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The Financing of Education: an economic issue?

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Introduction

Education has always been the subject of heated debates. After the Second World War, a sort of consensus seems to have been reached with the Universal Declaration of Human Rights voted by the General Assembly of the United Nations in 1948. As a result of this recognition of education as a basic human right and because economic research seemed to have proved that education was a highly profitable investment for society as well as for the individual, there was a worldwide explosion in school enrolments. From a little over 240 million pupils in primary schools in 1960, the figure reached 541 million 20 years later. In higher education, the growth was even more spectacular, from 11.7 to 51 million students. Although the growth rate has somewhat slowed down in the last 20 years, it has remained great at the primary level in developing countries, where the number of pupils increased from less than 450 million in 1980 to over 570 million in 1996. But the developed countries were experiencing a decrease due to the decline in the birth rate. Yet higher education enrolments kept growing everywhere, from 51 million students to over 84 million. This could but raise many problems. In developing countries, it generally meant opening thousands of schools and hiring thousands of new teachers and creating institutions of higher learning from scratch. In developed countries, where all children already received basic education in 1960, reforms mainly affected the upper secondary system and higher education, which now enrol a majority of each age group.

Recognising that education is a basic human right implied that it should be free, at least at the lower levels. This principle was more or less respected in most countries, which induced a tremendous increase in the public budgets devoted to education. A financial crisis was forecast in the mid-1960s (Coombs, 1968). The financing of higher education soon became a major issue and the financial burden on public budgets in many developing countries was often considered unbearable as from the mid-1970s when the effects of the world economic crisis became difficult to ignore. In any case, it became clear that the increase in the public effort in favour of education, which was visible almost everywhere in the 1960s (where the percentage of Gross Domestic Product (GDP) spent publicly on schools increased from 3.47 to 4.86 in developed countries and from 2.55 to 3.63 in developing countries), could not be sustained for very long. The fact that social demand kept increasing was bound to create tensions and give rise to speculations about new sources of financing.

At first, no major changes were observed, but public resources became scarcer. Public resources in proportion to the GDP tended to stabilise in the late 1970s and in the 1980s in developed countries and a growing number of developing countries stabilised or

decreased their effort in the 1980s. Research on the actual spending shows that resources allocated to schools have, in most cases, decreased much more sharply than these macro indices show, especially in Africa. The slight improvement that was seen in the 1990s in the poorest countries is not sufficient to enable them to reconcile an increase in enrolment in primary education and acceptable quality. In many developed countries, public expenditure per tertiary level student has tended to decrease since the mid-1970s.

But if changes in the sources of funds are visible in most cases, one observes that they are the result of the financial squeeze on public budgets and, until very recently and in a minority of cases, are not the result of a coherent and systematic reflection on optimal financing. Why is that? We shall attempt to answer this question after giving an overview of the financial situation of the education sector and its evolution in the world by studying the shortcomings of the analytical approach of this problem by economists. Then, we shall focus on the main areas of discussions which have emerged recently.

An Overview of the Financial Situation

The adoption of the principle of the 'right to education' by all the countries that signed the Universal Declaration of Human Rights was generally expressed as a right to free basic education. We shall therefore consider basic education and the higher levels of schooling separately.

Basic education is generally compulsory, whether this is rigidly enforced (as in all developed countries) or not. Its financial basis seems to be clear-cut: the public authorities shoulder the whole burden, as it is provided free to the households. But, in fact, there is always a cost to the latter for at least three reasons:

First, the principle applies to public schools but not always or fully to private schools which may, in some cases, enrol a large share of the student population.

In developed countries, the private sector is generally limited or non-existent at primary level. In Europe, only Belgium and the Netherlands enrol a majority of pupils in private schools which are fully subsidised by the State. The same is true in France and Denmark, where that proportion is between 10% and 20%. Only Spain, the U.K. and Greece have a significant sector of non-subsidised private schools where tuition fees are fairly high. But it does not exceed 13% of enrolment in Spain, 6% in the U.K. and 4% in Greece. In the US, the private sector enrolls a little less than 10% of the primary school pupils in schools where tuition fees amount on average to around \$1,700. The proportion is lower at the secondary level (6%) but the fee is higher (\$3,650). In Canada, the respective figures are 4% and 6%. In Japan, there are almost no private schools at the primary level and less than 3% at the lower secondary level.

