging debt advice companies in money advice provision*, Claire Whyley and Sharon Collard, Federation of Independent Advice Centres, 1999.



volunteers) are capable only of providing very basic levels of advice.

#### *Enforcement and collection*<sup>46</sup>

The Government enforces the collection of debts through the courts and in some cases is involved itself in the collection of debts. In 1999, 1.76 million summonses for money judgments were issued for both public and private debts, 1.71 million of which were default actions.

Creditors can apply to the courts for a range of enforcement methods. They can ask the courts to:

- Issue **warrants and writs of execution** against debtor's goods – where goods are, if necessary, seized by bailiffs. In 1999, 538,337 warrants were issued. The Lord Chancellor's Department (LCD) commissioned an independent review of bailiff law by Professor Jack Beatson of Cambridge University. His findings were published in July 2000. Professor Beatson's Report made 46 recommendations, and argued that 'rules governing distraint should be set out clearly in one place, preferably in a Statute'. Although Beatson's report did not consider abolishing the use of distraint (unlike a similar review by the Scottish Law Commission) the LCD's Enforcement Review has identified that there is a continued place for distraint within the enforcement system. However, that system should encourage the use of the most appropriate enforcement method rather than the widespread use of distraint. Following the introduction of the Debtors (Scotland) Act 1987, Scotland uses distraint as a method of debt collection less often than England and Wales. The Abolition of Pounding and Warrant Sales

Bill was introduced to the Scottish Parliament on 24 September 1999 and will take effect on 31 December 2002. A cross-parliamentary working group is considering alternative procedures for enforcing debts, and the Scottish Executive is committed to legislating for an alternative system before the end of 2002.<sup>47</sup>

- Issue **attachment of earnings orders** – where deductions are made from the debtor's earnings. In 1999, 34,399 orders were made. In Scotland deduction from earnings is far more commonly used – they account for 88% of enforcement proceedings, and distraint is far less common.<sup>48</sup>
- Issue a **charging order** – where a charge is placed on a debtor's property or shares and the debt is collected when the property is sold. In 1999, 13,600 charging orders were issued.
- Issue a **garnishee order** – allowing creditors to gain access to funds held by the debtor in a bank or building society account.
- Arrange an **administration order**. County Court Administration Orders (CCAOs) provide the county court with a mechanism for dealing with multiple debtors and give the debtor respite from enforcement proceedings while paying off debts. Current parameters restrict them to those who have a county court judgment against them and at least one other debt, with no more than £5,000 worth of debt to be included in the order. Taking into account the debtor's income and outgoings, the court sets a repayment rate and then arranges to pay off creditors scheduled to the order. In 1999 there were 8,720 CCAOs.

<sup>46</sup> All statistics from Judicial Statistics, 1999.

<sup>47</sup> *A Consultation on Striking the Balance – a new approach to debt management*, The Scottish Executive, 6 July 2001.

<sup>48</sup> *Independent Review of Bailiff Law*, Professor J. Beatson QC, Cambridge, 2000. p.7.

- Arrange an **oral examination** – where a debtor is asked questions under oath about their financial circumstances. This enables the creditor to make an informed decision about the most appropriate enforcement process to use.

The creditor and debtor can also petition for **bankruptcy**. Once declared bankrupt, the official receiver or an insolvency practitioner takes over some of the financial affairs of the debtor. The Insolvency Service realises the value of any assets and pays off creditors as far as possible. Some debts are then written off. The Government is planning to introduce reforms to allow for early discharge of bankrupts, remove many of the restrictions on bankrupts' activities, and allow for civil prosecution of rogue debtors.

People can enter **Individual Voluntary Arrangements (IVAs)** with their creditors – a method of managing debts without bankruptcy. These are administered by insolvency practitioners who facilitate payments between the creditor and debtor. There are concerns about the role of some insolvency practitioners who are profiting by abusing IVAs. The Government is proposing to allow the official receiver to administer IVAs, in competition with private sector insolvency practitioners.

