

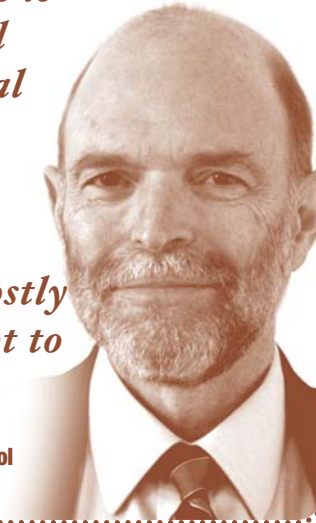
# 20 reasons why a graduate tax is a bad idea

In the context of Lord Browne's review of university funding, Mike Harris, Head of Education & Skills Policy at the IoD, looks at the pros and (many) cons of a graduate tax.

*One of life's battles is between analytical rigour and political feasibility.*

*Politicians claim both, but when the chips are down mostly give greater weight to politics.<sup>1</sup>*

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## SNAPSHOT

- The funding of universities is under scrutiny, with the coalition Government anxious to arrive at a politically acceptable solution.
- Should it build upon the current system of variable tuition fees and loans, or should it embark upon a new system of funding in the form of a graduate tax?
- A graduate tax may be easier to administer and politically more palatable, but these advantages are far outweighed by its many flaws, which this article describes.

How best to finance the country's higher education sector is an ongoing, and politically very sensitive, conundrum. In 2004, introducing variable tuition fees almost broke the back of the then Labour Government. Six years on, the issue has lost none of its potency. The coalition Government finds itself perched atop the horns of a particularly prickly dilemma: how to secure the investment universities need to remain internationally competitive, whilst simultaneously tackling the fiscal deficit? And, just as importantly, how to do both of these things and keep the coalition afloat?

University funding is currently under formal review. Whilst we await the recommendations of Lord Browne's Independent

<sup>1</sup> Nicholas Barr, "Financing higher education: tax, graduate tax or loans?" in J. Hills, J. Le Grand & D. Pichaud (eds.), *Making Social Policy Work*, 2007, p.109

Review of Higher Education Funding and Student Finance, this article examines a surprisingly durable proposal for reform: the graduate tax. First advanced by Milton Friedman in 1955,<sup>2</sup> advocated latterly by all but one of the current contenders for the Labour leadership, and seemingly flirted with by both the present Business Secretary and the universities minister, it has enduring appeal. It also has many flaws.

## BACKGROUND: THE 2004 HIGHER EDUCATION ACT

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On 27 January 2004, the Labour Government faced a crunch Commons vote on its Higher Education Bill, one of the key provisions being a measure enabling universities to charge variable tuition fees of up to £3,000 per year. Against a backdrop of high political drama – the Hutton Report was due to be published the very next day – 71 Labour MPs voted against the Government and a further 19 abstained. The Conservative and Liberal Democrat parties also opposed the Bill. At 6.59 p.m, after a six-hour debate, a government with a majority of 161 sneaked home by 316 votes to 311.

The 2004 Higher Education Act is arguably one of the Blair administration's most notable public service reforms. It also pushed a conceptually bold policy to the outer limits of political feasibility. In addition to policy compromises, a number of specific commitments were made to help get the Bill through Parliament. The fee level would not rise above inflation unless the Government secured the approval of both Houses of Parliament. The Government would not raise the cap in real terms through the next Parliament. And it would establish an independent review to report to Parliament on the operation of variable tuition fees when these had been in force for three years.<sup>3</sup>

## LORD BROWNE'S REVIEW

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This review process is currently underway, under the chairmanship of Lord Browne of Madingley, and is due to report this autumn.<sup>4</sup> It has not enjoyed full cross-party support, being jointly commissioned by Labour and the Conservatives but denounced as a 'conspiracy' by the Liberal Democrats.<sup>5</sup> For, whilst Lord Browne and his team have played their cards very closely to their chests, it was expected (accurately or not) that the review would recommend a rise in the variable fee cap to £5,000 or perhaps £7,000, which the Liberal Democrats would fiercely oppose. But the background scenery to the review has changed rather dramatically since its inception. Rather than sitting outside

