

# AN EQUITABLE APPROACH TO THE PRIVATE SECTOR FUNDING OF UNIVERSITY TUITION FEES

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A FINANCIAL INNOVATION TO SUPPORT THE  
GROWING DEMAND FOR HIGHER EDUCATION  
THAT WILL ASSIST IN THE REBALANCING OF THE  
UK ECONOMY

transforming what once was the workshop of the world  
into the university of the world

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# FUNDING with AFFORDABLE INCOME based REPAYMENTS

A FAIR AND EFFICIENT SYSTEM THAT ALIGNS RISKS WITH RETURNS FOR  
STUDENTS, UNIVERSITIES AND INVESTORS

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## EXECUTIVE SUMMARY

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This paper proposes a new scheme for funding students through Higher Education that is affordable for students, rewards teaching excellence and relieves the public purse of a growing burden.

Recognising that both the Graduate Tax option and the alternative of raising tuition fees have significant shortcomings the suggested approach is designed to exhibit the best characteristics of both systems, without their disadvantages.

The scheme, named "FAIR" for "Funding with Affordable Income based Repayment" has three key characteristics:

1. Students only pay after they leave University and payments are proportional to earnings.
2. Universities' receipts are tied to graduate earnings to align their economic interest with that of their students.
3. Pension investors provide the upfront funding to gain an earnings linked asset

In summary, students either pay their fees upfront or they agree by contract to pay a proportion of their income for a period of time to the University they attend. The contract terms are set by statute and are the same for all Universities. The contracts are bundled up and invested in by pension funds who pay according to their expectations of the future earnings of graduates of

that institution. The state is relieved of all costs, students liabilities are affordable and proportionate, Universities' receipts are a function of their reputation and plans for helping the careers of their charges, and pension investors have an asset that is a perfect match for their earnings linked liabilities.

The scheme is not designed to solve all aspects of University funding. However, by arranging an economically efficient intergenerational transfer of assets and liabilities, it relieves the state of a large financial burden so that it is able to use its limited resources to achieve its social objectives.

The scheme is preferable to an income-contingent loan based scheme, as in place in the UK today, because it is progressive across all incomes, whereas the present scheme places the greatest burden, as a proportion of income, on middle income earners; and because it can be funded by private sector investment.

The scheme is preferable to a graduate tax because it creates a nexus between a University and the future success of its graduates and because non-nationals can participate.

The paper reviews the evidence and useful precedents in Germany, the Americas and the UK and outlines a detailed scheme which has won support from students, and from both the academic and financial community.

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#### BACKGROUND

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Post the 2008 "Credit Crunch" the UK economy's dependence for wealth generation on the financial services industry is considered a weakness. The Coalition Government has stated its desire to "re-balance" the UK economy. While this is typically considered to imply an increased share of GDP contributed by manufacturing, the UK's share of global manufacturing output is in long term decline<sup>i</sup> and it lacks comparative advantage in this field. Higher Education, on the other hand, is a long term growth sector where the UK has a strong reputation and comparative advantage.<sup>ii</sup>

The 2010 budget implied a reduction in government expenditure on education over five years of up to 25% in real terms.

In a recent speech David Willetts, Universities Minister, was quoted as saying that Universities should: "secure new funding streams" and innovate.<sup>iii</sup>

**The clear implication is that UK Universities need to find a means of raising funds from the private sector to support their growth and export success in undergraduate education while simultaneously reducing their demands on the government's purse.**

This is not to deny that there are social gains to be had from higher education; it simply recognises that the UK government's fiscal position means it cannot afford to pay as much as it has in the past for those benefits.

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**SOURCE OF FUNDING**

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The four traditional “private” (non-government) sources of income for the higher education sector are: businesses; benefactors; foreign (non-EU) students and domestic (EU) students. First we examine the potential of each as sources of materially increased funding.

**BUSINESSES**

Excluding any role as potential benefactors, businesses will only pay for services which have commercial value. A number of Universities do carry out research work to assist companies and are compensated for this work. However, to the extent that academic time is used in carrying out research, it is not available for educating undergraduates. Much of the research will be carried out by post-graduates and this is an efficient way for them pay for their education but, unless companies pay an uncompetitive rate for the research, and Universities cross-subsidise undergraduate education with the profit on post-graduate effort, then selling academic and post-graduate time for research purposes will not raise money to finance undergraduate education.

Companies could be a new source of income if they were obliged to compensate a University when they hire one of its graduates. Businesses will sometimes pay up to 25% of one year’s income to a headhunter to hire someone with a couple of year’s relevant experience. So the idea of paying a premium in excess of the direct employment cost to the “supplier” of the new employee is well accepted. So long as the total costs of a new graduate hire remain materially less than the cost of an experienced employee there need be no significant impact on the attractiveness of hiring fresh graduates. If we assume a 20% fee and a median initial salary of £25,000 such a system could yield an average of £5,000 per student which would represent a substantial contribution to tuition costs.

It would be necessary to extend the scheme to cover graduates regardless of their country of study to ensure that it does not make UK graduates expensive relative to those from other countries; with the proceeds from the employment of non-UK graduates being paid to Universities whose graduates initially take up employment abroad. However, such a scheme could only ever subsidise a small portion of tuition fees without making UK graduates prohibitively expensive to hire and, combined with the complexity of dealing with non-UK graduates who take up employment in the UK, and UK graduates who take up employment abroad, it cannot be considered a complete solution.

**BENEFACTORS**

Benefactors are a significant source of Higher Education funding in the United States and some UK Universities have been successful in raising sizeable sums. However, the UK starts from a very small base as far as endowments are concerned and it is unlikely that any but the oldest and most prestigious Universities could raise a meaningful amount in the next several years. So, it is right that all Universities should continue to solicit donations to build endowments, but it is unrealistic to think that benefactors can provide sufficient income in the near term to satisfy the growth and reduced government support that are the current imperatives.

### NON-EU STUDENTS

The “export” market as represented by non-EU students has been a growing source of income for the University sector and a key objective should be to expand this market to assist in the “re-balancing” of the UK economy. Unlike manufacturing it is sector where the UK has a global leadership position – No 2 to the United States – and significant comparative advantages – language, history and reputation.

As with any commercial enterprise, expansion of a market typically will require a lower price. If the current system of charging tuition fees to non-EU students continues, this becomes problematic as, while a lower price per student will no doubt increase demand (student numbers), it cannot be certain to increase total income. Many Universities have been addressing this conundrum by opening institutions abroad. However, while that will generate profits for the Universities, its impact on domestic employment will be limited, and so it will not materially help to re-balance the UK economy. It would be preferable if a way could be found to reduce the effective cost of a UK based education for non-EU students in such a way that the total revenue received by the Universities increases. FAIR aims to do this.

### DOMESTIC (EU) STUDENTS

Domestic students are the key customers and beneficiaries of the UK higher education sector and, if education were a commercial activity, they would be expected to fund it. They currently do account for a significant proportion of the sector’s income through the payment of the capped tuition fee, though the aggregate amount paid is generally agreed to be less than the amount that would be required to enable the sector to retain its global competitive edge.

Even this capped tuition fee has turned out to be unaffordable for some graduates. To ensure opportunities for a wide range of students the government has arranged that, instead of the student contracting directly with the University, most students take out a form of loan contract with the Government. The Government then forgives the loans, in whole or in part, where the repayment obligation is deemed excessive. This private/public hybrid scheme has proven costly for the Government with losses on the loan “book” estimated at £7bn on a face value of £27bn.

### CONCLUSION

**As students (EU and non-EU) are the direct beneficiaries of the education they receive it is appropriate that the burden of bringing additional income into the higher education sector should fall on their shoulders.**

What needs to be designed is a system that enables students to pay a greater part, or the full cost, of their education, while reducing the burden on Government, in a way that makes higher education affordable for all prospective students.

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### STATE OF THE DEBATE

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The current state of the debate has largely been between raising tuition fees and charging a graduate tax. However, both approaches have significant failings. Increased tuition fees will reduce the burden on government but will make higher education prohibitively expensive for those from less wealthy backgrounds and those who enter low earning careers. A graduate tax

will make a higher education affordable for all but it will not reduce (and may increase) the burden on Government as the revenue will not be collectable for many years and will not be collectable at all in the case of graduates who work abroad.

A summary of the limited strengths and multiple failings of these two suggested approaches is shown in table 1 below:

**TABLE 1. CURRENT OPTIONS AND THEIR SHORTCOMINGS**

| Issue  | Graduate Tax | Raise Tuition fees funded by loans |
|--|--------------|------------------------------------|
| Autonomy – reduce Government control of HE funds | ✗            | ✓                                  |
| Growing the foreign (export) market              | ✗            | ✗                                  |
| Get cost off Government balance sheet            | ✗            | ✗                                  |
| Don't discourage less well-off students          | ✓            | ✗                                  |
| Align interests between University and Students  | ✗            | ✗                                  |

Clearly both of the standard approaches are suboptimal.

The FAIR scheme, proposed in this paper, aims to square the circle of reducing the burden on government while making a higher education affordable to all by combining the best features of increased tuition fees and a graduate tax, while eliminating their flaws.

To achieve this the key challenge is to find a way by which students can raise the capital to pay for their education from private investors at the point of entering University, when their prospects are so very uncertain. To solve this problem we rely on portfolio theory and asset-liability modeling and compare equity and debt financing.

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#### PORTFOLIO THEORY

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The theory of portfolios is related to the adage that “one should not have all one’s eggs in the same basket”. It is based on the observation that taking a single big bet is riskier than taking a number of small bets. Even though it is reasonable to expect a proportion of bets to have a successful outcome, any individual bet has an uncertain outcome. Taking a single bet risks total loss, whereas the taking of a number of smaller bets reduces that risk. As the portfolio size grows, the risk of a nil return can, in practice, be eliminated altogether.

Applied to students the lesson is that each student represents a bet.

For the individual student they cannot avail themselves of portfolio theory. Their life and career outcome will be determined by what happens to themselves alone. If they are fortunate they



will be successful. If they are unfortunate they will fail. They may choose to work hard and take many qualifications but luck in their choice of career and employer can overwhelm their best efforts. Investment Banking was not always the route to riches that it currently appears to be and, no doubt, will not be in the future. There was a time when a religious education guaranteed status and a high income; today it is associated with penury and possibly even ridicule. Times change.

On the other hand, a University has a relationship with a broad spectrum of students studying a range of subjects. Clearly it is in the position to benefit from portfolio theory. Although the success and future earnings of a given student cannot be known, if the University is doing a good job then, on average, its graduates should have a high level of earnings.

**The implication of portfolio theory is that the risk that a higher education may not result in high earnings for a given student should be taken by the University, not by the individual student.**

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#### ASSET-LIABILITY MODELING

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Considering just an individual's financial position, they will have assets – things they possess – and liabilities – representing their financial needs.

Asset-liability modeling seeks to measure such assets and liabilities and to acquire or trade financial assets which help to bring one's aggregate assets and liabilities into line with one another, reducing the risk of a mis-match between the two.

For example, it is safer to take out a mortgage in the currency in which one earns an income. Having the asset (your earnings) and the liability (mortgage payments) in the same currency means that whether that currency rises or falls in value, there is no impact on your ability to pay the mortgage. If they are in different currencies a risk is being taken. If the currency in which the mortgage is denominated rises relative to the currency in which your earnings are paid, the cost of the mortgage will rise.

At the point of entering University students' liability is the need to make an upfront capital payment for the tuition fees. However, on the asset side, by attending University they have a reasonable expectation (with a degree of uncertainty) of a long term stream of above average earnings from employment.

