

Open Universities

**A funding strategy
for higher education**

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CENTRE**FORUM**

■ About the author

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■ Executive summary

Britain's universities are facing two seemingly intractable problems.

First, they are struggling to maintain the quality of their teaching and research on the basis of current funding levels. Since the 1970s, student numbers have more than doubled, while the amount spent on each student has halved. As a consequence, student-teacher ratios are high, academic salaries are low, and teaching facilities are ageing.

Second, despite years of public subsidy, our universities are still disproportionately populated by the sons and daughters of the affluent middle classes. In 2002, 81 per cent of children from professional backgrounds went to university compared with just 15 per cent of children from manual classes.

There is general agreement that any reform of the UK's higher education funding system must, therefore, meet the twin aims of increasing quality and widening access. There is agreement too that more money is needed to realise these objectives. But on the issue of *who* should pay – and *how* they should pay – there is little consensus.

The government's approach has been to pass the additional costs of increased university funding to graduates (through the introduction of variable tuition fees) and to taxpayers (through the extension of grants and loan subsidies) – a policy now supported by David Cameron's Conservative Party. The Liberal Democrats, meanwhile, stand alone in opposing tuition fees and pledging to fund higher education exclusively out of general taxation.

This paper seeks to measure both approaches against the principles of sustainability, equity and efficiency that should underlie the design of any new funding system. It concludes that the introduction of private payment in higher education is not only necessary, but desirable – a conclusion supported by practical experience both in the UK and abroad.

The British experience of financing higher education exclusively from general taxation for most of the last 50 years illustrates the dangers of relying on government funding alone. Such a system requires universities to operate under all the political and economic constraints that bear down on government expenditure as a whole. It also requires them to compete for their share of resources with all the other claims on the public purse that voters believe to be more urgent, more

deserving, or both. Conversely, a system that by-passes government, and transfers resources directly from graduates to universities, is comparatively secure and open ended. It is, for this reason, more likely to prove sustainable in the face of further expansion and additional future costs.

In contrast to the UK, countries such as the United States, Australia and New Zealand which have introduced greater private payment, have seen their universities' reputations grow and their higher education participation rates rise across the social spectrum. This is because fee income not only allows for significant investment in teaching infrastructures and staff recruitment, but because it frees up resources that can be recycled in the form of scholarships and bursaries to help bring students from low income families into the system. With top-up fees about to come into force in England, the same pattern is already emerging. In total, universities will spend more than £300 million on financial aid in the 2006/07 academic year – a third of their income from the new fees, and significantly more than even supporters of the government's reforms had predicted.

A fee-based system is also fairer. Funding higher education exclusively from taxpayer receipts is regressive – it redistributes resources from the poor to the rich. A system that seeks to capture some of the financial benefits of higher education to graduates, through a graduate contribution scheme, is significantly more progressive. It works on the principle that those who benefit should pay, and that those who benefit the most, should pay the most – a precondition, not just for equity, but for economic efficiency.

However, asking graduates to pay more, on the grounds that they are likely to enjoy much higher lifetime earnings than non-graduates, risks punishing those who end up, for whatever reason, with low incomes. It also risks deterring those for whom a fear of debt represents a barrier to participation. It is therefore crucial to ensure that the student loans system is properly 'designed'. By making repayments income contingent – so that those who can't pay, don't pay, while everyone else pays only as much as they can afford – it becomes impossible for the borrower to become overwhelmed by debt.

For all these reasons, the introduction of variable fees and income contingent loans are welcome. But the changes of recent years represent only the first tentative steps towards the creation of the decentralised, flexible funding system needed to support a diverse, mass higher education sector. For one thing the introduction of fees has *not* done is fundamentally to alter the command and control relationship between universities and government. The government's reforms have given universities a much needed and long overdue injection of new

money. But they have not freed them from the top-down, centrally-planned, target-driven policies that have done so much to frustrate demand, restrict access, distort choice and undermine quality.

This paper argues for further change, phased in gradually, to loosen the government's bureaucratic grip on the higher education system. It does so in the belief that, in a large and complex higher education system, decisions – about what should be provided and at what cost – are best made by those directly affected by them (universities, students and their parents).

This paper argues that further reforms should include:

- The conversion of part of the central government teaching grant to universities into a learning voucher for students, redeemable at any time, and in any approved tertiary education institution. This should help iron out the distortions created by funding further education and higher education differently.
- The gradual relaxation of government controls over student numbers to allow universities to expand and contract in response to demand and to inject a degree of competition into the system.
- A phased lifting of the cap on tuition fees – to £5,000 in the first instance – allowing charges to vary between institutions and courses.

A pound-for-pound extension of student loans to cover higher fees
- A move from blanket loan subsidies to targeted loan subsidies, to help those most in need. Some of the billions of pounds saved in the coming years could be recycled within the higher education system to provide more generous grants, bursaries and scholarships. But a more radical approach would be to spend the savings earlier in the education system – particularly on 'early years' education – where the real battle for equal access to higher education will be fought.

■ 1 The funding crisis

More and more students

The story of the higher education sector in Britain in recent decades is one of meteoric expansion. An elite system, open to just 1 in 20 young people 50 years ago, has been transformed into a mass system, through which almost 1 in 2 school leavers now pass. Almost four times as many 18 to 30 years olds are attending university today than 25 years ago.

This expansion is not yet over – far from it. Ever greater numbers of children are acquiring the necessary qualifications to apply for university. And the cost to school leavers of not getting a degree – in terms of reduced employability and future earning power – continues to grow. The reason for this is simple. When only a tiny percentage of school leavers move onto university, there is little job market stigma for those without a degree. But when half the population go to university, not having a degree sends a much more powerful negative signal to prospective employers. The lesson from those countries where the expansion of higher education began earlier, or proceeded faster, than in Britain (most notably the United States, Australia, New Zealand and Sweden), is that the participation rate is likely to climb even higher – from 44 per cent now to perhaps 60 to 70 per cent.

The overall number of students in higher education may not grow as fast as the participation rate, however, because there will be fewer 18 to 20 years olds in the UK after 2010.¹ Furthermore, the government could, at any time, slow the pace of university expansion to curb costs. In a publicly funded system, the government has control of entrance procedures, financial resources and the supply of places. But in the face of the upward pressures on enrolment rates outlined above, these supply-side constraints are unlikely to have any real effect in the longer term. The number of people in higher education has been rising year on year across the developed world. This trend will continue until the supply of graduates outstrips the demand of employers to recruit them. With the graduate job market buoyant and graduate salaries still rising, the signs are we are still some way short of reaching this point in the UK.²

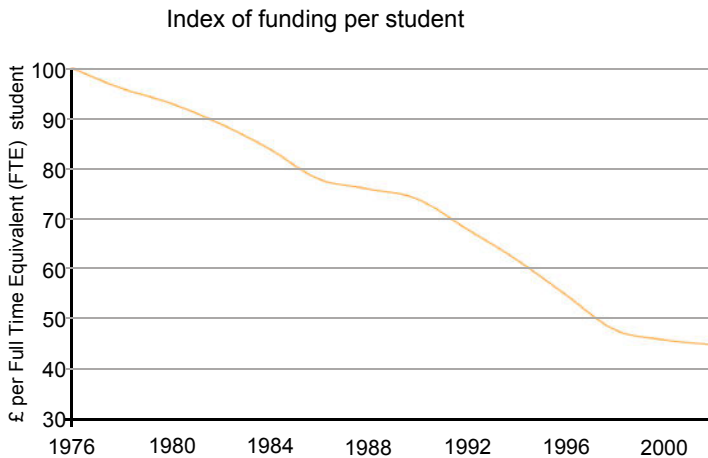
This is why the current debate about whether or not there are too many, or too few, people going to university is fundamentally misconceived – as is the discussion of whether the government was right or wrong to set an arbitrary participation target of 50 per cent. Not only are school leavers and their parents going to make up their own minds about

whether going to university is in their best interests, but they are far more likely than bureaucrats or politicians to get that decision right. Ultimately, the market, not the Prime Minister, will decide the size and shape of the higher education sector in the UK.