<sup>2</sup> Under Friedman's original proposal the Government, in advancing funds to the student, would effectively "buy" a share in an individual's earning prospects". In return, the graduate would contribute – via his/her earnings – a percentage of income related to how much had been advanced. The payment would be combined with income tax to minimise administrative costs. Milton Friedman, "The role of government in education", in R.A. Solo (ed.) *Economics and the public interest*, Rutgers University Press, 1955, p.138, cited in Nicholas Barr, "Financing higher education: tax, graduate tax or loans?" in J. Hills, J. Le Grand & D. Pichaud (eds.), *Making Social Policy Work*, 2007, p.109

<sup>3</sup> "Higher Education reforms will protect students and graduates and give investment and freedom to universities – Clarke", Department for Children, School and Families press release, 8 January 2004

<sup>4</sup> For more information, see the Review's website: <http://hereview.independent.gov.uk/hereview/>

<sup>5</sup> "Review a conspiracy to keep tuition fees hike off agenda until after election – Williams", Liberal Democrat Party press release, 9 November 2009

the Browne tent, Liberal Democrat MPs are now sitting around the Cabinet table.

## COALITION AGREEMENT

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Political room for manoeuvre has consequently become uncomfortably tight. The coalition's initial Agreement anticipated the problem by providing for Liberal Democrat MPs to be able to abstain in any Parliamentary vote should they disagree with the Government's approach.<sup>6</sup> But the mood music of the coalition suggests that the Government's preference would be for a policy that both its constituent parties could sign up to, rather than a policy provoking mass abstentions on one side. Moreover, given that the Browne Review is expected to be published either just before or just after the Comprehensive Spending Review, a Government already braced for a storm of negative publicity won't be over-anxious to throw an additional grenade under its own wheels. The search for politically acceptable reforms is apparently underway in earnest.

## GOVERNMENT INTERVENTIONS

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Prior to the 2004 Act, some members of the Labour government strongly favoured a graduate tax over deferred fees repaid out of income contingent loans. A graduate tax was, seemingly, the Treasury's favoured approach.<sup>7</sup> It is now backed by leading contenders for the Labour leadership, including Ed Balls and Ed Miliband (though not by David Miliband). But it was the suggestion that a graduate tax had risen up in the coalition's own thinking that really caught the attention this summer. On 15 July, Vince Cable gave a speech widely perceived to call for such a tax – an impression which may or may not have been aided by some judicious departmental spinning.<sup>8</sup> In a BBC interview on 8 August, David Willetts appeared to give further backing to the idea – though he too chose his words extremely carefully.<sup>9</sup>

## THE ARGUMENTS AGAINST A GRADUATE TAX

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These interventions may well turn out merely to have been exercises in political kite flying. However, given that a graduate tax appears to

<sup>6</sup> "If the response of the Government to Lord Browne's report is one that Liberal Democrats cannot accept, then arrangements will be made to enable Liberal Democrat MPs to abstain in any vote." See *The Coalition: our programme for government*, Cabinet Office, May 2010, p.32. Available at: [http://www.cabinetoffice.gov.uk/media/409088/pfg\\_coalition.pdf](http://www.cabinetoffice.gov.uk/media/409088/pfg_coalition.pdf)

<sup>7</sup> Anthony Seldon & Dennis Kavanagh (eds.), *The Blair Effect 2001-5*, Cambridge University Press, 2005, p.263

<sup>8</sup> Cable actually expressed his desire to look "at the feasibility of changing the system of financing student tuition so that the repayment mechanism is graduate contributions tied to earnings", which could, in theory, actually describe the current system. However, five sentences earlier he had mentioned the magic phrase "graduate tax" which appears to have prompted the surrounding media coverage. See Vince Cable speech on higher education, 15 July 2010, available at: <http://www.bis.gov.uk/news/speeches/vince-cable-higher-education>. It has been suggested that the Secretary of State was not unhappy to have been 'misunderstood'

