

## **The Opportunity Cost of Inaction**

Advice to the Minister of Finance on Fees-Free Bachelor Programmes

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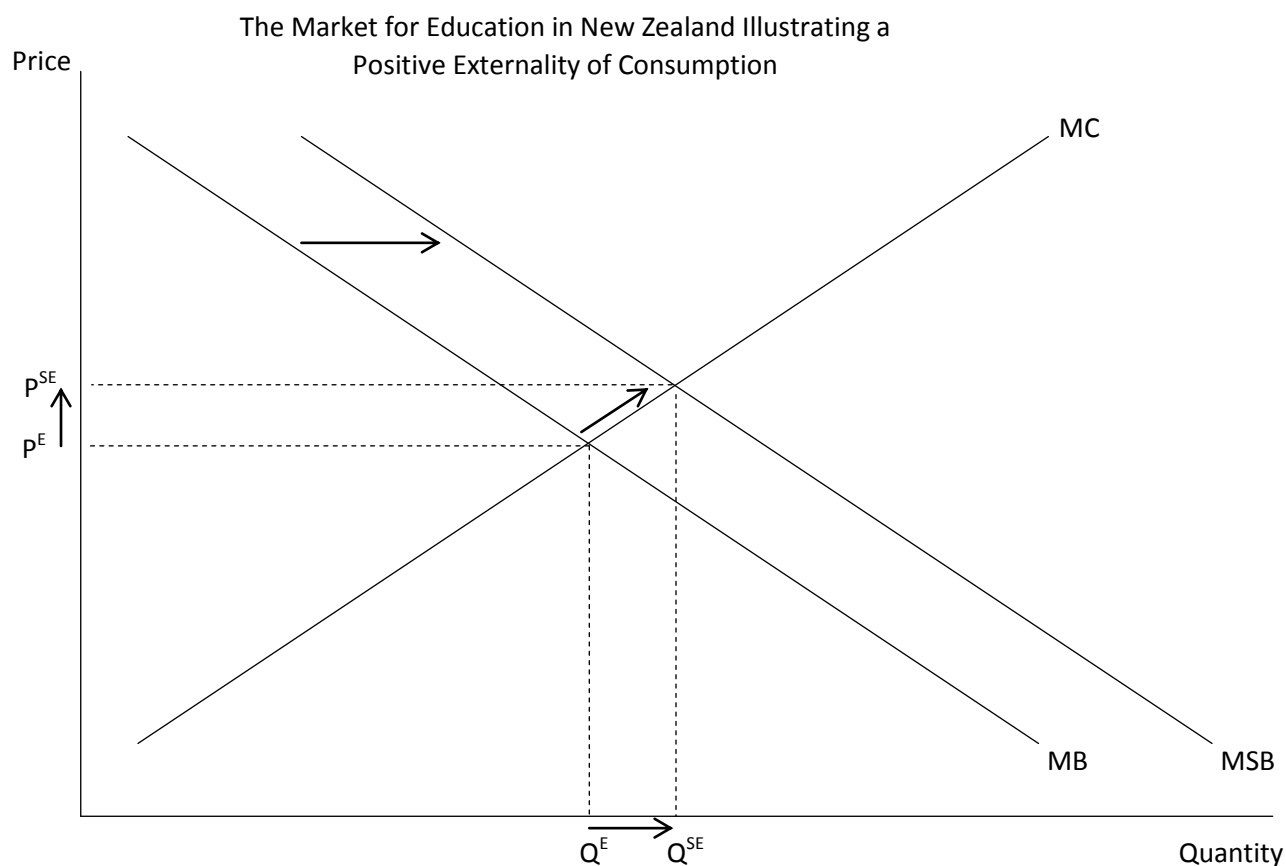
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Education enhances labour productivity and improves peoples' standard of life. It equips the economy with the excess capacity necessary for sustained growth without inflation, and it is from this which the other benefits stem. Increases in workforce productivity, economic growth, equity, overseas competitiveness and social cohesion are all boons from further education, and those from certain, target socioeconomic groups - namely students from low socioeconomic backgrounds or of Maori and Pasifika descent - stand to most benefit those from it. Skills are also becoming obsolete at an increasing rate due to the rapid capital intensification of many industries in the ongoing shift to the information age, and education provides transferable skills which will increase New Zealanders' resilience in rapidly changing times. The alternative to educating our workforce is to risk a human capital shortage - the consequences of which could be drastic.