The interesting observation is that the student position is exactly the opposite of that in which pension investors find themselves. The latter have accumulated capital – their asset – and their liability is that they have many years living costs to meet, where such living costs will rise with inflation. The best match for their liability would be something akin to an income from employment.

Typically pension investors will invest in a mix of bonds and equities to seek to match (hedge) their liabilities. However, these assets are not well suited to the purpose. The returns on bonds are nominal and reduced in value by inflation so are inadequate for providing a long-term inflation protected income. Equities are considered a "real" (inflation proof) asset but can be

highly volatile and can exhibit negative returns for extended periods of time. The Japanese equity market, for example, is still a long way below its levels of twenty years ago.

**The conclusion from a consideration of the asset-liability positions of students and pensioners is that the asset of one matches the liabilities of the other so a transaction where they each traded their assets should be mutually advantageous.**

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## EQUITY VS DEBT FINANCE

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### UNDERSTANDING EQUITIES

“Equities” or “Equity” refers to a type of investment that represents an equal share – the root of the word - in the success or failure of a venture. The contrast with loans or debt is that while they represent a fixed obligation on the part of the borrower to repay some nominal amount, equity represents a variable obligation.

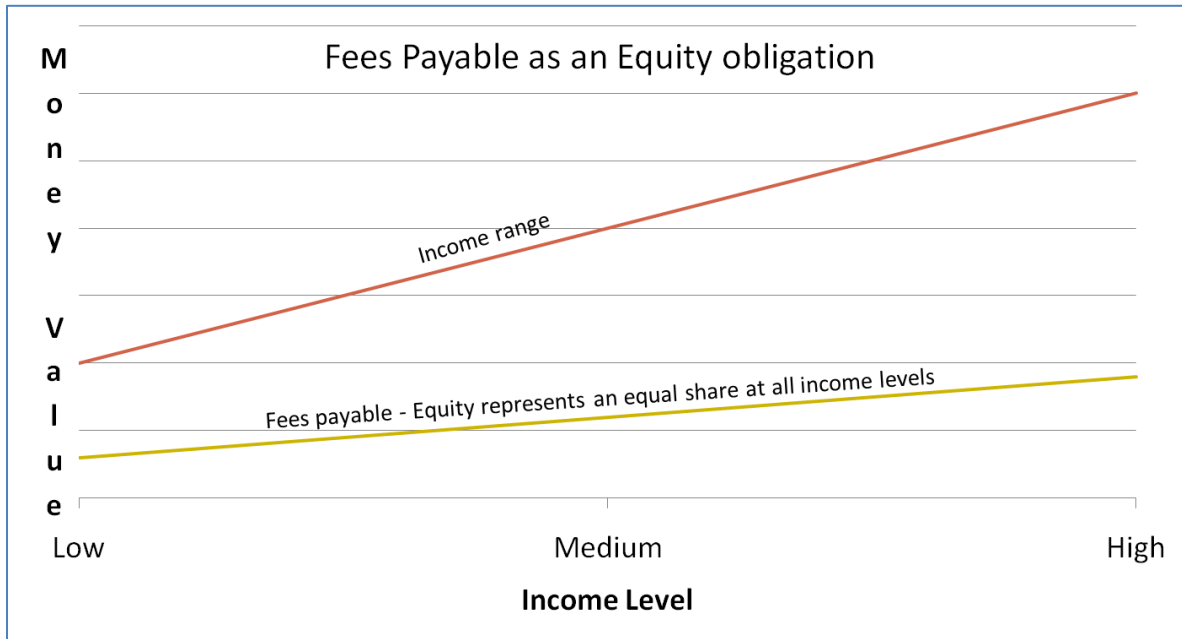
A Company might use debt finance to enable it buy stock (e.g. a clothing retailer will buy clothes). This is efficient and appropriate because against the fixed cost of the debt the company has an asset (the clothes) that it should be able to sell for a predictable amount, enabling repayment. On the other hand, if the Company is making a major new investment – a new factory or store, for example – it will often seek to raise the finance to pay for that by selling equity to investors. If the factory or new store is a success, it will have to share the earnings from that success with the investors; but this is balanced by the fact that, if the new venture is a failure, then the equity investors will share in that failure and will get paid little or nothing.

Equity is designed to fairly share the risk of starting a major new project between the company and a multitude of investors. By spreading the risk of new ventures, it is possible for more new ventures to be begun.

If we treat a graduate’s income as the measure of the “success” of the “venture” of entering into higher education we can consider the impact of using debt or equity finance to fund the student’s access to that opportunity.

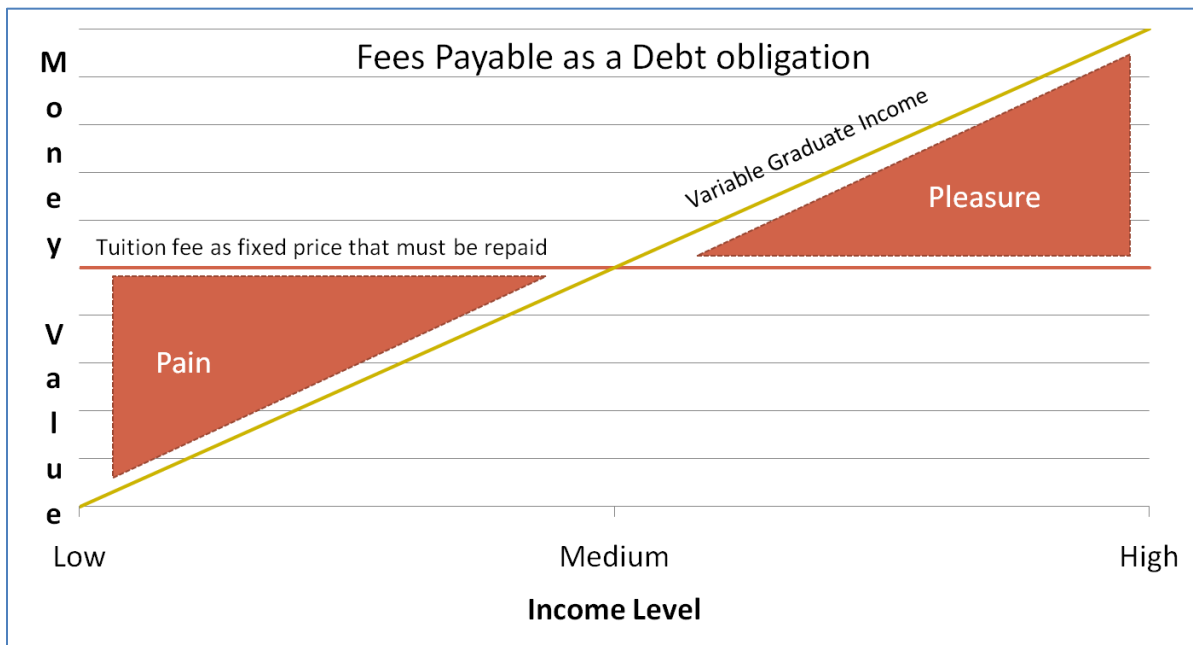
Chart 1 shows the cost of tuition fees on an equity basis. As earnings rise so does the amount repaid as it is always an “equal share” of the “success” (earnings).

Chart 1: Relationship between fees and earnings with an Equity based obligation



On the other hand, in Chart 2 we see the situation with debt based finance. Here the repayment obligation is unrelated to future earnings and the Chart highlights two segments, one where graduates with low earnings suffer “pain” because the debt obligation is large relative to their earnings and the other “pleasure” where the obligation is comparatively small.

Chart 2: Relationship between fees and earnings in a Debt/Loan based obligation



**Causing students to finance their tuition fees with loan obligations will lead to some experiencing repayment difficulties while others will find the obligation very comfortably affordable.**

Before putting forward the FAIR scheme it is necessary to consider in more detail why debt finance is problematical.

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MILTON FRIEDMAN – CAPITALISM AND FREEDOM, 1962

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First, let's turn to Friedman's pathbreaking book, "Capitalism and Freedom", first published in 1962, where, in relation to paying for higher education, he stated that:

**"The average expected return [to higher education] may be high, but there is wide variation about the average"**

This is an unarguable observation yet it is often missed in the discussion about a "graduate premium" – the established truth that, on average, going to University will lead to higher lifetime earnings. The fact that such a premium exists is the justification for higher education *in general* but it cannot be used in relation to any given individual for whom the benefits of a higher education are highly uncertain. It simply cannot be denied that many graduates do not have successful careers, and some do not have careers at all. This dispersion of outcomes must be taken account of in the economics of paying for a University education. Friedman did so by referring to:

**"the inappropriateness of fixed money loans to finance investment in training"**

Recognising that training (education) has a variable return, so that tying such a return to a fixed cost, as in Chart 2 above, will lead to (financial) pain for many. He went on to suggest a different model for financing higher education:

**"The device adopted to meet the corresponding problem for other risky investments is equity investment... The counterpart for education would be to 'buy' a share in an individual's earning prospects; to advance him the funds needed to finance his training on condition that he agree to pay [] a specified fraction of his future earnings"**

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DISPERSION OF OUTCOMES

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While the existence of a "graduate premium" is well documented, so is the wide dispersion of outcomes. A University education shifts the mean expected lifetime earnings in an upward direction, but the distribution of lifetime earnings remains wide. Evidence shows that there is variation in future earnings between subjects studied, within subjects and over time. Students' careers are subject both to macro-economic changes and personal good and bad fortune.

Figure 1 illustrates this dispersion by subject. It demonstrates that the dispersion of returns is such that, for certain measurement periods and subjects, the returns to a University education may even be negative. Figure 2 shows the difference in returns for subjects between their best and worst years. Given that within a given subject cohort there will be a distribution of

outcomes by individual, it is unarguable that a given individual cannot be certain of the value to them of a University education.