Less and less money

A fast expanding university sector costs money – money that governments have, until recently at least, found difficult to find. The amount spent per student has declined dramatically as the numbers going to university have grown. As Figure 1 below shows, spending per student in Britain halved between 1976 and 1997 (the year before tuition fees were first introduced).³

Figure 1



Source: Alison Wolf, 'Does Education Matter?', 2003

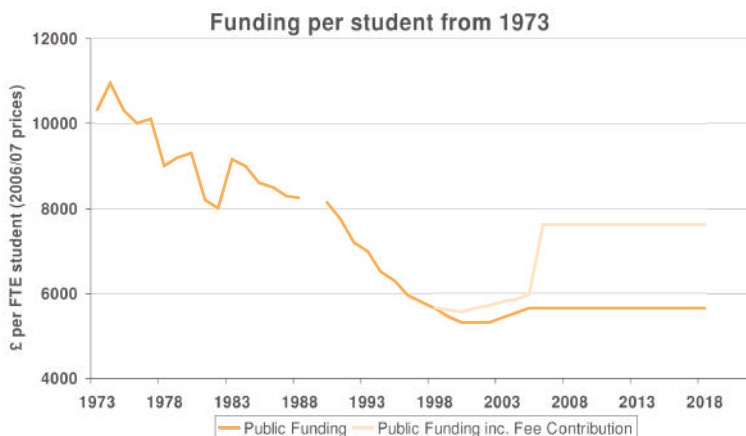
The reason behind this funding crisis is a familiar one. Universities are heavily reliant on the state, and suffer from all the familiar problems that afflict state-run enterprises – including a lack of investment. They must operate within the political and economic constraints that bear down on overall government spending levels. And they must compete for their share of resources with all the other claims on the public purse that voters regard as more important than higher education. Since the current government came to power, overall public expenditure has increased by a third in real terms from £372 billion to £496 billion (in 2003 prices).⁴ Public spending on education has risen from £35 billion in 1997-98 to £51 billion in 2004-05, and is forecast to reach more than £60 billion

by 2007-08. As a result, per pupil funding in the school system has increased by a third in real terms over the same period, in line with the increase in total public expenditure.⁵

In higher education, on the other hand, public spending per student is no higher today than it was when the government came to power nine years ago. At just under £6,000 per student, it remains at little more than half the level of 1974.

But, as Figure 2 shows, the introduction of tuition fees in 1998 did begin to put *overall* higher education expenditure on an upward trajectory that is set to jump sharply as the new system of variable fees comes into force later in 2006.

Figure 2



*Source: Dearden et al, 'Higher Education Funding Policy Who Wins and Who Loses?', IFS, March 2005 **

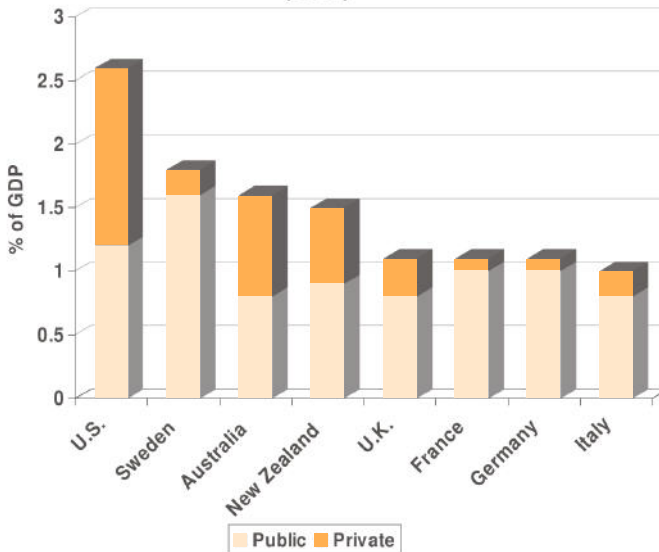
For universities, this injection of new money into the system is welcome news. As Figure 3 shows, total expenditure on higher education in the UK (prior to the introduction of variable rate fees) is significantly lower than in several competitor countries. In large part this is due to the UK's relatively heavy reliance on public funds. Private expenditure on higher

* The line break in this chart reflects the fact that the figures come from two different sources. Pre-1989 figures are calculated by IFS, based on Carpentier (2004). Here public funding is total public funding excluding capital grants per full-time home student. Figures cover Great Britain 1948-50 and UK 1951 onwards. Former polytechnics are not included. Figures are converted to 2006-07 prices using RPI index 1948-55 and GDP deflator thereafter. 1989-90 to 2005-06 figures are based on DfES series on public funding per FTE student in England, including HEFCE and TTA grants (which includes the public contribution to fee remission from 1998-99 onwards).

education in Britain currently stands at 27 per cent of the total, compared with 54 per cent in the US, 50 per cent in Australia and 40 per cent in New Zealand. Only Sweden manages to combine high total expenditure levels with low private expenditure levels – something made possible by the fact that government revenues account for 58 per cent of Sweden’s GDP.⁶ For countries that do not tax and spend on anything like this scale, the lesson is clear: universities need to be able to raise more money privately if they are to remain competitive in the medium to long term.

Figure 3

**International higher education funding (public/private)
(2003)**



Source: OECD, 'Education at a glance', 2005

Falling behind?

So where do Britain’s universities rank in today’s increasingly global higher education market? The short answer, according to The Times Higher Education Supplement’s (THES) survey of the world’s universities, is second.⁷ Britain has two universities (Oxford and Cambridge) that appear in the top ten of the THES rankings, eight universities in the top 50 and 30 in the top 200. This is, however, some way behind the US, which boasts seven of the top ten universities, and 62 of the top 200.

Britain may be leading the chasing pack, but it is the US that unquestionably dominates the global higher education market. And it does so because of the greater resources it has put into the higher education system: average annual per student spending in the US stands at £7,500 in state universities, £11,000 in private universities and £16,000 in elite Ivy League universities.⁸

Among the countries ranked below the UK, some interesting changes are taking place. Those that have taken steps to attract significant additional funds into their universities – like Australia, which has six universities ranked in the top 50 – are gaining in reputation. Those countries that remain reliant on static or declining public spending – such as France, Germany, Italy and Spain, which have just three universities in the top 50 between them, are losing ground.

