

A Submission to Senate Enquiry on Higher Education Reform

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February 20, 2015

1 Introduction

What follows are observations concerning the planned fee deregulation arrangements proposed in the Commonwealth government's higher education 2014/15 Budget. The government has made significant and positive changes to the suggested policy reforms since the Budget was announced, including important modifications to the suggested interest rate on HECS debt.

But there is a remaining and in my view a very important further change needed, and this involves the notion that institutions be able to set their own prices without government involvement. To me this is highly contentious and requires further thought and input. This submission offers a potential solution to what might I believe is still a major issue for general support for the proposed changes.

I describe below my views concerning the potential size of charge (and thus student debt) increases that are likely to follow if the Budget is passed as is, and the reasons for these views. I suggest that the government uses the lever of subsidies to inhibit and limit the extent of likely price increases. I believe such an idea has the potential to help reform very productively the funding mechanisms of Australian higher education.

The possible reform suggested involves changes in government subsidies reflecting, and to influence, the choices made by institutions with respect to pricing. The basic notion is that if universities choose to increase their prices by high levels there needs to be reduced government subsidies to these institutions as a consequence. This type of instrument is designed to limit the extent of price rises and will be labelled in this document the University Subsidy Contingent Scheme (USCS) (a plethora of possible names could have been chosen and this is only for short-hand convenience).

My background is as an academic economist with considerable policy and research experience in the area of income contingent loans, of which the Higher Education Contribution Scheme (HECS) was the first of its kind. I helped motivate and design HECS in 1988. Since then with respect to income contingent loans (ICL) I have: published around 100 articles in peer-reviewed journals (and 40 book chapters); been an author or editor of several recent books; advised the World Bank and the governments of over 20 countries in the area of student loans; provided direct advice to governments that have helped lead to the adoption of ICL; and given over 300 presentations, many of these at international conferences. I am considered to be an expert in the area of ICL and feel well qualified to comment on the 2014/15 Budget proposals.

As context to this submission I note the interaction between David Phillips and me with the Department of Education. David Phillips and I have been close colleagues for over 25 years and first met in the office of the Honourable John Dawkins when HECS was being devised, in 1987/88. We have talked extensively about many of the issues raised in the 2014/15 Budget, particularly with respect to fee deregulation, and came to very similar views about a possible way to improve outcomes, involving a governmental response to "excessive" charge increases.

David Phillips and I ended up approaching the Department of Education in January 2015 to see if developing our thinking with some real data might provide a constructive contribution to the debate. The Department agreed and we spent several days with technical staff in the Department developing our suggestion, and testing it with current data held by the government. This assisted us through the use of their expertise in an understanding of the development of the reform suggestion, and the results of some of this work are provided below with the permission of both the Department and the Minister's office.

The data used comes from the Department's administrative records and Departmental officers provided useful technical input in calculating the possible effects of our suggested reform. But, transparently, the policy proposal is not the Government's position. It is a suggested change to it, aimed at correcting for what many believe to be a risk and concern in the Government's suggested reform. But, with the agreement of senior officers and the Minister's office, Departmental officers were of assistance in developing the proposal and the illustrative example(s) used below.

Consequently, David Phillips and I take full responsibility for the analysis and policy debate aspects of the proposal now motivated and outlined.

2 The Potential Price Consequences of Fee Deregulation under HECS

2 (i) In theory

There are several important reasons for believing that full fee deregulation in the Australian institutional and policy context would potential lead, eventually, to very high course prices (and thus debts) for students in some - perhaps many- areas of higher education. The bases of this claim from a theoretical point of view are:

(a) Because the collection of HECS debt is conditioned by capacity to pay, the system provides insurance against the potential adverse consequences of normal loans. With HECS there is no prospect of default through debtors/graduates experiencing low incomes, and there will not be repayment difficulties in any future period, because no repayments are required below a threshold of about \$52,000 per annum (in current dollars) and, by law, repayments can never exceed 8 per cent of annual incomes. Thus institutions can raise prices, and students can commit to debt repayment, without concerns about there being debilitating future circumstances for borrowers;