These priority learners have the greatest marginal benefit from tertiary education, because the education will give them access to work and a standard of life that they are typically precluded from - the median salary after 2 years for a worker who completed a bachelor's degree is \$43,486, versus only \$32,457 for someone with education only up to certificate level. But the policy as it stands has certain, identified failings when measured against Treasury's Living Standards Framework, in areas such as equity, efficiency and sustainability. Therefore, the final recommendation is a combinatory policy which builds on the core of the original policy by adding aspects of alternative policies considered. Below is the evaluation of this policy, and the explanations of the alternatives.

The discussion must begin by stating the assumption that has been followed in all analysis of this issue. This is the assumption that a higher quality labour force will benefit all New Zealanders. This is a fair assumption, because of the highly interdependent nature of the New Zealand economy.

This policy will have equity benefits, and this is important because it enables people to "participate in society in a way that they value". This subsidy of tertiary education will give poorer individuals the choice to gain further education, ensuring that our nations' youth are not limited in their aspirations by a circumstantial inability to afford course fees. Furthermore, once educated these individuals will be able to earn a level of income sufficient to lift both themselves and their Whānau out of poverty, as well as contributing to wider New Zealand society through their greater skill, knowledge, and tax contributions. Some would consider this policy inequitable, as it forces people who are already educated and working to effectively pay for someone else's, with no direct benefit to themselves and with most of the benefit of higher education accruing to the student rather than society. But the equity gains from the redistribution of wealth outweigh this small dent in equity stemming from taxation. Furthermore, all New Zealanders will benefit from education due to the positive externalities that it has.



However, though this policy does fit Treasury's criteria for equity by "increasing the chance for people to live a life they choose to value", there are greater equity and efficiency problems with this policy. One issue is that some Maori and Pacifica individuals will be wealthy, yet eligible for the grant. Therefore government spending in such cases will provide little improvement in equity.

Another important consideration is that people just above the income cut-off would be excluded from the grants, and therefore significantly worse off. Also, inflation could cause bracket creep - causing some individuals to lose access to the programme, despite having no real increase in income. Therefore there would be a strong incentive for families with children completing high school and just above the income cut-off to reduce the hours they work in order to qualify for the grants. This threatens to be a grossly inefficient situation. It could be addressed by a system whereby each individual's application is individually assessed, but such a process would be extremely costly. Thus a more efficient solution would be a regressive system whereby the proportion of fees funded would decrease with increasing household income. Under this system a small disincentive to work would still exist, but this is outweighed by the cost savings over the

alternative of individual assessment.

Social infrastructure is closely tied to equity considerations, because "a community's cooperative capacity is arguably a function of the degree of social and political inequality." Thus, it is clear that the increased equity that will result from fees free bachelor programmes will lead to a direct increase in the level of community trust, and social infrastructure will improve as social tensions stemming from income inequality are dampened.

This policy is deemed to be environmentally sustainable, because the global trend is for overall environmental stewardship to improve as a country's education and per capita income improve, and such improvements will result from implementing this policy. However, this policy is not fiscally sustainable (at least in the short run) without identifying other areas of government spending to rein in. This is because the funding of fees-free bachelor programmes comes with the opportunity cost of spending cuts or tax increases in other areas - "the money has to come from somewhere."

Furthermore, the gains in income tax through the higher earnings of graduates will not come to fruition until several years after the implementation of the policy, because of the inherent time lag present in education.

