Financing higher education for quality and access

Nicholas Barr
London School of Economics
http://econ.lse.ac.uk/staff/nb

Conference on the White Paper and Beyond: Tertiary Education Reform in the Czech Republic
Prague, 16-17 October 2009

Financing higher education for quality and access

1 The backdrop
2 Lessons from economic theory and international experience
3 The 2006 UK reforms
4 A general strategy for OECD countries
5 Some reflections on the Czech White Paper
6 Concluding comments

1 The backdrop

- Talking about how to pay for teaching, not research
- Will suggest a broad framework for developed economies based on economic theory and international experience

The world has changed

- Tertiary education matters
  - To promote core values
  - To pursue knowledge for its own sake
  - Economic growth in competitive economy
    - Technological advance a major driver
    - Tertiary education is vital both for national economic performance and for individual life chances
- The world has changed: 50 years ago tertiary education was not important in economic terms
- Specific objectives
  - Quality
  - Access
  - Efficiency

What is the problem?

- Countries pursue three efficiency goals in tertiary education
  - Larger quantity
  - Higher quality
  - Constant or falling public spending
- Can achieve two but only at expense of the third
  - Large and tax-financed, but with worries about quality
  - High-quality and tax-financed, but small (UK till 1989)
  - Large and good-quality, but fiscally expensive (Scandinavia)
- The only sustainable way to achieve all three is to supplement public finance with private finance

2 Lessons from economic theory and international experience

2.1 Lessons from economic theory

Lessons rooted largely in the economics of information, i.e. the arguments are largely technical, rather than ideological

Lesson 1: Competition between universities helps students

- Does competition work? Yes when consumers are well informed
- Are consumers well informed?
  - Students mostly a savvy, streetwise bunch
  - Much information is available and more can and should be made available
  - Good information is a central source of quality assurance:
    - On the student experience
    - On teaching
    - On employment outcomes
- Are all students well informed? No. Students from poorer backgrounds face information problems which policy needs to recognise and address

Nor is central planning of higher education any longer feasible

- Not only is central planning of higher education undesirable; it is also no longer feasible
  - Number of tertiary education institutions
  - Number of students
  - Diversity of subject matter
- The same body of theory leads to a very different conclusion for school education

Lesson 2: Graduates (not students) should share in the costs of their degree

- Higher education creates external benefits:
  - Growth, social participation
  - Thus right that society (aka taxpayer) should contribute
- But also significant private benefits in financial terms, and *also* in nonmonetary terms, e.g. job satisfaction
- Thus right that beneficiaries should share some of the costs
- BUT students generally cannot afford to pay
- Thus need a way that students can get it free, but graduates repay – loans

Lesson 3: Well-designed loans have core characteristics

- Income-contingent repayments, i.e. calculated as *x*% of graduate's subsequent earnings
  - For efficiency reasons, to reduce uncertainty
  - For equity reasons, to promote access, since loans have built-in insurance against inability to repay
  - A genuine loan
- Large enough to cover all fees and, as far as possible, living costs; thus tertiary education is free, or largely free, at the point of use
- An interest rate related to government's cost of borrowing

2.2 Lessons from international experience

Why fees? Why variable fees?

- Variable fees promote efficiency
  - By making funding open-ended, thus increasing the volume of resources going to tertiary education
  - By strengthening competition, improving the efficiency with which those resources are used
- Variable fees promote quality via competition
- Counterintuitively, variable fees are also fairer
  - Shift resources to the worst off
    - Those who can afford to contribute more do so
    - This releases resources to promote quality and access
    - Thus strategy is deeply progressive; it shifts resources from today's best off to today's and tomorrow's worst off
  - Variable fees are also directly fairer: why should a student at a small local institution pay the same fee as at a world-class institution?
- Assessment: see OECD (2008)

International lessons about fees

- Fees relax the supply-side constraint (UK)
- Competitive systems appear to produce higher quality (at least as measured by world rankings)
- Flat fees mean that funding is closed-ended hence will not provide extra resources except in the short term (Australia)
- Big-bang liberalisation of fees can be politically destabilising (New Zealand)
- But failure to liberalise is also a mistake
  - Harms quality
  - Harms access
  - Continues regressivity

