tutor2u™

Supporting Teachers: Inspiring Students

Economics Revision Focus: 2004

A2 Economics

Market Failure and Government Intervention – Tuition Fees Debate

tutor2u™(www.tutor2u.net) is the leading free online resource for Economics, Business Studies, ICT and Politics.

Don't forget to visit our discussion boards too as part of your Economics revision.

A2 Economics Market Failure and Government Intervention – Tuition Fees debate

A2 Syllabus Requirements: Candidates will be expected to extend and develop the models of market failure introduced at AS level and also assess the consequences of the variety of government policies that are used to deal with market failure. These policies should include extending property rights. Education can be used as an example of government intervention

Graduates derive substantial benefits from having gained a degree. Given these benefits to an individual … the government has decided that it is fair to allow universities, if they so determine, to ask students to make an increased contribution.

Department for Education and Skills, 2003

Labour's university tuition fees are a tax on learning … leaving young people with huge debts when they start work. … The Conservatives are promising to abolish university tuition fees.

Conservative Party News, 2003

What is market failure?

Market failure occurs when markets operating without government intervention, **fail to deliver an efficient or optimal allocation of resources** - Therefore - economic and social welfare may not be maximised – leading to a loss of allocative and productive efficiency (i.e. welfare losses for society).

Externalities

Market failure exists when the outcome of markets is not efficient from the point of view of the economy. This is usually because the benefits that the market confers on individuals or firms carrying out a particular activity diverge from the benefits to society as a whole (i.e. there are **externalities** not taken into account within the market). This is particularly relevant to the concept of education as a **merit good**

The idea of **positive educational externalities** is that the benefits of individually acquired education may not be restricted to the individual but might spill over to others as well, meaning that there will be **macroeconomic advantages** from a higher level of education spending and attainment.

For example, there is compelling evidence that **human capital i**ncreases **productivity** and thereby increases an economy's **trend rate of growth** and **international competitiveness.** Education is found to yield additional indirect benefits to growth for example by stimulating physical capital investments and **technological development** and adoption across many different industries (creating the potential for gains in **dynamic efficiency**)

The free **"spill-over effects"** of improved educational provision can be said to take education away from being purely as a **merit good** and more towards meeting the characteristics of a **public good.**

The **social returns** to increasing the average length of time that people spend in education depend in part on the stage of economic development – recent studies suggest that an expansion of tertiary/higher education is the most important for growth in OECD countries such as the UK.

Imperfect information

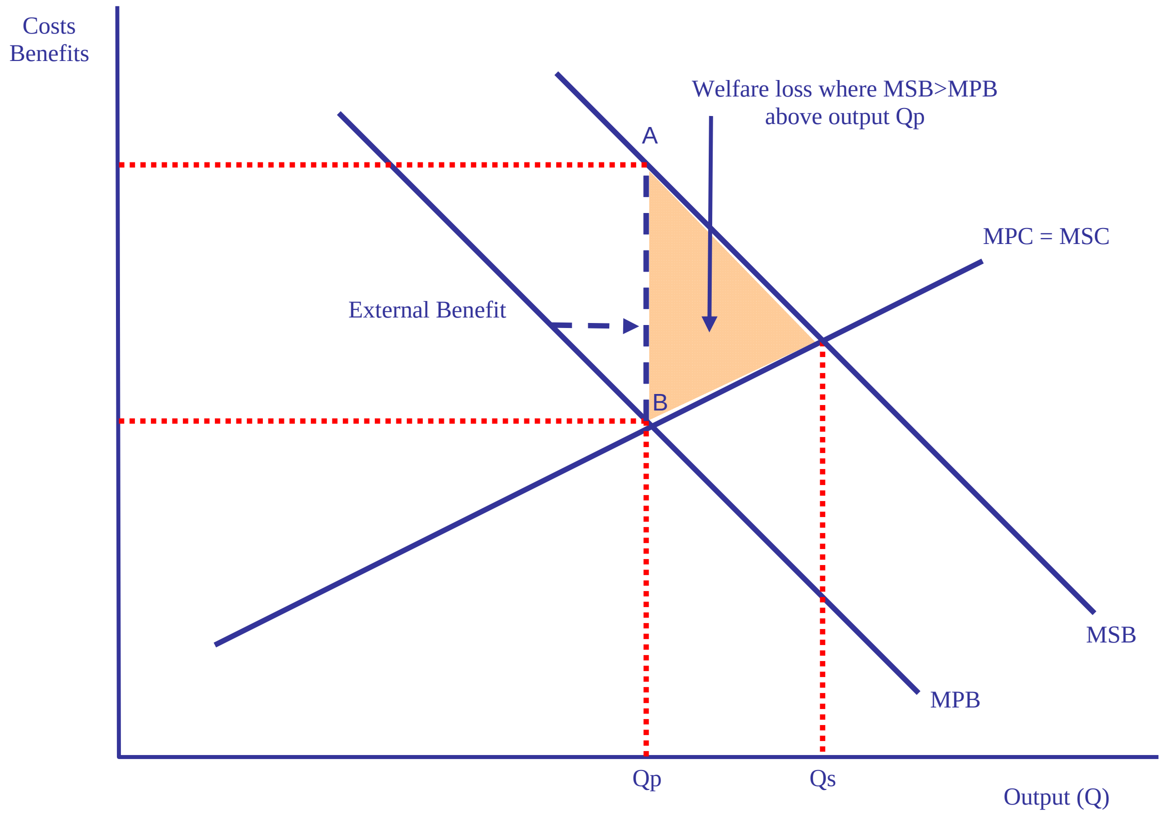
Markets can also fail when the individual or firm does not have **sufficient information** to recognise the **future returns** from undertaking an action – again this is relevant to decisions that individuals take as to how much education they should "consume" or "purchase" at different stages of their life. Many young people are **myopic** when making university/degree decisions. Or they may be **averse to taking on debts** even though it might be in their long-term financial interest to do so. In this case, there might be an economic case for the government to adopt a **"paternalistic"** view on what is best or for younger people.

