A Free Market Graduate Tax: FAQs

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About the author

Peter Ainsworth is the Managing Director of EM Applications, a software and consulting firm that assists the global investment community with the measurement and understanding of market risk and uncertainty. Previously, he worked for Investec Asset Management as Head of Product Development and for Drexel Burnham Lambert as Manager of Quantitative Marketing. His interest in the problem of how to encourage training by corporations and university education was first sparked by a 1994 article in The Economist. It subsequently published his letter suggesting that risk sharing between corporation/university and employee/student would provide the appropriate incentives to optimise the provision of training and education. Peter has a BA in Economics from the University of Cambridge.

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In October 2014, the IEA published ‘Universities Challenged: funding higher education through a free-market ‘graduate tax’’ (Ainsworth 2014), which made the case for a fundamental overhaul of the system of student finance.

Why fundamental reform?

Students are being asked to pay ever more for an education that, for a growing proportion of them, has little value. 44 per cent of recent graduates are in non-graduate jobs[1], with 34 per cent of graduates – one in three - still in non-graduate jobs more than five years after leaving full time education. Simultaneously, skill shortage vacancies have increased by 60 per cent in just three years to 146,000. Companies cannot find prospective employees adequately competent in skills they could acquire at university: oral and written communication, planning, organisation and problem solving. Too often a university education is not value for money. This is a damning indictment of a bureaucratic centrally planned system that focusses on inputs rather than outputs.

The result will be a large class of graduates in non-graduate jobs with debts of up to £50,000 hanging over them for 30 years. Painful for them, this will also bring a substantial cost for all taxpayers, as the remainder of the loan is written off at that point – in effect, providing arbitrary subsidies. Academics, also, are not well served by the current system. Many argue that funding is inadequate while others complain about being tied up in red tape, obliging them to tick boxes rather than teach creatively.

A funding system that costs the state billions while frustrating the academic community and leaving graduates with high debts is not fit for purpose and must be replaced.

The solution is to correct the incentive structure so that universities are motivated by the long-term employment success of their graduates. This principle has been adopted by several institutions already. The London School of Business & Finance’s Springboard programme waives tuition fees if earnings do not increase by 50 per cent within 2 years. BPP meanwhile has a Career Guarantee which offers re-training if a graduate is unemployed after six months. These institutions are sharing the risk that students face and supporting those that need extra help. It is this principle that needs to be extended to the whole sector to align the interests of university and graduate over the long term.

What is the alternative?

The key insight of the IEA’s Discussion Paper is that incentives for better performance in the sector could be achieved through an overhaul of the funding system to replace student loans with a ‘Free Market Graduate Tax’. This scheme would be like a graduate tax in that the individual would repay a fixed proportion of their earnings above a certain threshold. However, all the terms would be freely agreed with the institution and payment would be made directly to the university itself rather than to the government. It has been demonstrated that such a system would improve teaching quality (McKenzie and Sliwka 2011).

Universities would individually or collectively offer contracts to their students, who would agree to pay the university they attended a given percentage of their earnings after graduation. That percentage could vary by course and institution, though some agreement between universities could be helpful to achieve standardisation. Essentially, the university would be taking an equity interest in the graduate premium earned by the student, although any student who chose to do so could, alternatively, pay the full fees up-front prior to beginning their studies. The university would, over time, mutate from acting

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[1] ONS data Q2 2014. Researchers at the University of Warwick and the University of the West of England have defined a non-graduate role as one which does not require a higher educational background.
See Elias, P. and K. Purcell (2013) ‘Classifying graduate occupations for the knowledge society’. Futuretrack Working Paper No. 5. Warwick Institute for Employment Research.
http://www2.warwick.ac.uk/fac/soc/ier/futuretrack/findings/elias_purcell_soche_final.pdf

like a school that simply teaches a defined body of knowledge to, instead, supply long term educational and career guidance and support in exchange for a share in the benefits created.

What are the key advantages?

This approach would ensure that universities have a much stronger interest in the employability of their graduates. That interest will continue after graduation. As such, universities will have an incentive to invest in careers advice and related services and in continuing to provide such services after graduation.

Given that universities would have entirely independent funding streams, they could also be released from all regulation of undergraduate courses. Furthermore, they would be free to innovate in terms of course provision, develop cheaper part-time courses using online provision, and so on. There would be competition between universities. However, competition would lead to a 'race to the top' and not a 'race to the bottom' because universities would have a direct economic interest in the success of their students. They would now have incentives to provide courses that will be useful to their students, rather than those perceived to be easy and enjoyable.

Who would decide which students participate? Above what level of income would payments kick in? Over how many years would the graduate have to pay the levy? Would there be a maximum repayment?

All of these details would be decided by the universities and their students, and set out in the contract between them.

What would universities do in the meantime before the funds started coming through?

Transition to this type of scheme would inevitably lead to an extended period before the university received substantial repayments from graduates. In the mean-time, universities would be able to borrow against their future income, as many of them already do. Alternatively, a university (acting alone or in conjunction with another university) could choose to sell its future income rights to investors through the process of securitisation.

Would it not be very difficult to collect annual payments from those who have moved abroad?

