

Submission to: Senate inquiry into the Higher Education and Research Reform Amendment
Bill 2014

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Behavioural Economics of Education

This submission is a statement of my personal views and does not
reflect the position of RMIT University

Dear Senate Committee,

My key concern with the Higher Education and Research Reform Amendment Bill 2014 is that it **relies upon an outdated understanding of the economics of education and how markets in education behave**. Advances in behavioural economics have only recently been applied to education. There are still many questions that need to be answered before we can reliably predict the economic outcomes of radical changes to education policy.

My submission will focus on the following areas:

- Markets and the complexity of choice in education
- Universities, research and reputation
- Financial risks of deregulation
- Scholarships and Moral Hazards
- Bond rates and stealth taxes
- A suggested solution to improve choice quality

Markets and the complexity of choice in education

We still don't understand the behavioural mechanics of how choices in education are made. It is not simply a case of predicting future earnings and choosing an appropriate course that matches your abilities. Individuals are face with very high levels of uncertainty about the future and choices involve a very large number of variables.

Consequently, markets in education are complex and non-linear. The opposite of simple markets that have linear responses to demand and supply, such as bread and milk. Linear markets are easy to predict. Non-linear markets however are incredibly hard to predict. Market dynamics associated with adverse selection, signalling and social positioning may lead to deregulated markets minimising overall education quality rather than maximising it.

We have seen this happen in the vocational education and training (VET) market in Victoria. Deregulation has resulted in lower quality, higher prices and over-servicing. This outcome is likely to happen again in the university sector if radical free market deregulation occurs.

Standard economic theory views education as a market. The more choices an individual has, the more competition there is. And for markets, more competition should lead to improvements in school quality and better educational outcomes. But we don't see this with education. In the US for instance, governments have spent billions of \$ over the last 30 years trying to improve the availability of education choice through market deregulation and the provision of financial subsidies. With the expectation that free market dynamics would lead to improvements in quality, and hence academic outcomes. However, over the same period in the US, student academic performance has actually fallen as the availability of choice has increased.

There is a fundamental question that is yet to be answered - why is education different to other markets?

Universities, research and reputation

To understand the relationship between research and reputation, it is useful to treat universities as being 'club goods'. Club goods are artificially scarce goods that are excludable but non-rivalrous, giving rise to positive network externalities. For club goods with network externalities linked with social prestige, direct advertising to boost reputation can lead to the opposite effect. As Rory Sutherland noted in the Forward of the 2014 Behavioural Economics Guide¹ :

"In fact, the idea that advertising is always persuasive is disproved by the fact that in many categories, it acts as a discouragement. No London club (or Ivy League University) can advertise successfully, as prospective buyers would take that as a sign that the club or university has more vacancies than applicants – and it is assumed that any club worth joining is oversubscribed already."

And here lies the problem for universities. As a 'club good' with 'social network externalities', being able to maintain the 'belief' of excludability is paramount. Trying to boost reputation by directly advertising to students and focusing on teaching quality cuts against the core 'belief' of excludability. The only alternative is to advertise quality through a signal that doesn't imply vacancy. Consequently, universities signal reputational quality through 'elite' research.

For universities, A-list researchers attract other high quality researchers and also crucially high quality teachers. Why is this important for attracting high quality teachers? Academics themselves are generally seen to be sensitive to reputational influences of their peer group. High quality teachers will be hesitant to join to a university who's reputation is ambiguous (uncertainty as to rank). The solution is to have an unambiguous reputational signal. However, the signal needs to overcome the problems of asymmetric information associated

¹ <http://www.behavioraleconomics.com/BEGuide2014.pdf>

with the observation ('measurement') of quality. **It is for this reason that research reputation trumps teaching reputation.** Research reputation is a less ambiguous signal as a result of the strength of external validation – active peer review in both academic and public domains (media). Teaching reputation is harder to validate outside the university in which it occurs, leading to the problem of asymmetric information. Students can only assess the quality of teaching while experiencing the subjects being taught².

The idea that universities are economic 'club goods' with positive social network externalities requiring a belief in excludability leads to another key policy implication. **Universities will continue to signal excludability through entrance score cut-offs (ATAR scores) or higher fees.** Any attempt by universities to increase enrolments by loosening cut-off requirements will put the value of these network externalities at risk. Without this signalling, the benefits of positive social network externalities will cease to exist and consequently the organisation's financial viability. This is possibly the key reason behind the failure of the vocational education TAFE system in Australia. The uncapping of student places in vocational education lead to the loss of the key social belief of excludability. As a result, the strong growth in the numbers of students entering universities over the last 5 years has been at the expense of the vocational educational institutions. Importantly, the human capital benefits of going to a good university are more likely to be associated the positive social network externalities of attending an institution with like-minded individuals than the actual skills or knowledge being taught.