Equity is important

Markets can generate what is perceived to be an **'unacceptable' distribution of income** and too high a level of **social exclusion** where people on low incomes are denied access to essential goods and opportunities considered 'normal' by a society. Education comes into this category – not least on the issue of whether students should make a financial contribution to the cost of their own tuition when they are in higher education.

Merit Goods and Market Failure

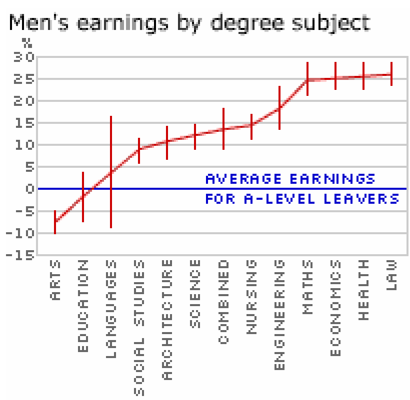
A merit good is a product that the government believes **consumers undervalue** and **under-consume** because of **imperfect information.** A merit good is deemed to be 'socially desirable' and also 'better' for a consumer than the consumer realises – a value judgement is involved whenever we talk of merit goods.



- How can a monetary value be placed on the additional social value of education overlooked by consumers suffering from information failure? Is it simply the present value of higher income?
- How can the value to society of a well educated and more skilled and productive work force be estimated both in the short term and the long run?

Private and Social Benefits of Education

Private Benefits of Education	Social Benefits of Education
Fun and enjoyment of learning (personal satisfaction and fulfilment)	More literate and intelligent society – lower crime rates?
Accumulation of human capital (qualifications and experience) that will reduce the risk of unemployment and allow people to hurdle over entry barriers to certain occupations	Contributes to international competitiveness of economy – importance of high-knowledge sectors in international trade continues to grow – expansion of scientific research etc
Higher expected earnings in work – a university degree is a signalling mechanism for employers – e.g. in promoting fast-track promotion	Higher tax revenues in the long run – can be used to fund other socially beneficial government spending programmes
Blundell (2000) estimated that the average return to completion of a first degree for a cohort of 33-year-olds in 1991 was around 17% for men and 37% for women compared with people with A levels as their highest qualification	Social benefits from having more doctors and teachers and scientists – increased provision of public and merit goods



Source: Univ of Warwick

Improvements in the occupational mobility of labour – lower structural unemployment – contributes to lower natural rate and higher productivity

Education and Social Benefits

Social benefits refer to the **total benefit to society** from a good i.e. the benefit to individuals and any beneficial unintended spill-over effects on third parties. Social benefits are found by adding together the private and external benefits of a given economic activity