The LCD is working in partnership with the Insolvency Service in exploring a unified scheme for personal insolvency which would see the end of CCAOs and the availability to all debtors of a reformed personal insolvency regime. One of the aims of the new scheme would be to provide effective rehabilitation of those who fall into genuine difficulties. This would be achieved through clearer signposting for multiple debtors of available options for advice, and the management of repayment plans agreed with creditors, and relief for those debtors with no ability to pay.

Finally, the Benefits Agency collects several debts for public and private institutions by deducting payments directly from Income Support. Debts collected include Council Tax, Social Fund repayments, water and fuel debts.



### Box A4.13(e): The priority given to government debt

Debt advisers, when prioritising debt repayments, recommend that debts should be paid back in this order: housing, food and fuel, child maintenance, secured debt and then unsecured debt. It is not clear how government debt should be treated according to this debt prioritisation 'ladder'.

In practice, some government debts (unpaid taxes and loan repayments) take priority over private sector debt in a number of circumstances:

- **Direct deduction from benefits.** Social Fund loan repayments, Council Tax payments and certain other private sector payments such as water and electricity bills can be deducted directly from Income Support. The debt repayment is taken before the benefit is received as income. This income might, of course, be used to pay other debts – giving government a *de facto* priority.
- **Distrain.** Distrain for a debt owed to the Crown takes priority over other debts. In particular the Taxes Management Act (1970) provides that if a debtor is in arrears for certain tax payments, no one can distrain upon his or her goods unless the distrainer pays the tax debt.\*
- **Insolvency.** The Crown has priority on the proceeds of asset liquidation during bankruptcy. The Government will shortly issue a White Paper recommending the removal of the Crown's preferential right to recover unpaid taxes ahead of other creditors.
- **Some government debts not provable.** Student loan debts, for example, are 'not provable' in bankruptcy proceedings: they will not be written off during bankruptcy.


\* *Independent Review of Bailiff Law*, Professor Beatson QC, Cambridge, 2000, p. 101.

## A4.14 A review of government's policies towards reducing over-indebtedness and rationalising government debt collection

The Performance and Innovation Unit (PIU) concluded that **analysis of the effectiveness of over-indebtedness reduction strategies should be undertaken.** This analysis, together with the DTI-commissioned research into the extent and causes of over-indebtedness, should form the basis for a **review of government policy towards reducing over-indebtedness; the roles and responsibilities of government departments and agencies; and policy towards the collection of debts to Government.**

Part of this policy review is already under way. The LCD's Review of Enforcement arises out of the Government's commitment to improving access to, and the efficiency of, civil justice in England and Wales. It is based on the premise that those creditors who have established a legitimate claim ought to be able to pursue it through a straightforward and accessible system, while debtors who genuinely do not have the means to pay ought to be protected from the oppressive pursuit of their debts.

The first phase of the Enforcement Review identified that better and increased use of information was key to improving the enforcement of civil court judgments. More effective enforcement could best be achieved



by improving the information available on which to base informed and responsible decisions about enforcement. Phase two is building on proposals arising out of this analysis to develop mechanisms by which effective, fair and appropriate enforcement can take place.

#### *Cross-cutting review*

Sections A4.11 to A4.13 outline the pattern and depth of Government's involvement in strategies to reduce over-indebtedness. They highlight that there are some issues which could usefully be addressed by a short cross-cutting review. These include:

- **External benefits.** Are there external costs caused by over-indebtedness? If so, how large are these costs? The review should estimate any externalities associated with over-indebtedness.
- **Early intervention.** Should the Government intervene earlier? The research outlined in box A4.14(a) should assist Government in answering this question. The analysis will also provide guidance as to which strategies should be targeted. The review should assess the costs and benefits of earlier intervention.
- **Provision of debt advice.** There is some evidence of a shortfall in the supply of debt advice. The review should investigate

#### *Box A4.14(a): Research*

Not enough is known about the effectiveness of interventions in reducing over-indebtedness. In determining the level and pattern of resources which should be put into debt reduction strategies, it is necessary to build up a knowledge base about the most effective forms of intervention.

