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The Economics of the 'Graduate Tax' By J. R. Shackleton

One of the things which the Blair government got right was establishing the principle of student fees in higher education. At the time of writing, Lord Browne is conducting an inquiry into student finance, and the coalition's Vince Cable is proposing a graduate tax. Whatever the outcome of the inquiry, the debate is sure to rage on and it is useful to clarify some basic economic principles.

Graduate taxes involve imposing additional taxes on people who have degrees simply because they have a degree. This is a bad idea. The proponents of such taxes claim that the income will be ring-fenced for higher education. This is not credible. Hypothecated taxes – those collected to fund a particular area of government spending – have a long history of being raided by finance ministers for other purposes. And, of course, it is perfectly compatible with graduate tax hypothecation for other university funding to be slashed.

A graduate tax, based on a percentage of income earned, means that the more successful graduates pay more. This is wrong on two counts. Firstly, highly paid graduates are already taxed at a higher rate than poorly-paid ones as their enhanced incomes push them into higher income tax bands. Secondly, the average individual returns on higher education quoted by politicians conceal the fact that much of the higher pay of graduates is a reward for underlying ability, experience and effort rather than for the qualification. Econometric studies of pay indicate that only a fraction of the 'graduate premium' is explained by a degree or other qualifications. A degree is not a passport to a well-paid job, particularly nowadays: a graduate tax is really a tax on effort.

Moreover, high-earning graduates often make their money in fields which have nothing to do with their degrees. Consider Lily Cole, currently studying the history of art at my old college. She is a top model and actress, who will earn huge amounts in her future career. Of course she should pay fees like everybody else, but why should she or others like her be taxed at a higher rate than, say, Twiggy, who has featured with her in Marks & Spencer adverts but never went to university? A graduate tax might lead to the paradoxical situation that those who expect high earnings after graduation choose not to go to university – to avoid the tax – while those who do not expect high earnings are more likely to go.

Furthermore, such a tax would increase universities' dependence on government funding. A crucial discipline for universities involves responding to real students spending real money on course fees. State funding makes universities subject to the whims of every new higher education minister rather than the needs of students and their future employers.

There are other arguments against a graduate tax. How would the government define a 'degree' for the purpose of the tax? Professional and vocational qualifications often have the same advantages as degrees and students who expected high earnings would face distorted incentives not to take the graduate route. What would happen to people who went to university here and then went to live abroad? Student loans are a personal debt and individuals can be tracked even when they move overseas. There is, however, no agreement that a graduate tax could be imposed on those working in other countries.

Few economists would now argue that students should have all their higher education costs financed by taxpayers, many of whom are on low incomes. There are huge potential private gains from higher education that justify students financing themselves. There is legitimate debate about the extent to which government should subsidise some or all undergraduates, although most economists accept that they should be given government-guaranteed loans because of the difficulty 18-year-olds have in signalling their creditworthiness to private providers of finance.

However, the debate surrounding student finance should be around the development of the loans, fees and bursaries systems. We should not finance higher education by a tax imposed on people simply because they are graduates – a tax that would be unrelated to the cost of an individual's higher education and only loosely related to its benefits.

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Immigration – A Student's Guide

By Daniel Griswold

For thousands of years, human beings have moved across continents, oceans and national borders seeking a better life. Immigrants have been drawn to new lands by greener pastures, higher wages, family bonds and freedom. In the process, they have spread ideas and improved living standards in the places where they have settled.

Along with physical obstacles, immigrants have faced political barriers in the form of government controls on the movement of people between nation states and also within. In *The Wealth of Nations,* Adam Smith lauded 'the free circulation of labour' while criticising restrictions on immigration and internal migration. In eighteenth-century England, the 'settlement law' restricted the movement of labour between parishes so that no church would be overburdened by an influx of poor people needing assistance. An unintended consequence of the law was that wages varied sharply between parishes.