The situation is different and very heterogeneous in developing countries, as Table 1 shows. As most of these private schools receive little or no public subsidies, one can see that in some countries, and especially at the secondary level, basic education is costly for a significant number of households.

TABLE I. Proportion of Pupils Enrolled in Private Schools (Number of countries in each category for which data are available)

	Less than 20% in private schools	Between 20% and 33%	Above 33%
Africa			
Primary	24	6	2
Secondary	4	11	13
Latin America			
Primary	18	4	1
Secondary	1	9	6
Asia			
Primary	16	3	3
Secondary	15	7	4

Source: World Report on Education, UNESCO 1998 - Table 10.

Second, in most countries, certain costs are borne by parents or have been shifted to them in recent years. In Africa, for instance, textbooks and uniforms (often compulsory) in many cases represent a heavy financial burden. Only the salaries of teachers are generally paid by the State.

Third, some costs have to be borne by the family if a child is attending school. Transport, for instance, is rarely free. In some countries like Japan and the Republic of Korea, private lessons are important, especially at the secondary level. On the whole, in developed countries, although most of the private sector is usually heavily subsidised, the financial burden of compulsory education has not increased in the last 40 years because of a decrease in enrolments due to the declining fertility. But in many developing countries it has increased both for the public authorities and for the households and more for the latter for the reasons evoked above.

At the post-compulsory level, the situation is different. There has been a great, often spectacular rise in enrolments in most countries of the developed and developing world. The private sector is usually much larger than at the lower levels. A majority of pupils are enrolled in it in upper secondary education in some countries like Botswana and Zimbabwe, El Salvador and Lebanon and between one-third and one half in many others.

In higher education, the sources of financing are more diversified. In the 1980s, there were four different patterns:

- In the USSR and countries which had adopted the same political régime, the State paid all expenses and controlled the supply. Higher education was free. Students paid no fee and room and board were free.

- In Japan and several other Asian countries (the Republic of Korea, the Philippines, and to a lesser extent Indonesia and Thailand) and in Brazil, the system was mainly private. Between 70% and 80% of the students attended private institutions

which received most of their income from tuition and fees and (marginally) from research subsidies from private firms.

Public institutions also charged tuition and fees which, although much lower than in the private sector, were quite sizeable.

Other countries have since followed the same route, the most visible example being Chile.

- In the US and Canada, there is great diversification. The private sector enrolls a minority of the students (around 25% in the US) but charges high fees. Tuition is nevertheless fairly expensive in public universities (\$3,750 vs \$13,700 in private universities in the early 1990s). But a significant proportion (39 % in 1993) of students are enrolled in two-year institutions, mostly public, where tuition and fees are low (\$1,250 on average) and student aid high. One may therefore say that the type of financing ranges from almost 100% public to 75% private and the amount spent per student from \$5,700 to \$30,500.

- In Europe (and in many developing countries which were colonised by European countries in the past) the situation at first seemed far from uniform. But, from the financial point of view, there was great uniformity until recently: students paid no tuition fee or a token one ; close to 100% of the resources of the universities came from public authorities; aids to students were widespread and helped the most needy to support themselves while studying.

In recent years, the Soviet model has disappeared, the Japanese model has slightly changed towards an increase in State participation to the financing of the private sector (at least in Japan and Korea) and the American model has shown a slight retrenchment in public subsidies and a rather sharp increase in tuition fees at the research universities. The European model has become more homogeneous as far as State control of universities is concerned, but shows divergent evolutions in tuition fees. Today, in a majority of countries, tuition and fees have substantially increased. Three groups may be observed:

- Countries which still charge no fees. They are a clear minority : Denmark, Norway, Sweden, Germany, Austria and Greece.
- Countries where they are low and have been kept so for the last 25 years in spite of aborted efforts by the government to raise them: today, France is the last country in this situation, with a basic fee of around \$150.
- Countries where fees are substantial (between \$400 and \$4,000): Belgium, Ireland, Italy, the Netherlands, Portugal, Spain, Switzerland and the UK.