<sup>9</sup> Speaking on the *Andrew Marr Show* on BBC1 on 8 August, Mr Willetts said: "We do have a preference that graduates, after they go into work should make a higher contribution to the benefits of the university education they have received." See "Graduate tax wins backing from Willetts", *ft.com*: <http://www.ft.com/cms/s/0/ba126086-a309-11df-8cf4-00144feabdc0.html>, accessed 10 August 2010. Again, as with Cable's July speech, this may be read a number of different ways

be being given serious consideration again in at least some quarters of Westminster and Whitehall, it is timely to remind ourselves – at the risk of driving fresh stakes into old vampires – of why this approach to funding higher education should not see the light of day.

1. **It is ‘the student loan you never pay off’.** Under an open-ended graduate tax (which, it should be noted, not all the models recently advanced are), the link is broken between course cost and repayment. Those subject to it could contribute both for a very long time and to a level that would far exceed the actual cost of their education.
2. **It would increase the role of the state.** Receipts from graduate taxes would flow to the Treasury, thereby cementing higher education institutions’ reliance on public funding and perpetuating central planning. This would, rather obviously, be a devastating blow to universities’ autonomy. It would also run strangely counter to the emphasis in the Government’s policy in primary and secondary education.
3. **It would break the link between institutions and their students.** As a result of point (2), a graduate tax would probably kill stone dead universities’ efforts to increase their engagement with their alumni and to build private income streams.
4. **Hypothecated taxes tend to go missing.** Hypothecated taxes have a history of being, in reality, anything but ring-fenced. Universities would be reliant on the Government of the day remaining committed to ensuring that all the income from a graduate tax continued to flow to higher education and not, for example, used to subsidise other parts of the education system or other public services.
5. **It would be a tax on effort and merit.** The more diligently a student spent his or her time at university, and the more effectively he or she laid the foundations for a successful and well-remunerated career, the more they would ultimately contribute towards the cost of their studies. Conversely, a student who enjoyed the same opportunity, at the same university, but wasted it, would likely contribute less. For the same reasons, it would act as a dampener on career development once in the workplace.
6. **Why should payments for university be redistributive?** Graduates enjoying well-paid careers as a result of their degree will in any case pay more in income tax than those graduates in less well-paid occupations. Is it necessary also to have an explicitly redistributive university finance system? Even if one argues for a public finance and tax system that is, as a whole, redistributive, it does not follow that every element of it should reflect that principle.

7. **It can be difficult to isolate the benefit of a degree.** One Liberal Democrat MP has written: “A graduate tax would be based on a simple principle: that those who benefit the most from their university education pay the most.”<sup>10</sup> But this presupposes that it is the degree that has transformed an individual’s earning potential rather than, say, an earlier phase of education or the individual’s own skill and commitment in their chosen profession. Many graduates will not feel that their success is determined by their university education alone.
8. **A degree will be of diminishing benefit to its holder.** Over time, a degree becomes less important to a recruiting employer as compared to experience, skills developed in the workplace and further professional development. Yet the amount contributed by the graduate via a graduate tax would rise as their earnings increased.
9. **It would encourage a ‘brain drain’.** A graduate tax would increase marginal tax rates and could act as an incentive to the most able domestic students to study and work abroad, thereby depriving the economy of vital skills, universities of income and the Treasury of receipts. Attendant difficulties in collecting the tax across international boundaries would presumably act as a disincentive to domestic, EU and international students from remaining in the UK following graduation. By making the UK a less attractive destination for international students, a graduate tax could impair UK universities’ ability to compete for the brightest and the best and damage what is currently a big export earner.
10. **Tuition fees are not a ‘poll tax’.**<sup>11</sup> They are a fee for a service, from which the graduate may derive substantial financial gain. Higher education is an investment, not a tax. It is also a heavily (and unsustainably) subsidised investment. A graduate tax is often portrayed as ‘fairer’ than tuition fees. It isn’t.
11. **A graduate tax ignores institutional differences.** A graduate from an internationally-renowned university could pay the same rate as a graduate from an institution with a less glowing reputation, despite the different benefits conferred from an employability perspective.
12. **A graduate tax would not recognise course differences.** On average, the benefits to graduates of scientific, medical and technical degrees are substantially greater than for graduates of, for example, arts and humanities degrees. Yet under a pure graduate tax both would pay the same rate.
13. **It would enshrine an inconsistent approach to taxation.** Two people with identical earnings, one a graduate and one