Smith observed that restrictions not only prevented a more rational distribution of labour, capital and production, but also infringed liberty. 'To remove a man who has committed no misdemeanour from the parish where he chooses to reside, is an evident violation of natural liberty and justice' he wrote.[1]

The economic benefits of migration

One of the principal economic benefits of immigration is that it allows workers to move to geographical areas or political jurisdictions where they can be more productive. Indeed, a major incentive for migrants is the prospect of a better-paying job, which typically means a job with higher marginal productivity compared with jobs available in the sending country. A worker whose labour was worth $1 an hour in their home country can quite quickly become a worker whose labour is worth $7 an hour in the host country, raising the income of the individual worker as well as the productive output of mankind.

The American economist Julian Simon, in his book *The Economic Consequences of Immigration,* noted, 'The explanations of migration boil down to the proposition that the expected gains from the move outweigh the expected costs of the move. That is, the market value of the individual must be greater in one place than in another, over and beyond transaction costs.'[2]

The receiving nation benefits when immigrants produce goods and services that would not otherwise be available, or at lower cost than could be produced by native workers. When immigrants enable a society to produce a good for $4 rather than $4.50, native-born households pocket the difference, raising their standard of living. Immigrants allow native-born workers to shift to sectors where they can also be more productive, thus earning higher wages – we widen the scope for the exploitation of comparative advantage.

Immigrants are most beneficial when they complement rather than compete directly with native-born workers. Immigrants can fill niches in the labour markets of more developed countries, at both the higher end of the skill spectrum (for example, doctors) and at the lower end in sectors such as cleaning, food processing and construction.

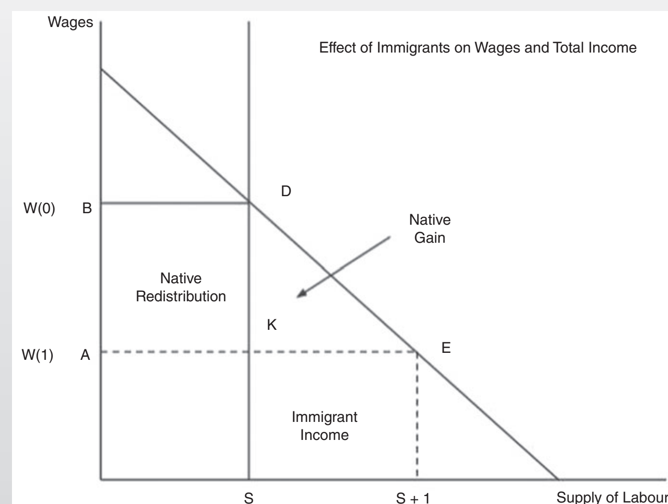
Figure 1 neatly illustrates the welfare gains to a society from an increase in immigrant workers. An influx of lower-skilled workers moves the supply curve from 'S' to 'S + 1.' This reduces the wages collected by workers who compete directly with the immigrants from W(0) to W(1). But this also means a gain to others in society who are able to acquire the goods produced by those workers at lower cost (represented by the area ABDE). The gain comes from a 'Native redistribution' from the lower-skilled workers to higher-skilled workers in society, but also from expanded output represented by the triangle marked 'Native gain.'[3] A society can offset the redistribution effects of immigration by transferring resources to lower-income workers and still reap the net welfare gains from expanded immigration. It should be noted that any losses to native workers will be lower in the longer term (as native workers move into other occupations) and will be lower if immigrant workers have complementary skills.

Along with expanded labour, immigrants can bring ideas, entrepreneurial energy and human capital. In the USA, for example, immigrants account for a disproportionately high number of engineers and computer scientists in the technology sector centred in Silicon Valley, California. A 2007 study from Duke University found that immigrants were founders or co-founders of one-quarter of high-tech start-up companies in the USA between 1995 and 2005.