A key advantage of the FMGT is that the payment obligation arises out of a free contract which can be enforced around the world. The present scheme in contrast is legally closer to being a tax and is consequently very hard to enforce on non-residents. Lumni (www.lumni.net) have been offering income-linked tuition fee finance in Mexico, Chile, Columbia and the US for over 10 years and have not had any cross-border enforcement problems. Prodigy Finance (www.prodigyfinance.com) has funded nearly 2000 students from 90 countries and quotes a borrower repayment performance of 99 per cent. The spread of social media means that people do not disappear and can be traced easily.

How costly would it be to collect the funds?

Lumni was set up 10 years ago partly on the pretext that technological advance had reduced collection costs to an economic level. Since then most banking functions have gone online and it is a reasonable assumption that all graduates have email addresses. Together these technological changes mean that communication with and collection from graduates can be very low cost regardless of where in the world they reside.

Is it not unfair to charge higher-earning graduates more than the incurred cost of the course?

It would be unfair to set a higher price for high-earning graduates or to change terms on them arbitrarily. Currently, high-earning graduates are charged a higher rate of interest than low-earning graduates, despite the fact that they are the better credit risk. There is no economic logic in this and it is simply punitive. Although the terms have not changed as yet, the government reserves the right to increase the stated costs after the graduate has completed their education, and it is a reasonable assumption that any raised costs will fall most heavily on the higher earners. In contrast the FMGT offers all students the opportunity to pay a fixed upfront tuition fee or to enter into a risk-sharing agreement with fixed terms that cannot be varied. In the latter case the student will benefit from long-term educational support and will pay according to the benefit gained, which is fairer than paying for something that may have little or no value.

Will the FMGT not just lead to all universities offering "high-earning" courses such as finance?

This is a risk under the current system where universities are incentivised to offer whatever course attracts students regardless of the risk of over-supply in a particular profession. Neither students nor universities face strong incentives to take sound long-term decisions. Universities receive money up front for students, whatever course they take; students have repayment terms which mean that if they are unsuccessful in the labour market, the loan will be written off. Under the FMGT, if universities offered too many courses in areas where there was over-supply they would receive less income for the universities.

Does this not over-estimate the role of courses in improving potential income? Isn't a lot of the benefit of going to a decent university merely a signalling effect?

The skills shortage survey data and increase in graduates in non-graduate jobs demonstrate that many graduates are not receiving an education that has work-place value and so there is no doubt that courses could be improved. Any "signalling effect" is likely to be based on the history of a given institution's graduates having good employability skills. In other words, employers have experience of graduates from "X" being "good" and so focus their recruitment effort there. Even if it is currently the case that the advantage of a degree from certain universities is a signalling effect, the FMGT encourages all universities to raise the employability of their students in order to improve the value of the signal that attendance at any university will give.

Is higher education not a merit good that would be under-provided in a pure market system, and hence something public money should support?

The continued existence of a positive graduate premium suggests that there is under-provision of higher education under the current arrangements. Under the FMGT the state would face no costs so all student number controls could be abolished and provision would expand up to the point where, at the margin, expected revenues approximately equalled costs. As the marginal cost of provision of higher education is below the average cost a pure market system could increase supply significantly. Any government funding is ultimately paid for by taxpayers who will be either graduates or non-graduates. As most of the public benefits of higher education accrue to the graduate community, any government funding of higher education risks making less-well-off non-graduates pay for the private and public benefits that accrue to wealthier graduates.

What is the incentive in the proposed model to offer courses with high public returns but low private returns?

So long as "high public returns" courses lead to employment then universities will be encouraged to provide them. It may be that some courses could be re-designed to incorporate on-the-job training as well as in-classroom work to get the best mix of cost to employment-value. The FMGT ensures that universities are encouraged to improve that ratio, whereas the present system provides incentives in relation to STEM subjects but nothing in relation to high public value occupations.

What about incentives to select students with low earning ability (e.g. students with debilitating disabilities)?

Under the FMGT the universities are incentivised to recruit all students of whatever age that are likely to gain a material benefit from a higher education. With this freedom universities as a sector would be expected to develop a very wide range of courses to meet diverse needs. Whereas the present scheme "signals" that a three year course costing £9,000 per annum is "the best that you can get", leading to a clustering at that charging level, the FMGT will result in a wider range of course fees with each indicating expected earnings through the income-linked repayment formula.

Is this scheme not similar to that which was developed, and ultimately failed, at Yale University in the 1970s?

No. The key attributes of the Yale scheme were: (i) the university set fixed fees and took no risk, (ii) graduates paid back proportionate to income and (iii) the liability of higher earnings graduates was not known at the outset and in many cases increased over time (in the Yale case, because of the cohort-based nature of it). These are all characteristics of the current scheme in operation in England. The third attribute has not been apparent as the scheme is new, but the government has reserved the right to increase the liabilities to graduates long after they have graduated, and will no doubt use that freedom in the future. In contrast, the FMGT shares only the second, attractive, attribute of the Yale scheme, that repayments are proportional to ability to pay. It contrasts with Yale and the present English scheme in that the payment formula is fixed by contract and cannot be varied and the proceeds flow to the university so that it shares in the graduate's employment risk and has an incentive to provide a worthwhile education and to support the graduate throughout their career.

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Author of 'Universities Challenged: funding higher education through a free-market 'graduate tax'.

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