Short policy briefing

What is a graduate tax?

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Quite a few prominent Liberal Democrat and Labour politicians and the National Union of Students have recently advocated a "graduate tax" as a way of funding UK and other-EU undergraduate students to go to English universities. This is a major departure from just a few years ago, marking the end to the support by major groupings of the idea that undergraduate graduate education in England should be paid entirely out of general taxation. This acceptance seems a watershed moment and I think welcome, for many UK and other-EU graduates benefit enormously from their English university education and if they do it is economically and socially just for them to contribute to the cost. But what is a "graduate tax" and how does it differ from the current system of funding? Does it represent an improvement over our current system, where graduates pay for their education up to a fixed tuition fee according to the level of their earnings?

Pure graduate tax

The simplest graduate tax, which I will call an "pure graduate tax", has the following structure. All UK and EU students have their tuition paid by the state (currently around £3k a year) and UK students have a grant from the state for their cost of modest living (currently around £4k a year, although £8k is more representative of the real cost). In return, UK residents who are graduates at English universities pay an extra amount of income tax for the first 20 years after graduation (the Treasury cannot levy income tax on people outside the UK). The rate of extra income tax may vary with the level of earnings, in the same way income tax does. Roughly the rate of extra income tax may be around 5%. The state determines the level of tuition it is going to choose to pay the 150 odd universities we have in the UK. In effect all undergraduate teaching would be funded through a block grant from the state. One might note there is no country in the world which uses this system. We will see why in a moment.

The current system

How does this differ from the current system? Currently all EU citizens who go to English universities can opt to either pay their tuition fees upfront (around 15% of UK students do this, perhaps double this percentage of other-EU do) and cover their own cost of living expenses or receive student financial support so university can be free at point of use. If they receive support they are asked to pay back a percentage of their income over a threshold (currently 9% above £15k) when they graduate wherever they work in the world. This behaves like an extra income tax, but it is capped for the payments stop when the graduate has paid back the student support they receive from the state. A typical student receives around £20k of student support. Anything outstanding after 25 years is forgiven. As David Willetts recently said, economically this is really a finite income tax --- or as Vince Cable has said it might be branded a "graduate contribution" or a type of

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“graduate tax”.   This system can be made more progressive without changing its principles, with lower payment rates for lower earnings and higher rates for higher earners. I would strongly welcome such a change. I would also like to amend the system so universities are financially rewarded for providing high quality education, and I have written elsewhere about how to do this using what I call deferred fees.

Common features

From the perspective of students and graduates there is an enormous amount of common ground between the two schemes. (i) education is free to students, but UK residents who are graduates pay if they are better-off, (ii) payments made are related to earnings. The payment rate could vary with level of earnings if desired under both schemes, (iii) the graduate payments are collected through the PAYE tax system, (iv) poorer graduates pay nothing, (v) the system of payments eventually stops.

What is different between the two schemes

Pure graduate taxes are the same as the current system except, (i) tuition fees are in effect infinitely large for graduates can never pay enough extra income tax to stop paying early, (ii) parents, business or philanthropists are banned from paying upfront the tuition costs of students, which reduces intergenerational wealth transfers, (iii) education at English universities is entirely free to other-EU citizens or UK graduates who then leave the country -- only those who are resident pay, (iv) a graduate tax would take a long time to generate much revenue, in the mean time under the public accounts all the HE spending would be added to the public deficit. Hence the deficit would increase by around £4B to £5B a year compared to now, (v) people who drop out of university or just fail the exams seem not to pay anything, (vi) the yield from standard income tax will fall due to the increase in tax avoidance or reductions in incentives to work caused by having in effect a higher marginal rate of income tax on graduates under 45 years of age (this incentive problem is less severe if the graduate tax is capped as it is under the current system), (vii) there is no guarantee that the income would go to the universities, for the vital direct link between student funding and universities will be broken, (viii) graduate taxes give the Treasury extremely strong powers over universities. The last point is important. In the long-term strongly autonomous universities tend to outperform state controlled ones.

I think all of these additional features are bad.

Student debt

The perceived advantage of the pure graduate tax is that the current system delivers “student debt”. It is sensible to fear debt, particularly if you are financially poor, it can be devastating to lives. But the payments made under the current system and a graduate tax are exactly the same, they are simple functions of earnings above a threshold just like income tax.   This is not normal debt, it is what economists call income contingent. Prospective students being put off going to university due to fears of student debt is as logical as being put off by the fear their incomes will rise resulting in having to pay more income tax.

A change in language is important to communicate this. The use of the terms debt and loans is neither economically accurate nor needed. I like the phrases suggested by Professor Janet Beer, vice-Chancellor of Oxford Brookes University who described the system we need in the future as being named in terms of progressive “graduates contributions”. The Student Loan Company might be a Student Support Agency to more accurately reflect its mission.

The evidence suggests students can see through the horror stories of student debt from the Daily Mail and the NUS, which seem to actively try to discourage the poor from going to university. Since the current system was introduced in 2006 student applications in England from all social classes have risen more quickly than in Scotland which uses its own system. This is true before and after the recent recession. The main access issue at the moment is the scandal of over 200,000 people who would like to go to university each year who are denied a place due to the financial inefficiency of the current system. This would be made worse by an pure graduate tax.

Conclusion

University and student financing is contentious, reflecting the importance of education to the future of our country and its costs. However, there is a growing consensus on many aspects. The current system does have flaws and needs to be updated to be made more transparent to students and the public, fiscally more efficient, more progressive and incentivising high quality provision. The language needs to change. However, it does provide a sounder basis than us alone amongst countries going down the pure graduate tax road.