<sup>10</sup> Tim Farron MP, “Graduate tax is the fairest way of abolishing tuition fees”, Liberal Democrat Voice, 19 July 2010: <http://www.libdemvoice.org/graduate-tax-is-the-fairest-way-of-abolishing-tuition-fees-20359.html>

<sup>11</sup> See, for example, Vince Cable’s 15 July speech: “...most students meet these costs [of higher education] by taking a student loan, payable direct from income after graduation when earning a reasonable salary. In this sense, we already have a form of graduate tax. The problem is that it is a fixed sum – a poll tax – regardless of the income of the graduate.”

not, could pay different rates of tax – simply because one had been to university. An international student with a degree from an overseas university would also, presumably, pay less tax than a graduate from an English university.

14. **It would remove incentives to improve quality.** Just as with fixed fees, a pure graduate tax would offer no encouragement (or, indeed, resource) to institutions to deliver enhanced quality over the minimum level as there would be no opportunity to recoup the costs. Put another way, it also removes incentives to competition and, by extension, to potential efficiency gains.
15. **The benefits would be delayed.** There would inevitably be a time lag between the imposition of a graduate tax and the income coming on-stream. Given that funding for universities is almost certain to be cut further as a result of the Comprehensive Spending Review, this would leave the Government with a severe headache about how to plug the gap in the meantime.
16. **A graduate tax would be at least in part a burden on employers.** Graduates would expect higher salaries to compensate. It might seem to be fair enough to charge employers for the benefit of having highly-educated employees. But to the extent that education is commercially worthwhile, that is already reflected in higher salaries. This means increased national insurance contributions from employers. And the rate of contributions is going up in April 2011, from 12.8 to 13.8 per cent. So employers already pay extra for valuable graduates, and they are going to pay even more in the near future. A graduate tax, therefore, could act as a counterweight to the Government's laudable aim to create the most competitive corporate tax system in the G20.
17. **What about non-completers?** A pure graduate tax, by targeting those who had 'graduated' from a higher education institution, would presumably not apply to those failing to complete their courses, and might offer a perverse incentive to drop out just before finishing.
18. **What about part-time and mature students?** Debates about higher education often assume the traditional model of a three-year full-time degree. How would a graduate tax deal with students studying part-time, those already in employment, or mature learners? If it wasn't applied, there would be inconsistency. If it was, it is difficult to imagine a greater disincentive to those making the effort to combine work with further study.
19. **There might be adverse effects on course diversity.** Should a mechanism be found to route income from graduate taxes directly back to universities themselves, rather than into Treasury coffers, this might tempt

institutions to specialise in courses that were likely to allow graduates to go straight into well-paid jobs, so that future income from the graduate tax was maximised. Courses that were linked to highly-paid professions, such as law and accountancy, would be favoured over courses that led people into professions with slower and more modest salary growth.

