Mind the Gap: how should we fund public universities?

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Abstract

Australian university students pay among the highest tuition charges in the world, but universities receive less than it costs to provide their education. The problem is a funding model that takes no account of the actual expenditure required to provide an adequate standard of higher education.

The funding model is also an obstacle to achieving the policy goal of greater diversity in the higher education system. All universities must offer courses that generate the revenue needed to cross-subsidise disciplines that cannot reliably finance themselves under the current funding model. Specialist institutions are not possible in under-funded disciplines.

A new funding model is needed that avoids these cross-subsidies. The Productivity Commission could do a review of the necessary funding levels. Politically sensitive decisions will need to be made about how much students pay.

Australian higher education is living through yet another moment of change. This time the transition challenges the Whitlam national consolidation of the mid-1970s and the later Dawkins national unified system of the late 1980s. The remaining legacies of both eras - Commonwealth control over how much government-subsidised students pay, and convergence on a single model of higher education institution - are being called into question.

Yet system change may founder on an obscure impediment: the disparity between costs and revenue for Commonwealth-supported students.

Mind the gap

Commonwealth support per student has been falling steadily for 30 years. For no discipline does the Commonwealth teaching subsidy purport to cover the costs of education. In the field of law, the Commonwealth pays just 16 percent of the funding it allocates for each student. In economics and commerce, the Commonwealth share is just over a quarter of the total assigned cost.

In principle, the difference between Commonwealth subsidy and actual cost is provided by the student, through the Higher Education Contribution Scheme, or HECS. Thus

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Canberra pays for the public good component of a university education, while the student meets the balance, in the hope of future private returns.

It is less than 20 years since tertiary education was free in Australia. Now local students – those fortunate enough to secure a Commonwealth Supported Place – pay fees among the most expensive in the world.[2]

Despite these high costs, in practice the two direct sources of funding for tertiary education – a public contribution by Canberra and a private payment by students – do not sum to the total cost of the education provided. At the University of Melbourne, for example, the gap between income and cost for a Commonwealth supported place is calculated to average $1,200 per student each year.

Federal legislation specifies maximum rates for the amount paid by students, and Canberra decides the level of public subsidy. Thus the federal Minister for Education sets the price for university study, and can do so without regard to the actual cost of provision.[3]

If income does not meet expense, universities must make their own arrangements. The sector has done so with conspicuous success, meeting the gap between domestic income and cost by attracting hundreds of thousands of international and domestic fee-paying students.

Such impressive results have reflected the good reputation abroad of Australian higher education built through generations of public investment, a shortage of public places for local students, and the lack of domestic competition.

This once strong market position of public universities has eroded noticeably. Over the last two years, a combination of a buoyant labour market offering immediate employment choices, stronger competition from private providers, and stagnant demand has left some public universities unable to fill all their Commonwealth-supported places. Traditional source countries in the international student market are turning into competitors. The capacity to cover a funding gap through external income is no longer secure.

Faced with the possibility of tightening revenue, public universities will once again face the awkward question: who should pay for tertiary education?

The standard response is to call for more spending by government. However strong the case, this is an act of optimism given the history of the past 30 years.

A more difficult reply is to suggest higher fees for domestic students. This suggestion is unpalatable to universities and politicians alike. Rises in HECS charges are understandably unpopular, and so infrequent. Substantial increases occur only when government is prepared to wear the political opprobrium, not as needed. Labor introduced a single rate of HECS in 1989 and, apart from a minor revision in 1992, did not revisit the rate during its next two terms in office. The Coalition has lifted rates only twice during the past decade. It also indexes student contributions at below the annual rate of cost increases for universities, effectively reducing them in real terms each year.

