A properly designed ‘graduate contribution’ could work well for UK students and higher education – even though the original ‘graduate tax’ proposal is a terrible idea

First mooted by Vince Cable last month, the discussion of a possible ‘graduate tax’ policy has caused much disagreement within and outside of the coalition. The Liberal Democrats support it because it would make student fees disappear, but the Tories fear another ‘stealth tax’ on the middle classes. ***Nicholas Barr*** *takes an in-depth look at the proposed graduate tax and shows how the earlier graduate tax would never work, but a modernized form of graduate contribution would deliver many benefits to students, parents, universities and UK government.*

The idea of a graduate tax is much in the news. But is it a good idea? The answer is a typical academic one – it depends on what you mean by ‘a graduate tax’. A pure graduate tax, where graduates pay *x*% of earnings forever, or until retirement, or for (say) 25 years, is a very bad idea. But a system which allows people to make an affordable capped contribution via payroll deduction to the cost of their degree once they start work is a good idea.

What’s wrong with a pure graduate tax?

The idea is intuitively attractive, and hence it has been around for a long time. It was first suggested in the UK literature by my LSE colleague Professor Howard Glennerster. In that form it was an important idea in the context of the 1960s and entirely plausible for the small university system of the kind that we had then. But today, when mass, high-quality tertiary education is essential, the original idea has at least five strikes against it.

1) It’s public money. The revenue from a tax is irredeemably public finance, ruling out net private finance until cumulative repayments by graduates outweigh the cumulative upfront outgoings by government.

2) Funding is closed-ended. With a graduate tax, the Treasury continues to control the funding envelope. Funding is a zero-sum game. So Oxford and the brand new Chichester University compete for the same pot of money.

3) Incentives to produce quality degree course are muted. Public finance plus closed-ended funding restores central planning, and thus it muffles the competitive incentives facing universities, and hence creates concerns about possible quality declines.

Why is competition important? The economics of information argues that competition is useful where consumers are reasonably well informed, which is broadly the case with higher education. Thus competition within a regulated market benefits students, employers and the wider economy.

Why does quality matter? It matters, of course, for its own sake. But in today’s world it matters also for national economic performance. To illustrate the competition Europe faces, in South Korea in 2007, 76 per cent of 19-year olds were in tertiary education (the average for the European Union countries in the EU19 was 29 per cent). Total spending on tertiary education in South Korea in 2006 was 2.5 per cent of GDP, almost double the average for the EU19 of 1.3 per cent. And *private* spending on tertiary education in South Korea was significantly higher than *total* (public plus private) spending in any OECD country except the USA and Canada. (See the OECD document *Education at a Glance 2009*, Tables C1.3 and B2.4).

4) A closed-economy model. If repayments are part of a person’s income tax liability, they apply only to people with UK taxable earnings, thus exempting students from mainland Europe who study in the UK but then work elsewhere. They would also exempt UK graduates who work abroad. Unless the graduate tax is very small (in which case, why bother?) it will create perverse incentives for UK talented graduates to emigrate.

5) Politically problematical. Though it sounds like a good idea, a graduate tax would be politically difficult. If the tax is compulsory, it causes what I call ‘the Mick Jagger problem’. In a graduate tax regime, Mick Jagger, once an LSE student, would finance a good chunk of UK higher education. Compulsion, as well as encouraging emigration, will come under political attack from the right, as violating individual freedom., and hence it might not be stable – which is very important for a scheme that works over the long term.

If the tax is voluntary, the problem is one of adverse selection – the rich would pay upfront, reducing the redistributive capacity of the system. This tendency would in turn provoke political attack from the left, again impairing stability.

Turning a bad idea into one that works

The fact that a pure graduate tax is a bad idea is not, however, the end of the story. Imagine a ***graduate contribution*** with the following features:

- Repayment takes the form of a payroll deduction related to a person's earnings, with a cap on the maximum size of repayment by any graduate.
- The size of that maximum can vary by university or course, e.g. an LSE economics graduate would face a higher maximum contribution than an economics graduate from Balls Pond Road University. The choice of maximum repayment is one for the university, subject to regulation.
- The timing of when repayment stops is based on a calculation which takes account of the interest cost to government of financing the upfront costs of the person's degree, i.e. it would implicitly include an interest rate equal to the government's (generally low) cost of borrowing.
- The contribution is based on a contract between the individual and the student support agency, broadly as at present. Hence working abroad does not exempt the graduate from making his or her contribution.
- The contribution can be structured so as to build a redistributive tilt into the system, with capped overpayment by the top earners making up for underpayment by low earners, thus introducing a social insurance element into the system (see, the discussion of Option 3 on page 38 of my evidence to Browne review).

An arrangement of this sort (see, for example, the evidence by the Alliance Group to the Browne Review) has considerable advantages. It fosters competition between universities which aids quality. It avoids the fiscal black hole and regressivity of the current blanket interest subsidy on student loans (see my earlier article on this here).

The third advantage is one of perception, and very important. The term 'graduate tax' moves the idea of a graduate contribution from the credit card bit of people's brains to the payroll deduction bit. The present system focuses on *DEBT*, and the problem is worse because people conflate student loan debt with credit card debt. A parent whose child has £20,000 of credit card debt rightly has sleepless nights; credit card debt has a short repayment duration, a high interest rate, and potential bankruptcy for defaulters.

Student loans are very different, with a long repayment period, low interest rate, and automatic suspension of repayments when earnings are low. So a graduate contribution is not a credit card debt but a payroll deduction. Parents do not worry about their child's future tax bill. Nor should they worry about a graduate contribution in the form of a payroll deduction.

The bottom line is this: a pure graduate tax is a terrible idea, but a graduate contribution organised as a payroll deduction is not only sound but, in today's world, essential.

This note draws on my evidence to the Browne Review: Nicholas Barr (2010), *Paying for higher education: What policies, in what order?*, http://econ.lse.ac.uk/staff/nb/Barr_HEReview100215.pdf.

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