Looking at this evolution, five conclusions can be drawn:

- There is a clear trend towards higher fees. This is seen in the fact that most increases are recent (in the 1990s in Italy, Portugal, U.K.), that heated discussions preceded and

accompanied the raise in most cases, and that in two of the no fee countries at least (Denmark and Germany), the question is raised.

- This encountered strong resistance on the part of student organisations and political parties on the left of the spectrum; that resistance was strong enough in some cases to defeat several attempts (in France) or to bring a partial revision of the initial decision (in Ireland and Portugal).
- Rather high fees do not always mean high costs to the students. For instance, in the Netherlands the fees are largely compensated by public subsidies.
- The fees are generally in the \$500 to \$1,000 range, which is far below those in American (or Korean) universities.
- But, although the issue of student fees is coming to the fore in different forms, the situation is far from stabilised and an alignment of all countries on the substantial fees group is not yet on the official agenda.

Why such an array of financial solutions, especially in higher education? Why have countries with comparable political institutions made very different choices? Part of the answer lies in the incapacity of economists to offer a clear 'optimal' solution.

The 'Classical' Discussion on Financing and its Shortcomings

When the Human Capital theory was developed 40 years ago it was radically opposed by Marxist economists on the ground that the appropriation of capital by a few leads to the exploitation of man by man, so that pretending that, through education, man is investing in himself and therefore expecting profits is tantamount to saying that he is exploiting himself through the appropriation of those profits. This rather abstract controversy obscured the fact that the approach of Human Capital theorists and of Soviet economists to education was very similar and was based almost exclusively on considerations of efficiency. Both groups started with the hypothesis that education is an investment in man, in other words, that it mobilises scarce resources today in the hope that the productive capacity of the recipient will improve in the future.

The Marxist approach, developed by Soviet economists like Strumilin in the 1920s, was quite coherent (Strumilin, 1969). It was based on the assumption that education improves the skills of the worker and therefore contributes to an increase 'in the productivity of the nation' (Strumilin, 1969, p. 432). It went on to try to measure these differences in productivity and then compare them with the cost of training in order to calculate the equivalent of what would be the rates of return in market economics and to determine the optimal development of the school system. The problem of equity was not analysed but was supposed to be solved by the organisation of a Socialist society: salaries were not linked to individual productivity, only social rates of return were pertinent. Society as a whole, represented by the State, paid for the investment in education and reaped the benefits. People were educated according to their intellectual capacities. It was therefore

assumed that equality of opportunities prevailed. But in actual practice the system never worked quite this way.

The Human Capital approach initiated by T. Schultz in the late 1950s (Schultz, 1959) and developed by G. Becker (Becker, 1964) was also based on the assumption that education should be considered as an investment and went on to propose measurement of its rate of return in order to determine its optimal level. But it mainly considered the point of view of the individual and concentrated on demand. It was only later that Human Capital theorists and other neo-classical economists developed considerations on the financing of education. Starting from the 'orthodox' assumption that the market system, as long as it works properly, leads to an optimal allocation of resources, these authors encouraged a mixed system of public and private contributions. The main arguments have often been presented (Eicher & Chevaillier, 1993). We shall only summarise them here.

Private financing by the students (or their family) is mainly justified by the straightforward Human Capital argument of profitability: education enables students to earn more after graduation. They should therefore finance the initial investment. But other arguments are also advanced: on the demand side, the 'token user charge' argument states that what is provided free is often consumed wastefully. If students have to participate in the cost they will behave more rationally, choose more wisely their field of study and try to graduate as quickly as possible. The 'participation' argument says that students who pay tuition are entitled to participate in the definition of the content and organisation of their curriculum which may therefore be more adapted to their needs than when it is built only by

academics who are primarily interested in their own welfare.

