FILING

Why not a Pure Graduate Tax?

This paper gives a brief overview of how a graduate tax might work and how it compares with the Government's proposals for a Graduate Contribution Scheme.

department for
education and skills
creating opportunity, releasing potential, achieving excellence

Why not a Pure Graduate Tax?

What is the proposition?

The concept behind a graduate tax is similar to that behind a deferred fee system – namely that after they graduate students pay a special tax to cover part of the cost of their higher education. Instead of repaying through the tax system a loan that covers the sum charged by the HE institution (HEI) for their course, graduates would pay a tax rate for graduates only that would raise additional funds which could be put back into the HE sector.

The features of a graduate tax might be:

- A supplementary tax rate for graduates only
- A threshold below which the tax is not charged
- A period over which the tax is paid
- The existing private contribution to tuition fees are met by the Government
- The possibility for the tax to cover maintenance as well as tuition costs, for example by converting maintenance loans into a universal grant

For the purposes of comparing the different approaches, we assumed that while they were students, full time undergraduates would:

- get a maintenance grant instead of a loan (at the same level as the current maximum loan);
- not pay any fee. The existing private contribution of £1,125 would be met instead by the state;
- pay an extra 3p in the pound on all income over £6,575 (the threshold for the standard rate of tax) for 25 years.
- There are all sorts of way that this model could be varied. For example, it would theoretically be possible to combine a graduate tax with keeping maintenance loans (rather than converting the loans to grants) but that would mean students having to pay off two sums when they graduated. Making two payments simultaneously would be unfair on low earning graduates, and organising the two payments to be made consecutively would be practically and administratively more complex, imposing additional burdens on employers.
- One could also adjust the threshold, number or level of tax rates and repayment periods while raising the same level of revenue – a higher threshold would mean graduates either pay the tax for longer or at a

higher rate on income above the threshold. But for the purposes of comparison the above illustration is used throughout this note.

How would it work?

Under our assumed model of graduate tax, all graduates would receive a grant (equivalent to the current maximum maintenance loan) when they began their studies, irrespective of income.

The tax would then be collected through the tax system after graduation. Under this model all graduates would have to pay the same rate. However, it could be possible to vary both the length and the rate at which the tax is paid.

- **The cost and who pays**

There are high initial costs because:

- HEIs are given public subsidies to cover the existing fee income and an additional amount in anticipation of money to be raised from the graduate tax;

- grant support is more expensive because it is universal and non-means tested.

- These costs begin in 06/07 whereas the additional income from taxation only begins to flow back to the exchequer in 09/10. Over time, the flow of the additional tax revenue builds up; reaching break even point, where in year expenditure is equal to revenue, in about 20 years.

- If you aggregate that future revenue, then in the long term, based on 06/07 student numbers, the graduate tax would cover the government cost of borrowing to finance the upfront investment required to pay for grants and current fees, as well as generating additional income to reinvest in the sector.

Advantages of a graduate tax

- A graduate tax operates on the principle that the fairest way of raising additional income for higher education is from the beneficiaries of the system. High earning graduates subsidise lower earning graduates, so the higher the financial returns to your degree the more you pay. Under this specific model, all graduates pay at the same rate whatever degree they study.
- The repayment arrangements for a graduate tax mean that the student doesn't pay anything while they are studying. They pay after they have graduated when receiving the financial benefits of their qualifications. The repayments are made through the tax system and are linked to ability to pay.

- The graduate tax may not be perceived as debt in the same way as a student loan particularly if a student is worried that he or she may be a low earner after graduation.

Disadvantages of a graduate tax

- A disadvantage of a graduate tax is that there is no guarantee universities would receive the additional funding raised. The Government would therefore have to develop a credible and transparent mechanism by which extra revenue would be dedicated to Higher Education.

- Even if hypothecation were accepted in general terms for universities, it would be very difficult, but not impossible, to relate additional funding from the graduate income tax to specific courses at specific universities.

- There would be no direct relationship between what the student paid and the price, economic value, characteristics and quality of their course. It would therefore be more difficult for students to exert pressure on the value for money offered by HEIs by the choices they made at the time of their application to university.

- There could be no mechanism for paying early and so the financial benefits to Government of students opting to pay early are foregone.

- The graduate tax would not allow differentiation between a student from a lower income background and one from a high income background.

- For a significant minority, the amount they re-pay will be substantially greater than the full cost of their course.