For its part, Britain has begun, belatedly, to tackle the problems brought about by sustained under-investment. Student to staff ratios had increased from nine to one to 23 to one in the decade to 2004.⁹ By 2002, the cost of the backlog in infrastructure investment in teaching and research facilities was estimated at more than £7 billion.¹⁰ And academic salaries lagged so far behind those in key competitor nations that universities were finding it increasingly hard to recruit and hold onto high quality staff. Indeed, the fact that Britain's universities have not seen their reputations decline at the same rate as their funding says much about their ability to 'do more with less' in recent years, as the Treasury has urged. It is also down to their success in attracting around 300,000 foreign students paying an average of over £7,000 per year in fees.¹¹ Whether the £4 billion they bring into British universities each year is likely to be maintained or increased, however, is unclear. According to the Universities and Colleges Admissions Service (UCAS), the fact that four out of five universities saw enrolments of overseas students decline in 2005 may herald the start of a worrying trend. UK universities face intense competition from English speaking competitors – such as the US and increasingly Australia, which has doubled its foreign student intake in the last five years. At the same time, Asian countries, which are the traditional source of many overseas students, have invested heavily in their own universities. China, for example, has doubled its undergraduate provision in the last five years, underlining the rate at which global competition is intensifying.

■ 2 The government's response

The introduction of tuition fees

The Government's response to the growing funding crisis was to introduce a charge for Higher Education – something that remains deeply contentious in the UK, as it does in most of Europe.

Many oppose private payment in principle, arguing that education is a right and therefore should be free. This simple refrain, however, misses several important points:

First, there is no such thing as a 'free' service – someone, somewhere, has to pay. A funding system in which taxpayers bear the entire burden is regressive. The majority of taxpayers do not benefit directly from the higher education they are required to fund – as graduates do through higher wages. The argument that graduates pay for their education through income tax is also flawed. Only a quarter of government revenues are raised through income tax, and most income tax payers, and many upper rate tax payers, are non graduates.

Second, a system with no private payment element included is highly vulnerable to changing economic circumstances. As public spending growth falls below the rate of growth of the economy as a whole in the coming years – as is forecast – this problem can only intensify.

And third, it does not follow that because something is accepted as a right, it should be free. Rather, the objective should be that nobody with the requisite qualifications who wishes to attend university is prevented from doing so because of cost. This argues not for free higher education, but for higher education that is provided free at the point of delivery.

The 'up-front', flat rate tuition fee introduced in 1998, failed this test because it presented a financial barrier to participation at the point of entry. For those who qualified for the fee exemption and the means-tested maintenance loans, this mattered little. But for those students whose family income was just above the means test threshold of £34,000, the absence of an adequate loans system was a serious problem. It left them, and the system as a whole, heavily reliant on assumed parental contributions.

But parents often contribute only on the condition that their child chooses a particular course, or a particular institution. The evidence shows that this problem particularly affects female students, and students from certain ethnic groups with well established and rigid 'life course' expectations of their children. Furthermore, many parents simply do not or will not make the full, expected contribution, thus deterring many young people from applying at all, or prompting others to drop out of university before graduating. Those that do make it through often do so by living below the official poverty line or by spending a high proportion of their study time working in bars or restaurants simply to pay the rent.

The introduction of a £1,000 up-front, flat rate fee, then, did much to exacerbate the problem of student poverty. What it did not do, was address the continuing problem of university poverty. That it caused so much pain for so little gain explains why the system was abandoned six years later.

From free to fee - the development of the higher education funding system in the UK

Until 1990, the cost of living while at university was met either by government grant or by parental contribution. There was no tuition charge.

From 1990, tuition costs remained fully state funded but living costs were split – half paid for by students through a new loan system (in which debts were repaid in fixed amounts much like a mortgage), and half paid for either by government grants or through parental contributions, depending on the student's family income. The government steadily diminished the value of the grant throughout the 1990s while the size of the new maintenance loan was increased.

In 1998, an up-front, flat rate tuition fee of £1,000 was introduced on a means-tested basis. The size of the fee varied between zero for those students with a family income below £18,000 a year up to a maximum of £1,000 for students whose family income was greater than £34,000 a year. At the same time, the maintenance grant was removed and means-tested income contingent loans made available to cover living costs (see separate box for details of income contingent loans, page 14).

At the start of the academic year beginning in September 2006, a new system is due to come into force. The government is replacing the flat rate, up-front tuition fee with a variable system capped at £3000 per annum. Students will repay the new fees via a non means-tested loan. Two grants will be available on a means-tested basis to cover both tuition and living expenses. Students from families with an income below £22,560 will receive a grant of £1,200 towards their

tuition costs, tapered to zero for students with a family income of £33,560. To cover a proportion of living costs, a further grant of £1,500 will be available to students with a family income of less than £15,970, falling to zero for those with a family income of £22,100. In total, the poorest students will be eligible for direct government grants of £2,700. However, universities must also provide a bursary of at least £300 a year for poorer students if they charge the full £3,000 fee. To cover the costs of living, further loans of up to £4,070 will be available – the exact amount depending on family income. All loans – for fees and living expenses – will be income contingent, and will be repaid at the rate of 9 per cent of earnings above a minimum threshold of £15,375. These repayments will carry a 0 per cent real interest rate (interest will be charged at rate of inflation). Any debt still outstanding after 25 years will be written off.¹²

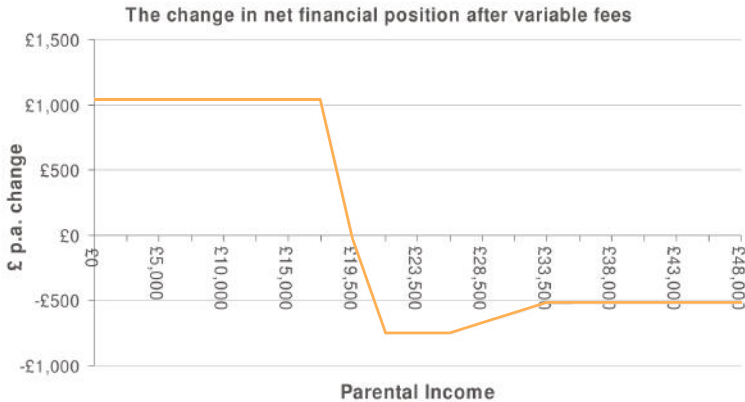
The new variable tuition fees will still constitute only a small proportion of total spending on higher education, however. The bulk of university income will continue to be allocated by way of a grant from central government to universities. The size of this grant is linked to student numbers. This ‘head count’ approach is partially refined by a weighting system which distinguishes between full time, part time and foundation course students, and between types of course, as set out below.¹⁴

Price Group	Description	Cost Weight
A	The clinical stages of medicine and dentistry courses and veterinary science	4
B	Laboratory-based subjects (science, pre-clinical stages of medicine and dentistry, engineering and technology)	1.7
C	Subjects with a studio, laboratory or fieldwork element	1.3
D	All other subjects	1

The funding regime that comes into force in 2006 – based on variable fees, more generous grants, new bursaries and extended loans – channels more money to both students and universities. Replacing the flate rate fee of £1,200 with variable fees capped at £3,000 will result in university fee income rising from £900 million to £2.25 billion per year. This extra revenue will push per pupil funding up from £5,700 in 2005 to £7,600 in 2006.¹⁵ The poorest students will be better off than at present because of the greater provision of grants and subsidised loans (see Figure 4). All remaining students will be able to spread the

slightly increased cost of their higher education (around £500 per year) over the course of their working lives, leaving them less dependent on parental contributions and part time employment.