A risk from the current policy is that graduates have no obligation to remain in New Zealand after the completion of their degree. Therefore if they cannot find suitable employment locally they will be likely to look overseas to apply their skills and build their careers - whilst the cost of their fees to the New Zealand taxpayer is sunk, and they will have received little benefit from funding the bachelor programmes. Thus a possible solution is an addition to the grant policy which bonds the beneficiaries of the scheme to work in New Zealand for a period of time, such that their returns to society at least make up for the cost of their education borne by the government. But, such a clause may in actuality turn out to be useless, because it fails to realise the root of the issue - skill irrelevancy due to an underlying scarcity of suitable industry or enterprise to usefully make use of these graduates' skills. It is not just enough to invest in a higher skilled workforce, because businesses too must be willing to hire these graduates - it is of no use to have a surplus of graduates with no suitable local industry for them to be gainfully employed in. Thus increasing labour utilisation, too, must be a deliberate consideration of any education policy. It is only when there is a positive synergy between skilled graduate workers and employers that sustainable economic growth and prosperity is achieved. Therefore the recommended solution is to ensure that sufficient funding is allocated to offering these grants in subject areas in which New Zealand has already established a comparative advantage. Maybe an even better solution would be to *concurrently* make changes to legislation, implementing deregulation that streamlines the start-up of new enterprises or industry to increase the demand for skilled graduates.

Another risk is that of moral hazard. The individuals undertaking the scheme face a reduced incentive to put in effort to pass their courses because the government is paying for their fees.

Therefore they may make the rational decision to put in less effort and possibly fail papers, posing a greater cost to the government and society (in the both the cost of their fees and the opportunity cost of alternative uses of their time.) The proposed solution to this is to require a certain grade average to secure the funding. This would have the further benefit of discouraging those people for whom university study may not be their comparative advantage, and thus would increase the efficiency of the policy. But, this raises the next issue - and this is one of equity.