(b) In markets with poor information, such as with respect to the relative quality of universities, the established institutions will likely avoid having low prices compared to their close competitors because doing so can be taken as an indicator of

poor quality. This concept is known in the economics literature as a "Veblen good", and is well known and documented in higher education world-wide;

(c) Australians wishing to undertake an undergraduate degree face a difficult situation in the sense that there are no viable/inexpensive non-HECS options available, such as studying overseas; and

(d) In the presence of HECS, and with a real interest rate subsidy on the loan, the true price differences faced by students undertaking debt will be far less than they appear to be on paper. This is because higher prices simply add to the time taken to repay a HECS debt, given that the rules mean there can be no higher loan repayments per period of the debt. Thus the consequences of higher prices take effect not at the time of enrolment but in at least 10 to 14 years in the future, meaning that price differences will be heavily discounted by prospective students in their choices between institutions.

It follows from the above that so-called "price competition" under HECS, while it will exist, will be quite muted. Indeed, this was the basis for the original idea of HECS, which was to limit the discouragement effects of charges and to not have important and adverse effects on the participation decisions of prospective students (particularly those from poor backgrounds).

2 (ii) Evidence

There is now considerable available concerning higher education price-setting in situations/countries in which there are ICL. Some of the relevant data are:

(a) In Australia when HECS was introduced in 1989, the charge increased from effectively zero to around \$(2015) 3,000 a year, but there were no consequences for demand. Enrolments actually increased after HECS was instituted;

(b) When New Zealand introduced its version of HECS in 1991, universities were allowed to set whatever prices they wanted to, but the government chose to impose price caps after about 8 years because the charges had increased substantially, by at least 300 per cent at minimum for Arts, and much more in other areas;

(c) When the UK government allowed price caps to increase from 3000 pounds per full-time student year to 9000 pounds a year in 2011, about 95 per cent of the institutions put their prices to the highest level, with some of them citing the reason noted above as the Veblen effect; and

(d) If an Australian university with 25,000 students decided to *not* increase its average price as much as its close competitors, but instead set prices \$2,000 a year lower, for example, then the annual revenue foregone would \$50,000,000. In a world of low price elasticities of demand, which the theory implies is our world with HECS, this constitutes a very high annual cost from price restraint by such an institution in the (likely forlorn) hope/expectation of establishing a competitive price advantage.

No one can be sure what will happen in Australia if full fee deregulation happens after the beginning of 2016. But it is difficult to believe from the evidence and arguments provided above that fee deregulation in the form proposed in the Budget will result in moderate only price increases overall, and in important parts of the higher education market the potential for very high price changes seems very real.

2 (iii) The social costs of high charges

It needs to be asked: Does it matter that students/graduates might end up paying very high prices for higher education in Australia? Why should we be concerned about this possibility when it will still be the case that even with very high price rises, average lifetime graduate incomes will remain far greater than the incomes of non-graduates? This issue has exercised considerably my reaction to the fee deregulation debate since the Budget was brought down in May 2014. Some basic points are as follows.

There is no compelling and accurate answer to the question of how much students should contribute to the costs of running Australian public universities. Including my own research, all attempts to explain and measure the social benefits of university teaching are fraught with problems of inadequate data, less than convincing method and unclear conceptual interpretation.

But we do at least know that the private rates of return to higher education investments (the lifetime income advantages held by graduates) are high on average, implying strongly the case for a contribution to teaching costs from graduates. Indeed, this argument was fundamental to the reintroduction of fees in the form of HECS in 1989, and it remains powerful today.

However, I believe the question of what the "right" price to charge students for public sector university teaching services can be clarified with allusion to a principle concerning the role of government. It is not an argument that can be made easily with reference to economic theory or compelling evidence related to allocative efficiency. It is instead basically an ethical issue.