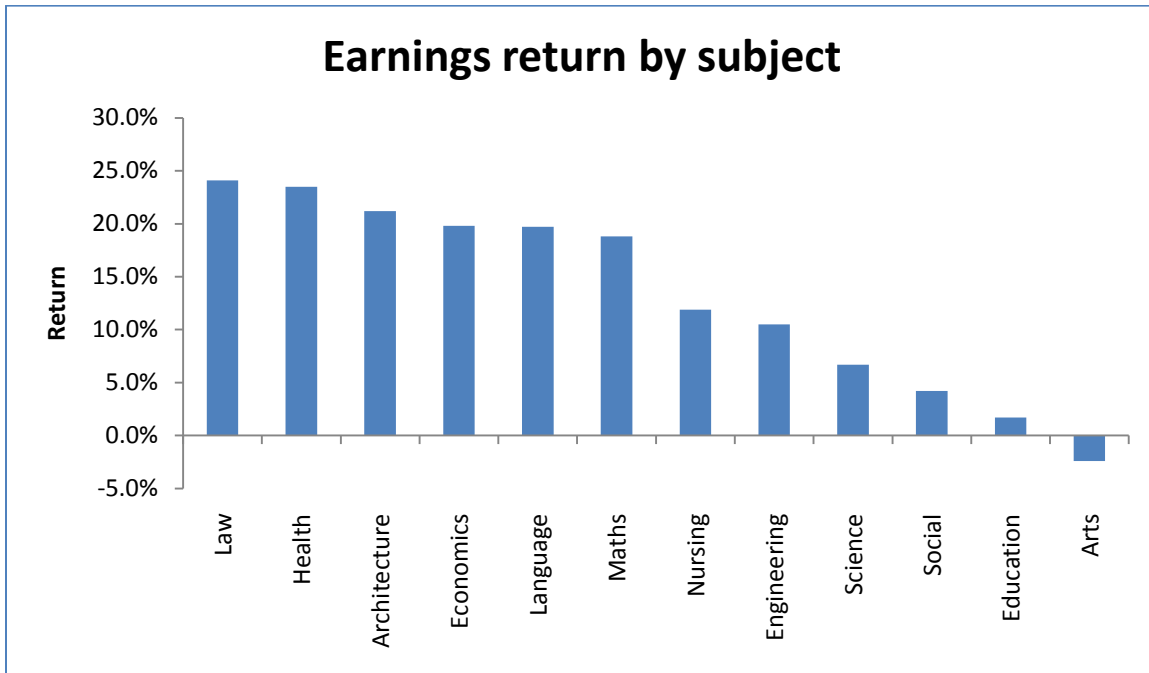


Figure 1: The Returns to Education, Walker and Zhu, 2001 (Table 15, Men)

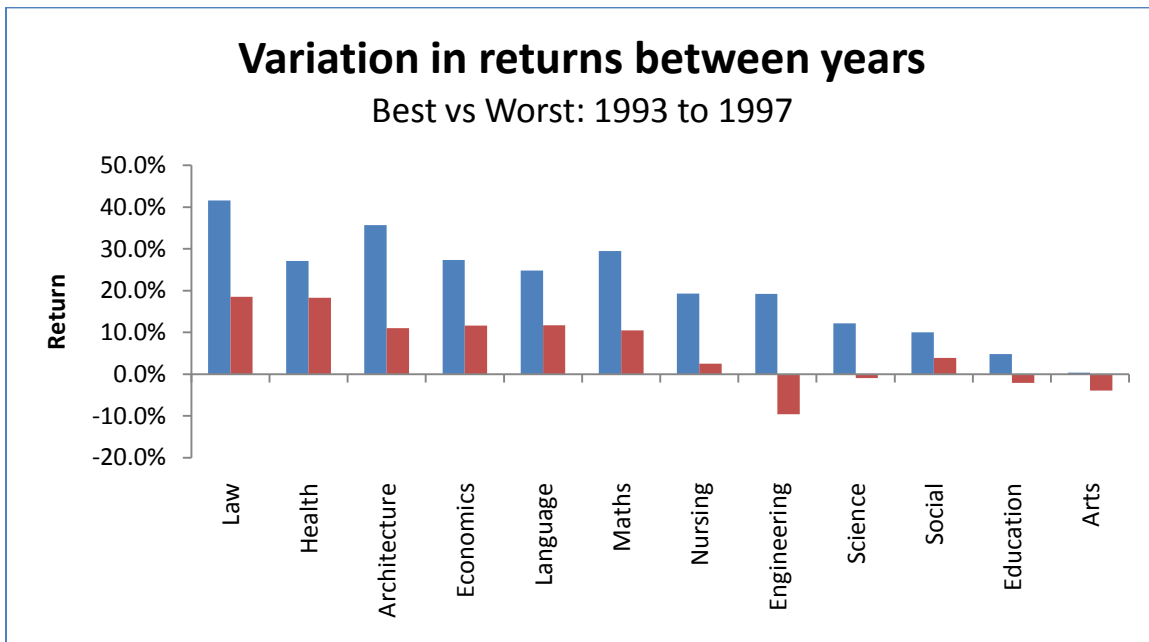


Figure 2: The Returns to Education, Walker and Zhu, 2001 (Table 15, Men)

The consequence of this uncertainty is that the taking on, at the point of purchase, of an obligation to repay a fixed amount of money in exchange for an education, when the value of the education is unknown, will result in some students being obliged to pay far more than the

education was worth to them while some others will pay far less. Such a mis-alignment between the cost of education and its value is untenable, politically and economically.

In many cases, where the graduate's earnings are low, the burden of a fixed amount of debt could become unaffordable leading to a default on part or all of the debt. Fear of debt is likely to discourage students from less wealthy, less financially confident, backgrounds from engaging in higher education. Given that the earnings payoff is lower for graduates living in certain regions, high fixed costs to education would have an effect on participation by region.

**Given the uncertain earnings future a given student faces, charging for higher education on a fixed obligation debt basis is likely to discourage participation and lead to credit impairment for many graduates and losses for lenders. An equity based scheme matches cost to ability to pay without these problems and appears more appropriate for financing higher education.**

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#### EDUCATION – NATURE OF SERVICE

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Eighteen year olds are free to borrow money and may do so to enable them to purchase a car and even, in a few cases, property. Many will use debt to finance their lifestyle – paying for food, alcohol, mobile phones etc. Nobody argues that there is anything wrong with students using debt finance to pay for such things, so why did Friedman state that debt finance as a means of paying for an education was “inappropriate”?

The reason is that, the case of education, the value of the “purchase” is not known to the “buyer” at the point that they enter into the transaction. Furthermore, once a particular educational option is chosen, there are considerable transaction costs to switching to an alternative option should the student decide that they are not getting what they expected. It is hard to switch course other than once a year and there is the risk that the new course will be no better than the old. Students are faced with making a major life choice that they will generally be stuck with once the choice is made with very limited reliable information about what they will gain from the decision.

This is not at all like buying a physical good such as a car. A car has well defined technical specifications which can be considered and relied upon. It is possible to see exactly what a car looks like. It can even be test driven and, if not liked, one simply walks away. The University choice would be like a situation where one can only buy one car in one's whole life. The car must be bought blind and a fixed price is paid. Only after committing to the cost does the buyer find out what they have bought. For some it will be a Rolls Royce, but for others a second-hand Lada. To find yourself with a large debt when the car you receive is an old Lada is, in Friedman's delicate terms, “inappropriate”.

Buying a University education is more akin to purchasing the services of an investment manager by acquiring units in a mutual fund. One subscribes ones assets and the manager sets to work. Instead of agreeing to pay the manager some fixed fee, the agreement is to pay a fixed proportion of the value of your assets. If the manager is successful and your assets grow in value, he will be paid more. If he fails and your assets fall in value, his own income falls with yours. Hedge Funds take the logic even further with the application of performance fees, making clear that the manager's earnings are tied directly to the success he achieves with your assets.

The reason that investment funds charge on this basis is because investments, like education, have uncertain outcomes. When an investment is made although, in general, investing will make a profit, there is a wide range of possible outcomes. Some investments will make exceptional gains while others will record large losses. If the investor was obliged to pay a fixed nominal fee there would be an increased risk that, in poor market conditions, the whole investment would be consumed by fees. Much better to share the risk of poor performance with the manager, who is being employed to mitigate that risk, in exchange for sharing the proceeds of great success.

If paying a performance based fee is accepted practice in investment management there is a much stronger case for it in relation to education. It is possible to invest with a range of managers in many different strategies and the costs of changing from one manager to another, though not negligible, are affordable. With the choice of University the student, in general, makes one choice of institution and course in their lifetime. They cannot study at multiple institutions and cannot read many different courses. While some students do change institution and/or course the costs of doing so are high both financially and in terms of lost time and only a very small number have the personal resources to make a change.

We can see why Friedman thought that paying a fixed price for an expensive, once in a lifetime, choice with an uncertain outcome was “inappropriate”. Better to follow the mutual fund method and pay in proportion to the benefit gained.

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#### INCOME CONTINGENT DEBT SCHEMES

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To address the fundamental problem that Friedman identified: that some graduate’s earnings will be low so a fixed debt obligation will be unaffordable, a number of countries, the UK among them, have created loan schemes whereby the repayment obligation is tied to the graduate’s earnings.

In such “Income contingent” arrangements there is a fixed debt that is due to be repaid, but the amount to be repaid in any one year is based on the graduate’s income. If income is low, less needs to be repaid. Typically there is also a date by when, if repayment of the debt has not been made by that point, it is nevertheless forgiven.

Looking again at Chart 2, such schemes mitigate the pain felt at the lower end of the income spectrum but do not capture the excess return shown by the “Pleasure” triangle. This represents the excess of what higher earning graduates would be capable of paying over what they are asked to pay in a fixed loan obligation scheme.

The effect of income contingency in a loan environment is extremely unfair to middle income earners as shown by Chart 3 below. It means that, at some point in the middle income spectrum, there is a level of income where those individuals are paying out the highest share of income. Lower earning graduates get part or all of the debt forgiven, while higher earning graduates only face the same nominal repayment obligation as the middle earning graduates.

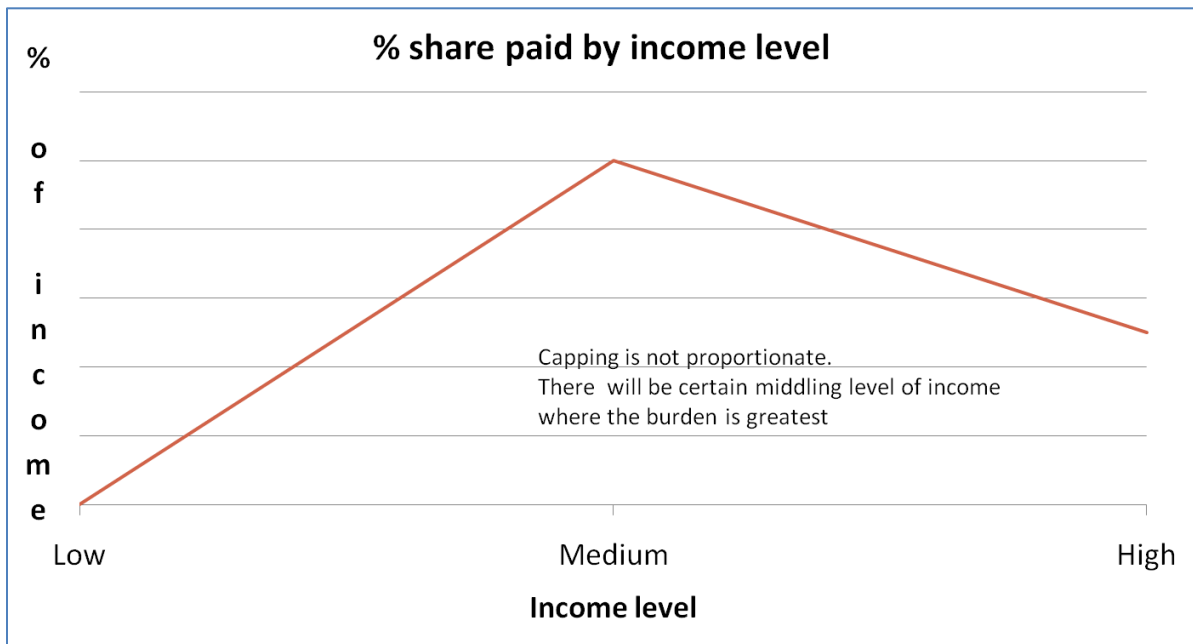
In addition, such schemes create an unhealthy incentive to delay earnings, and to earn less than the minimum on which repayment is based, as the liability is reduced by these strategies.

Income contingent loan schemes are uneconomic as they cap the liability of those who benefit most from their education and can afford to overpay but do not recover the full cost from those who benefit least or who cannot afford to pay. For example, it is estimated that the UK government is carrying a £7bn loss on the student loan book, with issued loans of £27bn worth no more than £20bn. Clearly, any such scheme would not be attractive to private investors.

In order to raise investment returns, one possible approach is to add a high default premium to the level of the debt so that the higher earners subsidise the fail-to-payers. Adding such a “default premium” to the loan level is even more unfair to middle income earners as they would be obliged to bear the same burden of premium as much higher earning graduates.

