Financing tertiary education: Some thoughts on the reform proposals in Chile

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Bill to create a new public funding instrument for higher education, Bill N°17169-04. Public hearing organised by the Treasury Commission of the Parliament of Chile

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1. Lessons from economic analysis
2. From theory to policy: A case study
3. Some thoughts on the reform proposals in Chile

1 Lessons from economic analysis

Lesson 1: Graduates (not students) should share in the costs of their degree

Three reasons

1) Higher education creates private benefits (higher pay, greater job satisfaction) and also social benefits. Taxpayers should pay for the social benefits, graduates for their private benefits
2) There is a railroad crash between the need for a large, high-quality system of higher education and other pressures on public finance (pensions, health care)
3) It is still mainly students from better-off backgrounds who go to university

Thus need a way that students can get it free, but graduates repay – loans

Lesson 2: Well-designed student loans have core characteristics

1. Income-contingent repayments, i.e. repayments of x% of the student's subsequent earnings like income tax and social security contributions

- Why income-contingent?
  - A loan to finance a degree has no physical collateral and is thus risky to both lender and borrower
  - With income-contingent repayments, if income suddenly falls, loan repayments automatically and immediately also fall; and if earnings fall to zero, e.g. if someone leaves the labour force to have a baby, their repayments fall to zero
  - This encourages students to take out loans by making them less risky

Lesson 2, continued

2. Loans should be large enough

- Loans should be large enough to cover fees and if possible living costs so that higher education is free, or largely so, at the point of use

3. **An efficient interest rate** related to the risk-free cost of finance, e.g. the government's cost of borrowing
4. **A sensible way of including student loans in the public accounts**

Lesson 3: Competition between universities helps students

- Does competition work? Yes when consumers are well informed
- Are consumers well informed?
  - Good information is a central source of quality assurance
    - On the student experience
    - On teaching
    - On employment outcomes
- Mistakes to avoid
    - Not all students are well informed. Students from poorer backgrounds face information problems which policy needs to address (more below)
    - Competition without sufficiently robust quality assurance

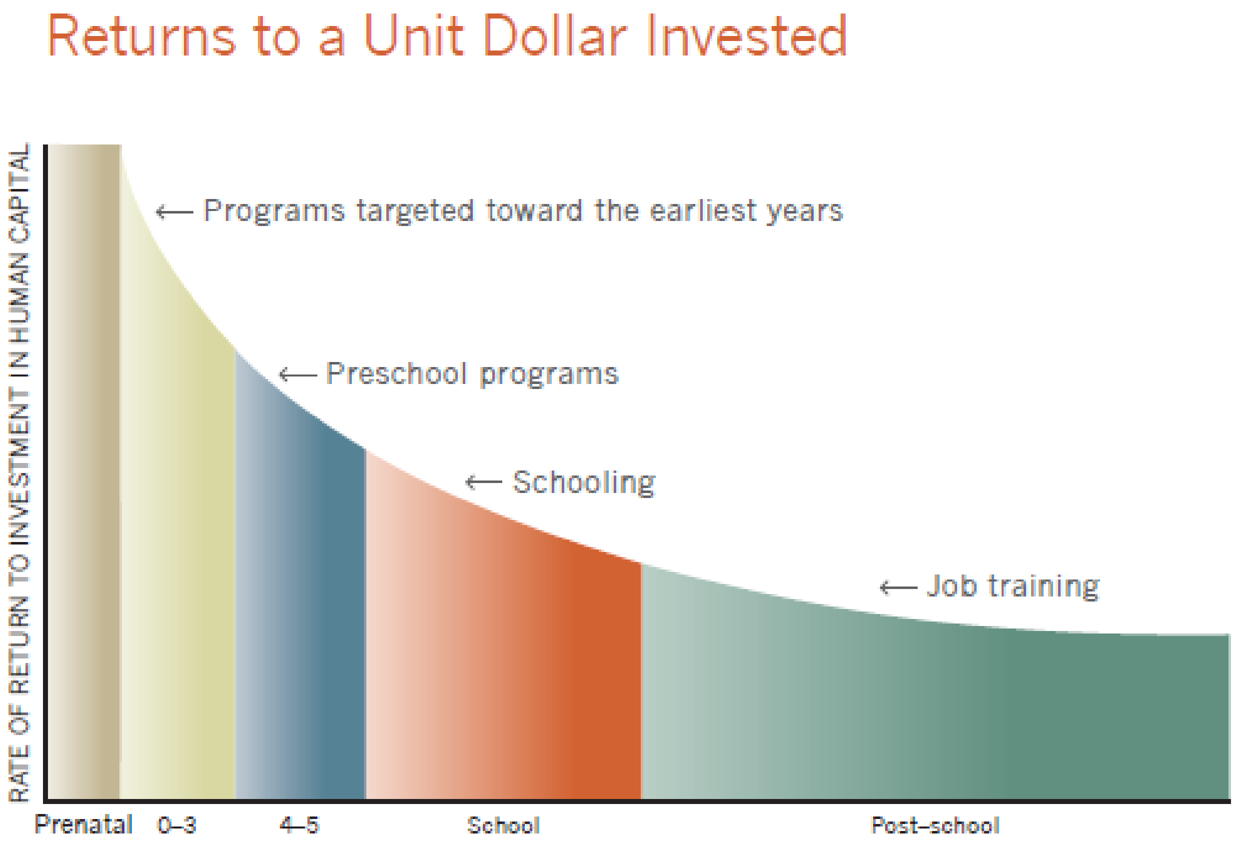
Lesson 4: Government has an important and continuing role

