A critical aim of a higher education financing system is to help ensure that there are minimal barriers to the participation of talented but poor students. To this end, governments of mature economies typically intervene, either through the provision of taxpayer subsidies covering all tuition costs and some proportion of student living expenses, or through public sector involvement in loan programmes. This chapter begins by explaining, with reference to capital market ‘failure’, why it is that some form of government intervention is necessary to minimise problems of access.

The most common form of financing assistance involves governments offering access to guaranteed commercial bank loans. Interventions of this type address part of the capital market problem but, as explained in section 4, the approach does not offer a comprehensive solution.

A relatively new form of government loan intervention (in application terms), known as income related loans (IRLs), is examined conceptually in section 5. This approach involves former students repaying debt contingent on their future incomes, meaning that capacity to pay is given weight. Policies of this type are now in place in several countries, and their experiences are considered briefly in section 6. A cautionary note is offered in this section designed to highlight implementation problems of particular significance for the adoption of IRLs in developing countries.

2. THE CASE FOR GOVERNMENT INTERVENTION: CAPITAL MARKET ‘FAILURE’

To understand what, if any, might be the correct forms of public sector higher education financing involvement, it is useful to ask: what problems would arise in the absence of government intervention? This could involve the following arrangements. Assuming that the public sector accepted the existence of externalities from higher education, there is thus a resource allocative efficiency case for the provision of taxpayer-financed subsidies equal to the presumed marginal value of the spillovers.

In the absence of intervention this could be achieved by the government providing the appropriate level of finance to universities and allowing the institutions to charge up-front fees to cover remaining costs, assumed in this...
approach to be equivalent to the marginal private benefits of higher education attendance (see Chia 1990; and Chapman 2004).

However, there are major problems with such an arrangement, first raised by Friedman (1955). The argument can be best understood with reference to the nexus between labour markets and human capital investments, the essential point being that educational investments are risky, because (Barr 2001; and Palacios 2004):

(i) enrolling students do not know fully their capacities for (and perhaps even true interest in) the higher education discipline of their choice. This means in an extreme they cannot be sure that they will graduate and, in Australia for example, around 25 per cent of those enrolling end up without a qualification;

(ii) even given course completion, students will not be aware of their likely relative success in the area of study. This will depend not just on their own abilities, but also on the skills of others competing for jobs in the area;

(iii) there is uncertainty concerning the future value of the investment. For example, the labour market – including the labour market for graduates in specific skill areas – is undergoing constant change. What looked like a good investment might turn out to be a poor choice when the process is finished; and

(iv) many prospective students, particularly those from disadvantaged backgrounds, may not have much information concerning graduate incomes, due in part to a lack of contact with graduates.

These uncertainties are associated with important risks since if graduate future incomes turn out to be lower than expected, the individual is unable to sell part of the investment to re-finance a different educational path, for example. This is critical in an understanding of capital market failure, and explains why banks will not be interested in unsecured loans for higher education investments, compounded by the fact that there is no collateral to be sold in the event of default. And even if it were possible for a third party to own and sell human capital, its future value might turn out eventually to be quite low.

These issues are apparently understood by the governments of most countries because there are typically public sector loan interventions. Until recently, government intervention almost exclusively took the form of public sector guarantees for commercial bank provision of education loans, and over the last decade or so has increasingly involved IRLs. While quite different in practice, both approaches are motivated in part by the recognition that left to themselves, higher education markets will function poorly.

An assumption implicit in the above discussion is that the capital market issue is important enough to mean that, in the absence of government intervention, access to higher education will be restricted significantly. But the borrowing problem takes on a serious form only if it is actually the case that there are constraints for individuals in need of bank financing. There is evidence concerning the extent to which access to credit limits human capital investment, and it takes several forms.