A debt based scheme is therefore not a viable private sector solution; it is only feasible where, for policy reasons, a government is willing to take the loss on the under-payers. Putting aside policy, it is probable that the UK Coalition government would argue that it is unable to take this loss.

*Chart 3: Income Contingent Loan Scheme / Capped Tax*



**In conclusion to this part, obliging students to take out fixed obligation loans is, for a number of powerful reasons, as Friedman put it, “inappropriate”. Whether the obligation is fixed or income contingent, it creates a number of winners and losers and as one loser is the provider of funds a debt based scheme is not a viable means of raising private sector finance.**

Before putting forward the FAIR proposal, there are two financial/economic concepts that need to be introduced as they form an essential part of the logic and structure of FAIR.



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**CONCEPTS**

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**SECURITISATION**

This term means “making into a security”, where a security is an asset, such as a bond or an equity (share), which can be traded by investors. It is the process by which a large number of financial assets of small value and high variability of expected return are pooled together to create a single financial asset of large value and more predictable expected return. The larger size of the created security and the greater stability of its expected returns make it capable of being efficiently traded between investors. The assets created through “securitisation” can be either debt or equity securities with the division between them being a function of the expected variability of returns; the higher the variability the greater the proportion of equity that is appropriate.

**ECONOMIC INCENTIVES**

In the 18th century, the UK exported its criminals to Australia, and paid on the basis of every convict shipped aboard at the quayside at Bristol or London. On average, 12 per cent of those who were shipped aboard in Britain died en route; on some voyages more than one in three of those shipped died before reaching Australia. In 1792, the system was changed (according to some reports, on the suggestion of Jeremy Bentham). Shippers were paid for every convict delivered alive in Australia, rather than shipped aboard in Britain. In 1793, three convict ships sailed to Australia transporting 422 convicts, of whom 421 were delivered alive – a mortality rate about 1/50th of what had previously occurred. The new reward structure produced immediate and dramatic change.

In relation to higher education there are myriad incentives for Universities and Students arising out of different economic arrangements. The example above makes clear how powerful such economic incentives can be and how, by arranging incentives that are consistent with the desired outcome, behavior will adjust to deliver a better result.

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**THE FAIR PROPOSAL**

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Having reached the conclusion that the most efficient solution for the private sector financing of higher education is an equity based scheme where the University takes the risk that individual graduate’s earnings are highly uncertain and where pension investors will be keen buyers of an asset that delivers returns tied to graduate earnings the next step is to design the specific features of such a scheme so that it meets a broader range of needs and is politically feasible.

This paper will therefore now set out a proposal for a scheme which, as explained earlier, the Author has labelled “FAIR” for “Funding with Affordable Income based Repayments”. The financial assets created under this scheme through securitisation, being pools of earnings based obligations, shall be known as “FAIR assets” or “FAIR paper”.

Further explanations of the specific features of the scheme along with a discussion of the various issues that it needs to satisfy or address will then be discussed in turn.

## THE FAIR SCHEME

1. Applies to all Registered Institutions offering a minimum 3 year study course to students aged between 18 and 23 on entry.
2. The cap on standard tuition fees stays but is reduced in real terms, possibly to nil.
3. Universities are allowed to publish “upfront additional” tuition fees which are in addition to the regulated and capped standard level. There is no upper limit to the “upfront additional” fee and it may vary by course and by institution.
4. On accepting a place at University, in relation to the upfront additional fee, students have an option:
  - i. to pay the deregulated upfront additional fee from their own means OR
  - ii. to take on an obligation to pay a fixed percentage, X%, of their total earnings (capital, earned income and unearned income) for the first Y years that they pay either income or capital gains tax in any jurisdiction.
    - This obligation, the “FAIR contract”, is in the form of a private contract with a special purpose company which would be set up to provide funding for a given University or group of Universities.
    - in the contract the Student nominates the University in relation to which they are willing to make future income based payments. A similarity is the mobile phone contract, where a subscriber contracts with a network but selects a phone from a manufacturer to whom the network pays the cost of the phone, recovering the cost from the subscriber over the contract period.
    - Should a student not complete their course a reduced or nil fee would be charged. Given there is a benefit to partial completion of a course it is suggested that there be no charge where the ungraduated student discontinues before the end of the first year and otherwise is charged at half the standard rate.
5. The Government sets X and Y to apply across all subjects and all Universities
  - i. Higher values of X and Y could be set for non-EU students.
6. The FAIR contract would be regulated, standardised<sup>iv</sup> and designed to be effective in all jurisdictions<sup>v</sup>
  - i. The terms of the FAIR scheme remain under Government control. It is thus a government sponsored and controlled scheme, where the private sector simply acts as the provider of the funds.

7. By agreement with the special purpose companies, banks would act as financial intermediaries, processing the contracts and, in due course, collecting payments from graduates.
  - i. Neither the special purpose companies nor the banks have any financial risk as the FAIR investor will be paying (buying shares) at the point of student acceptance of a place, prior to any costs being incurred, so there is no pre-funding requirement.
8. Banks would pool the contracts for a given special purpose company and sell them, as share issues (equity), or as a mix of annuities (debt) and equity, to the investment community.
9. The sale proceeds, less issue costs, would be paid to the University or group of Universities whose students' obligations had been pooled.
10. The proceeds would cover the tuition fees for the whole three year period.
11. The sale proceeds will vary based on the market's perception of the future earnings potential of the group of students whose obligations are in a given pool.
  - i. Although students will contract on identical terms, universities will receive different amounts of money based on their value added
  - ii. The Universities will know their receipts for the duration of the student's course shortly after the student has accepted their place and have no financial risk in relation to the student fulfilling the terms of the agreement.
12. Banks and non-bank savings institutions would manage the process of collecting payments, compensating Universities where students move from one to the other during their undergraduate career, of re-packaging the obligations of those students who fall below the tax threshold in some years (to ensure economic pools of assets are maintained) etc.

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#### SPECIFIC FEATURES

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The FAIR scheme has a number of specific features which need explanation:

##### REGISTERED INSTITUTIONS

It would be advantageous to allow new entrants into the higher education sector to expand the range of courses on offer and encourage competition. Since FAIR, although a regulated contract, allows Universities to raise funds independent of the government, if an institution is economically viable on FAIR receipts alone, it should not need government approval to operate. The fact that it will only be viable if it is supplying an education that has economic value to the students and investors means that viability and educational added-value go hand in hand.

FAIR could make it viable, for example, for a foreign University such as Harvard to set up in the UK. Since they would only need to persuade students and investors, and not the government, of

the value of their venture, the barrier to entry is significantly lowered. Although a share of the profits would return to the US, the employment and most of the income attributable to such a venture would remain in the UK. Facilitating the foundation of branches of prestigious foreign Universities in the UK would have the potential to make the UK an “Education Cluster” and the leading global destination for undergraduate education.

### **3 YEAR COURSES**

FAIR is a radical notion. At the outset it would be preferable to keep it as simple as possible with as much standardization as possible. Three years is the “standard” length of an undergraduate education and it would be simplest if FAIR, therefore, covered three years of tuition fees across the board.

It is true that mandating three years means there is no incentive for Universities to consider the possibility of enabling students to complete their studies in two years. However, it could be argued that a course does not have enough content if it could be completed in two years. Instead, FAIR would encourage the University still to complete in two years what perhaps once took three, but then to add to the course so that the third year is also used productively.

Where courses take longer than three years the proposal is that FAIR would cover the first three years and then, at the end of the third year, the student would have to decide whether to continue and, should they so decide, they would have to finance the remaining tuition fees either out of their own resources or by means of borrowing. There still remains a case for equity style finance for the remaining years of study, but after three years at an institution, studying a given course, the student is no longer as poorly informed about what they are “buying” as they are at the point when they first accept a place at University. So, although the case for an extended FAIR type payment is strong, it is not as strong as the case that can be made when starting out, and the simplest solution for the initial introduction of FAIR is for it to cover exactly three years of tuition in all cases.

### **AGE BAND**

It is proposed that FAIR only apply to students who start their courses at ages between 18 and 23. There are two reasons why FAIR should not apply to mature students: (i) they will have fewer years of employment ahead of them and so their economic value to investors is lower and (ii) they will have had ample opportunity to work and save money and so should be able to finance themselves.

### **ALL EARNINGS**

To avoid the incentive that arises out of different rates of tax being charged on different types of income it is proposed that the FAIR charge apply to all forms of income – earned, unearned and realised capital gains. As the rate of FAIR charge is low and known at time of taking out the contract it is hard to see how a graduate could argue there is anything unfair about the charge being levied regardless of the characterisation of income.

### **TIME LIMIT**

Although Y, the number of years for which the charge should be paid, is not specified, it should have a specific value and not be indefinite. If there is no time limit it will be unfair between

those who work from University to retirement and those who take long career breaks. This will, in general, mean it will be unfair between men and women. The consequence of that unfairness will be that Universities will seek to raise the proportion of men in their intake as investors will, in this scenario, prefer pools of predominantly male graduates. To maintain the “needs blind” appeal of FAIR it is important that those who, for whatever reason, choose to take long career breaks, are as likely as all others to make a full contribution.

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#### CONTRACTING PARTY

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It was argued earlier that the University is better placed than the student to take the risk that an individual does not gain any material benefit from their time at University, because the University can spread that risk across all its intake. However, that does not lead to the conclusion that the University should contract with investors, because the portfolio effect can work simply by the obligations of many students being pooled and marketed as a single asset to investors by the financial technique known as securitisation.

The contracting issue is different.

If the University is the contracting party, it means that Universities are providing the funds to cover the cost of each intake’s education in the hope that they will recoup the income from their graduates over time.

#### **This would make Universities financial intermediaries.**

They would be operating like banks, “lending” students the cost of their educational services subject to a contract whereby the student must repay that cost over time.

This is not an efficient risk for Universities to take. They will incur costs to educate a given cohort of students and are then at risk over an extended period of time that that cohort may not earn enough to cover the costs already incurred. Given that likely repayment periods would be of the order of twenty years, by the time the University had discovered that its graduates earnings and ability to pay were insufficient to cover the costs already incurred many years of excess expenditure would have been accumulated. It could be too late to address the deficit and the University could become insolvent.

For example, let’s say a University had a particular subject bias towards computer science. At a point in time there is a development in the computing industry that means that computer scientists are no longer needed and they are all made redundant. That University would be faced with a liability (educational costs already incurred and borrowed against) in excess of its assets (prospective income) and it would become insolvent.

In addition, as the Universities would be providing a service in exchange for the students taking on a long term financial obligation it is hard to avoid the logical conclusion that they would become subject to regulation as financial services providers. Consequently, representations made by a University about the cost and value of its services would potentially be deemed to be part of the contract with the student with the possibility of a subsequent “mis-selling” claim in the event that the “product” did not live up to reasonable expectations.

The alternative, whereby students contract directly with investors via a financial intermediary such as a bank, has no impact on the students but has the benefit of moving the long term risk from the Universities who are not well placed to manage that risk to investors who can diversify between universities and so can easily tolerate the long term risk.

The University can remain the party that takes the risk that individual students do not have high earnings, but they will experience the consequence of that risk at the point when a given cohort of students join them and investors provide the funding for that cohort. If the amount received in relation to one year's intake is less than expected the University knows that in advance of incurring three year's worth of costs and so can adjust quickly. It can either reduce its costs or improve its programs so that investors pay more in future.