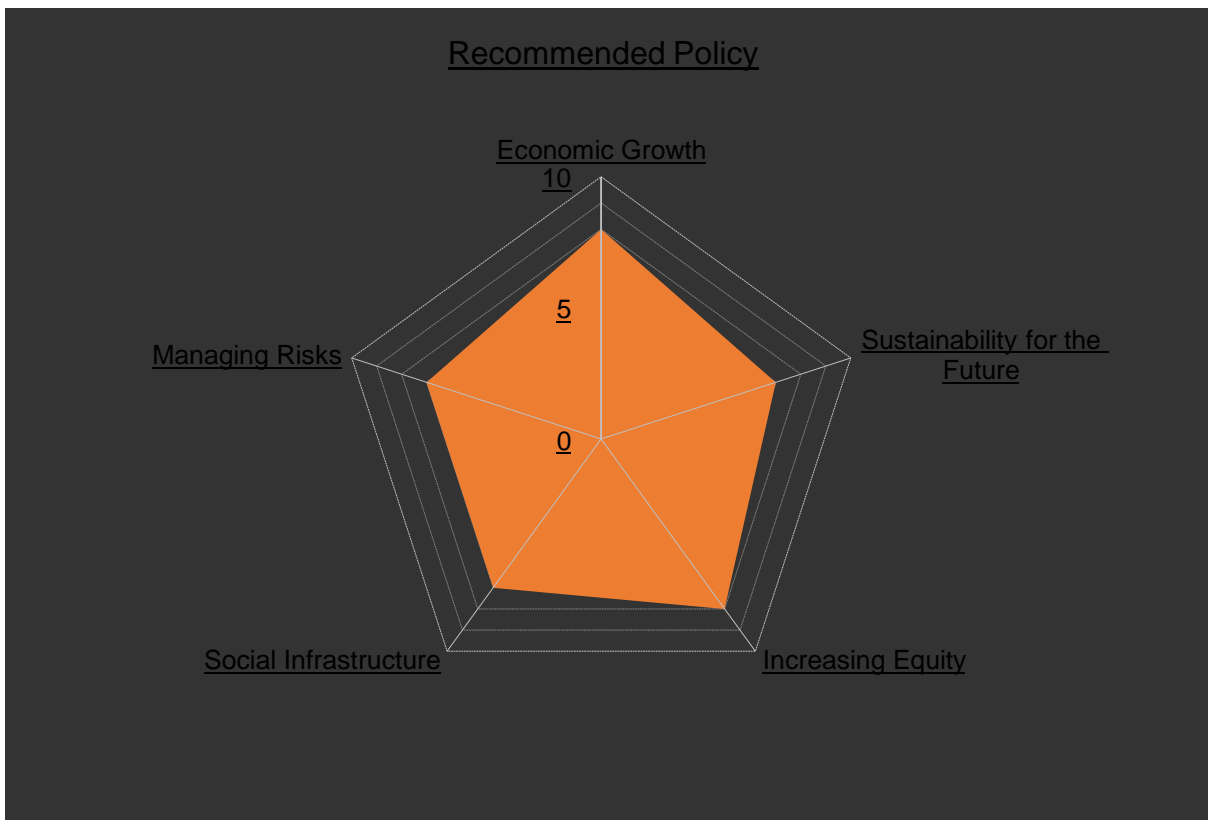
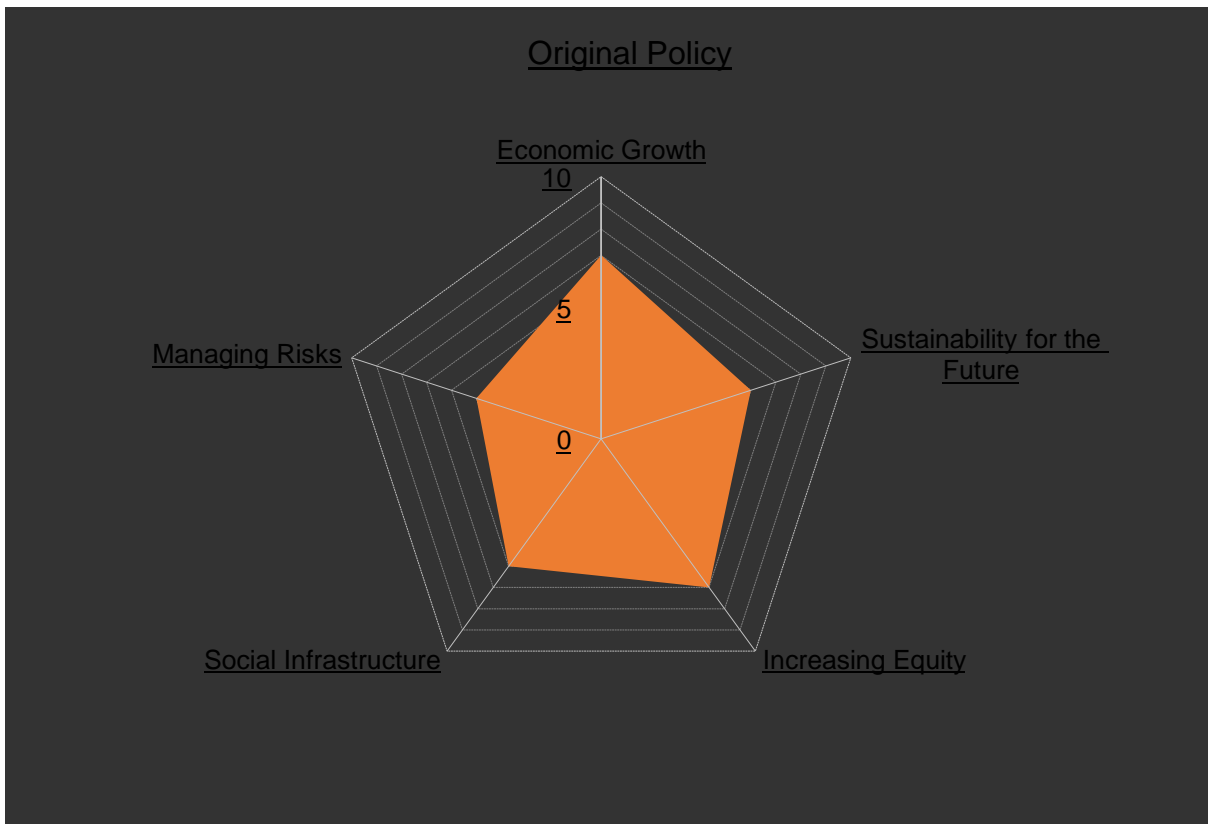
The proposed policy purports to improve equity by enabling individuals from low income groups to study a bachelor programme. Whilst true that this policy does achieve an increase in equity, it does so inefficiently. It is skewed to favour bachelor's programmes, ignoring the many other useful and productive ventures such as vocational studies, apprenticeships and entrepreneurship. The solution is a policy encouraging a broader range of tertiary education pathways, which would also help prevent a glut of graduates with bachelor degrees. But data suggests that there is also an issue at lower education levels, with 34% of Māori leaving school with no qualification - the same figure is only 13 % for non-Māori/non-Pasifika.