Figure 4



Source: A Goodman, 'Charging Ahead? Spreading the costs of modern public services', Social Market Foundation, February 2006

However, higher fees will leave those not eligible for the various forms of financial assistance completing university with higher debts. To cushion the impact of these higher debts on those who must repay them, loans will be heavily subsidised and income contingent. This point is fundamental, for it is income contingent loans that ensure a fee-based funding system works efficiently and fairly (see box 2).

The importance of income contingent loans to a fee-based funding system

As Professor Nicholas Barr of the London School of Economics has explained, income contingent loans have a profound effect on the student finance system.¹⁶ Income contingent loan repayments are collected directly by the Inland Revenue like income tax and are structured in much the same way. Below a set threshold (£15,375 per year) graduates pay nothing. Above that threshold, they pay a fixed proportion (9 per cent) of additional earnings, regardless of how much they borrowed or how much they earn. Furthermore, graduates pay no interest (above inflation) on their borrowings, and, if they fail to repay the full amount during the 25 year repayment period, any outstanding debt is forgiven. In each respect, income contingent loans differ absolutely from other forms of

borrowing such as credit cards, bank loans or mortgages. Like income tax, income contingent loans are based on the 'ability to pay' principle, so that low earners make low, or no repayments, while everyone else pays only a set proportion of their earnings. Indeed, the only real difference between income contingent loan repayments and income tax is that the former is capped at the amount borrowed and 'switched-off' either at the point at which the debt has been repaid, or when the repayment term ends. In this way, income contingent loans allow borrowers to defer payment, spread cost and avoid risk at one and the same time.

Government lending on these terms carries a cost for taxpayers, estimated to account for 42 per cent of the value of fee loans (the estimated cost of the subsidy on maintenance loans, assuming these are paid off first, is 29 per cent).¹⁷ Consequently, under the new arrangements, any increase in private payment (through a rise in tuition fees) would also lead to a significant increase in public spending. This point is little understood. The assumption is that fees are bad news for graduates but good news for taxpayers. In fact, the cost of subsidising income contingent loans means that for every extra pound of student fees, public expenditure will also rise by 42 pence.

Thus, the redistributive consequence of increasing fees and extending subsidised income contingent loans is a transfer of resources from graduates and taxpayers to universities and students.

Alternative funding options

There are, of course, other ways of funding higher education, which produce different winners and losers. Clearly, the planned increases in university funding could be reversed. This would either mean dramatically reducing per student funding, or significantly reducing student numbers. Unsurprisingly, neither option carries much political favour.

At the last General Election, all three parties pledged to increase higher education spending, but differed over who would pay. The Conservatives promised to abolish tuition fees altogether, while cutting loan subsidies to offset the cost of the policy to the taxpayer. They have subsequently abandoned this policy – and the opposition to tuition fees on which it was based.

The Liberal Democrats also pledged to abolish tuition fees, but passed the entire cost of the policy – averaging £1.16 billion per year across the life of a five year Parliament – to the taxpayer.¹⁸ Or rather, they passed it to taxpayers earning in excess of £100,000 per year who,

under their plans, would pay a new 50p marginal rate of income tax, some of the proceeds of which were 'earmarked' for higher education.

For universities and students, the difference between the policies was slight – all three parties were proposing to increase higher education funding by about 30 per cent. The main difference between the proposals was over who would pay for this increase. Under the Labour and Conservative plans, graduates and taxpayers would share the costs, whereas under the Liberal Democrat proposals, the full cost of this increased funding would have fallen to the taxpayer. One of the criticisms of a funding system that relies exclusively on taxpayers is that it is regressive. But since the taxpayers in question were, under Liberal Democrat plans, only those with earnings in excess of £100,000, this objection does not apply. However, it is worth questioning whether this policy – progressive as it is – would prove sustainable over the longer term.

The first problem is that the costs of the Liberal Democrat policy to upper rate tax payers would be likely to mount over time as more students entered higher education, or as per pupil funding was further increased.

This is exacerbated by a second problem: as economic circumstances change and political priorities shift, the Liberal Democrats may decide to move away from their pledge to create a higher rate of income tax for top earners (or to spend the proceeds of that higher tax rate on priorities other than higher education). Should they do so, higher education costs would fall again on all taxpayers, the majority of whom are non-graduates. Whether they will be any more enthusiastic about bearing this burden in the future than they have been in the past is questionable.

Another alternative funding option is the one introduced by the coalition government in Scotland. This system charges Scottish students nothing for tuition, but requires them to pay £2,216 into a graduate endowment scheme established to fund additional financial assistance to disadvantaged students in the future. The contribution can be paid either in a lump sum, or in instalments on an income contingent basis above a minimum threshold of £15,000, as with the graduate contribution scheme in England. The problem with this system, however, is that none of the money from the endowment scheme ends up in Scotland's universities, which remain entirely reliant on public funding. For this reason, the creation of the endowment scheme represents half a reform – it promotes access, but does nothing to increase quality. To achieve both, graduate contributions would need to be larger (the £2,216 is a 'one off', not an annual charge) and would need to be channelled to universities as well as to students – a change prevented by the opposition to tuition fees on which the policy is based. If the system

remains unchanged, with graduate contributions going only to pay for student support, the funding gap that will open up between Scottish and English universities in the coming years will have to be plugged by Scottish taxpayers. This requirement is clearly recognised by the Scottish Executive which is committed to increasing public higher education spending by 17 per cent between 2004 and 2008. It remains to be seen whether taxes will, over the long term, prove as reliable a source of income for Scottish universities as tuition fees will for English universities.

A final alternative is that of the graduate tax. A graduate tax, as its name suggests, is simply an income tax supplement payable by graduates. This option, like the government's loans-based approach, takes as its starting point the need for those who benefit directly from a university education to pay a greater share of the cost. It also shares many of the characteristics of a loans-based system – it leaves education free at the point of delivery, it is income contingent and it has the potential to generate significant revenue over the long term. But it also has a number of drawbacks that may be hard to overcome and which explain why no country has so far adopted such an approach. First, graduates would have to pay throughout their working lives, severing the link between the benefit they receive and the price they are asked to pay – and opening up the possibility that many graduates could end up paying for their education several times over. Second, a graduate tax would not reflect the varying costs and financial benefits of attending different institutions and studying on different courses. All graduates would pay a certain proportion of their salary, regardless of where or what they studied. Third, the process of transferring money from graduates to universities via the state involves a degree of uncertainty that cannot be completely ignored. The UK has no tradition of hypothecated taxation, and a long tradition of government revenues being diverted from their intended purpose by changing economic and political circumstances. And fourth, it is unclear how students who moved abroad after graduating could be made to pay their dues.

By contrast, a fee/loan system, which transfers money directly from graduates to universities, is transparent, flexible and secure. It is, in this sense, the most 'future proofed' system available.

A fair system?

Sustainability, however, cannot be divorced from the issue of fairness. It is true that encouraging universities to seek reliable private funding should insulate them from the political and economic pressures that bear down on the size of the grants they receive from central government. But is this fair? And should the willingness of students to incur a debt that they will be obliged to repay during their working lives simply be assumed?

The answer, in most cases, comes down to a simple cost/benefit calculation that each student (and their parents) makes before investing in higher education. If costs are set to increase, students will want to know that the financial benefits make attending university worthwhile.