My view is that there is no clear economic justification for public sector universities to be allowed the use of a government instrument, HECS, to raise substantial revenue, in a situation in which this can lead to unjustifiably very high fees. An informed guess is that if Australian universities were to charge the sort of prices that I believe many of them could under the planned fee deregulation, the revenues received would in many cases far exceed the costs of teaching. While there is little doubt that in many cases these sorts of cross-subsidies already occur (particularly from the revenues received from international students), the issue for me concerns the extent to which this can be considered a "proper" use of the HECS instrument.

That is, if it is the case that fee revenues from price deregulation exceed considerably the costs of teaching, it is arguable that this is an improper use of a government instrument; basically put, it can be considered to be unfair. This then promotes a case for considering "excessive" fee increases in a space which economists label "negative externalities", or, broadly speaking, as costs borne by us all, in this case because of the presence of an unreasonable/unfair use of policy power.

3 Is There a Way to Mitigate "Excessive" University Charge Increases?

3 (i) Dealing with "externalities"

In conventional economic theory a principal role of government is to design and enforce arrangements that encourage activities that provide social benefits beyond the consequences of the private benefits to citizens. Otherwise there is so-called "market failure", in which without public sector intervention societies end up with poor outcomes in terms of the social good. As examples, this is why governments regulate against pollution or anti-social behaviour from citizens (such as the acts of murder or speeding).

Governments everywhere also punish potentially socially damaging consumption, such as with respect to smoking cigarettes or the consumption of alcohol, in the form of higher taxes on these purchases. And there are many examples in which governments have regulation and subsidies to increase social benefits, such as with respect to infrastructure, schooling and health services.

Moreover, there are examples of public sector activity in which governments withhold and/or reduce subsidies to citizens and institutions if their situations or behaviour warrant diminished support. Because the latter are pertinent to our fee deregulation proposal (USCCS), I turn now to several of these examples.

3 (ii) Several examples of contingent subsidies

What is being proposed in this submission with respect to reform of the deregulation aspects of higher education charges involves the government reducing subsidies to universities which choose to impose socially costly price rises, that is, debt increases to students which far exceed the costs of the teaching involved. It is useful to note that this type of public sector instrument is not unique or even unusual. There are several clear examples of the use of this kind of approach in the Australian and international policy context, including:

- (a) To meet the immunisation requirements for the [Family Tax Benefit Part A supplement](#) parents need to have their children immunised during the financial years that each child turns 1, 2 and 5 years old (unless a case is made against this on conscientious grounds);
- (b) Many governments private higher education subsidies to students studying abroad, but these subsidies have to be repaid in the event that graduates choose not to return and work for the funding agency (the government) for given periods; and
- (c) Whilst not about behavioural change, it is commonplace for governments to reduce social security if recipients increase their income from paid work, for example with respect to eligibility for and the level of Youth Allowance.

3 (iii) How reduced subsidies for excessive university price rises might work in practice

In operational terms the basic idea of USCS is as follows. For each subject cluster the government allows a price to be charged (let's label this x) and at this price all the revenue charged to the enrolling student is received by the institution (and is registered as a normal HECS debt owed by the student). Universities still have complete price discretion, but unlike the current Budget proposals, if the price imposed on the course exceeds x , there will consequently be a reduction in the government's overall grant to that university. Further, to make sure that there are likely to be significant and unambiguous effects on university price setting, the reduction in grants will become increasingly more severe the higher the prices are set.

Thus the scheme is designed to limit the imposition of high prices in a HECS-type world, but with parameters to be chosen by the government that achieve this objective without excessively reducing university autonomy to charge the sorts of prices that make sense in their particular educational, geographic and socio-economic environments. It is essentially a conditional market-based reform, very similar to proposals suggested by David Phillips in 2012 and the Browne Report provided to the UK government on fee deregulation in 2010.

4 The Choice of Parameters

For a government interested in the application of a system such as USCCS, there are many critical decisions to be made to maximise the prospects that the policy is able to achieve its objectives. The most important of these are:

- (a) The decision concerning the course unit chosen (such as course cluster) for which given price and subsidy parameters apply;
- (b) The level of price charged for a given course under which there is no public sector subsidy loss for the institution;
- (c) The rate at which the subsidy loss is set; and
- (d) The rate of progressivity of the subsidy removal with respect to price level increases.