Private Benefits	+	External benefits	=	Social Benefits
Benefits to individual consumers or firms of their economic activity		Benefits to others of individual consumers or firms economic activity		Total benefits to society of a given economic activity
Benefits to first parties - individuals		**Benefits to third parties - others**		**Total benefits to society – everyone**

There is **no such thing as a free lunch.** Higher education involves costs – the main issue is really how best it should be funded. Clearly there are many normative judgements involved – but we should also try to bring economic arguments into the discussion. A recent research piece by the Institute for Fiscal Studies made the situation clear:

It is important to be clear that higher education is never free, whether the costs are met upfront by students, later in life by graduates or in an ongoing way by taxpayers in general. Altering the system of HE finance changes the incidence and the timing of payments but does not change the fact that the cost of university education must be paid for in one way or another.

Adapted from www.ifs.org.uk

Summary of some of the arguments on tuition fees

Arguments for introducing tuition fees	Arguments against tuition fees
The "benefit-pay-principle" A university education is a valuable and expensive privilege. Why should something that is so rewarding and costly be free? It is **equitable** for students to make a financial contribution to their degree teaching – they stand to gain financially from a degree – education is an investment and it is rational for students to borrow at this stage of their life-cycle to finance such investment. It is rational to forgo current earnings in return for higher future earnings **Extra funding for facilities, teaching & research** Tuition fees will provide extra finance that will allow the government to fund an expansion of the number of students able to enter higher education – **promoting wider access to HE** - New entrants into universities under the new scheme may be drawn mainly from lower-income households.	**A tax on learning? Equity issues** Only 7% of children from families in the lowest social class currently go to university – tuition fees will make it harder for relatively poor families to fund a degree. This will widen **educational inequality** and create a further **widening of the two-tier education system** Top up tuition fees or a graduate tax will raise extra revenue – but they are **not an alternative for a higher level of government funding** designed to increase education spending as a share of GDP **Student debt – may deter poorer students** Tuition fees will lead to a huge **surge in student debt** and hardship which in turn will have negative economic and social consequences in the long run **Means-testing is costly to monitor** and can create **disincentive effects**
Means testing to protect access for poorer students Access to higher education to people from less privileged backgrounds can be protected. Tuition fees can be **means-tested** to offset the danger that fees will hit lower income students hardest. Maintenance grants can also be means-tested	**Social benefits (externalities) argument** The benefits to participation in higher education accrue not only to the individual graduate but also to society at large. And seeking to expand higher education too much may work against the best interests of the economy – the graduate market may become over-crowded

Improvements in dynamic efficiency Fees will encourage students to be more **selective** in the courses they choose and will stimulate an improvement in teaching quality if universities are	**Limits to the market – tuition fees no answer** A graduate tax exhibits no relationship between the cost of the course attended and the amount repaid by the student. It therefore introduces no `market-

to keep student numbers high and remain viable - tuition fees make parents and students ask hard questions about the purposes of higher education	based' element into the HE sector in terms of students choosing between courses and institutions based on the various prices of attending them
Research and international competitiveness Extra funding is needed for universities to maintain high levels of research – offering long term macroeconomic benefits for the economy	**Uncertain flow of tax revenue** The amount that tuition fees will raise is uncertain because it depends on the future earnings of graduates once they enter employment – and it will take years for the extra funding to come through
Progressive system of tuition fee repayment Repayment through the income tax system introduces a progressivity into the system – higher income earners will repay their debt more quickly. Specifying that the loans need only be repaid when incomes rise above a certain level should help overcome students' reluctance to borrow when they cannot be confident about their future earnings. It is a pay-roll deduction scheme rather than a tax	**Education as a basic economic and social right** Belief that access to university should be available to all people who qualify independent of their ability to pay (a value judgement) – i.e. education as a right not a commodity Is education fundamentally different from providing health care "free at the point of need"?
Fees are more equitable than general taxation Funding tuition from general taxation is an expensive and poorly targeted way of intervening in the market, because graduates, who are predominantly found towards the top of the income distribution, benefit at the expense of everyone else i.e. why should non-graduates pay for the degrees of graduates? The argument that education should be provided free is much stronger for the case of primary and secondary education than for higher education.	**Impact on demand for certain degrees** It is feared science and engineering - among the most expensive courses to run because of equipment costs and specialist staff – will see a fall in demand – threatening long term damage to our manufacturing competitiveness

Further background available from the BBC web site:
http://news.bbc.co.uk/1/hi/in_depth/education/2003/higher_education/default.stm