It is possible to estimate the financial benefits, or 'private returns', of a university degree. A number of studies have calculated the average additional future earnings for a graduate compared to those of someone with the next highest qualification (2 'A' levels).¹⁹ By factoring in the costs (direct and in terms of foregone earnings during the period of study) and controlling for other factors that could impact on graduate earnings (natural ability, family background, schooling, place of residence etc), these studies seek to quantify the private return from a university education.

Although they differ over the precise size of the wage premium that a degree brings, they all reach the same broad conclusion: going to university pays. The reports show that a graduate is likely, over the course of a working life, to earn between 15 and 25 per cent more than someone with the next highest qualification (a difference measured in hundreds of thousands of pounds).

In addition, the literature points to a further four key findings. First, that the benefit of holding a degree relative to the next highest qualification is more pronounced for women than men. Second, the financial return on a university degree is higher for some courses, such as engineering or science, than others, such as arts. Third, the financial return to an investment in higher education varies from institution to institution, with those who attend the prestigious 'Russell Group' universities for example, earning more than those attending the so-called 'new' universities. And finally, private returns have not diminished over time as student numbers have increased.

Higher education also confers benefits on society as a whole – known as 'social returns'. Social returns are calculated by subtracting the wider costs of university education (the costs of teaching and of foregone taxation during studies) from the wider benefits such as higher tax and national insurance revenues. Here, the literature points to social rates of

return of between 6 and 15 per cent in the UK, in line with the OECD average of 10 per cent.²⁰ This economic approach does not encapsulate numerous other potential benefits from higher education, such as the promotion of values such as tolerance, social cohesion, political participation, charitable giving, good parenting, healthy living and respect for the law.²¹ But it is one thing to note that these values and behaviours are more prevalent among the graduate population than among the non-graduate population (although even this assertion is disputed). It is another thing altogether to establish a clear causal link between higher education and these social goods.

Nonetheless, several broad conclusions can be drawn out of the research into higher education's benefits – to individuals and to the wider society:

- The university participation rate has increased so fast in recent years because graduates are receiving a dividend of several hundred thousand pounds from their investment in higher education.
- This wage premium has not diminished as a consequence of the expansion in student numbers, confirming that the demand for graduates is at least keeping pace with supply. Or, to turn this conclusion around, the fact that the participation rate continues to rise supports the theory that the private rate of return is not falling significantly, if at all, over time.
- Higher education confers wider benefits on society that are unlikely to influence an individual's decision to attend university. This suggests that some public subsidy is required to produce an optimal level of participation. But the fact that private returns remain higher than social returns shows that, despite the rising cost of going to university, most of the financial benefits of higher education are still being captured by individuals. This supports the argument against a completely free market, but in favour of a 'freer' market than exists at present. In concrete terms, this means that asking those who benefit directly from higher education to bear a greater share of the cost of that education is both sustainable and fair.
- Private returns to higher education are heterogeneous – some institutions and some degree courses are more 'profitable' than others. Thus, students should pay variable, rather than flat rate, fees. Flat rate fees backed by a mortgage type loan, require those who benefit, to pay. Variable fees, backed by income contingent loans, require those who benefit most to

pay the most, and those who benefit the least, to pay the least – a quantum shift.

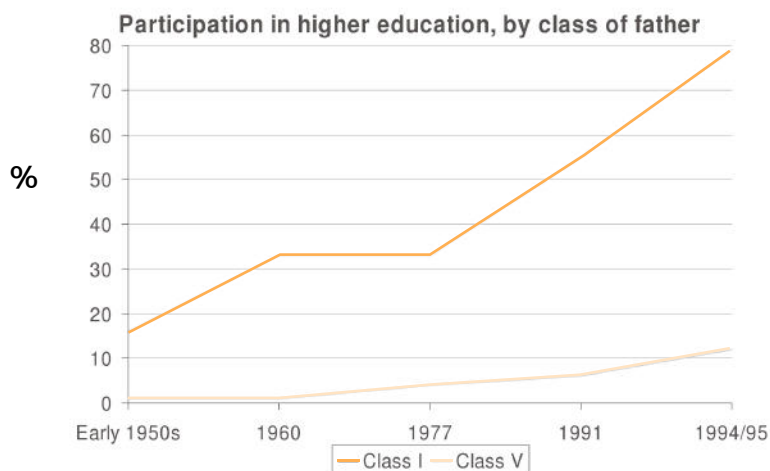
An accessible system

A fee and loans-based system is, therefore, fairer than a purely tax-funded system. However, it could still deter some potential students from applying to university – particularly those from poorer families with greater debt aversion.

This concern is not only legitimate, it is the yardstick against which any new system must be measured. Any system that would have the effect of giving a student from a rich family greater access than an equally bright, equally qualified student from a poor family deserves to be rejected out of hand.

As Figure 5 shows, in 1960, when the overall university participation rate stood at 6 per cent, participation amongst the children of professional fathers stood at 16 per cent, compared to 1 per cent for the children of unskilled workers. In 1995, before tuition fees were introduced, the participation rate for those in the first category had risen from 16 to 79 per cent, while for those in the latter category it had reached just 12 per cent.

Figure 5



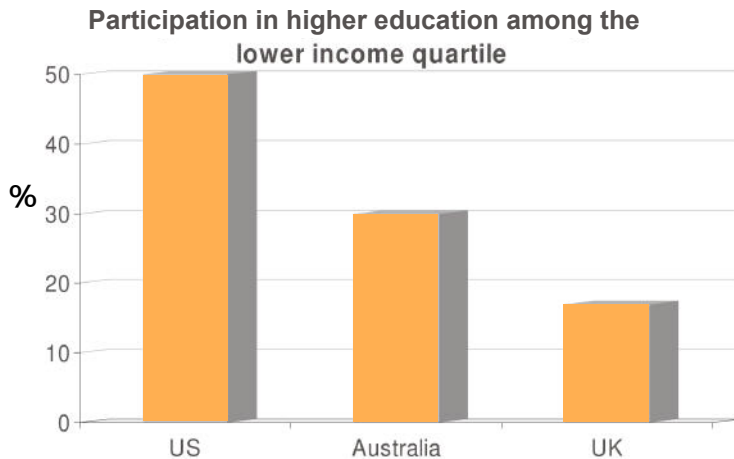
Source: A Wolf, 'Does Education Matter?', 2002

So although over time all groups sent their children to university in greater numbers, the system was no less dominated by the middle classes in 1995 than it was 35 years previously. In fact, a rich child had a better chance of getting into the elite university system of 1960 than a poor child had of entering the mass system of 1995.

That is why it is impossible to defend the system of taxpayer-funded 'free' higher education on the grounds that it guaranteed equality of educational opportunity. The record shows that it did nothing of the sort. Rather, it spread financial assistance across the student body, diverting public subsidies to the vast majority of students that came from white-collar backgrounds.

The failure of a system based on no, or low, tuition fees to draw in students from across the income distribution scale does not mean that a system based on higher private contributions would fare better. But the records of those countries that do raise a significantly higher proportion of total funds through private contributions suggest it could. Not only do these countries boast higher overall participation rates, but they also manage to attract a larger proportion of their student body from low income groups.

Figure 6



S Schwartz, 'Reclaiming our universities', 2003

As Figure 6 shows, the participation rate among the lower income quartile is 50 per cent in the US, 30 per cent in Australia, but just 17 per cent in the UK.