- 20. A graduate tax does not solve the problem of widening participation. It fails to do this because it doesn't address the root cause of why those from poorer backgrounds are less likely to go to university.** Ed Balls recently wrote that variable tuition fees “would create an unfair market in higher education that shuts out those from modest and disadvantaged backgrounds from our best universities.”<sup>12</sup> This runs counter to actual experience of the 2006 reforms. It was (and is) widely believed that these would deter access. They haven't; the opposite in fact is true.<sup>13</sup> The single biggest factor determining participation in higher education is not social class, not worries about variable fees, but earlier educational attainment.<sup>14</sup>

All in all, it is difficult to avoid the conclusion, whichever way you look at it, that abandoning the current system of higher education funding in favour of a graduate tax would be a spectacularly bad idea. It is, for all the reasons set out above, simply not sophisticated enough to reflect the complexity of the mass higher education system we have today. Admittedly, graduate tax cheerleaders would claim (with some justification) that the 20 criticisms above over-simplify their argument. It would be possible to design a more 'impure' graduate tax that contravened fewer of these objections.<sup>15</sup> It could be time-limited, for example; there could be an upper limit to contributions; and it might be possible for the Government to devise a mechanism to bridge the funding gap and deliver upfront income for universities. A graduate tax could, in other words, be designed to operate more like the current system. Which does beg the question, why bother? Why finesse a graduate tax so that it better apes the current system when you could more easily seek to improve what is already there?

<sup>12</sup> Ed Balls, “The case for a graduate tax”, 14 July 2010: <http://www.edballs4labour.org/blog/?paged=3>. See also “Ed Balls: ‘They said we were not on their side, that we lost touch’”, *The Guardian*, 14 May 2010: <http://www.guardian.co.uk/politics/2010/may/14/ed-balls-labour-election-leadership>

<sup>13</sup> According to the latest analysis by HEFCE, there have been “substantial and sustained” increases in the proportion of young people from disadvantaged areas entering higher education since the mid-2000s. Young people from the most disadvantaged areas entering higher education in the academic years 2009-10 and 2010-11 “are around +30 per cent more likely to enter higher education than they were previously, and around +50% more likely to enter higher education than 15 years previously.” Moreover, “the increases in the participation rate for those living in the more disadvantaged areas have been greater in proportion terms and, since the mid-2000s, percentage point terms, than the rises for those living in advantaged areas.” See *Trends in young participation in higher education: core results for England*, Higher Education Funding Council for England, January 2010, p.6. Crucially, these rises in participation rates for disadvantaged groups are consistent with trends in GCSE performance, pointing to the importance of earlier educational attainment in determining HE entry

<sup>14</sup> IFS analysis of the participation in HE of students from the richest 20% and poorest 20% of families shows almost identical participation when allowing for A-level performance. The key issue is the correlation between social class and the likelihood of gaining the A-levels needed for university entry. Thus 25% of the richest 20% get ‘top’ A-levels compared to just 3% of the poorest 20%. Cited in *The impact of fees: A review of the evidence*, University Alliance, January 2010, pp.31-32

<sup>15</sup> For instance, in their submission to the Browne Review the National Union of Students refined their original blueprint for a graduate tax to address various weaknesses. See *Progressive, proportionate and practical: Response to the second call for evidence to the Independent Review of Higher Education Funding and Student Finance*, National Union of Students, January 2010

## THE ADVANTAGES OF A GRADUATE TAX

There are two principal advantages of a graduate tax. A graduate tax would, in theory, be easier to administrate than a system of fees and loans. It wouldn't be entirely straightforward. Employer software would need extensive modification in order to implement the tax, as would HMRC software, but given that the Government has just started to consult on a re-think of the way in which PAYE works, and that a graduate tax could be built into any re-vamp that were to take place, it could be made to work – with a bit of hassle. But given that a system of fees and loans is already in place, this is very much a theoretical advantage.

### BOX 1

#### How a Higher Education Bill might hit the Parliamentary rocks

Under the terms of the Coalition Agreement, Liberal Democrat MPs who cannot accept the Government's response to the Browne Review will be allowed to abstain in a Parliamentary vote. But the Agreement aside, most Liberal Democrat MPs, many Labour MPs and two Conservative MPs also signed a pre-election pledge organised by the National Union of Students not to raise tuition fees in the next Parliament. Should a Higher Education Bill be felt by some of these MPs to contravene their personal pledge, one would expect this to influence their voting intention. In particular, should Liberal Democrat MPs not merely abstain from voting, but vote against the Bill, it could fall.