Looking at other jurisdictions with minority groups and how they increased education and labour force participation rates amongst members of those groups reveals insights into possible policy strategies for New Zealand. For example, the Singaporean government forged partnerships with local communities to improve the outcomes of two specific minority groups, the Malay and the Indians. The Singaporean government actively cooperated with these minority community groups to set up organisations (Sinda and Mendaki) dedicated to improving the educational outcomes of members of their community. The result has been targeted action, through programmes ranging from math to character development. These have been created and implemented by the respective communities, and have been very effective and also incredibly efficient because of the insight that the communities themselves best know what their youth need. Such a policy could be used to great effect in New Zealand too, with similar community-education organisations set up in target demographic areas. This would carry the benefits of being extremely specialised toward the needs of each community, as well as being capable of improving education outcomes at all age levels. Furthermore, this policy will entail less risk as it has already been effectively implemented in Singapore in a similar form.

Therefore, the final recommendation for the policy, considering the above merits and faults of various options, is the combinatory policy of a regressive system of grants, with these grants being awarded for tertiary education at any institute, and with a requirement for grant recipients to work in New Zealand for a period of time upon completion of their programme. The requirement to maintain a satisfactory passing grade would also be a requirement to continue to receive funding. Concurrent to this policy, community-level education organisations would be set up to cater effectively to younger students, and the start-up process for new enterprise would be further deregulated.

Current economic thinking is in agreement that education entails benefits - the disagreement lies in the extent of the spillover benefits to society, and the corresponding level of subsidy. Arguably this can lead to indecision, where a specific policy cannot be decided upon, or its intricacies taking a long time to sort out. In such cases, it is clear that the collective hive mind of all the involved decision makers is effectively indifferent between the proposed options being considered, given the unpredictable nature of the future returns on investments which must be made now. Therefore, it is urged that the minister make a fairly swift decision on the major aspects of this education policy, and then fine tune the details after the policy is implemented and its impacts can begin to be measured. This is because in the time usually spent "fine-tuning" a policy to perfection a lot of time is lost, and the opportunity cost is substantial - greater labour productivity months sooner than with delays in tertiary funding. In short, any decision is better than no decision being made. And so, it is urged that a decision be made and passed fairly quickly, because the opportunity cost of inaction is the greatest cost of all.

The following graphs provide a diagrammatic representation of the relative strengths and weaknesses of both the original and the recommended policies, as judged against Treasury's Living Standards Framework



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