REPORT ON

FUNDING OF TERTIARY EDUCATION

FOR THE MINISTER OF FINANCE

Intended use of this document:

The Davis Tax Committee is advisory in nature and makes recommendations to the Minister of Finance. The Minister will take into account the report and recommendations and will make any appropriate announcements as part of the normal budget and legislative processes.

As with all tax policy proposals, these proposals will be subject to the normal consultative processes and Parliamentary oversight once announced by the Minister.

THE DAVIS TAX COMMITTEE

October 2016

Dear Minister

We, as the Members of the Davis Tax Committee, have the honour and privilege to provide you with this report which has been:

Prepared by:

Judge Dennis Davis (Chairperson)	________________________	__________________
Professor Ingrid Woolard	________________________	__________________
Dr Tania Ajam	________________________	__________________

Reviewed and supported by:

Professor Annet Oguttu	________________________	__________________
Professor Deborah Tickle	________________________	__________________
Professor Matthew Lester	________________________	__________________
Dr Nara Monkam	________________________	__________________
Professor Nirupa Padia	________________________	__________________
Professor Thabo Legwaila	________________________	__________________

And the Secretariat for the Davis Tax Committee

Introduction

The point of departure for any response for government funding is the Constitution and its commitment to socio-economic rights. In the case of tertiary education section 29(1)(b) provides: "*Everyone has the right to further education, which the state, through reasonable measures, must make progressively available and accessible*."[1] It is the aim of this note to propose one such "reasonable measure" that might be able to address a large share of the legitimate demands made by students across the country, while not putting prohibitive strain on the budget.

We will argue that fee-free higher education for everyone (<u>including the wealthy</u>) is not economically financially possible or desirable in the short to medium future in South Africa. With an understanding of the budgetary realities in the medium term expenditure framework, we agree that it is simply not possible to find an additional R60 billion to R90 billion without massive re-prioritisation or large-scale additional borrowing. Thus, whatever additional funds can be raised and ring-fenced for higher education should be allocated in an *explicitly* pro-poor fashion. A 'no-fee' policy (apart from being infeasible) cannot possibly be pro-poor in South Africa.

A blanket 'fee-free' policy is clearly regressive and amounts to a large additional subsidy for the rich and goes against the grain of the progressive commitments of the Constitution. Based on the 2011 Income and Expenditure Survey, the World Bank[2] and Van der Berg[3] both estimate that as much as half of the university funding in South Africa accrues to the richest 10% of households. As Van der Berg notes, this constitutes an "extreme bias towards spending on the rich if all students are equally subsidised." Thus it is imperative to highlight the regressive, pro-rich nature of a 'no-fee-for-everyone' type policy. The above rebuttals do not apply to a "no-fee-for-the-poor" option.

[1] Note that the right to further education (unlike the right to basic education) is not immediately realizable and includes internal limitations. This distinction between basic and further education has been interpreted explicitly by the Constitutional Court in *Governing Body of the Juma Musjid Primary School & Others v Essay N.O. and Others (CCT 29/10) [2011] ZACC 13, para. 37; 2011 (8) BCLR 761 (CC).*

[2] World Bank (2014) *South Africa economic update: Fiscal policy and redistribution in an unequal society*, p. 48, footnote 44.

[3] Van Der Berg, S (2016) The nature of university education: Merit or Private Good? Kagisano (10) Available: http://www.che.ac.za/sites/default/files/publications/Kagisano%20Number%2010%20-%20Student%20Funding%202016%20-%20electronic.pdf

The most comprehensive student proposal that has been put forward (by students at Wits[4]) suggests that it is better to raise all the revenue necessary from taxation and none from student fees, not even from the rich. The misunderstanding is that it is possible to raise the full amount without major reprioritisation or borrowing. In the absence of raising the full amount (which seems exceedingly unlikely), using existing fees charged to wealthy students provides one additional source of revenue, something that the students acknowledge briefly at the very end of their proposal as a 'second-best' option.