These parameters are very important to the operations of USCCS, and there is no doubt that those chosen would have the potential to make the system benign (even irrelevant) with respect to price setting behaviour. These would include the choice of very high initial prices before the subsidy loss takes effect, and/or very low rates of subsidy withdrawal for given price increases.

On the other hand, if the parameters chosen severely limit the choices available to assist individual institutions set prices to reflect their particular circumstances, the advantages of price discretion would disappear, or be so restricted as to have no real benefits. These would include the choice of having very low initial prices before the subsidy loss takes effect, in combination with very high rates of subsidy withdrawal.

5 Summary

Importantly, the sort of policy approach suggested would retain the benefits that deregulation seeks to achieve: the ability of our higher education institutions to offer quality services for students in a differentiated higher education system, and one in which institutions can pursue their own strategies to attract and retain students. Critically, though, policies such as UCCS, if designed well, have a real potential to limit price rises to socially reasonable and fair levels.

Appendix: An Illustration of How the USCS Might be Made Operational

David Phillips and I worked closely with Departmental officials to illustrate how the subsidy withdrawal scheme might operate. What follows is a simple illustration only, with parameters chosen somewhat arbitrarily, and not to reflect our view of the right parameters of the scheme. There are many other choices available to government, some of which the Department also explored with David Phillips and me, and which could have stronger effects on price choices. These are issues for policy choice that need further explanation and development.

But matters of detail are not relevant to the example offered; what is important is to explain with the use of sensible data and good technique what is possible in principle. I reinforce the point that the example is not a reflection of the endorsement of the proposal by any agency.

Under the following version of the proposal the Government would remove the 20 per cent reduction in Commonwealth subsidies currently proposed in the Higher Education and Research Reform Bill 2014, which would in turn take away the imperative for institutions to increase their fees to maintain current resourcing. Other versions of the proposal might leave the government cut in place but instead have a lower level of an initial price chosen after which the subsidy withdrawal begins to take place.

The grant reduction would apply to the increase in tuition fees above a specified threshold, starting with the existing three maximum student contribution bands (in 2016 prices). The rate of the grant reduction would increase as the amount charged by institutions increases, to a maximum marginal reduction rate of 80 per cent. The grant reduction would be recovered from payments made to institutions by the Commonwealth.

A table showing possible annual fee thresholds and the grant reduction rate at each threshold is shown below, again only for illustrative purposes. In each of the three bands, the first threshold reflects the projected (and rounded) value of the current maximum student contribution in that band at 2016, with each subsequent threshold set at \$5,000 steps.

As the grant reduction increases with the fees imposed by institutions, it would therefore introduce a constraint on excessive fee increases. Under the thresholds and rates set out in the table above, the Group of 8 (Go8) universities would be expected to provide around 55 per cent of the reduction on grants savings and non-Go8 universities contribute 45 per cent. Under the current 20 per cent reduction to Commonwealth subsidies, the Go8 universities contribute around 30 per cent of the savings.

Table 1

| Band | Fees charged by institutions | Percentage of fee above the threshold to be applied as a reduction in grants |
|---|-------------------------------------|---|
| Band 1: Humanities, behavioural science, social studies, education, clinical psychology, foreign languages, visual and performing arts, nursing | \$0 - \$6,499 | 0% |
| | \$6,500 - \$11,499 | 20% |
| | \$11,500 - \$16,499 | 60% |
| | \$16,500 and over | 80% |
| Band 2: Mathematics, statistics, computing, built environment, other health, allied health, science, engineering, surveying, agriculture | \$0 - \$9,199 | 0% |
| | \$9,200 - \$14,199 | 20% |
| | \$14,200 - \$19,199 | 60% |
| | \$19,200 and over | 80% |
| Band 3: Law, accounting, administration, economics, commerce, dentistry, medicine, veterinary science | \$0 - \$10,749 | 0% |
| | \$10,750 - \$15,749 | 20% |
| | \$15,750 - \$20,749 | 60% |
| | \$20,750 and over | 80% |