On the supply side, it is argued that tuition fees represent a source of independent income for the institution and increase its autonomy and its capacity to use resources in an optimal way.

Other private sources of funds are also advocated, drawing on the same profitability argument: if firms are going to benefit from the higher productivity of the graduates, they should participate in the financing. The same may be said of philanthropists who derive satisfactions from the development of education.

But it is also observed that there is no fully competitive market for education which militates in favour of public financing. Public financing of education is recommended by advocates of the market system on two main grounds.

On the one hand, imperfect information. The students are unable not only to evaluate with any precision the quality of their training, and more precisely its market value, but also to know how much they will earn until they retire from active life. This amount depends not only on the present market value of their degree, but also on future competition in the labour market and on general economic conditions. There is also the question of the imperfect information of lenders on the credit-worth of students, which may mean a high risk premium on loans. This lack of accurate information is bound to lead most students to be cautious and to undervalue their private benefits. This means they will underinvest in education unless public subsidies push the price down.

On the other hand, education is typically a good which has spill-over effects. The family, the local community and society as a whole all benefit from this progress in knowledge, but individual student-investors do not take these positive external effects into account when they make their choice. This is a second cause of under-investment and another reason why public subsidies are required to reach the allocative optimum.

Finally, one may add another argument in favour of public financing if one considers the State as an autonomous decision-maker which attempts to maximise its utility. If the income tax is progressive, graduates, who earn more than non-graduates, will pay more. The State may therefore consider it worthwhile to spend on education now in order to get more tax revenues later.

The sum of these arguments leads to conclude in favour of a mix between private and public financing. Market imperfections make the pure market solution, i.e. pure private financing, sub-optimal. But it is to be noted that none of the arguments in favour of public financing leads to a conclusion in favour of free education. This economic approach therefore brings the beginning of a solution to the problem of the financing of education. But it does not provide a clear-cut solution in any concrete situation.

First, only the general principle is clear: each constituency should contribute to the cost of education in proportion to the benefits it expects from it. Unfortunately, most of these benefits are difficult or impossible to measure. The monetary profits represented by higher incomes have to be valued today, but will be spread over time. Those who obtain the same degree at the same time will not have the same income. Even if it were possible to measure each future individual income stream, would it be considered as acceptable to base each individual present contribution to the cost of schooling on these differences?

Many of the benefits are non-monetary and non-economic: a better social status, a more interesting job... as well as the present satisfaction derived from student life.

One thing at least is clear. The sum of the various benefits accruing to the individual graduate is great. The 'European model' of financing higher education where students' contribution to the cost of their studies is very low does not seem to be an optimal solution from the point of view of resource allocation.

Second, this economic analysis only looks at the efficiency dimension of the problem. But the economist, much as he would like to remain in the positive dimension of his field of research, cannot avoid the normative aspects. After all, the aim of economic activity is to increase social welfare and social welfare is not independent of the welfare of each person.

'A society is a co-operative venture for the mutual advantage of its members' (Barr, 1993). In order to survive, its members must have some common values. The satisfaction of recognised 'basic needs' is a fundamental principle of organisation.

In modern societies, education is recognised as one of those basic needs. Optimal financing should therefore not only be that which brings about an optimal allocation of resources (the efficiency principle), but also that which ensures the satisfaction of that basic need for everybody. If the optimal financial scheme defined only along efficiency lines supposes a private contribution which is beyond the contributive capacity of a fraction of the population, equity is not ensured. This is the other reason why financial

settings vary so much from one country to the next: the solution proposed by neo-classical economists was not considered acceptable.

But great progress has been made in recent years in the approach by economists to the problem of social justice. It has led to focus on new issues which are worth discussing.

Main Issues under Discussion

In the field of financing non-market activities, the issues are many. Of course, there is still the central question: who should pay and for what? But there is also that of the definition of the cost to be borne and shared: cost of supplying the service as it has for a long time more or less implicitly been assumed, or cost to the recipient? Supply side or demand side analysis?