Before proceeding with our recommendations we note the following:

a) This report deals with university education only (higher education also includes TVET (previously FET) colleges and other forms of education).

b) **1 in 8 children get to university, 1 in 17 graduate:** Only **12%** of a starting cohort of SA students will ever access university and only **6%** will get some kind of undergraduate qualification.[5]

c) **The wealthy are *considerably* more likely to get to university**: 10% of children from income deciles 1-7 (the poorest 70%) qualify to go to university compared to more than 40% among decile 10 (the wealthiest 10%).[6]

d) **The richest 10% of households received 48% of government's university subsidy in 2011**: Fiscal incidence studies show that the wealthiest 10% of households disproportionately benefit from university subsidies: they received 48% of university subsidies and that the wealthiest 20% received 68% of university subsidies. The poorest 50% of households received 11% of university subsidies.[7]

[4] "*Thuto ke Lesedi: Model for Fee-Free Undergraduate Higher Education in SA*" (Wits Students, 2016) Available: https://t.co/dnCiWLWiid

[5] Van Broekhuizen, Van der Berg & Hofmeyr (2016: 3) "*From Matric Into and Through University" Available*: http://www.lmip.org.za/sites/default/files/documentfiles/Servaas%20van%20der%20Berg_0.pdf

[6] Van Der Berg, S (2016) The nature of university education: Merit or Private Good? Kagisano (10) Available: http://www.che.ac.za/sites/default/files/publications/Kagisano%20Number%2010%20-%20Student%20Funding%202016%20-%20electronic.pdf

[7] *Ibid* – page 177

e) **Graduate unemployment is 6%:** For those that do graduate with a degree, their employment and income prospects are *considerably* better than those with only matric.[8]

f) **Approximately R60 billion extra per year would be needed for no-fee higher education**: The SA Treasury estimates that over the next 3 years (MTEF 2017/18-2019/20) a 'no-fee' higher education policy will require an additional R90,5 billion[9] or about R30 billion per year. This figure only covers tuition, however. If residence accommodation, books, food and other living expenses are included the figure is roughly double, hence the figure of R 60 billion is adopted.

Moving from ideological demands to workable models

It is our view that the conversation needs to shift from an ideological approach: (1) "*How do we pay for a no-fee higher education system?*" to a pragmatic one that addresses the same underlying issue as well as the budget constraint: (2) "*How do we ensure that no student is excluded from university because they cannot pay the fees?"* Currently there is a large number of students who are not eligible for NSFAS and do not qualify for a traditional loan from a bank – these are the students in the "missing middle." Furthermore, the existing NSFAS grants do not, in most instances, sufficiently cover the cost of basic necessities (food, accommodation, books, fees etc.). In both cases students are excluded from university (either initially or subsequently) on purely financial grounds despite being academically deserving. This is unacceptable and is at the root of the righteous indignation of the protesting students and those that support them.

Unfortunately South Africa cannot afford to provide comprehensive university grants to all students that qualify to go to university. Doing so would require a reduction (in absolute or inflation-adjusted terms) in existing budgets such as health, basic education and social grants or if these expenditures are kept constant, then finding at a conservative estimate, an additional R60 billion in tax revenue which at 1,5% of GDP is unrealistic. Raising R 60 billion annually holds the following implications which we illustrate by way of relatively conservative estimates: VAT would have to be increased by about 3%. That has obvious retrogressive implications as it does, at least in the short term, for growth and inflation. A 1% increase in PIT for the top income tax rates provides approximately R 3.4 billion; thus the rate would have to be increased by about

[8] Van der Berg & Van Broekhuizen (2012) "Graduate unemployment in South Africa: A much exaggerated problem. Available: http://www.ekon.sun.ac.za/wpapers/2012/wp222012

[9] National Treasury submission to Fees Commission (June 2016). Available: http://www.justice.gov.za/commissions/FeesHET/submissions/ga/2016-FHETC-Sub-NationalTreasury.pdf

17% to 58%. CGT could be increased as well but this is unlikely to produce more than another R 2 billion. A 1% skills levy increase would generate approximately R 15 billion. But if we had to leave VAT alone, increase the skills levy and CGT plus enforce estate duty per the Committee's recommendations it would still require at least increasing the marginal rate from R 750 000 taxable income to about 53%. Alternatively an increase in CIT by a further 2% could reduce the increase PIT to approximately 49%. And, of course, there would be no further revenue available for NHI or other socio-economic goods including pre-primary education were this to be adopted.

What is the best way to decrease or eliminate financial exclusion from higher education?