Universities might welcome the equity effects of holding down HECS, but not the financial consequences. A strict ceiling on charges for domestic students conditions every

[2] OECD, *Education at a Glance 2006*, (Paris: OECD, 2006), p.240.
[3] Universities have some discretion over the final 25 percent of HECS charged. Since the maximum allowable rate is still less than the real cost however, it is no surprise almost every course in the country is offered at the same, maximum, price.

aspect of higher education policy, in ways that may not be obvious. To see why and how it has had these effects, we need to go back to the Dawkins reforms of the late 1980s.

How did we get here?

Free education lasted until the late 1980s when, faced with unprecedented growth in demand for places, Minister John Dawkins redesigned system fundamentals. Expanding the system in a time of budget constraint meant that free education was now too costly. Instead, students would contribute to their degree costs through a flat rate higher education contribution scheme repaid through the tax system. The distinction between universities and colleges of advanced education would be abolished, with all institutions funded at consistent national rates.

To establish appropriate funding rates, Minister Dawkins established a review, with the decisions expressed as a Relative Funding Model, or RFM. Sadly the RFM was not based on rigorous assessment of the real cost of providing, say, an economics degree versus a training in medicine or dentistry. Rather, the RFM reflected historic funding patterns, thus locking in any long-standing anomaly. The calculations were completed in 1990 and have not been revised since. The RFM remains at the core of federal funding policy, the basis on which all Commonwealth-supported students are financed.

There are many possible objections to such a funding approach, but the most important is simple: the RFM does not describe the real or relative cost of degree programs.

Subsequent changes to student charges have not addressed the fundamental inaccuracies of the RFM. The three tiers of HECS charges introduced in 1997, and the 25 percent increase in student contribution amounts that took effect in 2005, were as arbitrary as the original RFM. These numbers were driven by assumptions about future earnings rather than the cost of the course undertaken.

Thus university income is defined by an outdated but never accurate model of relative costs. Student charges, meanwhile, are not linked to course costs but to assumptions about future earnings. Neither is a sound base on which to predicate the finances of a large and important sector.

This is not an uncommon story in public policy. An original approach, introduced as a reasonable response to circumstances, is modified and entrenched over time. Since everyone and everything in the system is conditioned by the framework, it becomes harder and harder to change.

The problem arises when the outcomes of a long-established incremental approach run up against new priorities. Like her predecessor and her Opposition number, Education Minister Julie Bishop is calling for more diversity in the higher education system.

This laudable goal is constrained by the present funding system. The Dawkins approach was designed expressly to reduce diversity by ending the division between colleges of advanced education and universities and equalising student funding across institutions. A unified national system is not a promising starting point for encouraging difference. Yet the financial fundamentals of the Dawkins system – an RFM and capped student charges - remain in place.

If a Minister wishes to encourage diversity among institutions, then sooner or later attention must turn to the question of who pays for the system.

The implications of uniformity

Let me offer a brief example of how the present policy framework for funding university education works against diversity.

In 2005, Minister Brendan Nelson introduced a modified schedule of funding rates for courses, to take into account an increase in student contributions. Based on existing RFM relativities, the revised schedule exposed some anomalies in existing funding arrangements. The rigid application of new rates proved a particular problem for the Victorian College of the Arts, then an independent institution affiliated for accreditation purposes with the University of Melbourne.

Because the visual and performing arts often require studio-based teaching, the VCA had negotiated some years earlier a rate of funding reflecting its particular configuration of courses. Standardisation imposed by the new Nelson rates ended this special deal. The creative arts would henceforth be funded at a single rate with no studio allowance. With application of the Nelson template, the VCA faced a shortfall of nearly $6,000 per student, or around one third of its operating budget.

Minister Bishop has noted that Australia lacks an equivalent of the University of Arts in London. Here is a vivid demonstration of why Australia has not developed specialisation under the present funding model. As the VCA discovered, an inflexible uniform funding system does not allow a free-standing arts institution to be financially viable.

Faced with urgent complaints from the VCA and its supporters, Minister Nelson did not rethink the RFM approach. Instead he imposed a unique funding condition on the University of Melbourne: the University, and not Canberra, must find the missing funds to sustain the VCA.