Large-scale immigration does create challenges in the form of increased demand for publicly funded services. But in most industrialised countries, immigration has partially offset steep declines in birth rates so immigrants help to maintain a growing labour force and tax base to fund these services. According to a major study in 1997 by the National Research Council (NRC), the typical immigrant to the USA and his or her descendants will pay more in taxes than they consume in government services.[4]

Most empirical studies have concluded that immigration delivers a net benefit to the host economy. The NRC study

Figure 1: The effect of immigrants on wages and total income



concluded that immigration boosts the US economy by about $10 billion a year, a relatively small number compared with the size of the US economy, but nonetheless 'a significant positive gain in absolute terms.'[5] A 2009 study from the Cato Institute found that legalisation of low-skilled immigration would boost the incomes of American households by $180billion after ten years.[6]

The sending country can benefit from emigration in a number of ways. The exit of workers can relieve excess supply in certain segments of the labour market, raising the wages and marginal productivity of those left behind. Workers who return can bring with them new skills, ideas and connections to promote trade and investment ties to other countries. Immigrants abroad also send significant amounts of money to their families back home in the form of remittances that can be used to pay for housing, education, and medical care.

Immigration is not solely about economics. People also relocate across borders to be reunited with family and to escape political persecution and natural disasters. In this way, 'the free circulation of labour' also serves a broader cause of enhancing human liberty and checking tyranny. Despots cannot rule indefinitely over a captive population if their citizens are free to 'vote with their feet.'

Migration and political controversies

Although most economists view immigration favourably, it remains controversial in the political arena. Many people see the visible, short-term costs of immigration without appreciating the long-term but more diffused benefits.

One common objection is that immigrants lower the wages of native-born workers by increasing the supply of labour. This can happen, as we have seen above, but since most immigrants are not direct substitutes for native-born workers they tend to cause the real wages of most native-born workers to rise. Immigrants also spur investment in certain sectors by increasing profitability, which in turn raises worker productivity and the demand for labour. The NRC study and more recent work from the National Bureau of Economic Research estimate that immigration modestly raises the real wages of the large majority of workers while depressing the wages of the lowest skilled by 1–2%.[7] Of course, the wages of the immigrants themselves are generally much greater than they could have obtained in their home countries.

Another objection is that immigrants impose significant costs on taxpayers. This is generally true of lower-skilled immigrants, who usually pay much less tax than the average citizen while continuing to consume government services. The impact can be most visible in public schools and hospital emergency rooms, which are required to provide services to immigrants and their children. But, governments can choose to restrict immigrant access to welfare programmes and insist that immigrants support themselves as a condition of admittance – at least in the early years. The studies referenced above show that more skilled immigrants are net contributors to government, and that the broader economic benefits from immigration more than compensate for the negative fiscal impact of the lower-skilled segment.

Another common worry is that immigrants displace native-born workers from their jobs. This is undoubtedly true for the generally small number of native-born people who most closely resemble the skill profile of immigrants. But there is no systematic evidence that immigration contributes to higher levels of unemployment in the economy as a whole. When jobs are not available, fewer immigrants will choose to enter, and more of those already in the country will choose to return to their home. In this way, immigration acts as a safety valve for the labour market, moderating when unemployment is high, and picking up when jobs are plentiful. To the extent that immigrants start businesses, create new products or attract investment, they can actually help create employment opportunities for native-born workers.

Beyond economics, many people worry that immigrants will fail to assimilate or, even worse, become a destructive social influence by engaging in crime and even terrorism. In general, most immigrants eventually integrate into productive society. In the USA, English is spoken almost universally among second-generation immigrants. The labour-force participation rate among immigrants is actually higher than among the native-born, and the crime rate is lower. The small number of immigrants linked to terrorism can be apprehended and prosecuted without restricting immigration generally.

Assimilation has been less successful in societies where immigrants have the option, and may even be encouraged, to become wards of the state. Rampant unemployment and geographic isolation can fuel alienation within immigrant communities. A productive job within the broader society remains one of the best engines of assimilation.

In our current era of declining barriers to trade and investment and expanding globalisation, immigration remains an exception. Restrictions on immigration are actually more widespread today than a century ago. Those restrictions are especially high against workers in less-developed countries who would benefit from relocating to a more developed country. As evidence and theory suggest, those restrictions are imposing real costs on people living in rich and poor countries alike.