Student support: lessons about loans

- Income-contingent loans do not harm access (Australia, New Zealand, UK, Hungary)
- Interest subsidies are expensive (Australia, New Zealand, UK)
- But positive real interest rates are politically feasible (Netherlands, Sweden, Norway, Hungary)
- The design of the loan contract matters
- The design of the loan matters: it is possible, with care, to design a system with income-contingent repayments but mainly private finance (Hungary)

But implementation matters

- It is easy to give away money; the difficult part is collecting repayments
- A country cannot implement income-contingent repayments effectively unless it can collect income tax
- But it is mistaken to think that collecting conventional loan repayments is easier
  - Banks deal with small, short-term, secured loans
  - Government guarantees
    - Reduce banks' incentives to collect repayments (USA)
    - Violate international criteria for private finance (IMF, Eurostat)
  - Conventional loans still require an income test
- If institutional capacity is insufficient, the *only* solution is to improve institutional capacity; the world is littered with failed loan systems that were introduced prematurely
- But note synergy between tax collection and loan repayments

Why not finance through taxation?

Over-reliance on taxation fails to achieve any of the main objectives

- Failure 1: quality
  - Shortage of resources
  - Lack of competition
- Failure 2: access (in most, though not all, countries)
  - UK: 81% professional/15% manual, so tax funding fails the poor
- Failure 3: regressive
  - The real barrier to access: staying on beyond 16
  - If raise €5bn, should spend it on nursery education; improving schools; staying-on post-16; grants
  - Early child development is central

Why not other sources of private finance?

- Potential sources of private finance
  - (a) Family resources – but fail to widen access
  - (b) Student's earnings while a student – but at the expense of studies
  - (c) Student's future earnings, i.e. loans
  - (d) Employers – but weak incentives to contribute in a world with high labour mobility
  - (e) Entrepreneurial activities by education institutions – but easily overestimated
  - (f) Gifts – but easily overestimated
- For all these reasons, (c) is central

What role for means-tested grants?

- Means-tested grants are important for access, particularly where students are badly informed
  - Indicative evidence in Canada
  - The option of scholarships for first-year students
- But mistaken to think that this is the main story
- The major determinant of participation is attainment in school
- Important that policies to widen participation take a holistic view – on which more later

3 The 2006 UK reforms

3.1 The pre-reform system

- The good news: since 1998, the UK has had income-contingent loans with repayments collected by the income-tax authorities

The bad news

- Continued central planning
  - Price
  - Quantity
  - Quality
- Complexity
- Inadequate student loans
  - Too small to cover living costs
  - No loan to cover fees
- Loans incorporate an interest subsidy

Loans attract an interest subsidy: 4 killer problems

A zero real interest rate

- Is enormously expensive – some 30-35% of total lending to students fails to come back because of the interest subsidy
- Impedes quality. Student support, being politically salient, crowds out the funding of tertiary education
- Impedes access. Loans are expensive, therefore rationed and therefore too small.
- Is deeply regressive, the main beneficiaries being successful professionals in mid career.

3.2 The 2006 reforms

- Variable fees, capped at £3000; in first year an extra £1.3bn (net of bursaries £1bn)
- Fees covered by an income-contingent loan (9% of earnings above £15,000/year)
- Larger loans for living costs
- Access: restoration of grants to cover living costs for poor students

Key lessons

- Continuing growth in applications – more below
- Why?
  - Loans cover fees and living costs
  - Thus higher education is *free to the student*
- Access has not worsened, but nor has it yet improved – more action is needed

4 A general strategy

- General strategy applies to all OECD countries
- Specific implementation a matter for country specifics

Leg 1: paying for quality: deferred variable fees

There is a key distinction between *upfront* fees and *deferred* fees. The latter

- Promote quality
  - by bringing in more resources, and
  - by increasing competition promote quality by assisting efficiency, diversity and choice
- Are fairer than any other method

Mistake to avoid: 'big bang' liberalisation

Leg 2: student support: free at the point of use

- Loans should
  - Have income-contingent repayments
  - Be large enough to cover all fees and all living costs
  - Be universal: all students should be entitled to the full loan
- As a result
  - Higher education is free at the point of use
  - Students are no longer poor
  - Students are not forced to rely on parental contributions
  - Students are freed from expensive credit (credit cards, overdrafts)
- Mistake to avoid: blanket interest subsidies