- For the specific illustration of a graduate tax assumed for this note there are the following financial implications:

- for graduates with average real terms earnings in excess of £27,000 per year over the 25 years of the tax, the total amount re-paid under this illustration of a graduate tax model is over £15,000. Since that is the average level of debt that we expect under our Graduate Contribution Scheme, graduates earning above £27,000 will be paying more under the graduate tax;

- at the other end of the earnings scale, graduates earning less than £15,000 would still have to pay tax, but would have to make no payments at all under the Graduate Contribution Scheme, unless the threshold were raised with associated increases in length of payment or tax rate.

- But as noted above, these assumptions are dependent on the specific variation of a graduate tax that is chosen.

- There are also a number of policy and practical difficulties that would need to be overcome. These include how we define the 25 year cut off (elapsed time versus years in work) and the interface with the FE sector and unregulated courses.

Comparison with the Graduate Contribution Scheme

The Similarities...

- The Graduate Contribution System has some of the positive features of the graduate tax:
- students only pay once they have graduated and are earning;
- repayments are made through the tax system;
- they would be linked to earnings;
- no real rate of interest would be charged for the deferral of payment;
- if you don't work, you don't pay.

The Differences...

- There are also some differences:
  - money from a graduate tax would go straight to the exchequer – so a mechanism for hypothecating the revenue would have to be developed. Money from the Graduate Contribution Scheme would go direct to universities and gives them an independent source of income free of Government;
  - with a graduate tax, repayments are not directly related to the costs incurred while studying. Under variable fees graduates would only pay back what they themselves had spent – it would be an "individualised graduate loan" based on their choices about what they studied and where;
  - under the specific graduate tax model the Government would not recover the money for at least 20 years. Graduates would pay for 25 years. Under the Graduate Contribution Scheme the graduate's average payment period would be around13 years.

What does International experience tells us?

We have been unable to identify any other country with a graduate tax system along the lines described that could serve as an exemplar for how a pure graduate tax might work.

However, there are a number of countries that do charge tuition fees. These include Australia, Canada, Japan, New Zealand, Singapore, the United States, Italy and Spain.

- The international experience (Australia and New Zealand in particular) suggests that higher variable fees can be introduced without adversely affecting the participation of students from poorer families, particularly when backed by fee deferral arrangements.

It is important to note that Australia, often described as having a 'graduate tax', has in fact adopted a system, based on the same principles as our proposal, of defined fees repaid after graduation through the tax system. Students are not obliged to pay any fees up front. Instead they repay their defined fee after graduation once their income reaches AU$25,000 a year (£10,900). For income above that, the repayment rate rises as income rises, from a rate of 3% of all income for those earning AU$25,000 (£10,900) to 6% of all income for those above AU$46,000 (£20,000), with payments continuing until the fee is repaid. Australia has also just this month enacted a variable fee reform which will require each university to set a fee in relation to each course, up to a national cap.

Dearing Report

In July 1997 Lord Dearing published a report on higher education funding. It included the following concerns regarding a graduate tax:

- it provides no mechanism for those who might wish to pay at the time they receive the tuition (to avoid tax) and thereby forgoes any short-term benefits to the Exchequer, institutions or graduates;
- it is open-ended: those graduates who are particularly successful will be expected to contribute large sums in total (even if their success has little to do with their higher education) which may encourage avoidance of the tax;
- it would provide no safeguard that higher education would receive any benefits from the contributions, since such safeguards would cut across the general principle that tax revenue is not earmarked for particular services;
- defining what length or type of higher education study made an individual liable for a 'graduate' supplementary tax would be difficult;
- it would not be straightforward (or necessarily desirable) to secure alignment with funding arrangements for further education;
- there is no experience of graduate tax systems elsewhere in the world.

The report then goes on to say:

“We have concluded the disadvantages are such that we do not support a graduate tax as the means of providing contributions from those who have undertaken courses of study in higher education.”

Conclusion

The Government decided to pursue the Graduate Contribution Scheme in preference to a pure graduate tax because of the following key reasons:

1. It provides a guaranteed source of additional income for HEIs independent of Government.

2. It generates a higher private level of revenue for universities with lower short and medium term public expenditure implications.

3. Graduates will know exactly what their higher education will cost them at the outset, and it will be an amount that relates directly to the choices they have made about their course and university.

4. Because of this, it gives students with greater leverage over the system leading to further improvements in quality and value for money.

8 December 2003