The analysis should estimate the comparative effectiveness of the following strategies for reducing over-indebtedness:

- **Financial literacy.** The analysis should encompass evaluations of adult financial literacy programmes and follow up evaluations of school programmes such as NatWest Face to Face with Finance.\* The analysis could also use longitudinal data to model the effect of low literacy and numeracy levels in childhood and adulthood on over-indebtedness in later life.
- **Money advice.** Evaluation of existing money advice schemes should be carried out. Alternatively, as the Community Finance and Learning Initiative Pilots are carried out, monitoring and evaluation should be designed to enable analysis of their effectiveness on over-indebtedness 'outcomes'.
- **Debt advice.** An experiment should be designed testing the outcomes for groups of debtors referred (with a control group not referred) to a debt advice agency. This would enable an evaluation of the effectiveness of debt advice and may give some indication of reductions in debt cases reaching the courts. The analysis could perhaps be done in conjunction with the LCD – who have an objective to '*Reduce the proportion of disputes which are resolved by resort to the courts*' (PSA, Objective 5). The DTI debt advice phone and Internet pilots should also have well-designed evaluation schemes.

\* An initial evaluation was carried out by the National Foundation for Educational Research in 1997.



whether the amount of debt advice currently provided is sufficient. It is also possible that the demand for more complex debt advice outstrips supply. The DTI and Money Advice Trust electronic debt advice pilots should provide further information about the numbers of people who can be helped through telephone and Internet-based advice. The review should analyse the demand for different types of debt advice.

- **Funding.** The review should assess the advantages and disadvantages of different forms of funding for money advice, financial literacy programmes and debt advice. The methods of funding explored should include: user fees, central or local government funding, and voluntary or compulsory industry funding. If public funding is increased the review should recommend the appropriate level of resources.
  - **Quality of debt advice.** There are concerns about the quality of debt advice. This relates both to the quality of advice given by volunteer-based advice agencies and the techniques of fee-charging companies. The review should set out best practice in debt advice and recommend methods of ensuring that best practice is achieved.
  - **Roles of government departments and agencies.** Financial literacy involves the Basic Skills Agency, the Financial Services Authority (who have a statutory obligation to promote understanding of the financial system) and the Department for Education and Skills. The responsibility for debt advice at present rests with DTI, while a strategy which successfully reduces over-indebtedness should lead to
- reductions in the numbers of court cases – which are the responsibility of the LCD. The review should also clarify the roles and responsibilities of respective government bodies.
- **The collection of debts to Government and the enforcement of government debts.** Government should take a coherent view of the methods it uses for collecting debts owed to it – laying a policy framework for any possible joined-up Government debt recovery service. The review will work alongside the LCD's Review of Enforcement.
  - **Government's preferential status.** Building upon the recent announcement that Government will remove the priority given to Government debt during bankruptcy, the reviews should consider elsewhere what, if any, priority should be given to debts to the Crown. This should be considered in the light of wider social exclusion and business policy objectives. The review should draw up a best practice debt repayment prioritisation 'ladder'. This will set a policy framework for any joined-up Government debt recovery service.