- To provide taxpayer support for higher education
- To ensure that there is a good loan scheme
- To adopt, encourage and mandate policies to widen participation
- To regulate the system
    - Price: arguments for a fees cap
    - Quality: ensuring that there is effective quality assurance
- To set incentives
    - Establishing the degree of competition (can vary by subject)
    - Larger subsidies for certain subjects
- To redistribute within higher education
    - May have a geographical element
    - May be related to different types of university
- To ensure that statistics are collected
- To finance research
- **Bottom line: a regulated market not a free market**

Lesson 5: The major driver of access is prior attainment

- Early child development is central
- James Heckman (Nobel Laureate)
    - ‘The highest rate of return in early childhood development comes from investing as early as possible, from birth through age five, in disadvantaged families. Starting at age three or four is too little too late …. The best investment is in quality early childhood development from birth to five for disadvantaged children and their families’

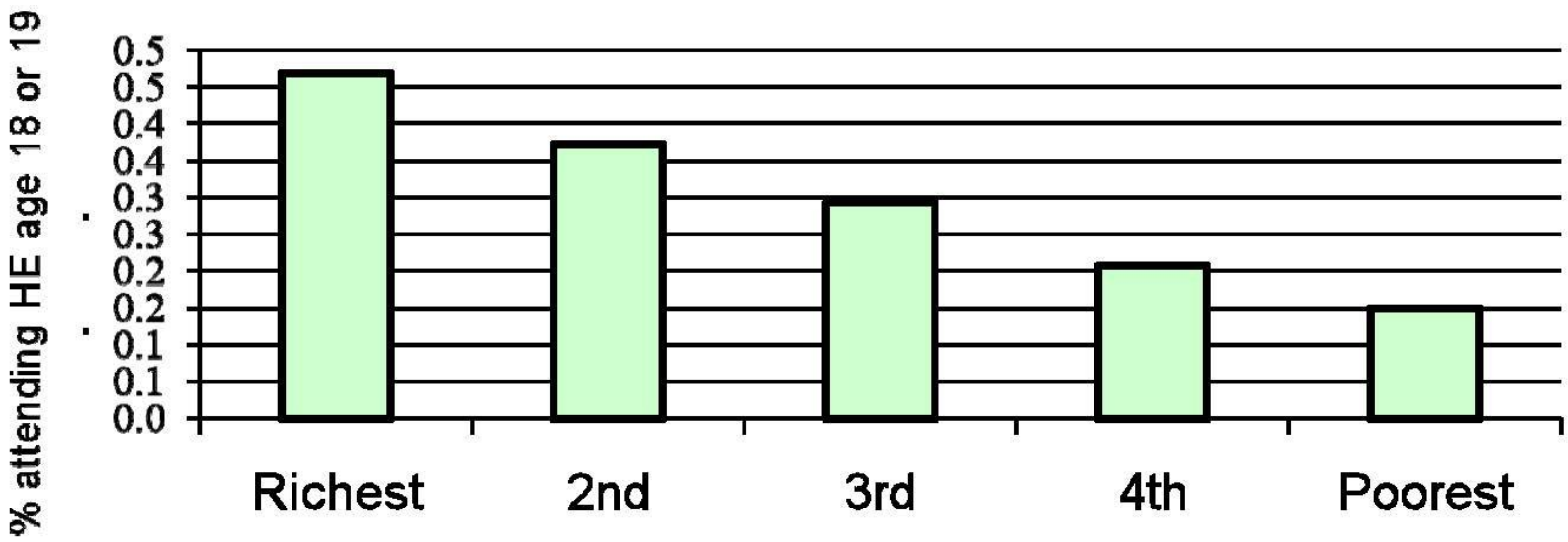
The economics (schematic illustration)



England: Fewer poor people go to university

Chowdry, Haroon, Crawford, Claire, Dearden, Lorraine, Goodman, Alissa and Vignoles, Anna (2013), ‘Widening participation in higher education: analysis using linked administrative data’, *Journal of the Royal Statistical Society*, Series A, 176, Part 2, pp. 431–457

25% of young people from the best off backgrounds get top grades, only 3% of those from the poorest backgrounds