1. Smith (1937), p. 141.
2. Simon (1989), p. 15.
3. The graph is adapted from the National Research Council, (1997) p. 138.
4. National Research Council, (1997) p.334.
5. National Research Council, (1997) p. 6.
6. Dixon and Rimmer (2009).
7. See National Research Council (1997), p. 220 and Ottaviano and Peri, (2006), p. 4.

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21st-Century Lessons from a 20th-Century Economist

By Eamonn Butler

Exactly a century ago, in Vienna, a young economist called Ludwig von Mises was just starting his career. He went on to become the leading exponent of a radical new approach to the science, one that is gaining traction today – the Austrian School of Economics. So what can this 20th-century pioneer tell us about our 21st-century problems?

Boom and bust

One immediate thing Mises can help with is how to avoid the boom-and-bust cycles that gave us the Great Depression and now the current world financial crisis. Paul Samuelson in his *Economics* textbook boasted that post-war Keynesian 'fine tuning' was making these cycles a thing of the past; but they are back, bigger than ever.

Mises founded an institute to research into business cycles, and his colleague F. A. Hayek eventually won the Nobel Prize for this work. They showed that every cycle stemmed from a surge in credit – magnified by bankers, true enough, but invariably rooted in the low interest rate policies of central banks and politicians.

Those low rates encourage people to borrow and spend. Business booms, and cheap loans, encourage entrepreneurs to invest in new plant and equipment. But this is mistaken, *malinvestment*, based on the false signals of credit-fuelled demand and artificially cheap borrowing. Soon, the increased demand for both investment and consumption goods bids up their prices, making them less affordable again; while the low interest rates discourage savers, drying up the supply of cheap loans. Eventually, reality reasserts itself and the bubble bursts. By now, though, lots of real resources have been invested in the wrong places. There's no solution but to write off equipment, close factories, and fire workers. The monetary incontinence of the authorities has caused real and severe long-term losses and, after a credit-induced boom, recession is inevitable.

Economics is *human* not mechanical

Mises also teaches us much about the nature of economics itself. Modern economics is highly mathematical; some economists believe they can measure, manipulate and predict economic events with the precision that scientists can forecast lunar eclipses.

Not so, says Mises. Economics is about how human beings choose between different things. Such choices are highly personal and unpredictable. Individuals themselves may not know what they would choose until actually faced with the choice. How often have you gone into town for one thing, and come back with something completely different? Your choices depend as much on your mood as on your mind, and on your physical circumstances too: ordinarily, you might think a cup of water of little value, but on a desert island it seems valuable beyond diamonds.

Economists can no more measure and predict such things than mathematically model emotions such as grief or love. Value is not an objective quality of things, like size or weight, but a very personal reaction to them. Every human choice – and thus economics itself – is rooted in human values. That makes economists' predictions hugely fallible, says Mises, and makes the search for mechanical relationships between economic aggregates – mere statistical summaries of these unfathomable choices – utter folly. He would therefore reject the relatively modern discipline of econometrics.

Interventionism

In the 1920s, when communism was riding high, Mises became its leading economic critic. Production goods such as factories and machines were not valued for themselves, he noted, only for what they produced. In a market economy, their prices reflect the prices that can be obtained for their end product. High prices show that more investment in them would bear fruit; low prices suggest their output is little valued.

In a socialist economy, however, production goods are communally owned. They are never bought or sold, so there are no price signals to guide investment. The decision is left to planning boards. But how could such distant political bodies really know? The inevitable consequence is that under socialism, resources are steered to the wrong places, causing real waste and loss. This, Mises would argue, makes a drive for efficiency in a government-controlled entity such as the NHS, an activity that is unlikely to bear much fruit.

The same is true, says Mises, whenever politicians try to 'improve' on the market, by setting maximum prices for essentials, say. The result is that people simply demand more of this cheap good, while producers become more reluctant to supply it. Soon the shelves are empty and the situation is worse than before. It's a lesson that the world's political leaders might reflect on, as they struggle to deal with the effects of the financial turmoil that – says Mises – they themselves have caused.

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