**With the consequence of a long term financial risk that would be hard to manage and the potential for regulation as financial services providers, it cannot be attractive or efficient for Universities to be the contracting party. FAIR envisages that students, as the buyers of education, should be the party that enters into a contract to pay for that education.**

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#### IMPLEMENTATION

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As there are friction costs whenever an economic system changes it is recommended that FAIR be introduced in a gradualist manner.

One approach would be for the present income contingent loan scheme to continue for the meantime but with its real value eroding over time. This will reduce the burden on the government's finances in accordance with its long term objectives while FAIR receipts provide a boost to Universities' financial positions.

The FAIR scheme will simply be a separate contractual charge that a graduate must pay in addition to their student loan obligation, in the same way that they must pay for rent, utilities etc. As the real value of the Student Loan Scheme tuition fee loan will reduce with each new intake, the rate at which the loan is paid off will accelerate. This will help with the state's financial position and will relieve graduates of those payments before higher nominal payments under FAIR which are tied to higher earnings later in their careers become payable.

In due course, when the current loan scheme has, in real terms, eroded to a much lower level, it could be abolished and the FAIR rate increased accordingly.

This approach is most suitable if a key objective is to introduce market discipline into the services Universities provide as quickly as possible. As the bulk of University tuition fee income will arise from the standard capped fee, which is funded through the government's income contingent loan scheme, it will be possible to issue FAIR assets to the market based on the students of single or small groups of Universities. Although this could result in a wide range of valuations placed on different institution's paper (the securitised asset being sold) that will serve as a powerful signal of the markets' view of a given institution (or small group).

An alternative would be to scrap the standard tuition fee altogether and set the FAIR parameters at such a level that they would be expected to provide, on average, a level of tuition fee approximately equal to or greater than, the current level. Because Universities would then

be substantially dependent on the FAIR asset proceeds, to avoid extreme outcomes that could cause financial difficulties for some institutions, it would be better to pool FAIR assets into very large groups, or for the government to guarantee that all institutions will receive funding at least equal to the present level (inflation adjusted) for a limited period, say 5 years. This would mean that those institutions that were adding sufficient value to earn more from FAIR than the current standard tuition fee rate provided for would be free to use the additional income to enhance their teaching provision and international competitiveness, while those that were adding insufficient value would have sufficient time to adjust their programmes to improve their value add and earn sufficient income for them to thrive.

This approach is most suitable if the primary objective is to reduce the burden on the government's finances. The whole of the standard tuition fee would be funded by the private sector and the government would then be free to provide additional funds to selected institutions to meet policy objectives, while able to keep the overall demand on the public purse down. However, as it would probably require FAIR assets, at least initially while data and experience are being accumulated, to be constructed from large groups of Universities, the market discipline on any given University will be less apparent and effective.

Although data on graduate income over the long term is currently sparse, it is growing rapidly as a consequence of the implementation of the income contingent loan scheme. The implication is that methods for valuing the FAIR assets income stream will improve over time. This is no different to the comparison between when a company makes an initial public offering and its future share issues. The IPO is hard to value and subject to instant market conditions, but subsequent issue values are much easier to forecast.

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#### POTENTIAL PROCEEDS

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As an example of the potential value of FAIR assets, if we assume:

1. FAIR terms of a 1% payment over 20 years
2. Starting salaries in three years time of an average of £25,000
3. Growth in average earnings to £45,000 over 20 years
4. All figures in current prices
5. A discount rate of 1.25%, as on index linked gilts

Then the present value of that stream of income is £5,600. These figures are potentially conservative as they represent current graduate incomes (rather than 3 year's time) and are medians whereas the mean is most likely higher.

Using the same figures but assuming a 2% obligation the present value is £11,200

This means that with a FAIR charge of just 1% a more than a 50% funding increase could be used to significantly improve Universities' financial positions, or a 2% charge could be used to replace

the existing standard tuition fee altogether and so eliminate the burden on the government's finances.

**The fact that a greater than 50% funding increase can be achieved with a 1% of earnings obligation creates the potential for an increase in student contributions that is considered equitable and affordable while delivering significant additional funding to Universities, or a 2% obligation could be used to eliminate tuition fees altogether.**

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#### PRECEDENTS

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There are two private sector companies which have been identified as creating useful precedents for the FAIR scheme.

CareerConcept AG, a German Company which was set up in 2002 has, as of 31.10.2009, offered equity-style (wholly income dependent) educational finance to German undergraduate students studying in 20 countries, attending over 300 Universities, generating returns of EUR 2.8 million. The financing has been raised mainly by means of closed ended funds sold to private individuals. CareerConcept agree student-specific fees as a percentage of their monthly gross income, normally between 4% and 10% over 4-8 years. Despite the fees being much higher than the FAIR examples above, they claim to have a greater demand for provision of funds than they are able to meet.

Prodigy Finance is a U.K. company, founded in 2006, which is in the business of providing funding for MBA studies. Although Prodigy offers loan based finance it offers useful legal and operational precedents. It has created a contract that is enforceable in over 100 countries, has set up a global payments network, has developed means of using social media to track graduates and maintain compliance with debt obligations and has sold pooled debt securities in the financial markets.

The current situation in the United States is a precedent that illustrates the problems that arise when Universities are free to set their own fee levels with no reference to the value of their courses in terms of future earnings power. Indeed, on July 23, the Obama Administration proposed restricting - and in extreme cases, cutting off entirely - programs whose graduates end up with the highest debts relative to their salaries and have the most trouble repaying their student loans.<sup>vi</sup> It would be unfortunate for the UK to introduce a system that did not link fees to earnings power just at the time when the US is questioning such an approach

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#### FAIRNESS

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The FAIR scheme is explicitly designed to be fair to all students by relating payment to income with a simple formula so that tuition fees are affordable for all.

In particular, it is hoped that the FAIR scheme will facilitate and encourage participation in higher education by those from less wealthy backgrounds, since their repayment obligation will be small if they are unable to achieve high earnings on graduation. It is surely "fair" that as wide a cross-section of society as possible has access to a University education.



More of the charges of “unfairness” are likely to be made in response to the fact that, under an equity style scheme, high earning graduates will pay back a larger sum of money than lower earning graduates. However, the scheme is just on the basis that the terms are known at the point of entering into the contract and they are the same for all students.

If a student is confident that they will be a very high earner but they cannot afford to pay the deregulated tuition fee it is more rational for them to attend their favoured University but to leave the country at some point to avoid high UK income tax rates, rather than to seek to avoid the FAIR obligation. Although it is true that wealthy students could avoid ever paying the FAIR obligation on future high earnings by paying the upfront tuition fee while a less well off student, in practice, does not have that option, by the time the problem becomes apparent that less well-off student is a very wealthy graduate. As they will have been a significant beneficiary of higher education being made available to those who could not afford to pay it would be hard for them to argue that paying a large sum for a life-changing and highly beneficial investment was unfair.

In any case, the present income contingent loan scheme is already unfair in that high earning graduates pay the loan in full while some low earning graduates see the loan waived, and medium income graduates pay back the highest proportion of their income.

The potential resentment felt by some high earning graduates can be addressed by recognising their payments as benefactors. It is likely that many of the high earners are competitive types and the recognition of their earnings success by comparison with their peers will be valuable compensation.

It is also the case that FAIR is not punitive towards high earners in the way that the tax system is. Although they have an obligation to pay a higher nominal amount than low earners, the percentage they pay will be the same and, as a proportion of disposable income, the proportion they pay will be lower. On the other hand, as the FAIR payment is due on gross income, the pre-tax cost to a graduate will rise with their highest tax rate, which will be considered fair by those who feel higher income earners should pay higher rates of tax. It remains reasonable from the higher income earner point of view because, were they to pay upfront for their education, that would, in any case, come out of post-tax earnings,

In the initial years of operation it is not envisaged that it would be possible to permit graduates who have signed up to the FAIR scheme, to buy themselves out of future obligations. The FAIR program operates like a private sector tax and it is not possible to buy ones way out of future tax obligations. If a graduate was keen to neutralize their future obligations with a capital payment they could, of course, buy the appropriate security in the marketplace. If their earnings are in line with the average, apart from costs, owning the FAIR asset will be a perfect hedge for their liabilities. Once FAIR has been in operation for a number of years it may be possible to allow early exits at a premium, subject to it being possible to model the consequences of so allowing in such a way that the attractiveness of the asset to investors is not materially prejudiced.

#### **NIL HURDLE REPAYMENT**

The impact of the FAIR scheme on very low earning graduates does not follow the approach of most tax systems. The X% is a flat non-varying rate payable on total earnings, not on an excess

over some figure. A graduate earning just enough to pay tax would be liable for X% on their whole income. Of course, if X is 1, that would mean a modest liability of just £100 on an income of £10,000. If the Government felt that such graduates should be relieved of the burden of paying such a fee, it would be free to bear that cost itself in the same way that it pays, for example, housing costs for low earners.

This flat, non-varying, approach is preferred because at the point of the parties (the student and the bank) entering into the contract future values of inflation are not known so appropriate hurdles at which the rate changes cannot easily be set. Also, the FAIR scheme is designed to facilitate the growth of demand for a UK university education from non-EU nationals and setting globally appropriate hurdles would be impractical.

The contract could be written so that hurdles were related to future experienced inflation. But this would mean that investor returns and graduate costs would be subject to the relationship between the measure of inflation chosen and graduate earnings growth. This adds a level of complexity which would diminish the appeal of the FAIR asset to both students and the investor community.

If hurdles were related to future income tax bands it would mean that investor returns would be subject to government whim, which would be an unacceptable risk and such securities would likely be unmarketable.

The obligation to pay under FAIR does however only trigger should the graduate have a liability for tax (income or capital gains). So if they are not working or are earning insufficient to pay tax they are relieved of any obligation. To balance this relief, investors are protected because the duration of the obligation is a set number of years that payments are made, so if a graduate is out of the labour market for a few years they merely postpone their obligation but cannot eliminate it.

The fact that avoiding earning a taxable income does not reduce the obligation to pay for a given number of years also has a positive incentive effect, discouraging intentional absence from the workplace. It is also fair between graduates who wish to take time out to bring up a family and those who do not. The obligation to pay for Y years survives that period. If Y is 20 years, given a working lifetime of approximately 40 years, there is sufficient time to bring up a family and also repay the FAIR obligation in full.

Although the effect of the life of the FAIR liability being 20 tax-paying years is that, for some, the liability will exist until retirement, in many cases that will be the individual's choice. Where, perhaps due to ill health, a delay in payment is not a free choice, a political decision could be made to compensate such unfortunates for their liability, in exactly the same way that the state pays other private sector costs, such as rent, for selected groups.

**A charge of just 1% or 2% on earnings has the potential to achieve a meaningful increase in University funding, while being unlikely to be regarded as an onerous obligation on the low paid or an unfair obligation on the highly paid.**

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**PRICING STRATEGY**

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The debate between different possible schemes by which tuition fees may be paid often hinges on the fairness or otherwise of students paying “more” or “less” than their education “cost”.

This line of argument assumes that: (i) the “cost” of providing an education can be correctly measured and (ii) that it is appropriate for education to be priced on a “cost-plus” basis.

Given that higher education is a service business with high fixed costs and low marginal costs it is questionable whether either of these assumptions hold.

The true “cost” to any business of a given customer is the incremental staff and resources it needs to provide its service to that customer. Its fixed costs are – by definition – fixed. They cannot be attributed to any given customer; they exist because without them the business would not. There is no doubt that the incremental cost to a university of any one student is very small and, furthermore, quite immeasurable at the outset as some students will require a large amount of academic and/or pastoral support and others will not.