2 From theory to policy: A case study

2.1 A general strategy from economic theory and international evidence

- Leg 1: paying for universities: a mix of tuition fees and taxpayer support
- Leg 2: student support: free at the point of use: loans should ideally be large enough to cover fees and living costs
- Leg 3: measures to widen participation
  - Policies to improve attainment in school
    - Increased emphasis on early child development
    - Action to improve school outcomes
    - Improving information about higher education and raising aspirations
  - Policies to address financial constraints
    - Financial support to complete high school
    - Income-contingent loans
    - Make part-time study easier

2.2. Does the theory work? Reform in England in 2006

The reforms

- Fees: universities financed by a mix of
    - Tuition fees of up to GBP 3,000 per year
    - Taxpayer support
- Loans:
    - An income-contingent loan to cover the full tuition fee and realistic living costs
    - Forgiveness after 25 years
- Grants for students from poor backgrounds
- Continuation of previous policies earlier in the systems

The 2006 strategy got it broadly right (full disclosure: I was heavily involved)

- The strategy followed the economic theory
    - Financing universities: tuition fees plus taxpayer support
    - Financing students: income-contingent loans to cover fees and living costs
    - Policies to widen participation included major policies earlier in the system

What happened?

Between 2006 and 2012:

- Tuition fee income +87%
- Number of grants and loans +25%
- Number of students +20%
- Number of applicants from most disadvantaged background **+53%**

Why the dramatic improvement in access?

- Improved high school graduation grades
- Source of improvement: earlier policies starting at earlier ages
    - Surestart
    - The literacy and numeracy hour
    - Education maintenance allowances
    - AimHigher

3 Some thoughts on the reform proposals in Chile

- Bottom line: I strongly support the direction that the proposed reforms are taking
- At risk of over-simplification
    - The economics is fairly straightforward
    - And the politics is fairly straightforward
    - The difficult bit is that they go flat in opposite directions

3.1 The design in bare outline

- Income-contingent repayments, maximum 8% of income
- Repayment duration: 2 years per semester
- Maximum duration 20 years (a standard degree takes 5 years)
- Free tuition for students from the bottom 60% of the income distribution
- Participating universities can charge top up fees, but
    - Only to the top 10% of students in terms of the income distribution
    - And no loan to cover the extra fees

3.2 Desirable design features

- The reforms
  - Draw the right lessons from past experience
    - Conventional bank loans are a bad fit for financing investment in skills
    - A government guarantee to private loans creates perverse incentives
  - Comply with the principles discussed earlier
    - Loans organised through a national system rather than banks
    - Repayment via the tax system
    - The loan is large enough to make higher education free at the point of use for most students
  - Cover accredited vocational courses as well as university courses

Questions for fine-tuning

- Graduate tax or loan?
- What role for ‘free’ higher education?
- What role for interest subsidies?

3.3 Income-contingent loan or graduate tax?

- Loan: in a pure loan
  - The duration of repayment is variable
  - Repayment is related to the size of loan
- Graduate tax: in a pure graduate tax
  - Repayment stops after a fixed number of years
  - Repayment is not related to the size of loan – higher earners repay more than they borrowed, lower earners less than they borrowed

A pure graduate tax: Arguments for and against

- For
  - Easy to understand
  - Redistributive
- Against
  - Public money
  - A closed-economy model, i.e. can’t collect repayments from students outside Chile
  - Potentially politically problematical if overpayment is not capped

A pure loan: Arguments for and against

- For
  - A better arrangement where tuition fees vary
  - Can be financed with private money
  - Repayment can be enforced on graduates working in another country
- Against
  - Focusses attention on the headline debt, causing political problems (a mistake in the UK reforms)

Hybrids with elements of loan and graduate tax

- The UK system
  - A loan inasmuch as higher earners repay in full
  - A graduate tax in that repayments stop after 40 years (previously 30 years, prior to that 25 years)
- A capped graduate tax
  - Repay for (say) 20 years
  - But repayments are capped at (say) 125% of the loan in present value terms, e.g. using the government's real 10-year bond rate as a discount rate. Thus nobody would repay more than 25% more than they borrowed
  - Thus higher earners repay for less than 20 years
  - In that respect the reform proposals are a form of hybrid

3.4 Should some people get higher education ‘free’

- The reform includes free tuition for students from the bottom 60% of the income distribution
- The argument that ‘free’ higher education assists access
  - Should not be overstated (UK evidence)
  - However, may be politically important
- ‘If I were a real socialist I would not spend a penny on higher education – I’d spend it all on nursery education’ (UK Education Minister in debate with students)
- The economic question: since the loan makes higher education free at the point of use, would the resources be better used
  - To pay maintenance support and/or
  - For pro-access policies earlier in the system, e.g. more and better nursery education
- The political economy question is what fraction of students should be exempt from paying tuition fees

3.5 What role for interest subsidies?

- Interest subsidies are politically popular and may be politically necessary
- However
    - Are badly targeted, e.g. benefits spill over to high earning graduates
    - Are expensive, and thus risk crowding out maintenance support and pro-access policies earlier in the system
- Thus the role of interest subsidies brings out a tension between economics and politics

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