Different ways of implementing income-contingent repayments

- Payroll deduction alongside income tax (Australia, New Zealand, UK)
- Based on last completed tax return (Hungary, Sweden)
- Fixed monthly repayments, but with procedure for reducing repayments for low earners (Netherlands)

Leg 3: measures to widen participation

Policy should address the two strategic constraints on participation

- Policies to address the attainment constraint
  - Increased emphasis on early child development
  - Improved school outcomes
  - Improving information and raising aspirations
- Policies to address credit constraints
  - Financial support to complete high school
  - Income-contingent loans that make higher education free at the point of use
  - Policies that respond to genuine debt aversion
  - Make part-time study easier

Mistake to avoid: Emphasis on the wrong policies to widen participation

- According to 'pub economics' it is obvious that 'free' higher education widens participation
- Pub economics is wrong
- Evidence follows later

5 Some reflections on the Czech White Paper

- Support for the proposal except where disagreement noted

Same railroad crash in the Czech Republic as in other countries

- Demand for places in tertiary education will continue to rise
  - For Czech-specific reasons, e.g. pent-up demand from the past
  - But global technological change also a driver
- But fiscal stringency – a problem long before the economic crisis

Principles of change

- Need increased spending on tertiary education
  - Largely from the taxpayer
  - But public finance needs to be supplemented on a significant scale by private finance
- Sources of private finance
  - Fees, financed via income-contingent loans
  - Employers: rightly identified as largely a blind alley

Leg 1: Paying for tertiary education institutions

- Formula funding
  - Should continue but on more systematic basis
  - The balance between fees and formula-determined block grants determines the degree of competition (which can and should vary by subject)
- The funding regime should apply both to public and private tertiary institutions
- Fee regime
  - Fees deferred, via income-contingent loan
  - Should there be a discount for upfront payment? Interaction between (a) whether a discount is desirable and (b) the interest rate on student loans. Caution over introducing a discount
  - Should there be a fees cap? Yes

Leg 2: Student support

- Basic Study Grant
  - Converted to loan for poor performance (e.g. if take too long to graduate)
  - Could reverse the process, as in the Netherlands, i.e. loan, converted to grant for good performance (i.e. carrot, not stick)
  - Behavioural economics suggests that the response to the carrot may be different from that to the stick
- Basic State Loan for (a) living costs, (b) fees
- Means-tested scholarships: discuss shortly why these should be regarded as the tail, not the dog

Design of the loan system

- Interest rate equal to the government's cost of finance + administrative cost + cohort risk premium
- But starting only when student ends enrolment (error)
- 25-year forgiveness
- Subsidised interest rates 'only partially desirable' (p. 125); but in a system with (i) income-contingent repayments and (b) forgiveness after 25 years, ***interest subsidies achieve not a single desirable objective***
- Collection integrated with personal income tax

Leg 3: Widening participation

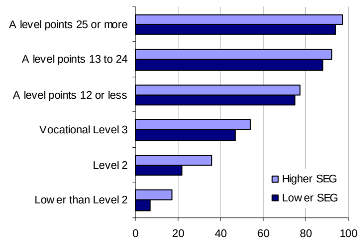
- Access as a goal: not only for social justice; also efficiency reasons (no nation can afford to waste talent)
- Students as independent persons
- Sources of inequality
  - Heavy emphasis in the White Paper on pro-access policies in tertiary education
  - However, UK evidence suggests that the primary driver is 0-18, not 18+
  - This latter element receives relatively little attention in the White Paper

What really determines participation?

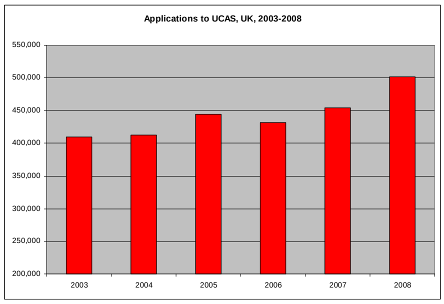
- Prior attainment constraint: UK evidence
- Credit constraint

Who goes to university? It's school attainment, stupid

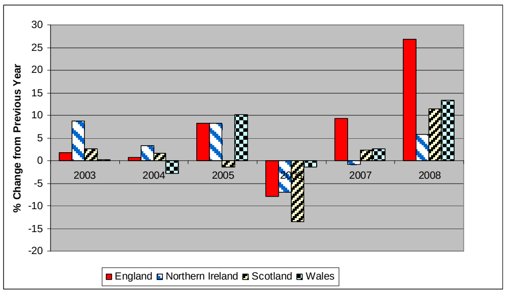
Source: Office for National Statistics (2004, Figure 2.15)



What happened to applications after variable fees were introduced?