To explain the second point, it may be useful to consider the airline business which also offers a service that faces very high fixed costs and low marginal costs. Rather than charge on a cost-plus basis airlines segment the market of potential customers according to a number of dimensions to deliver essentially the same product – getting the customer from A to B – but for a very wide range of different prices. The segmentation is designed to categorise customers according to the benefit they receive. The airline is aiming to cover its overall costs with money to spare for future investment, and to reach that objective the airline industry has established that it is most efficient to charge each customer according to the value that customer attributes to the service provided.

Nobody questions the “fairness” of customers who book at the last minute paying more than those who book in advance – with both flying economy class. It is accepted that the person who booked at the last minute simply places a higher value on being able to fly at short notice and it is their free choice to pay the greater amount rather than waiting.

**Hence the fact is that the cost of provision of a service is not an appropriate guide to a fair price – it is the benefit to the customer that is the relevant metric.**

Nevertheless, and consistent with the “freedom” policy objective of the coalition government, students should be allowed to pay an amount of money at the start of their studies as an alternative to joining the FAIR scheme. To compute the charge for being excused from participation in FAIR the Universities should base their calculations on the benefit that a student will gain from avoiding the FAIR obligation.

Let us assume that the University needs to receive £10,000 per student to cover its average costs (not the cost for an additional student) and invest for the future. The estimate of the present value of the average student’s income over the period that FAIR would be charged is £1m. If all students participated in FAIR, a charge of 1% would provide the required income. However, we estimate that 10% of students will choose to buy themselves out of FAIR by paying upfront. Based on survey data and experience of current students paying tuition fees up front

we estimate that such students are likely to be well above average earners with relevant expected earnings of £1.9m. That means that the other 90% of students must have average expected earnings of £900k. To generate the same income as when there is 100% participation in FAIR, the fee payable to avoid FAIR should be £19,000.

While the numbers above are very artificial, the example demonstrates that it is possible for the University to set the “upfront additional” alternative to FAIR at a level that accounts for the risk that future high earners may be over-represented among those students willing and able to pay the upfront additional fee, and at a level that is proportionate to the benefit that the pre-payers will get from their education.

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#### SUBJECT EFFECTS

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It may seem that the FAIR scheme would encourage Universities to focus on teaching only those subjects that result in students achieving high earnings. Clearly one intent of the scheme is to encourage the expansion of courses that add value and contraction of those that detract value, but this will not mean that all universities will just teach, say, law and medicine.

The reasons why this will not be the effect are twofold. Universities are not rewarded for the success of their graduates; that reward falls to investors who take the risk that graduates earnings may fall below expectations. In fact, Universities are rewarded according to the market’s view of the likely future success of their graduates. Investors are familiar with the laws of supply and demand. If a university that previously offered a wide range of subjects announced an intent to focus on law and medicine, for example, its FAIR issues would likely be marked down because the focus creates risk through lack of diversification – as it is not certain that what was true in the past (that lawyers and doctors were high earners) will hold in the future - and the increased supply of lawyers and doctors is likely to depress their future earnings.

Of course, some institutions, by design, specialise in a narrow range of subjects. There is nothing in FAIR that challenges their viability or that forces or obliges them to change their subject focus. However, if it were the case that the future earnings of their students did not justify their average cost per student they would need to find strategies to raise those future earnings or reduce their costs.

Secondly, the most prestigious institutions at present offer a wide range of courses. The students who attend such universities are probably looking for a broad experience and not just a narrow focus on their subject. Should a University focus on a few subjects that historically generate the highest earnings it is possible they will discourage the highest achieving students which will again have the impact of reducing the value of their FAIR assets and their income.

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#### IMPACT ON DONATIONS

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Earlier it was suggested that Universities could address the resentment that may be felt by some high earning graduates by recognising their contribution as though they were benefactors. If Universities, for example, provided different levels of recognition to the top 10%, 1% and 0.1%

of payers it is not unimaginable that some graduates will overpay in order to be recognised among a higher earning group.

Indeed, many Universities already recognise benefactors in this way, so the principle is already accepted and operational. Assuming the repayments under the scheme do not continue too late into a working life it is possible that there will be no detrimental impact on gifted donations as they will typically be made later in a working life. It is also possible the number of benefactors will increase as graduates will acquire the habit of putting money aside for their University and will have seen the recognition benefits of so doing.

A prominent American financier commented that the FAIR Scheme was, in effect, aiming to create, by compulsion, the American model where higher earning graduates are voluntary benefactors. This may be a better way to present the high payments by higher earners than as them paying more than their education cost – they are giving back in recognition of the benefit they gained, as is common in America. Longer term it is to be hoped that habit learned by compulsion will continue voluntarily and tuition costs will be able to fall as endowments grow.

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#### FAIR VS GRADUATE TAX

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The idea that graduates should pay X% of their income for Y years is, in principle, a graduate tax. However, there are important differences when the transaction is a private contract between parties freely entering into the contract of their own choice as opposed to a government levied tax. The consequence of a private arrangement is that it has many positive and essential characteristics which a graduate tax is unable to offer:

1. The terms of a private contract are known by the student at the point of entering into the contract and cannot be varied unilaterally by the lender.
  - a. In contrast, there can be no confidence that a tax will stay at a given level. Parliamentary sovereignty means that one Government cannot tie the hands of a future Government. The implication is that, with a graduate tax, a student is exposing themselves to an uncertain future obligation, which will discourage participation.
2. The value of the contract can accrue directly to the University that the student attends.
  - a. A graduate tax system leaves Universities subject to government whim about the level and distribution of funding.
3. As the present value of the University's receipts on the FAIR assets are tied to market expectations of that University's graduates' future earnings, there is direct alignment between the University's revenues and the economic benefit that students gain from attendance.
  - a. With a graduate tax the University's revenue is not directly related to the value it adds to its students careers.
4. A private contract will be enforceable in most jurisdictions.

- a. A UK tax will garner little revenue from non-UK students and will create an incentive for graduates to leave the UK, reducing the government's graduate and normal tax receipts.
5. As FAIR assets will be tradable a graduate can hedge their future liabilities by purchasing FAIR assets in proportion to the multiple of their expected income relative to the average, adjusted for tax.
  - a. It is not possible to hedge or otherwise avoid future tax obligations.
6. FAIR creates a new supply of private investment flows into the higher education sector, reducing the level of government funding required.
  - a. A graduate tax worsens the government's financial position in the short term, and it faces the risk that the long term take from the tax may not compensate it for the initial costs.
7. The FAIR contract can be made optional, with the alternative to pay an "upfront additional" tuition fee directly, consistent with the political objective of "freedom".
  - a. It is hard to see how it would be politically feasible to allow certain graduates to buy their way out of a future tax liability, making a graduate tax inconsistent with "freedom".
8. The FAIR system would itself represent exportable expertise which could generate foreign earnings.
  - a. A graduate tax would not create any marketable expertise.

**Consequently, FAIR has the positive attributes of a graduate tax, matching graduate payments to the benefit gained from education, while eliminating the arbitrariness that flows from government involvement. From the government's point of view, FAIR also means the financing of higher education has the potential to move off its balance sheet altogether.**

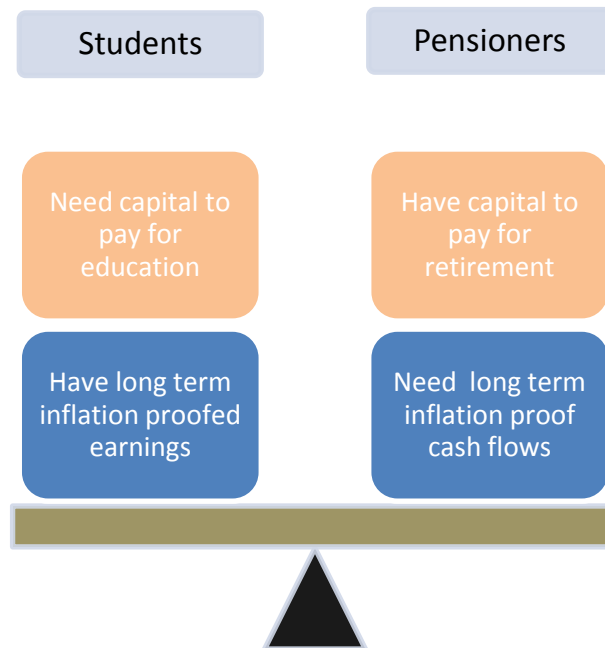
In response to the suggestion that a Graduate Tax is "unfair" because there is no cap on what a high earner might pay, some proposals suggest that "repayments" under a Graduate Tax should be capped. Such a scheme has the same effect as an Income Contingent Debt scheme (see Chart 3, above) in terms of creating some point in the middle income spectrum where the proportion of income demanded for repayment is at its highest. Given that the exact level of income at which the impact will be greatest is highly arbitrary, it is hard to see how a Capped Graduate Tax scheme can meet a "fairness" test. In addition, such a scheme is less economically efficient since it sacrifices revenue from those most able to pay.

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#### INVESTMENT DEMAND

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At the point of applying for University students are cash poor but have the potential for many years of strong inflation proof cash flows (earnings). At the point of retirement pensioners (excluding those who rely wholly on the state) are cash rich but in need of many years of inflation proof cash flows. Their positions offset each other perfectly and a market that facilitates transactions between the two parties should be economically efficient. This is illustrated in the diagram below:



Pensioners, either as individuals or in the form of pension funds or insurance companies, typically seek to meet their long term inflation proof income needs with a balance of debt investments to provide high levels of nominal cash flow and equities for long term growth to provide protection against inflation. However, the poor long term performance of equities over the last decade has driven strong demand for inflation proof cash generating assets, such as index-linked gilts.

Assuming GDP per head growth continues earnings growth will exceed inflation; in which case an asset that generates reliable cash flows that grow with earnings should see significant demand from pension investors. Index linked gilts currently yield around 1.25% and FAIR assets could conceivably be traded at even lower yields given the repayments would be indexed to earnings rather than inflation.

Preliminary discussions with a number of financial intermediaries suggest a range of sources of demand for FAIR assets.

Pension funds, both in the UK and abroad, especially public or quasi-public sector schemes, were identified as a key source of demand. It was suggested that investing in FAIR assets would help pension funds to satisfy their "Socially Responsible Investing" obligations. For such schemes a total issuance of around £5bn of FAIR issues – assuming half a million students at approximately £10,000 per student - would be easily absorbed.

Mutual funds seeking to generate low risk high income returns, typically for pension related investors, would benefit from a new asset class that offered stable cash flows relatively uncorrelated to equity or bond market prices. A mutual fund could be offered by National Savings, possibly tied to the earnings of all students, so creating a national public scheme for intergenerational capital & income transfers.

University endowment plans currently invest in debt securities which are a poorer match for their salary linked liabilities than FAIR assets on which the returns would grow with the earnings of cohorts of graduates. A given University's plan could choose to buy FAIR assets tied to the earnings of its own graduates to benefit from its success or it could reduce its risk by diversifying across the Universities sector as a whole.

Alumni at or close to retirement could well be an enthusiastic purchaser of a given University's FAIR assets. The positive association many alumni have with their University will raise the valuation of the FAIR assets.

The government could support selected institutions by purchasing their FAIR asset issues, using the assets as a hedge against its own pension liabilities.

The fact that FAIR assets will be pooled and securitised is not expected to have an impact on demand for them. Securitisation remains an attractive investment proposition so long as the underlying assets are of good quality and their nature transparent.