- All Labour MPs vote against **-256**
- Conservative MPs who signed the NUS pledge vote against **-2**
- Rest of Conservative MPs vote for **+303**
- All government Liberal Democrat MPs abstain **(19)**
- Rest of Liberal Democrat MPs who signed the pledge vote against **-38**
- SDLP, DUP, Independent, SNP, Plaid and Green MPs vote against **-23**

**Outcome: 303 votes to 319, Bill FALLS by 16 votes**

Total MPs (excluding Speaker, deputy Speakers and Sinn Fein) = 641

The second advantage is purely political. It does not take a considerable flight of fancy to imagine how a higher education Bill might hit the Parliamentary rocks if its provisions do not win sufficient backing from the Government's backbenchers (see Box). The simple virtue of not being tuition fees would make a graduate tax easier to sell to some, even if graduates do end up paying more.<sup>16</sup> Changing the funding lexicon away from 'fees' and towards graduate 'contributions' is probably necessary in any case, given how misunderstood the current system is. It would be hugely doubtful, however, that changes in language and presentation alone would neutralise the opposition of those pledged against a rise in fees.

<sup>16</sup> Though clearly, in worrying about what might be acceptable to Liberal Democrat backbenchers, the Government could not take support for a graduate tax for granted among Conservative MPs.



## WHAT NEXT FOR THE GOVERNMENT?


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Lord Browne's inquiry has received thousands of pages of submissions and hours of oral testimony from key witnesses. Its evidence collection has been admirably transparent, its deliberations unusually private. With so many variables, forecasting its conclusions would be pure guesswork. However, two predictions concerning the Review's report and the Government's response may be hazarded. Firstly, that whilst scrutiny will fall most intently on the mechanism for securing a bigger graduate contribution, the reform agenda will range much more widely. This is apparent from the speeches of both Vince Cable and David Willetts. Expect a greater focus on teaching quality and its leverage on funding allocations, on increasing competition in the sector by encouraging new providers, and on breaking down the divide between further and higher education.

Secondly, that there will be a strong collegiate flavour to the coalition's approach. Designing the most elegant policy solution is next to useless if you can't get it on the statute book. The survival of the coalition will inevitably trump other considerations. In their August letter to Cabinet colleagues, David Cameron and Nick Clegg wrote that: "this government... will govern for the long term. That's why we are prepared to take the difficult decisions necessary to equip Britain for long-term success."<sup>17</sup> We will likely see just how prepared, and just how far analytical rigour gives way to political feasibility, when the Government responds to the Browne Review and sets out its proposed reforms to university finance.

## CONCLUSION

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The introduction of variable fees by Tony Blair's government laid the foundations of a sound system of higher education funding, though political compromises meant that it seemed likely that it would be left to a future government to implement the reforms fully.<sup>18</sup> It would be a sad irony if the gains so hard-won in 2004 were now surrendered. Yes, the 2004 settlement left a variety of issues unresolved. There are legitimate criticisms of the current system – that the fee cap is too low to generate the additional resources universities need or to create a competitive market in higher education, and that the blanket loan subsidy is regressive and unsustainably expensive. These need to be addressed, but the answer is not, for reasons of political expediency, to throw everything out with the trash. It is surely far easier, and more logical, to build on the system we already have than to uproot it and start all over again. We have listed 20 factors against a graduate tax, but there is one final one: common sense. 

<sup>17</sup> PM and Deputy PM open letter to Cabinet, available at: <http://www.number10.gov.uk/news/latest-news/2010/08/pm-and-dpm-open-letter-to-cabinet-54208>

<sup>18</sup> Anthony Seldon & Dennis Kavanagh (eds.), *The Blair Effect 2001-5*, Cambridge University Press, 2005, p.280