

# Funding of Higher Education

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This note addresses two aspects of higher education funding: first, the economics of higher education and in particular the economic arguments for government intervention; second, on what I believe is the particular opportunity that the introduction of fees provides for improving higher education.

There are two main sources of justification for government intervention in any market: one justification is because of a desire to redistribute; the second is because there is some failure in the market.

I first want to consider redistribution as a rationale for subsidies to higher education. Redistribution through providing subsidies to higher education implies a transfer away from those who do not receive higher education towards those that do. It is true that at the time they are students, students are usually poor relative to the rest of the population. However, low income associated with being in education is a temporary state. To consider whether redistribution is justified, we need to look at earnings over the lifetime, rather than income at a particular age. On this measure, those who have gone to university have substantially higher lifetime income than those that do not.

A subsidy to higher education means students would receive a subsidy when at university, paid for by taxes from those not at university. But of course, some of these taxpayers were previously at university themselves and this is why the real transfer is from those who never go into higher education towards those that do. This transfer from the poor to the rich is not, in my view, a desirable social outcome.

In the current system, the transfer is in fact more subtle than this because the size of the subsidy varies across students according to their parents income; and about 23% of students receive full grants. However, the bottom line is that movements towards repayment holidays on loans, or greater

availability of subsidised loans redistributes away from those who typically have lower lifetime wealth towards those with higher lifetime wealth.

The second justification for government intervention is market failure. There are three potential failures: one is the failure of the credit market, the second is a failure in the insurance market and the third is that there exists a social benefit of HE that is greater than the private benefit. Each would justify some form of intervention.

The credit market failure arises from the inability of students to borrow against their future earnings. The insurance market failure is the lack of insurance against being unsuccessful after leaving university: that is, against unemployment and against low income later in life. The current system was set up to address these two market failures: first providing government backed loans solves the access to credit problem; second, making the repayments of loans contingent on income provides insurance against remaining poor after university.

Evidence on the third potential market failure - which is that the social benefit of HE is greater than the private benefit - turns out to be unconvincing. This is because private returns are substantial. This is in contrast with primary and secondary education where the social benefits justify intervention.

Given we have these two motivations for intervention (redistribution and market failure), what would it mean to move from the existing system of repayable fees and means-tested support, towards one without fees or where fees did not have to be repaid?

It would mean that those who are successful after leaving education would no longer pay and those with relatively high parental income would no longer pay. The key point is that removing the repayment would increase the redistribution in the wrong direction: away from those who do not go into higher education and away from those who are unsuccessful after higher education. The beneficiaries would be those who go into higher education and are then successful in later life. Furthermore, those currently in receipt of means-tested bursaries are unlikely to be any better off. Finally, the policy would no longer be correcting directly the aspects of the market which were not working (the credit and insurance markets).

This does leave the question of access. I would like to cite research by the Institute for Fiscal Studies (Chowdry et al., 2008) looking at participation in higher education. The question they asked was “once attainment at sixth form is taken into account, are there differences in participation rates

in higher education by background?” The answer (using data since 2004) is No. Part of the credit for this must lie with the efforts on access initiatives. However, what the result means is that the raw differences in participation in higher education by income bracket are due to differences in school attainment and in particular to differences in staying on rates beyond age 16. This area - secondary (and primary) school spending - is where the value of extra government spending is likely to be highest and where there are market failures to justify intervention.

This brings me to the second part of this note on where I think the debate on higher education funding should be focused, and in particular why I think the introduction of fees offers an opportunity to improve higher education. The key point is that paying fees provides students with the incentives to think about what they want to get out of higher education and it provides the leverage for them to achieve it. The issue then is what is the consequence of fees for the structure of universities.

Let me begin by dispelling a myth. The myth is that fees will usher in a new era of competition between universities. The reality of academia is that there is already intense competition: between universities, within universities and between academics. The point is that until now this competition has been focused on research success, and solely on research success. From the students’ perspective, the danger with the introduction of fees is that fee income is used to fuel that competition over research.

So what are the types of question we should be asking in the fees debate:

1. Is it desirable for research intensive universities to have to compete in terms of quality of teaching? Yes! The choice is that either we separate out research institutions from teaching institutions or we ensure competition happens over the quality of teaching.
2. Related to this first question: What is the fee income being spent on? Is it being spent on improving student learning, on providing an opportunity for students to think innovatively and on providing quality teaching? Or is it being spent on mass-produced teaching aimed at outcomes rather than the whole learning process?

This is where the debate should be and where the opportunity lies. The extra income from fees offers an opportunity to have the desired 50% participation rates in higher education alongside a high quality learning experience.

But, this requires the debate to be focused on how universities spend their income.

This is also the main reason why movement to a graduate tax (rather than a system with loans) undoes the potential benefit of having students pay fees: with a graduate tax, the government controls the resources that universities receive. This limits the incentives to increase quality. It also means that universities will again be competing with other demands on tax revenue, such as redistribution to those lower down the income distribution.

Let me conclude: the debate about whether and how (some) students should have to pay fees to attend higher education needs to be separated from the debate about what universities spend their income on. My view is that the second question is the key issue. The argument against the current financing framework relies on an implicit desire to redistribute away from those who do not go to university, away from those from the poorest backgrounds and away from those who are unsuccessful after university. Those who would gain from reducing fees are those who attend university from more well-off homes and those who are subsequently successful at work.

Worse, the focus of the debate on whether or not to reduce fees and on what I believe is this inappropriate redistribution, prevents a serious debate about what the university income is actually being used for and a debate about what it should be used for.

## References

- [1] Haroon Chowdry, Claire Crawford, Lorraine Dearden, Alissa Goodman and Anna Vignoles (2008) “Widening Participation in Higher Education: analysis using linked administrative data” Institute for Fiscal Studies Report, R69