Finally, while FAIR assets, in effect "human equity", would generally be considered a wholly new asset class in current financial practice, they are not without precedent as CareerConcept is lending to students on an equity basis and financing itself in the market. The CareerConcept scheme is different in that, as it is not government ordained, it offers terms that differ by student, but its growing success supports the contention that there would be substantial investor demand for this new asset class.

The valuation of FAIR assets, in the first instance, has some similarity to the valuation of an equity investment in a new company, which is familiar territory for many investors. In the same way that new valuation approaches get developed for new business models (e.g. dot.com, green energy, bio-tech), so new analytical techniques will need to be developed in relation to FAIR assets for a wide universe of investors to be comfortable with their return characteristics and valuation. Taking a big picture view, for all graduates in one year, UK GNP should be a good proxy for their aggregate earnings. Consequently, simulations of possible UK GNP outcomes over 20 year time periods should be the basis for valuing FAIR assets as a whole. As mean GNP growth is high relative to the volatility of GNP around the mean (in booms and recessions) the expected returns to FAIR assets, in aggregate, should be quite stable. This means that a straightforward discounted cash flow methodology, less an adjustment for administration cost and defaults, should be a good estimate of how the market would price FAIR assets.

**FAIR assets, generating earnings linked cash-flows, should be very attractive to pension investors seeking inflation proof income, subject to overcoming the lack of general precedent for this new asset class.**

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#### REGULATION

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As a private sector scheme whereby students take on an obligation to make long term monetary payments it is likely that FAIR would ordinarily be subject to financial services regulation. To reduce the costs and risks associated with a regulated environment it is envisaged that the contractual form of the agreement underpinning FAIR would be mandated by a state or quasi-state body. As there is no underlying asset over which security may be taken it is important to



the value of the FAIR asset that graduates cannot in due course argue that they did not understand the terms of the transaction and seek to avoid fulfilling their part of the bargain.

A government approved, standardized, contract should mean that investors have an implicit government guarantee that the contracts will be enforceable. Banks would have a duty of care to investors to use reasonable efforts to collect payments, but would be immune to claims that the contract had been mis-sold. Students would also be protected from banks creating unfair terms – the banks are here simply in the role of administrators of a government approved scheme.

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#### EXPORT POTENTIAL

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It is recognised that higher education is a significant export earner for the United Kingdom and is an economic sector in which this country has a comparative advantage. It is also the case that the global demand for higher education is growing, while globalisation is encouraging more students to study abroad.

Rational students will compare the cost of a foreign education with the boost it will give to their likely future earnings. If the UK operates a scheme whereby the risk that their future earnings may not meet their expectations is shared with investors it will lower the effective cost of a UK education and should lead to an expansion in the non-EU demand for higher education in the UK.

As non-EU students do not have access to the UK government's loan scheme and as the fees they pay are unregulated, it is suggested that the FAIR scheme for non-EU students should operate with higher values of X and Y, and Universities would be free to create pools of non-EU FAIR assets separate to the EU FAIR assets. The greater the sum that can be generated from the FAIR assets the lower the fixed fee that would need to be charged and the greater the market opportunity.

There is a long tradition of Indian students attending British Universities and currently there are 34,000 Indians attending courses, an all time high. Non-EU FAIR assets could, for example, be pooled by nationality so creating an asset that should be attractive to pension funds in that country.

FAIR assets will represent an investment in human capital and could be considered human equity. They represent a wholly new asset class. Just as the UK invented the process of Privatisation in the 1980's and then was able to sell that expertise to the world, being the first to place a marketable value on human capital and developing the associated expertise will also be a marketable skill, supporting the continued leadership of the UK's financial services sector.

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#### POLITICS

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For the coalition government to accept any new funding proposal it should be consistent with its stated principles of: "freedom, fairness and responsibility". It is also important to be cognisant of the Liberal Democrats' longstanding opposition to tuition fees in any form, though this may be tempered by budget realities.

The FAIR scheme is consistent with freedom. On the one hand FAIR will make higher education less financially intimidating for students who are less confident of their future earnings potential, typically those from lower income backgrounds. Therefore FAIR extends the freedom to choose advancement through higher education to a wider section of society.

On the other hand, students who are confident of their (high) future earnings potential and who have the means, are free to opt out of FAIR by paying the alternative deregulated tuition fee.

Fairness has been discussed above and, while there are some issues in relation to the FAIR repayments being due on total gross earnings, it must surely be the case that a flat rate across the board is easier to defend as equitable than a variable rate or variable fixed fees. Although tuition fees will rise under this plan and they will be variable, the fact that they are avoidable using a scheme that charges the same rate across all students should ensure that the whole arrangement is politically tenable.

FAIR is consistent with responsibility since students will be taking on a private contract from which they expect to benefit but for which they must, in due course, pay.

All loan based schemes are strongly objected to by the national student body. FAIR should address the students' legitimate concerns about taking on high levels of debt while, as a private sector scheme, addressing most of the Universities' justified concerns about a graduate tax.

Some commentators have expressed the view that there may be political implications of the potential for significant over-payment by wealthier graduates. This relies on the flawed "cost-plus" basis of pricing education and, in any case, the present perception will be that the most extreme earnings are likely to be made by high bonus earners in Banks and Hedge Funds. There is every likelihood that a greater burden on that community will be seen as a political positive.

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#### ADVERSE SELECTION & FEE INCOME STABILITY

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When setting the fee that a student can pay as an alternative to taking on a FAIR obligation, given that the value of the pooled FAIR assets will not be known by the University at the time of advertising the cost of a course, it is possible that it will make a charge for a course (in substitute for FAIR) that is less or more than the FAIR proceeds. However, there must be considerable uncertainty in determining the true marginal cost of a student studying for a given course in any case, so the University should have considerable flexibility in setting fee levels which can take account of the uncertainties.

This option to avoid the FAIR obligation creates the risk that all the future high earners will pay for their courses up front and the returns to the FAIR assets will be lower than expected. That assumes, of course, that there is a sizeable body of students who can afford to make a larger initial contribution for their education, who believe that they will be high earners, and who subsequently turn out to be so.

As data on student behavior and investor valuations of FAIR assets accumulates it should be possible to set the alternative fee option at a level that ensures sufficient returns to the University and investors.

Even if it were the case that all of the future high earners chose to pay for their tuition fees upfront the system still achieves the desired objectives if the deregulated tuition fees are set at such a level that the income from them plus the FAIR income meets the University's funding requirement. In any case, the risk that all the future high earners are the ones who have paid upfront is a risk that is taken by investors not by the University. The FAIR proceeds will only be impacted to the extent that investors believe that the future high earners are absent from a given pool.

With the FAIR system Universities know their receipts for a year intake at the beginning of study and can adjust fee levels for following intake years to take account of deviations from target levels. Once able to set fees, either directly or indirectly through FAIR, Universities will be in the same position as any other commercial enterprise – sales and income will not always be in line with targets. The only way to achieve security of income is with a wholly government funded scheme and, while this is secure, it is likely to be inadequate to maintain the long-term competitiveness of the UK Higher Education sector, especially at a time of fiscal stringency.

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#### ALIGNMENT OF INTERESTS

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While a University education yields benefits for the individual that go beyond the purely economic it is difficult to design a scheme that will fairly capture those non-economic gains because they will vary between students in an unmeasurable way. Consequently, when considering the alignment of interests between students and universities it is necessary to focus on the purely economic.

Even that is problematic as the true economic gain to a student is their lifetime earnings as a graduate less their lifetime earnings had they not attended university, which cannot be known. However, their actual lifetime earnings should be a good proxy for this gain and a fee based on earnings therefore proportionate to the benefit gained.

With the FAIR assets being sold to investors with each new intake of undergraduates a given University (or group of universities should they choose to pool their students' FAIR contracts) will receive an income that is based on investors' views as to the present value of a stream of earnings related income from graduates of that university.

Not only will investors take account of the past history of earnings for graduates of that university, but they will also take account of the University's current plans and actions to make both new students and past graduates more financially successful. Since, in our example, FAIR assets have a life of 20 years, the University will therefore have an interest in the earnings of its students for 20 years after they graduate. To the extent that the University can help those graduates onto a higher earnings path, perhaps with refresher courses or careers advice, it will be reflected in investors' valuation models of new FAIR issues by that University and hence current receipts by that University.

This is exactly as is the case with companies seeking investor capital. The rating (e.g. the Price:Earnings ratio) assigned to a company's equity will be a function of its past record of achieving investment returns and the convincingness of its current plans for achieving future success. In the current age where intellectual capital is becoming increasingly important as the key source of growth and competitive advantage, it is appropriate that universities, as

“manufacturers” of intellectual capital, should be able to finance themselves in a manner analogous to that successfully used by conventional manufacturers.

Since FAIR receipts become a function of a University’s past success in adding economic value and its future plans there is a direct alignment between the economic interests of students and the University that they attend. This economic alignment is likely to be a far more powerful means of driving up standards and efficiency than targeted measures which may not align with students actual and ever changing needs, both while at and post University.

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#### COMPETITION BETWEEN UNIVERSITIES AND VARIABLE FEES

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The second Russell Group submission to the Browne Review suggested that it desired competition between Universities. The FAIR system allows such competition but offers students a flat charging scheme across all subjects and universities. Allowing explicit price competition without a common rate choice could be considered elitist and would have a number of adverse consequences.

FAIR would support “needs blind” admissions policies because the student’s present financial situation is irrelevant to the cost or benefit to the University of admitting that applicant. The incentive under FAIR is for the University to focus on students that are likely to be successful in the future, which potential will, in many cases, be inversely correlated with family wealth.

Allowing competition in tuition fees could severely damage the standing of the more prestigious and higher charging Universities. Talented students from less confident backgrounds will be more likely to prefer the lower tuition fees of less prestigious Universities than less talented students from wealthier backgrounds. Higher charging Universities would therefore suffer from a bias in their applications towards the less talented wealthy which would have a negative effect on the quality of the graduate output, in due course damaging their reputation. In the United States this is addressed by a comprehensive range of scholarships being made available to the talented students from less confident backgrounds. In the absence of such scholarships a scheme of high and variable tuition fees is problematic.

Instead of exclusively competing on price, FAIR encourages competition on value added. The fact that success in adding value will raise the “price” (in terms of FAIR receipts) received by the University means that price competition is delivered, but in a way which is equitable between students.

There are other problems with explicitly variable charges. There will be times when the costs of providing a given course are large relative to the expected earnings from graduates who read that subject. Whether such students are charged a fixed loan amount or equity based fee percentage, the payments will be prohibitively expensive. Setting a flat fee across all subjects should not be considered a cross-subsidy as that would only be true if the future earnings of all graduates, 20 years into the future, were known.

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### “FAILING” INSTITUTIONS

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A number of Universities currently have high drop-out rates and they are considered by some to be “failing” and deserving of closure. However, high drop-out rates, from the point of view of the neutral observer, are not necessarily evidence of failure. This is because the current economic incentives structure dictates that Universities should seek to maximise the number of students *accepting places* at the institution, as opposed to the number *completing courses*, as that is how they are paid.

By analogy with the convicts example in the Economic Incentives section above, the incentive structure needs to change to reward Universities for the number of students completing courses (delivered alive) rather than for the number accepting places (shipped aboard). Although it is private investors, under FAIR, that take the risk that students may not complete courses and may have minimal earnings, to the extent that investors believe that a larger than average number of students at a given institution will not complete their course, they will reduce the amount of money they will pay for FAIR issues by that institution. Hence, Universities are incentivised to help students to complete their courses and it is probable that this shift in incentives will lead to a change in behavior by the Universities that some consider to be “failing” such that they justify their existence. This will avoid contraction of the higher education sector at a time when intellectual and human capital continues to grow in importance in the modern economy.