The key observation is that higher education fees will rise, and rise significantly, because higher fees signal prestige and a university's reputation is signalled by research quality which is costly to acquire.

Financial risks of deregulation

Financially it is a misnomer to call contingent loans 'debt' because they're not. Unlike normal loans, contingent loans protect students from the downside risk associated with their education choices. Contingent loans behave like financial options. When students take on a contingent loan they are really buying a call option on their investment in education.

A call option gives the buyer the right to benefit from investment gains without the obligation to pay any losses that may occur. The government as the seller of the option is **insuring the student against any downside risk** associated with their investment choices. Contingent loans in Australia are effectively zero premium call options. The requirement for an upfront premium payment being covered by the government participating in any upside gains via higher taxes. In contrast, buyers of debt have an obligation to pay the debt back irrespective of the investment outcome.

² University teaching is sometimes called an 'experience good' for this reason.

Putting this into perspective. If the government offered you zero premium call options on housing investments, with the government participating in any gains through a higher tax rate – how many call options and properties would you buy? The rational answer is as many as possible with no limit! Why would choices in education be any different?

This is not a criticism of contingent loans. Contingent loans work perfectly as a mechanism to achieve the policy objectives of increasing equity and opportunity. Disadvantaged youth are able to exercise choice in education independent of wealth constraints. For women, contingent loans remove the downside risks associated with the uncertainty of having children and subsequent impacts on their career earnings. Crucially, being able to resolve differences in individual life histories is the key reason why contingent loans are a far superior policy solution than the traditional approach of subsidising student debt.

However, contingent loans were designed to work within a policy framework of student caps. Contingent loans were not designed to work within a deregulated, uncapped, free market environment.

There is a significant risk that the combination of contingent loans with uncapped, deregulated free markets will lead to university fee inflation – an asset bubble - where the price paid for education is not reflected by underlying value.

Scholarships and Moral Hazards

The optional nature of contingent loans - the option to benefit from gains but avoid paying the losses - also leads to the potential for moral hazard problems associated with easy access to 'debt' that you don't necessarily have to 'pay off'. There exists an incentive for higher education providers to raise prices and use some of the price rise to increase demand. More benignly this takes the form of increased marketing.

However, there is also the potential for providers to hike prices significantly and still remain attractive to students by giving part of the price rise back to the students as 'living expense' scholarships. This problem is not too dissimilar to 'cash back' offers on consumer goods. 'Cash backs' are more attractive to credit card users than those who pay upfront. Disadvantaged students will be at greatest risk from these forms of inducements because their need for cash to cover day to day living expenses is a salient concern.

The potential for similar 'marketing' techniques to blur the line between cash backs and scholarships should not be discounted.

Bond rates and stealth taxes

Currently, outstanding balances of contingent loans are indexed to CPI. Changing the rate at which outstanding balances are indexed to the government bond rate will significantly increase the likelihood that outstanding balances will never be repaid. Combined with higher fees, this outcome is almost certain for most middle class Australians.

This is the equivalent of a stealth tax on middle class Australia, and in particular women.

A suggested solution to improve choice quality

In order to avoid the likelihood of university fee inflation and education asset bubbles, markets in education need to be subject to some form of choice constraint. In traditional deregulated markets, the quality of choice is improved by rationing imposed by wealth constraints – budget constraints. However, the key objective of contingent loans is to explicitly remove the impact of wealth constraints on student choices in education.

An alternative solution to a wealth constraint is to **cap the life-time contingent loan** amount available to individual students. This cap should be the same for all students across university, vocational education and trade apprenticeship sectors.

A life-time contingent loan cap will increase the salience of choice for students and motivate investigation of choice alternatives. **It is only through this process of active student choice that universities will respond to demand for diversity and quality.**

The life-time contingent loan cap should be around \$60,000 plus any surcharges (excluding medical/vet/dentistry students).

There are other alternatives to a cap on the life-time contingent loans amounts: co-payments, capping student numbers, capping by ATAR result. Co-payments increase choice salience and improve the quality of choice but have equity impacts. While, capping student numbers or ATAR do not improve the salience of choices in education. Capping course fees is also not a solution because price tends to be treated as a proxy for quality, and fee caps reinforce this behaviour. Once a fee cap is in place, any university that sets fees below this cap will be seen as being of lower quality.

In preparing this submission, I have drawn on my experience of working in international banking (Tokyo, London & Paris) to provide insight into issues of financial risk.

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