Until then the University of Melbourne had been only a conduit for the VCA's Commonwealth funding. Now it would be compelled to cross-subsidise the VCA – an untenable position for everyone involved. So from next year the VCA will become a faculty of the University of Melbourne rather than the independent 'university of arts' sometimes evoked as a government aspiration.

Most consequences of the funding model are less dramatic. Yet the effects are felt across many disciplines. The original RFM classification for physiotherapy, for example, failed to recognise the required clinical load. This has triggered a crisis for the discipline, with some institutions unable to afford the clinical placement necessary for graduates to receive accreditation. At a time of workforce shortage in physiotherapy, universities have been discouraged from seeking further Commonwealth-supported places by the financial penalty involved.

Overall the system survives because of external income from fee-paying students, allocated across the institution through internal cross-subsidies. Popular courses which attract fee-paying load, such as business administration, provide income that is redistributed to struggling programs with a higher proportion of Commonwealth Supported Places, such as many health sciences or the visual and performing arts.

This complex pattern of cross-subsidies, made essential by the inadequacies of the RFM, works against diversity. In criticising what she called the 'relentless pursuit of sameness', Minister Bishop noted that all 37 public universities offer courses in business and management. The reason is simple: the income from popular courses is what keeps alive courses in science, engineering, humanities, music and numerous other disciplines. Business is attractive to fee-paying students, and large classes produce economies of scale. Returns are invested in sustaining disciplines that cannot, under current funding arrangements, reliably pay their own way.

Private higher education providers did not fail to notice these potentially lucrative fee-paying markets. Using their access to FEE-HELP, the HECS-like loan scheme for full-fee students, they are competing with public universities in potentially profitable areas of higher education. Over time the risk is a public sector which fails to remain competitive in popular choices, and therefore unable to support the important but financially unattractive parts of a comprehensive education system.

While cross-subsidies are essential within comprehensive institutions (and public universities cannot drop disciplines without prior ministerial approval), the federal minister will struggle to achieve the diversity she advocates.

It is time therefore to return to first principles. Every university should be able to raise, from Commonwealth, student and university contributions, enough to cover the real costs of delivering a place in each discipline. That revenue should cover costs is, of course, far from an original idea. But achieving the goal of self-sustaining disciplines is an essential starting point if we are to move toward institutional diversity.

If government is to persist with an RFM to set funding levels, it will need to start again, and to review regularly the relativities established. It is encouraging to note that Minister Bishop has been quoted saying she is not 'averse to hard decisions and difficult arguments' in reviewing funding clusters, and that the recent white paper from Shadow Minister Jenny Macklin canvasses also a revision of the funding model.

One option to advance these proposals is to engage the Productivity Commission, which is already at work on a review of public support for science and innovation. The Commission has the skills to review funding levels, and the independence to determine a minimum level of funding required to deliver courses at an adequate standard.

Once minimum costs are clarified, the debate must move to the always embarrassing question: who will pay? For the minimum amounts involved are certain to be higher in some if not all disciplines.

Who pays?

There are five players who might contribute to the cost of higher education – the Commonwealth government, students, universities, business and the states and territories.

Canberra already makes a large contribution, about 42% of the total, and students both domestic and international contribute 36% of all university revenue. Both benefit from their investment. The economy needs a steady stream of highly skilled graduates, as does the cultural and social life of our community.

For students, education produces life-long economic advantage. The Australian Bureau of Statistics reports that weekly earnings before tax are $500 more for a graduate holding a bachelor's degree than for males with a Year 12 qualification only. For women the margin is around $300 a week. Such differences, repeated week after week, month after month, and year after year add up to very substantial income premium over a career, even after allowing for HECS and lost income while studying.

Universities themselves are major contributors to system income. Education is now the seventh largest export industry in Australia.[4] In the public sector, returns from fee-paying students are reinvested in teaching, research and knowledge transfer.