In Australia, which introduced fees in the late 1980s, the university participation rate for the children of manual and unskilled workers almost doubled between 1980 and 1999, rising from 13 per cent to 25 per cent²², this despite the introduction of fees in the meantime. In fact, this widening of access didn't come about *despite* the introduction of fees and income contingent loans. It came about *because* of the introduction of fees and loans.

The reason for this is that fees bring more money into the system, some of which can be used to provide greater financial assistance for poorer students. British universities intending to charge the full £3,000 fee will in future be obliged by law to offer a bursary of at least £300 to poorer students.

Some free marketeers claim that such assistance is unnecessary.²³ Means-tested grants, scholarships and bursaries are awarded on the basis of parental income, yet, they point out, students from poor families may well end up earning just as much in later life as students from more affluent families. They argue that the poor student's debt aversion is therefore irrational, and public money should not be used to reward myopia.

But *do* graduates from low income families go on to earn as much as graduates from more privileged backgrounds? A recent study into the effect of social class on wages which looked at two cohorts of students, one born in 1958, the other in 1970, found that:

*"The expansion of the education system in Britain has disproportionately benefited the higher social classes. Less able children from higher social classes are more likely to participate in higher education and they then go on to benefit from the on-going increase in the labour market demand for graduates. Nevertheless, higher education appears to have become a successful class leveller in that, conditional on achieving a degree, we do not find differences in the price of cognitive skills for different social classes."*²⁴

In other words, social class *is* a determinant of whether an individual is likely to get a degree. But once an individual acquires a degree, the impact of class on future earnings largely disappears.

This leaves the policy maker with a difficult dilemma: if public subsidies are targeted on those from deprived backgrounds, they may well end up

benefiting high earning professionals with no real need for them. If, on the other hand, public subsidies are denied to those who start out with relatively low incomes, poorer students may be discouraged from going to university at all, and will consequently never achieve the higher earnings that graduates can expect.

The reasons for this are complex and numerous. But it is likely that financial considerations (debt aversion and a disinclination to forego three year's earnings in return for a higher future income) do play a part in deterring those from low income backgrounds from applying to university.

If widening access is a key objective of reform, resources must be focused on those for whom cost represents a significant barrier to entry – something that the introduction of fees makes possible. The new funding regime about to take effect will translate this theory into practice.

Market pressures have already superseded the regulatory requirement that all universities that intend to charge the full £3,000 fee must offer a bursary of at least £300. A third of universities are offering bursaries of between £500 and £5,000, half of which are means-tested, the rest awarded according to academic ability.²⁵

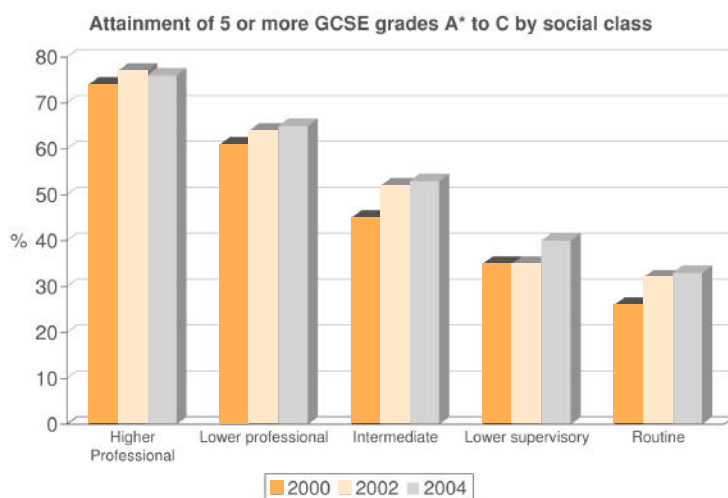
But cost is not the only barrier to participation in higher education. Universities also need to take steps to attract bright individuals who might otherwise never apply. In particular, they should be developing relationships with schools, identifying and encouraging the most gifted children, inviting them to open days and talking them through the many advantages of a university education, both during study, and later in life. The government is seeking to assist universities in this process through the new National Academy for Gifted and Talented Youth (NAGTY) which is to be given access to school test results for 11-year-olds to help them track the 30,000 top achievers from every year group up until the age of 16. It has also taken steps to assist would-be students through the establishment of the Aim Higher – a website and series of events designed to provide information about higher education institutions, student support and admissions.²⁶

One other small, but important, change would be to reform the admission process from one based predominantly on predicted 'A' level grades, to one based on actual attainment – the Post Qualifications Admissions system recommended by the government's admissions task force in 2004. The prediction-based admission system favours applicants from private schools over those from state schools, as the latter tend to be less ambitious in their applications, and receive more conservative predictions of their likely exam performance. However, this

reform is still being resisted in some quarters on the grounds that it would require university staff to work over the summer holidays!²⁷

Ultimately, the key to widening university participation across the social spectrum lies not in reforming the admissions process, in providing more information and assistance through mentoring, or even in reducing costs. All of these will help to equalise access between rich and poor students with the same qualifications. But they will not overcome the biggest single barrier to participation in higher education – unequal attainment levels at school.

Figure 7



Source: DfES, Youth Cohort Study, 2002 and 2004

The real reason why bright but poor school children do not go to university in much greater numbers is because, despite their natural talents, they are far less likely to get the five good GCSE passes and the two good 'A' level passes they need to apply. As Figure 7 shows, the attainment gap between the highest and lowest social classes, although narrowing a little, remains vast.

All of which points to the need to spend more public resources earlier in the system – through targeted interventions in early years, and in the school system – to ensure that educational opportunities are extended in ways that no reform of the higher education funding and admissions system will ever achieve.

A growing body of research has shown that children are set on a course either to educational success or failure by the time they arrive for their first day at school – a course that is difficult to alter through ‘second chance’ remedial interventions later in the education system.²⁹ Yet not only is the government spending more public money – in absolute terms – on higher education than on pre-school education, but, more tellingly, a much greater proportion of higher education costs are met by the state. Even with the additional £600 million promised in the government’s child care strategy up to 2007/8, 40 per cent of total costs will still fall on parents, compared to 30 per cent of higher education costs that will be met privately following the introduction of variable tuition fees.³⁰

Yet it is in these early years, and in the 13 years of schooling that follow, rather than at the point at which school leavers and their families consider the costs and benefits of going to university, that children from low income families are excluded from the higher education system. The real inequalities in the system are to be found between those who go on to get the qualifications they need to apply and those who do not. Set against the differential attainment levels of rich and poor school children, the inequalities that exist between equally qualified school leavers of different means pale almost into insignificance.

■ 3 The need for further reform

The higher education reforms of recent years have begun to arrest and reverse the funding crisis that has been growing in intensity for 30 years.

But it would be a mistake to think that these changes will, on their own, equip the UK with a higher education system that is fit for the 21st century. More likely, they will be seen in years to come as only the first tentative steps towards the creation of the flexible, decentralised funding system needed to support an increasingly diverse higher education sector.

The introduction of a small, flat rate tuition fee in 1988 did not fundamentally change the relationship between government and universities in the UK today. Like a vast nationalised industry, the system as a whole remains centrally-run, bureaucratically-directed and target-driven.