## A4.15: Source tables<sup>49</sup>

**Table A4.15(a): Debt and credit by demographic group**

Head of household's age	Marital status	Children	Proportion with loan	Loan amount (£)	Proportion with mortgage	Mortgage amount left (£)	Proportion with credit
20–34	Single	No	28%	7,685	40%	40,230	48%
20–34	Single	Yes	46%	4,711	34%	44,535	63%
20–34	Married	No	45%	7,333	52%	49,378	65%
20–34	Married	Yes	55%	5,860	46%	48,341	71%
35–49	Single	No	44%	9,230	53%	40,235	58%
35–49	Single	Yes	38%	5,649	44%	41,048	55%
35–49	Married	No	39%	10,385	64%	40,770	69%
35–49	Married	Yes	47%	9,051	73%	46,425	77%
50–64	Single	No	24%	8,566	30%	29,649	55%
50–64	Single	Yes	38%	7,862	43%	23,988	76%
50–64	Married	No	26%	10,853	43%	26,729	65%
50–64	Married	Yes	47%	12,080	59%	41,099	74%
65+	Single		10%	2,858	10%	15,525	48%
65+	Married		7%	7,347	8%	16,895	54%
<b>All</b>			<b>32%</b>	<b>8,367</b>	<b>41%</b>	<b>40,623</b>	<b>63%</b>

**Table A4.15(b): Debt and credit by income**

Income bands (£) (weekly average income)	Proportion with loan	Loan amount (£)	Proportion with mortgage	Mortgage amount left (£)	Proportion with credit
up to 100	15%	1,382	7%	28,255	34%
100 up to 200	15%	3,006	10%	23,911	41%
200 up to 300	21%	4,746	23%	28,753	52%
300 up to 400	32%	7,350	41%	31,278	66%
400 up to 500	38%	6,363	56%	32,770	70%
500 up to 600	43%	8,308	65%	35,803	77%
600 up to 700	49%	9,453	70%	37,620	85%
700 up to 800	49%	10,907	72%	42,205	83%
800 up to 900	54%	11,037	74%	47,623	87%
900 up to 1,000	53%	11,202	73%	47,875	90%
1,000 up to 1,100	55%	11,359	79%	47,365	89%
1,100 and above	44%	18,831	72%	78,253	90%
<b>All</b>	<b>32%</b>	<b>8,367</b>	<b>41%</b>	<b>40,623</b>	<b>63%</b>

<sup>49</sup> ONS, Family Expenditure Survey 1999–2000.

## APPENDIX 5. LEGISLATIVE CONSTRAINTS ON USE OF LOANS

This appendix sets out the main potential legislative constraints to use of loans. For each of the areas identified it examines the nature of the issue and the actions that are required to minimise the barriers.

The areas where there may be a legislative constraint include:

- The Human Rights Act;
- The Consumer Credit Act;
- The Data Protection Act (addressed in chapter 6); and
- EU State Aid rules.

Other EU and international legislation may also be relevant in specific areas, e.g. in aerospace, where a UK/US bilateral agreement has been established.

### A5.1 The Human Rights Act has implications for the way in which government loans must be designed

#### *What's the issue?*

The Human Rights Act allows people to claim their rights under the European Convention of Human Rights in UK courts and tribunals. The Act underpins this by including a general requirement for public authorities to act compatibly with the Convention rights. Specifically, it:

- makes it unlawful for a public authority to act incompatibly with the Convention

rights and allow for a case to be brought in a UK court or tribunal against the authority if it does so. However, a public authority will not have acted unlawfully under the Act if, as a result of a provision of primary legislation, it could not have acted differently;

- requires all legislation to be interpreted and given effect as far as possible compatibly with the Convention rights;
- requires UK courts and tribunals to take account of Strasbourg case law.

Provisions have been included in the Scotland Act, the Northern Ireland Act and the Government of Wales Act to ensure that devolved administrations must also act in a way that is compatible with the Convention rights.

#### *Action required*

The need for compatibility with the Convention rights applies equally to the design of administrative systems as well as loans policy, and should be addressed as part of the design of any new loan. For example, for a loan offered to students (see Case Study 2 in chapter 5), it will be necessary to ensure eligibility restrictions do not contravene the Act.

## A5.2 The Consumer Credit Act is a constraint on government loans which are awarded on a discretionary basis and loans administered by third parties

### *What's the issue?*

The Act regulates credit agreements between traders, individuals and partnerships, etc but does not include arrangements where the lender is under a statutory obligation to provide credit to those eligible, as is the case with local authorities providing student loans.