There is also the myriad of questions linked to public financing: should the public authorities supply education themselves, the institutions (the 'schools') being bureaucratic units without any autonomy, or should they subsidise autonomous actors? Which actors should be subsidised: the suppliers or the beneficiaries? How should they be subsidised: should institutions be given lump sums they can use as they like, or should the money be affected to a precise function? Should the subsidy to the recipients be given to the recipients or to those considered responsible for their well-being? And last but not least of this incomplete list of questions: should the subsidy given to the student be refundable or not, in other words, should it be a loan or a grant; and if a loan, should the refund be linked to future income or not (Eicher and Chevaillier, 1993)? Let us say a few words on each of these issues as an introduction to some of the main debates of the day.

Who Should Pay for What?

We reminded the reader earlier that the neo-classical economic analysis centred on efficiency led to conclude that mixed public and private financing was preferable to either polar solution. But besides the fact that it was unable to recommend a precise mix in each actual case study, it implicitly neglected considerations of social justice.

If the economist acknowledges that in any society a fundamental principle of organisation is that agreed-upon basic needs must be satisfied and that education is considered as one of these basic needs in modern nations, he has to admit that, in order for this need to be satisfied, education must be free. But this is not the final and universal answer to the question of the financing of education. As Nicholas Barr quite aptly reminds us 'the importance of Education in people's lives should not obscure its economic dimension. Resources devoted to education cannot be used for other purposes ... ; if we spent the whole of national income on education, there would be no food or health care' (Barr, 1993, p. 337).

In the other words, there is the crucial question of the extent of the right to satisfy this basic need. One may assume that basic education fills this basic need and that it was made compulsory for that purpose. This means that basic education should be totally free,

which is not always the case, but that post-compulsory education has no reason to be so.

This distinction is not always well understood, as witnessed by the discussions in the preliminary phases of the UNESCO World Conference on Higher Education of 1998. In the synthesis on Management and Financing prepared by Malcolm Slibeck (Slibeck, 1998), the latter cites the main arguments put forward against the levying of tuition fees. Among these, there is that of the benefits to society as a whole, which in no case may be used to advocate full public financing, but only to argue that fees should not cover the whole cost; the bold assertion of many studies that the existence of fees reduces access (which is contradicted by the spectacular development of higher education in Japan, Korea and other Asian countries); the surprising statement that 'it is not reasonable to have fees in periods of economic recession' (should the State spend more when it has lower tax revenues?); another extreme assertion is that in developing countries most families are unable to pay the fees; and, finally, another unproved statement, that fees are not a necessary condition for better efficiency.

Fortunately, the general conclusion and the introduction by Jacques Delors are more nuanced and admit that 'it will be impossible to indefinitely postpone the participation of the student to the cost of his (or her) studies' (Delors, 1996). But the emergence of mass higher education in developed countries means that many teenagers from less privileged groups who, in the past, did not accede to the university level because they followed short professional streams in secondary schools, now enrol in higher education institutions. They usually cannot afford to pay substantial tuition fees and to support themselves without taking at least a part-time job. The equal opportunity principle, if applied to this group, means that either they should be partially or totally exempted of fees, or that they should be allowed to make deferred payments. The basic question is not: should they pay fees, but when should they pay them? Low fees or no fees at all does not seem to be the optimal solution, either from the efficiency or from the equity point of view, and the traditional attitude in favour of free education, which still prevails in Europe, does not seem warranted, even when many youngsters from low-income groups start to have access to higher education.

Another important question is that of the *limitations of the supply side approach*. Cost analysis and cost measurements usually study what could be called the production side. What is measured is the resources that are mobilised in order to offer the training. But schooling is an activity which takes a long time, much longer than to buy most goods and services. This means that it cannot, as a rule, be acquired during one's 'free' time and prevents the trainee from having a full-time wage-earning occupation. Beyond the period when schooling is compulsory, it engenders forgone earnings. In other words, students are prevented from earning an income that is sufficient to cover their needs while studying. For them, the cost of education comprises the cost of living (or the part of it which they cannot cover by working part-time) plus the portion of the supply cost they are asked to finance through fees. It is quite different from total supply cost.