Year on year change in applications from the three lowest SEGs



Credit constraint: Czech-Netherlands comparison

- 'It is found that the context of steadily increasing tuition fees, accompanied by an efficient student support system (the case of the Netherlands), does not generate inequalities in access, whereas a tuition free system accompanied by mainly indirect (parent-based) student support did not manage to reduce high inequalities in participation after the fall of the communist regime in the Czech Republic' (Mateju et al, 2009, Abstract)
- Higher fees + higher loans = no credit constraint => no affect on access
- Higher fees with no higher loans = credit constraint, harms access (Czech Republic)

6 Concluding comments

- Financing tertiary education: high quality is essential; this requires more resources
  - Taxpayer support for post-compulsory education will decline in the face of competing fiscal imperatives
  - Variable fees (with a fees cap)
    - Provide extra resources
    - Create incentives to use those resources efficiently
- Financing students
  - Upfront fees are inefficient, inequitable and politically inept
  - Deferred fees are very different; if loans cover fees tertiary education remains free for students

The resulting system

- A regulated market (*not* a free market)
  - Universities set fees, subject to a fees cap
  - But governments still pay block grants; the balance between fees and block grants determines the extent of competition
  - Students apply to the institutions and courses of their choice
- A continuing important role for government
  - To provide taxpayer support for tertiary education
  - To regulate the system
    - A fees cap
    - Ensuring that there is effective quality assurance
  - To set incentives, e.g. larger subsidies for certain subjects
  - To ensure that there is a good loan scheme
  - To adopt policies to promote access

Misleading guides to policy design

Is it immoral to charge fees?

- Tertiary education is a basic right and should therefore be free
  - Food is a basic right, but market allocation is entirely accepted
- It is immoral to charge for education
  - It is immoral if a bright person from a poor background cannot study at a top institution
  - Morality applies to the outcome, not the instrument
- Elitism has no place in tertiary education
  - Distinguish social elitism and intellectual elitism – the latter is both necessary and desirable

Drivers of the future: getting the politics of change right

- None of this is an attack on public funding, which should remain a permanent part of the landscape
- Reform should not create a free market but a regulated market
- Students get tertiary education free – it is graduates who repay
- Across the OECD, the politics of higher education are a minefield – but the mines are in very different places in different countries
  - Fees are 'taboo' in some countries (Norway, older member states of the EU) but not in others (USA, new member states)
  - Positive real interest rates are 'taboo' in some countries (UK), not in others (Norway)

References

Nicholas Barr (2002), 'A way to make universities universal', *Financial Times*, 22 November 2002, p. 21, downloadable from www.econ.lse.ac.uk/staff/nb

Nicholas Barr (2004),'Variable fees are the fairer route to quality', *Financial Times*, 30 March 2004, p. 21, downloadable from www.econ.lse.ac.uk/staff/nb

Nicholas Barr (2004), 'Higher education funding', *Oxford Review of Economic Policy*, Vol. 20, No. 2, Summer, pp. 264-283.

Nicholas Barr (forthcoming), 'Paying for higher education: What policies, in what order?'.

Nicholas Barr and Iain Crawford (2003), 'Myth or magic', *Guardian*, 2 December 2003, pp. 20-21, downloadable from www.econ.lse.ac.uk/staff/nb

Nicholas Barr and Iain Crawford, *Financing Higher Education: Answers from the UK*, Routledge, 2005.

Nicholas Barr and Alison Johnston (forthcoming), 'Interest subsidies on student loans: A better class of drain'.

Office for National Statistics (2004), , *Focus on Social Inequalities, 2004 edition*, London: TSO.

OECD (2008), *Tertiary Education for the Knowledge Society, Volume 1: Special Features: Governance, Funding, Quality* and *Volume 2: Special Features: Equity, Innovation, Labour Market, Internationalisation*, Paris: OECD.

LSE