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# Alternative Options for Funding

Over the recent decades, the pros and cons of various kinds of higher-education funding have been discussed. In this section, we will discuss some of the proposals for a funding reform in the light of our framework and the main results we have obtained so far.

In the preceding sections we emphasized the role of tax distortions. We ignored the role of externalities and we made no attempt to address the role of capital-market imperfections or unequal opportunity to access higher education. The persistent debate on alternative funding options, however, often tries to consider most of these problems and to look for alternative funding schemes that alleviate or solve all or most of these problems.

Among others, the most popular ideas for a funding reform are: a graduate tax, vouchers, differential fees, and loans (see, e.g. Greenaway and Haynes (2003)). Most of these are mutually compatible in the sense that they work in a similar manner. Both vouchers and loans aim to correct market failures such as credit constraints. However, both schemes intend that graduates repay support received during their lifetime. A graduate tax is a mechanism to differentiate with respect to a concept, often weakly defined, of *ability to pay*; differential fees have a similar aim. However, only a small minority of economists claim that grants should be wholly state financed. The opposite attitude, however, seems to interest more economists, but two main drawbacks are also widely accepted. The first is concerned with equity considerations: tuition fees have become a target of much social hostility, mainly because they have to be paid at a time when young people have the least money. The second disadvantage is concerned with efficiency: considering the first drawback, parental contributions become more and more important and, despite the suggestion that this might also be socially undesirable, it separates payers (parents) and users (students). Consequently, so the argument goes, higher education is not an efficient decision because of a principal-agent problem.

Furthermore, this divergence of payers and users may be the source of what John Stuart Mill labeled *fiscal illusion*.[1]

Therefore, the debate within the economics of education is centered on a scheme somewhere between fully subsidized costs of obtaining higher education and tuition fees in its rough form. The main question in this field seems to be the relationship between the benefit granted during the investment period and the amount of *repayment* over the subsequent lifetime. The options here can be summarized as

- a pure (mortgage-type) loan scheme,
- a loan with income-related repayment (up to the borrowed amount), and
- a graduate tax.

Under a loan scheme, a graduate repays what he or she has borrowed until the loan (plus interest) has been paid off, at which point repayments cease. With an income-related repayment, the borrowed amount can be regarded as a maximum value of repayment. Agents who are not very successful in the labor market repay less than received. Interestingly, most education economists seem to favor an income-related repayment. (Blaug, 1980, p. 45) has pointed out that "virtually every advocate of student loans in Britain [...] favors an income-related loans scheme [...] and not a personal loan repayable in a fixed number of years after taking up employment."

A graduate tax, however, is a tax supplement that applies only to graduates. If the graduate tax is regarded as a *repayment* for benefits received during the education period, the repayable amount may have the opposite effect to an income-related repayment of a loan. High-income graduates are pushed to *repay* more than they received. Graduates, in this case, are taxed twice. Glennerster (2003) and Glennerster et al. (2003) refer to two equity grounds that both date back to Adam Smith: capacity to pay and disproportionate benefit.

> As we argued [...] graduates disproportionately benefit from higher education in ways no other group does from investment made in them by their fellows. State funded lifetime expenditure on the higher education of the richest fifth is worth five times as much as that on the lowest fifth. A graduate tax combines the principles of ability to pay, disproportionate benefit and efficient collection. Adam Smith's perfect tax! (Glennerster, 2003, p. 26)

However, the concept of a graduate tax has been supported by several economists. Arrow (1993); Lincoln and Walker (1993) regard a graduate tax as a means to achieve a just contribution by students for the subsidies they received. Pennings (2000) pointed out that a graduate tax is an example for

[1] "Perhaps [...] the money which [the taxpayer] is required to pay directly out of his pocket is the only taxation which he is quite sure that he pays at all". (Mill, 1848[1994], p. 237).