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### EXTERNALITIES

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The second Russell Group submission to the Browne Review points out that there are many positive externalities offered both to students and society as a whole beyond the potential for improved earnings. As explained above, such externalities cannot readily be captured by a free market price mechanism.

However, it is notable that the earnings of Russell Group graduates exceed those of graduates of the Modern Universities, given that the latter probably provide more career oriented education. This indicates that a system that compensates Universities for the value they add in terms of graduates future earnings does not require a focus on technical or career specific courses. Indeed, many of the highest earning graduates now successful in the financial community will have studied arts subjects at University, demonstrating that the relationship between degree subject and earnings is obscure and that the totality of the University experience is often more important than the subject matter of the degree.

Of course, this may not be due to value added, but may instead be that students of Russell Group Universities were always destined to earn more than students attending Modern Universities given the higher A-level standards required (on average) to gain entry to a Russell Group University. If that is the case it means that students themselves are placing a higher value on a more academic education, or on other aspects of the service provided by top Universities, than could be attributed to the pure economic gain, meaning that under FAIR Universities will be compensated for providing an overall experience that attracts high achieving students.

To the extent that the FAIR system will not capture for specific Universities the full value of the positive externalities they generate it will be necessary for them to seek compensation where appropriate. If the externalities benefit companies, through R&D support, for example, they must seek to recover the benefits from companies. To the extent that Universities generate non-monetary benefits to the country as a whole, they must seek recompense from the state.

The purpose of FAIR is to materially increase the income to Universities in the short term while reducing the burden on Government finances so at least there is a possibility that the government will be financially capable of considering arguments in favour of funding the non-economic benefits supplied by Universities. If, for example, the government wishes to encourage provision of particular courses that, under the FAIR system, the market places a low value on, it should subsidise such courses directly.

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#### ADMINISTRATION

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As small amounts of money must be collected from, ultimately, millions of graduates, many overseas, it is essential that the collections system is highly efficient.

While it is envisaged that banks would be responsible for collecting payments the model is probably closer to how utilities currently operate. They set a standard monthly charge and review consumption on an annual basis, changing future payments to take account of current consumption and adjusting for prior over or under payment. Under the FAIR scheme simply replace consumption with gross income. Graduates would declare their estimated income at the beginning of a year and their actual income at the end and the bank would make a monthly deduction from their account accordingly. As “collection” would be by means of a direct debit, collection costs should be low.

As with the tax system a statistical model would highlight possible cases of mis-reporting which would then be investigated, with penalties should mis-reporting be established. When a graduate is seeking additional credit – for example for a car or house purchase – they will need to disclose their income with an incentive to maximise it, highlighting any conflict with their FAIR declaration. Career-Concept has data on expected salaries by occupation which helps to identify exceptions. Legally it should be possible to oblige graduates to disclose their aggregate gross income, as disclosed on their employer’s statement or personal tax return, on demand, subject to confidentiality. Default is less likely in an equity based scheme because the liability is always proportional to the ability to pay.

Although the obligations would not be backed by any physical security, neither are credit card obligations where the loan limits are also proportionate to income. The 2008 Credit Crunch, where the banks took significant losses on loans backed by physical property in the form of real estate, demonstrated that physical security does not prevent large losses on default. As the payment obligation is a small fraction of income and as even bankruptcy would not extinguish a FAIR obligation, since a new obligation arises each year that income is earned, so long as collection costs can be minimised, default losses on FAIR should be small.

The UK’s Student Loans Company would not be involved in the collection process as this is a private sector scheme with a global audience of students and graduates. Banks have experience

of pooling mortgage payments and attributing them to particular securitised assets and it is this expertise that is required.

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#### MAINTENANCE

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The FAIR scheme is not designed to help with maintenance costs as they are not necessarily payable to the University and the student can mitigate these costs through lifestyle choices – living at home, quality of accommodation etc.

In addition, there is no logic to tying a payment based on future earnings to accommodation and living costs as there is no reason to expect higher standards of these to lead to higher future earnings. It could even be argued that more luxurious accommodation and spare cash for non-essentials might reduce the students' focus on their studies which would be expected to reduce their future earnings.

Living costs and expenditures are readily assessable by the student – they do not have the characteristic of an uncertain outcome that tuition has. A bigger room with ensuite bathroom will deliver more space and convenience. There is no uncertainty and no basis for an equity based means of paying for such things.

However, looking at the current UK scheme, it is odd that the requirement to repay a maintenance loan is a function of parental income rather than graduate income. That means that a high earning graduate from a poor background gets their maintenance for free, while a low earning graduate from a less well off, but above the grant threshold level household, faces the full burden of repayment.

It would seem fairer and more efficient to give the same maintenance loan or grant or mix of both to all students regardless of background, but make the loan repayment income contingent. This could then be administered in the private sector (so as to have contracts that are enforceable when graduates move abroad) with the government covering the costs of default by low earners.

The banks are keen to have graduates as customers and currently offer subsidised overdraft facilities to entice them. It could be made a condition of their participation in FAIR that they offer overdrafts up to a regulated amount, sufficient to pay basic maintenance costs, to any student that applies. Repayment would attract a regulated rate of interest but be income contingent, with the Government guaranteeing a minimum rate of return to the banks. The banks would then have an incentive to run the scheme efficiently, but would be protected from the risks flowing from the social objective of making funds available to all.

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#### CONCLUSION

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Loan based schemes cannot overcome the reality that for many students the cost of their education will exceed the economic benefit they gain from it. If the state is not willing to pay for the social benefits resulting from the extension of higher education opportunities to such

students, loan based schemes will discourage many students, lead others into penury, while creating losses for lenders. The students' representatives recognise the burden placed on students by fixed loan commitments, adding to the political difficulties of promoting loan based schemes.

As implied by Willetts in his June speech, Universities have just two options, either to find a way of offering education much less expensively, possibly by distance learning or shorter courses, or to be innovative.

Distance learning or shorter courses would be hard to implement quickly and would change the whole character of the English University experience.

The FAIR scheme, on the other hand, satisfies the main objectives of the key stakeholders:

- 1) Universities
  - a) Increase in autonomy
  - b) Receive differential fee income
  - c) Export growth opportunity
- 2) Students
  - a) No fixed obligation debt
  - b) Equal terms for all students
  - c) Aligns universities' and students' economic interests
- 3) Financial sector
  - a) New asset class attractive to pensioners
  - b) Opportunity to export the concept to other countries
- 4) Government
  - a) Retains overall control of fee system
  - b) Moves cost of tuition fees off public sector balance sheet

The author therefore recommends that UK Universities and the UK body politic be bold and innovative and work to develop the world's first effective market in human equity.



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## Appendix 1

### NUS requirements

The 'five tests':

1. End the market in course or university prices- it puts students off

There should be no 'sticker price' variation between institutions or courses, and direct price variation should be actively barred within the system. This ensures that students choose courses for the right reasons and ensures equality of opportunity at the point of use.

2. Ensure that graduates on low pay don't pay; and set a maximum for high earners

There should be a lower threshold of earnings below which no payments are collected, balanced by an overall, single maximum amount that any person can pay in total. This ensures fair and proportionate treatment for both low and high earning graduates.

3. Only charge students a percentage of their earnings for a fixed period, it's progressive

Payment should be made at a fixed percentage of earnings above a threshold for a fixed period. This ensures simplicity for users and also ensures that graduates with sustained high earnings pay the most overall, while those with sustained low earnings pay very little.

4. Don't given the money to the state, ringfence it in a trust

Money collected should flow into a trust or other body that is controlled by the higher education sector, which is legally independent of government and accountable to Parliament.

The trust or other body should itself determine the rules for distributing its funds to institutions. This ensures hypothecation of resources to the higher education sector at a high level and ensures that overall control and shared responsibility lies within the sector.

5. Issue bonds to ensure that universities get the cash they need now

The trust or other body should be empowered to issue bonds on the market, or to other investors, set against future revenues.

It should be empowered to operate an 'opt-out' scheme whereby the graduate contribution is waived where a student agrees to pay the 'maximum' amount to the trust in advance.

These devices allow the money from graduate contributions to be 'brought forward', mitigating the risk of a gap in resources for institutions.

## Appendix 2

### NUS 6 myths about graduate tax

1. Most graduates would pay much more than they do now

This is nonsense. In the NUS proposal, earners in the lowest quintile would overall pay less than £500, those in the next quintile about half than now, and those in the middle quintile roughly the same as now, it's only those who really benefit that would pay more.

A graduate tax has also been described as "the student loan you never pay off". This is also nonsense- in the NUS model there's a 25 year limit and an overall maximum amount to ensure fairness.

2. The money would go to the state

People would be right to worry about the money going to the Treasury, but that doesn't mean the only other option is fees going to individual universities.

In the NUS model, money collected would flow into a trust controlled by the higher education sector, which is legally independent of government and accountable to Parliament.

This ensures hypothecation of resources to the higher education sector at a high level and ensures that overall control and shared responsibility lies within the sector.

3. Don't we already have a form of graduate tax?

It's true that the current system of fees and loans is paid back by graduates through the tax system, but "rebranding" the flawed system won't fool anyone.

The problems of a market in prices and prestige would remain- and as Vince says, "it can't be fair that a teacher or care worker or research scientist is expected to pay the same graduate contribution as a top commercial lawyer or surgeon or City analyst whose graduate premium is so much bigger".

4. It would starve universities of the money they need now because the returns come in down the line

Vince Cable described this problem as "soluble". He's right. In our model the Higher Education trust would be empowered to issue bonds on the market, or to other investors, set against future revenues.

It would also be empowered to operate an 'opt-out' scheme whereby the graduate contribution is waived where a student agrees to pay the 'maximum' amount to the trust in advance.

These devices allow the money from graduate contributions to be 'brought forward', mitigating the risk of a gap in resources for institutions.

5. This is a huge threat to university autonomy who should receive the fees or contributions from their own graduates

We prize academic freedom and autonomy in the UK, but to conflate these concepts with the student contribution system is dangerous and disingenuous.

NUS wants to see a system where research is properly funded and excellence recognised, but that won't be delivered through a market in prestige where the rich institutions get richer and vice versa.

6. A pure market in fees will make Universities more efficient and drive down prices

There is no evidence from any other country that a market in Higher Education would work this way- and in fact most other countries' evidence points to the opposite. The average annual tuition fee at a private university in the US currently stands at \$26,273. That's just tuition- before we add in books, living expenses etc.

There is also no evidence at all that the "market" improves quality or that there is any link between the quality of teaching and the price paid. For a detailed look at the role of the "market" in HE, see here.

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<sup>i</sup> IHS Global Insight survey, published FT June 20, 2010

<sup>ii</sup> Russell Group Papers – Issue 2, 2010

<sup>iii</sup> [http://news.bbc.co.uk/2/hi/uk\\_news/education/10278662.stm](http://news.bbc.co.uk/2/hi/uk_news/education/10278662.stm)

<sup>iv</sup> Ideally this would be written by the Bank of England and approved by the Consumer Protection arm of the FSA with the aim of avoiding future legal challenge in any jurisdiction

<sup>v</sup> Prodigy Finance run an MBA funding program and have developed a legal agreement which is enforceable in 100 countries.

<sup>vi</sup> Reported on Bloomberg by John Hechinger, August 6 2010