While there are a number of models to fund higher education, the one with the largest leverage potential is a system of government-backed student loans. Given the reality that 10% of the population in our country own "at least 90-95% of assets"[10], the vast majority of South African households do not have sufficient assets or income to stand surety for their own children. Thus, the financial markets play almost no role in funding higher education for the poorest 80% of students. In this context, a **government-backed income-contingent loan** could be a way to ensure that more/all students are not excluded on financial grounds. What would the major features of such a system be?

1. **Leveraging existing financial infrastructure:** Using the existing financial and loan infrastructure of traditional banks and financial service providers means that government would not have to build its own infrastructure to administer the loans. This would also allow for a relatively quick uptake of the system. The NSFAS experience[11] and the administrative woes it has come against are instructive in this regard.
2. **Repayment is possible**: One of the major variables determining the success of a government-backed loan type system is the ability to collect repayments from those that do earn an income above some threshold. This is heavily influenced by (a) how many students graduate, (b) how much they earn, (c) whether or not the money can be collected. On all three fronts there is good news. The returns to higher education in South Africa are among the highest in the world[12] and graduate unemployment is currently at 6%. South Africa has an extremely

[10] Orthofer, 2016 "Wealth inequality – striking new insights from tax data" Available: http://www.econ3x3.org/article/wealth-inequality-%E2%80%93-striking-new-insights-tax-data

[11] Van der berg, HSF http://hsf.org.za/resource-centre/focus/focus-68/(1)%20S.%20Van%20Der%20Berg.pdf/download

[12] Montenegro CE and Patrinos HA (2014) "Human development reports.Comparable estimates of returns to schooling around the world". Washington DC: The World Bank.

efficient tax-collection agency (SARS) which could ensure repayment. Lastly, the latest estimates of university dropout rates (a 5-year dropout rate of 28%)[13] are *considerably* lower than what was previously believed to be the case (about 50%). Since previous estimates could not follow students, changes between universities and between courses were classified as dropouts.

3. **Financial leveraging**. Some estimates of the existing banking sector in South Africa suggest that banks are geared seven times such that they could lend R70 billion from R10 billion in deposits. While student-loans discussed here would typically have a higher default rate than traditional consumer loans, it would still be possible to grant loans to a much larger number of students (or with larger amounts) than would be the case under a grant-type system. Thus, an additional R10 billion might be able to create R30 billion-R40 billion of available loans even with much higher default rates.
4. **Income-contingent repayment and subsidized interest rates:** Much of the resistance to student loans are driven by a desire to not be permanently burdened with a student loan. One could thus implement income-contingent criteria which only require repayment if/when the student earns above some threshold. The interest rate on the loan could also be capped, or highly subsidized by government with capped repayment amounts. Apart from the threshold, a condition could be considered that, in the event that a student, upon graduation, works for x years within certain defined areas (i.e. defined in a regulation) such as, for example, development or human rights, the entire loan will be forgiven.

A hybrid system of grants (for the poor), Government-backed-loans (for the missing-middle) and fees (for the wealthy)

It is our view that a system of grants (free education) for the poorest students combined with a sliding scale of income-contingent government-backed loans for the missing-middle and full-fees for the wealthy is the best *workable* solution that currently exists. While it may not be the most politically palatable option it does provide the largest immediate reduction in financial exclusion for the smallest government expenditure.

For these reasons we have sought to explore the possibility of leverage off additional revenue of R15 billion per year, which we consider may be feasible.

---

[13] Van Broekhuizen, Van der Berg & Hofmeyr (2016: 3) "*From Matric Into and Through University" Available*: http://www.ekon.sun.ac.za/wpapers/2016/wp162016

How would additional R15 billion in tax revenue be sourced?

We estimate that raising the top marginal personal income tax rate for individuals by 1.5 percentage points would yield an additional R5,1 billion. Increasing the Capital Gains Tax inclusion rate for corporates from 80% to 100% would yield an additional R1,4 billion. An increase in the Skills Development Levy of 0,5% would yield an additional R8,8 billion.

These three items together would yield R15,3 billion.

Although we concede that the skills development levy has retrogressive elements, were government to choose to make the tertiary education sector a priority, an additional R 15 billion employed in this fashion would significantly move in the direction of realizing the right to tertiary education for those most in need, while not impairing an economic recovery by the excessive imposition of taxation.