In order to ensure equality of opportunity, students should therefore be helped financially to support this 'demand cost'. Help may come from the family, which raises the issue of the status of the student: should he or she be considered autonomous and at what age?

But the family itself may be unable to help the student, in which case the eventual public subsidy should concern not only tuition and fees but also the cost of living.

The question of *who should provide the service* is not a financial question except if it can be shown that it is provided more cheaply by autonomous agencies than by bureaucratic departments.

Nor does the issue of which actor should be subsidised have a direct financial dimension. What is important from the financial point of view is to decide whether it is more cost-effective to subsidise the schools or the students. Once this decision has been taken, further questions are raised which all have a financial dimension.

Subsidies given to institutions as lump sums are likely to be less costly to administer than targeted ones. From the financial point of view, the first solution allows for more money to be distributed. Subsidies distributed to the students usually require more detailed enquiries before a choice of beneficiaries is made than subsidies to parents, such as tax rebates. They are therefore more costly to administer (but probably more equitable).

This choice raises the question of the status of the children *vis-à-vis* their parents. In some countries, they are considered independent when they can vote. This is the case in Scandinavian countries where the financial situation of the parents is not taken into account when deciding whether students should receive public aid or not. As it is more and more frequent nowadays that children still live at their parent's home long after they reach their political majority, it may be considered as inequitable to give the same subsidy to those who remain dependent as to those who have to fare for themselves. But it avoids having to rely on the student's declaration.

A very important financial problem is that of the *type of subsidy the student should get*, or more precisely that of the choice between a grant and a loan. The case in favour of loans is now well documented (Eicher & Chevaillier, 1993, pp. 491-495). Loans do not deter the enrolment of the poor, as is often stated, because the main inequality between students of rich and poor families is not that the latter cannot pay but that they cannot pay now. Their degree will allow them to earn higher incomes than non-graduates and it is not *a priori* shocking to have them use part of this increase to repay the loan. Three other main arguments in favour of loans may also be cited: the student who has to borrow is likely to be more rational about his choice of field of study and more 'serious' about studying than the student who does not, especially when tuition fees are very low; loans allow 'rich' students not to rely exclusively on the goodwill of their parents; having to contract a loan may deter the less gifted and the less motivated students from enrolling, thereby making human capital accumulation more cost-effective. But purely commercial loans are likely to deter the poor (who have to borrow) and to create inequalities between those who will and those who will not have to repay a loan.

On the other hand, when loans have (in principle) to be repaid, a loan system will be less costly for the State than an aid system based on grants and would contribute to a better balance between public and private financing in countries where the initial participation of students to the cost of their studies is low.

Systems of income-contingent loans have been designed to conciliate efficiency and social justice. But they present two potential drawbacks: adverse selection if the amount repaid is much smaller for those who earn little than for those with high incomes, in which case those

who expect to obtain a high socio-economic standing after graduation opt out of the scheme; moral hazard if a sizeable proportion of the borrowers decides to drop out or opt for low-paid jobs. These drawbacks can be avoided or at least mitigated if only the level of each periodical repayment varies with income but not the potential total amount to be repaid.

It can be shown that, considering that a proportion of borrowers will have no income at all and therefore will not repay anything and that there is always a certain level of default, such a scheme must be subsidised in order to function at all. But, in any case it is less costly for the State than a grant scheme, notwithstanding its other potential advantages described above.

Today, these issues are more fully and systematically explored by economists, instead of being only dealt with in purely technical terms by the initiators of such schemes.

One last point. The building of a true European Union is hardly compatible with the existence of highly different financing schemes for post-compulsory education, and especially higher education, in the different European countries. Greater student mobility, which is strongly encouraged, would be impeded by these different arrangements. It is therefore to be hoped that this issue, which has emerged recently as a major one, will be tackled quickly and efficiently.

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