### *Action required*

- Loans provided under statutory obligation by Government are not considered agreements and therefore do not fall under the remit of the Consumer Credit Act (CCA).
- Loans not directly administered by government, which are considered regulated agreements, must be designed to comply with the CCA. For example, Homebuy equity release schemes (operated by the private sector) raised issues under the CCA relating to the calculation of APR – because ultimately the sum repayable is unknown. In order to overcome any potential difficulties the Office of Fair Trading used its powers under section 60(3) of the Act to modify the Act's documentation requirements to substitute other information for an APR. There is, in principle, no reason why this could not be done again for any future equity release-type schemes.

## A5.3 EU State Aid should not present a significant barrier to government offering loans to business

### *What's the issue?*

The legal definition of State Aids is set out in Article 87(1) of the Treaty of Rome. An intervention is considered a State Aid when the effect of aid:

- distorts competition;
- is selective in its effects (e.g. only affects sub-groups of firms, or only affects businesses in a specific region or locality);
- affects trade, or could potentially affect trade, between EU member states.

Effect, not intention, is what matters. A State Aid could be any form of government subsidy to business (including subsidised loans, grants or tax incentives).

### *Action required*

All potential State Aids must be notified to the European Commission. The approval process rarely takes less than six months – this timing therefore needs to be built into any policy-planning process.

To win EC approval there is a need to demonstrate that:

- the aid addresses a defined market failure and it delivers horizontal support to specific areas as set out in the Commission guidance. For example, it might include delivering support to small and medium-sized enterprises or to regions;
- the proposed solution is proportional to the problem.

Further advice on EU State Aid rules is available from the State Aid Policy Unit in the DTI.<sup>50</sup>

<sup>50</sup> See: [www.dti.gov.uk/europe/stateaid/index.htm](http://www.dti.gov.uk/europe/stateaid/index.htm) for further information and contact details.



## A5.4 Government accounting rules must be followed by departments when using loans

### *What's the issue?*

Resource accounting presents a number of issues relating to accounting for government loans:

- Departments must show the full cost of loans in accounts, that is, they must spell out how much of the loan they expect to recover and at what levels of interest.
- When the money from loan repayments comes in, it goes into the Consolidation Fund which departments must then claim.
- If more money comes back than expected, then departments do not directly benefit from their success in recovery – the additional monies beyond the estimates are passed to the Treasury.

It is intended that the guidance on the use of loans in the report and resulting policy ideas will also be relevant to devolved administrations and can be used for developing their own policies for relevant policy areas. The team consulted with the devolved administrations in the course of the project, and as for all policy issues, it will be important for the administrations to ensure that they confer and seek advice at the outset of any work they undertake.

Further advice on the implications for policy measures in respect of devolved matters is available on the Cabinet Office website.<sup>52</sup>

## A5.5 Devolved administrations can use this report's recommendation to develop their own policy proposals

### *What's the issue?*

Devolution is an established part of the UK's constitution, and the devolved administrations have substantial powers across wide fields of public policy.<sup>51</sup>

### *Actions required*

Because both the UK and the devolved administrations hold responsibilities for loans, it is important that they maintain close involvement in the development of loans policy and of collection procedures.

<sup>51</sup> Scotland Act: [www.hms.gov.uk/acts/acts1998/19980046.htm](http://www.hms.gov.uk/acts/acts1998/19980046.htm)  
Government of Wales Act: [www.hms.gov.uk/acts/acts1998/19980038.htm](http://www.hms.gov.uk/acts/acts1998/19980038.htm)  
Northern Ireland Act: [www.hms.gov.uk/acts/acts1998/80047--a.htm#1](http://www.hms.gov.uk/acts/acts1998/80047--a.htm#1)

<sup>52</sup> [www.cabinet-office.gov.uk/constitution/devolution/devolution.htm](http://www.cabinet-office.gov.uk/constitution/devolution/devolution.htm)



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