The majority of higher education funding is still allocated each year in the form of government grants. The size of those grants is based on student numbers. The number of students is itself determined, not by supply and demand, but by government quotas. These quotas continue to be based, not on student preference or university performance, but on the previous year's figures. And because fees are also set at a flat rate, the system of private payment is no less rigidly linked to student numbers.

As a result, the most popular universities are prevented from expanding and from raising their prices. And less popular universities are unable to reduce their intake or lower their prices in response to low demand. All students, meanwhile, are obliged to pay the same fee, no matter the reputation of the university, state of the facilities, quality of the teaching, cost of the course or value of the degree.

In the days when the system as a whole was small, and the number of degrees on offer was relatively limited, it mattered little that the government adopted a 'one size fits all' approach to university funding. But as the number of institutions, degree courses and students has proliferated, and the variations between different forms of provision have become more pronounced, so the tensions within the system have become more acute.

In the United States the journey from an elite, to a mass, to a near universal system brought with it a process of stratification. Nobody in the US today would pretend that all American universities are equally good or deserving of the same funding. There are some world class universities, which attract the most able students, offer the most costly education, and award the most valuable degrees. But there are many other universities which provide a less costly education, closer to home, over a shorter time span, and at much reduced cost. This is not a bad thing. It is the natural consequence of putting two thirds of all Americans through university. The alternative being, of course, that all those academically less able students in less prestigious universities do not go to college at all. With 'massification' comes stratification. And with stratification, comes diversification, as different universities develop different specialisms, pursue different missions and target different students with different aptitudes and different ambitions.

This process is already well advanced in Britain. But the parallel process of decentralising and liberalising the funding system – to allow universities to compete on the basis of price as well as quality – is yet to take place.

From an economic perspective, this is simply inefficient. Price signals send useful messages – to both service users and providers. By allowing the laws of supply and demand to establish prices, universities are better able to make informed decisions about what they should be providing, and students are better able to make informed decisions about what they should be buying. It may well be that a lower cost, more vocational degree course in a local university suits the talents, circumstances and ambitions of an individual better than an expensive, academically challenging course in a prestigious campus university further from home. Universities will only be able to meet the full range of students' preferences if they can develop their own niche and price themselves accordingly.

In theory, there are two ways in which variable prices can be set: by an all-knowing central planner, or by the market. In reality, the first option is a non-starter. The system is too complex. In a mass system, only universities can make informed judgments about the quality, cost and value of the education they provide, and about the willingness of students to pay for it.

The introduction of variable tuition fees should have created just such a market in higher education. But the £3,000 cap on fee levels, scheduled to remain in place for the life of the current Parliament has, in practice, prevented universities from attaching different prices to different forms of provision – 94 per cent of Britain's 121 universities have opted to charge the full amount.³⁰

The failure of the government's new fee policy to produce fees that vary has prevented meaningful competition, price comparison and choice – the market's way of driving up quality. This means that the task of maintaining standards must also fall to government. This is a responsibility it will continue to discharge in the only way it knows: by setting targets. As Alison Wolf explains:

“This approach is precisely analogous to the way in which Soviet planners ran their economy, and it has precisely the same drawbacks. Numerical targets have to be concerned with things that can be counted easily (like tractors or examination grades), not with more complex attributes which require judgement and are open to debate (such as curricula). In a centrally funded, target-driven, top-down organisation, the main and inevitable concern of lower-level functionaries is the satisfaction of their paymasters. If the things they are being asked to produce are genuinely simple to define and inspect, then the system may indeed produce them – albeit not very efficiently. But if they are complex and difficult to measure, like the quality of a university degree, then the effects of such systems tend to be pernicious. This is especially true when one marries centralised, target-driven controls with financial pressures. That, of course, is exactly the situation that modern education systems find themselves in.”³¹

The problem of front line professionals being diverted from their day-to-day duties to meet, and prove that they are meeting, the latest batch of centrally-defined and centrally-imposed targets is not unique to higher education, of course. The government has introduced a raft of targets across the public sector. However, targets, or any other administrative tool, will never be able to replace consumer satisfaction as the most efficient driver of policy or setter of priorities.³² The more universities are forced to respond, not to government, but to students, the quicker standards will rise.

There are situations, of course, where markets are likely to fail. Markets typically only work well where individual decisions can be anticipated and prepared for; where information is easy to obtain and process; where the cost of bad decisions is low; where there are diverse tastes that monopoly supply will struggle to meet; and where transaction costs are not unacceptably high. Clearly some sectors, such as acute healthcare, fail most, if not all, of these tests. Whether such arguments apply to higher education, however, is less clear.

Certainly, the decision to attend university can be anticipated in advance, and in any event is voluntarily entered into. Information about

different universities is readily available. The consequences of picking the wrong university are by no means catastrophic. Student preferences and needs are extremely diverse. And transaction costs, in this context, are non-existent.

One further potential cause of market failure that is particularly relevant to higher education (since most students need to borrow to invest in higher education) is the existence of credit constraints that, in a pure market, would likely lead to a sub-optimal level of investment being made. Since students cannot be certain that the financial return on their investment in higher education will materialise (should they fail to obtain a degree, or, alternatively, graduate but still end up with lower than expected lifetime earnings), the decision to borrow to finance a university degree carries risks. For the same reason, lenders are unable to properly secure their loans. If an individual defaults on a mortgage, their property can be sold to cover their debts. But if a graduate defaults on a loan, the lender could be left with nothing. It is precisely because they mitigate these risks, and overcome these likely market failures, that the introduction of subsidised income contingent loans is so welcome.

Overall then, the chances of market failure in higher education are slight, and can be minimised further by the judicious application of government subsidy. By contrast, the advantages of greater deregulation and liberalisation are significant. The most prestigious universities could expand or raise their fees in the face of demand, which would allow them finally to make the necessary investment to compete globally – by reducing student / teacher ratios, increasing teaching salaries and modernising university infrastructures. On the other hand, those universities not competing globally could begin to carve out a more sustainable niche based on local recruitment, lower costs and alternative specialisms.

Despite – or perhaps because of – the fact that the fee cap has dimmed the price signals that variable fees should have allowed for, universities have begun to compete on the basis of their financial aid packages. And it is the less prestigious universities that have led the way.³³

Middlesex University for instance, is offering five scholarships, each worth £10,000, to be awarded on a lottery basis to those who make Middlesex their first choice. Anglia Ruskin University is offering full time students £1,000 'cash back' in their first year, followed by another £500 in each subsequent year of study. The University of Central Lancashire is offering £1,000 per year to all new students from the start of the next academic year. Liverpool, Kent, Nottingham Trent and Southampton Solent universities are offering financial aid to encourage local students to apply. And Glamorgan, De Montfort, Loughborough, Swansea and Sussex universities are offering sports scholarships, while

Brighton University is offering five awards each year to elite disabled athletes.

In all, by March 2005, universities had already agreed to spend over £300 million in the academic year 2006/07 on bursaries for students from poorer backgrounds – almost four times as much as the £80 million it would cost to award the minimum £300 bursary as required by law.³⁴ The majority of institutions are setting aside up to a third of their additional fee income for bursaries and other forms of financial support which will help an estimated 400,000 students from poorer backgrounds through their degree courses.

The emergence of a bursary market represents only a modest boost to competition in higher education. But it also offers a glimpse of a future that the introduction of truly variable fees would provide – one based on variety, competition, choice, and specialisation.