[4] IPD to March 2006, http://www.idp.com/research/statistics/Export%20Report%20YTDMar06.pdf. Drawing on ABS data, IDP values education exports at $2.02 billion pa.

Universities also contribute income through commercial services, technology transfer and philanthropic receipts.

Business and state and territory governments are, at best, more modest partners in higher education.[5] At a time of labour shortage in many sectors, Australian employers need access to professional skills. Yet business lobby groups argue that business already supports universities through taxes and the salary premium they pay to graduates. Direct investment remains welcome but sporadic.

Likewise, while some states and territories have proved generous supporters of research projects and infrastructure, regional government overall takes more in rates and taxes on universities than it contributes to costs.

Realistically therefore, the overwhelming majority of income for tertiary education will rely on just three partners: the Commonwealth government, individual students, and universities. This trio defines who pays, and the issue becomes the allocation of costs assigned to each.

In this configuration, the Commonwealth sets the terms. Canberra decides what two of the parties will contribute to higher education – through its payments to universities and through the maximum charges allowed on HECS.

The gap between income and cost must be made up by each university, effectively defining its share of the bargain.

If the policy target is to fund the real cost of each course, and so allow specialisation, then choices are limited but clear.

Canberra could take on the additional funding burden itself and ensure income covers the recognised cost of each course – unlikely in the light of the last three decades, but always a theoretical possibility.

Alternatively the Commonwealth could lift the cap on student charges, either completely or to a level agreed as reflecting the real cost of a course.

For diversity to become characteristic of the Australian system, the Commonwealth must ensure that revenue matches cost within each discipline. Any other reality requires universities to meet the gap through cross-subsidies, and so perpetuates the complex transfers within institutions that prevent specialisation.

Conclusion

To create the institutional diversity sought, two key policy variables must come in play.

The first is the core driver of system finances: the relative funding model, which sets out the basis of Commonwealth contributions to higher education. If Canberra persists with this approach, it needs a more transparent and accurate RFM.

This in turn requires an accurate picture of the real outlay in degree provision. The Productivity Commission is one possible source of independent advice in setting and reviewing the agreed cost of quality higher education within the public system. When each discipline can pay its way, specialisation becomes possible.

[5] States contribute 3.5% of all revenue. 'Consultancy and contracts' make up 4.5%. Contributions from business may also be buried in donations and student fees, since we know from student surveys that employers pay some students' fees, and in donations and other fees and charges'.

The second variable is the most politically sensitive: what contribution students should make to the cost of their education.

The present discipline-focused system takes little account of diversity in the circumstances of students, or of the value they place in securing a particular degree. Instead, student contribution rates are based on rough calculations about the public good component of a degree and some estimate of average future earnings.[6]

For universities, this means the student contribution is determined not by the cost of provision but by an estimate of private benefit to graduates.

If the policy aim is to match cost with income so every degree can stands on its own, the Commonwealth must think again about student charges. With just four bands of HECS repayment covering all disciplines there is little scope for nuanced adjustment to cover cost differences. Perhaps there should be 12 maximum student contribution amounts matching the 12 clusters of funding provided for subject areas. Student contributions must also be indexed regularly to real rates of cost increase.

A more radical approach might ask whether estimating public good and future earnings is the only sound basis for setting student contributions. Perhaps the economic circumstances of the student might be another starting point, either as individuals or as regions, approximating the postcode methodology long used in setting subsidies for private schools.

Institutional diversity is a worthwhile goal, but will be difficult to achieve while the legacy of the uniform national system still shapes funding decisions. The impediments to change are less conceptual than political. We know what is required, but any discussion of student contributions becomes awkward and tongue-tied. The contribution of each player – government, student and university – is at the centre of any meaningful discussion of system change. Until we mind the gap and address its meaning, reform will remain a noble ambition.

[6] HECS includes is a safety mechanism for those who fail to reach an income threshold.