Securing that future, however, will require two further fundamental changes – one to the way in which public funds are distributed, the other to how the private payment system is designed.

First, the government should convert part of the annual teaching grant awarded to institutions into a learning voucher for students, to be redeemed at the institution and at the time of their choice. At the same time, the government should relax the controls on the number of students that each university may admit – to introduce a greater degree of competition between institutions, and more choice for students.

There is, furthermore, a strong argument for making this new learning voucher redeemable across the whole tertiary sector – in further education colleges as well as universities – to iron out the unnecessary distortions of choice between these two differently funded systems.

Second, the government should further liberalise the fees system, once universities and students have had time to digest the latest reforms. The government should lift the £3,000 cap on fees to allow prices to vary from course to course and institution to institution. Such a change would have four beneficial consequences: first, quality would increase as universities secured the resources necessary to offer more competitive teaching salaries, reduce student / teacher ratios and increase their infrastructure investment. Second, access would be further widened as yet more money became available to recycle in the form of bursaries and scholarships for bright students from poor families. Third, the system would become more efficient as benefits and costs became more clearly linked and universities and students better matched. Finally, the system would become fairer as students in less prestigious universities or on less 'profitable' degree courses were no

longer obliged to pay the same as those in the best universities and most expensive courses.

But allowing fees to rise also carries risks. The prospect of more debt *can* put students off, as the experience of New Zealand, where fees were liberalised overnight, shows. Although participation rates among all socio-economic groups recovered over time, the lesson is clear: big bang liberalisation does affect access. Government should thus adopt a careful, phased relaxation of the fee cap, to £5,000 in the first instance – a conclusion supported by news that even the introduction of the new £3,000 fee limit this year has led to a 4 per cent fall in applications for 2006/07 entry.

However, the significance of this fall should not be overstated. Applications also dipped in the lead up to the introduction of the £1,000 flat rate tuition fee in 1998, but that was followed by year on year rises thereafter. So these figures are likely to represent a short term correction, rather than the start of a downward trend. The fact that they come on the back of an unusually large rise in applications in 2005 (8.2 per cent above 2004), as prospective students rushed to beat the introduction of the new fee regime, only strengthens that assertion. But more important is the fact that the fall in the overall number of applications has not led to a fall in the proportion of applications from lower socio-economic groups, which has remained constant at 31 per cent for the past two years.³⁵ This makes sense, since the shift from the old to the new fee system, with its combination of grants, bursaries and subsidised loans, leaves those on low incomes better off than before.

Not only does a liberalisation of the fee system need to be carefully phased in, but it needs to be matched, pound for pound, by an extension of income contingent loans. This will ensure that as fees rise, the amount that graduates are required to pay back each month does not. Those with no incomes or very low incomes will continue to pay nothing, while everyone else will pay 9 per cent of their salary, deducted at source through the Revenue.

However, any extension of the loan system would have significant costs for the taxpayer. The annual cost to the taxpayer of subsidising student loans under the current system is £820 million. The introduction of fee loans this autumn, combined with some small changes to maintenance loans, will push this sum up to £1.57 billion.³⁶ Should the cap on fees be lifted in the future to £5,000, and loans extended accordingly, the total cost of subsidising student loans would likely exceed £2 billion per annum.*

* This is an illustrative example only. If raising the fee cap to £5,000 were to push the average fee up £4,500 (the average fee under the £3,000 cap is £2,910), the subsidy would cost the taxpayer £2.025 billion. The certainty of increased debt write-off as fees rise, combined with the possibility of greater loan take-up as student number rise, means this is probably a very conservative estimate

What is more, as Nicholas Barr of the London School of Economics has argued, these blanket subsidies are not just hugely expensive, they are also poorly targeted.³⁷ This is not to say they are regressive – low earners, who repay more slowly, *do* receive a larger subsidy than high earners. It is simply to say that from a life-cycle perspective, the subsidy helps people when they need help the least, and fails to help people when they need help the most.³⁸ This is because the interest rate makes no difference to how much each graduate repays each month (that is fixed at 9 per cent of earnings above a minimum threshold); it only affects the duration of the repayment period. A subsidised loan that takes ten years to pay off, might take 12 or 13 years to pay off if that subsidy was removed. This means that low paid graduates just entering the job market do not benefit from the subsidy (they must pay 9 per cent of their earnings regardless of the interest rate), but higher earning graduates in mid career do, as their loan repayments are switched off earlier than would be the case without subsidies. Furthermore, the interest rate subsidy also fails to help those graduates with the lowest lifetime earnings who are unable to repay their student loans in full, even with the interest subsidy. It would make no difference to this group if the interest rate stood at 5, 10 or 15 per cent. They would still pay the same amount, at the same rate (9 per cent of earnings each month), for the same period (25 years) as they do at present. They would simply have more debt written off at the end of the repayment period if they were charged interest.

The final reform, then, should be to replace the existing 0 per cent real interest rate on student loans, with one based on the government borrowing rate. At the same time, *targeted* loan subsidies should be introduced for those graduates most in need. These would be linked to each graduate's actual income during the repayment period, and would be triggered when an individual's contributions cannot cover more than the interest element. Such a scheme already exists in New Zealand, and could be introduced in this country without serious difficulty. By introducing an additional 'claw back' mechanism for those who receive the subsidy, but later end up with much higher earnings, the subsidy could be targeted more tightly still on the lifetime poor.

Some of the billions of pounds of savings that would accrue over the coming years as a consequence could be used to provide even more financial assistance to students. But the more radical approach would be to spend the bulk of these savings on pre-school education for the under fives – where the real battle against unequal opportunities and life chances has to be fought.

4. Conclusion

There are many reasons why liberalising the higher education funding system makes sense: it would lift the 'dead hand of the state' from our universities, insulating them from the consequences of inadequate public spending and freeing them from the pernicious effects of central planning. It would encourage diversity, specialisation and choice. It would be more sustainable and more efficient. And it would be fairer.

But the sceptics are unlikely to be won round by these arguments – powerful as they are. For them, the key test is access. Certainly many of the MPs that voted against the introduction of variable tuition fees did so because they were concerned about denying educational opportunities to future generations that they themselves had enjoyed.

There are, however, three reasons why this legitimate concern is likely, in the coming years, to prove unfounded:

- Practical experience: those countries that charge for a university education have higher participation rates across the social spectrum than those that do not. Children who are gifted but poor stand a much higher chance of going to university in the United States, Australia or New Zealand than in most of Western Europe.
- Economic theory: fees do not restrict access – they allow for a redistribution of resources from those who can afford to pay to those who cannot. Tax funded, 'free' higher education, by contrast, spreads resources thinly across the student body, diverting public subsidies to those who need them the least.
- The root cause of unequal access: cost is not the main reason why disadvantaged children do not go on to higher education in far greater numbers. The real reason is because they are far less likely than middle class children to achieve the exam results they need to apply.

Those who urge government intervention to ensure equal access to higher education should transfer their attentions – and the state's resources – to the root cause of our universities' social exclusivity: the poor performance of disadvantaged children while at school. Recent research has shown that, in the UK today, a clever child from a poor home will be overtaken by less bright children from well-off homes by the age of six.³⁹ It is this, rather than the introduction of a relatively

modest fee for university tuition, that represents the real affront to social justice and the most pressing challenge for social justice campaigners.

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