FINANCING EDUCATION: ARE THERE ALTERNATIVES TO STUDENT LOANS?¹

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Abstrak

In Islam, investment in human capital is one of the most important social objectives. Equality of opportunity in getting access to education regardless of socio-economic backgrounds should be promoted. However as we witness today students especially from low income families are facing problems with education financing. The establishment of National Higher Education Fund or generally known as PTPTN to provide loans for students suffers major problem when 60 percent of the borrowers defaulted on their payments. The substantial accumulated student loans debt is further aggravated by the current scenario of increasing unemployment rate among graduates. Even though the interest payment on student loans are subsidised by the government but the impact on students’ debt are huge. Thus in this paper we try to highlight several issues pertaining to student loans and discuss on alternatives methods of student support system in line with the Syariah to replace the current system of financing education.

1.0 INTRODUCTION

Education particularly higher education is considered as an engine of growth. It is one of the important elements of capital accumulation. Many economies in the world have invested huge amount of funds in human capital development as to ensure their competitiveness in the world economy. Thus knowledge based economy become one of the significant terms where knowledge is considered as a tool and plays an important role as any other economic resources. In Islam, the importance of acquiring knowledge has been stressed out in various verses of the Quran and the tradition of the prophet. The Prophet Muhammad (S.A.W) has shown a very keen interest in ensuring that the Muslim community have proper training and education. It was reported that during the Battle of Badr, the Prophet had released some of the prisoners on the condition that each of them should teach at least ten Muslim children how to read and write.

The fact that education is a critical ingredient in building a nation cannot be denied. However we must note that education mainly higher education is very costly. With increasing demand and higher cost of education, the traditional ways of financing higher education through government’s subsidies and grants no longer seem viable. Financing reform in higher education which stresses more on the importance of private sharing of higher education has been introduced. Around the world, scholarships and grant have been replaced with student loans. According to Ziderman (1995), there are more than fifty countries around the world using student loans as a mode of financing. Loan scheme at the outset was introduced to facilitate increase in tuition fees, provide

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greater cost recovery and help to ease the burden of the government. Loan programmes have been introduced in various forms in terms of repayment schemes and administration. Two basic types of repayment scheme are mortgage type loans, where the repayment is in fixed installment over a fixed period, and income contingent loans where repayment is a certain percentage of the borrower’s annual income making the repayment period endogenous. Some of student loans are highly subsidised and some work like loans from any other commercial bank.

The introduction of loan as a mean of financial support undoubtedly has helped students to ease their financial burden while studying but nevertheless most of them are facing problem with regard to repayment after graduating. Studies on loan programmes in many developing countries showed that many loan schemes suffered from the problem of defaulting. With the interest bearing loans, students found that at graduation their debt is much larger than they expected. A study carried out by King and Frishberg (2001) involving 1,031 students across United States suggested that about 78% of students underestimated the total cost of their student loans. Their study also revealed that students at their first years of college are at greatest risk of underestimating the impact of interest on loan repayment.

The emerging trends of interest bearing loans to replace other traditional ways of financing higher education are worrisome especially among Muslim students where interest is considered as Riba and strictly prohibited in Islam. As far as Islamic Scholars are concerned, they are still divided in their opinions as to whether or not interest on students loans is considered as Riba. Students in the United Kingdom for example have called for Shariah-Compliant student loans. Recently in Malaysia, Angkatan Belia Islam Malaysia (ABIM) or Malaysian Islamic Youth Movement has sent a memorandum to National Fatwa Council of Malaysia to look into interest on student loans managed by Perbadanan Tabung Pendidikan Tinggi Negara (PTPTN) or National Higher Education Fund Corporation (NHEFC) as ABIM believes there is an element of Riba in it.

The arguments as to whether student loans are complying with Shariah can be a long debated issue but for sure Muslim students are seeking an alternative method of financing their higher education which can strictly ensure them of the permissibility of such method. Thus it is in the intention of this paper to discuss the extend of the use of student loans as a mean of financing higher education among Muslim students (particular case of Malaysia), problems with student loans and some recommended strategies on alternative financing options and their advantages compared to student loans.

The paper will be arranged as follows. With the introduction in the first part, the second part of this paper will discuss on different views from prominent Islamic Scholars pertaining to the use of interest bearing student loans as a method of financing higher education. The third section will discuss the extent of the use of student loans as a method of financing higher education among

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2 The literal meaning of al Riba is excess or increase. According to Islamic terminology it refers to effortless profit or profit which comes free from compensation. Basically Riba is a loan with the condition that the borrower will return to the lender more than and better than the quantity borrowed.

3 ABIM (Malaysian Islamic Youth Movement) is a Non-governmental Organization which was founded in 1972 with the primary objective to establish and propagate Islamic tenets and principles and mobilization of Muslim youth in Malaysia.

4 It is an education loan program offered by the Malaysian Government and was established in 1997. The main aim of the program is to help students who have gained admission to further their studies in local public universities or private institutions of higher learning but unable to do so because of financial constraints.
Muslim students in Malaysia. The final part will discuss on some of the drawbacks of the mortgage typed loans and stresses on the importance of equity financing as an alternative option.

2.0 VIEWS ON STUDENT LOANS BY MUSLIM SCHOLARS

As mentioned, Muslim scholars are still divided in their views and opinions concerning the element of interest on student loans as to whether it is considered as Riba or not. Their argument basically centred on the issue that a certain percentage of interest charged on loan is linked to the rate of inflation thus whether in essence it is interest-free.

Dr Monzer Kahf who is a prominent muslim scholar and a counselor of student loans gave a fatwa with regard to interest rate linked to inflation. His stance is that interest charged on student loans does constitute Riba. His argument goes as follows:

“*In* lending, *the Shari’ah* requires that a loan be due in the same currency by which it was given. *At* the time of payment it may be paid in other currency, as long as it is paid at the exchange rate of the day of payment. You cannot change what is due from a person, and any increase in what is due from a person is Riba."

Muhammad ibn Adam al-Kawthari⁵ maintain the same opinion as Dr. Monzer Kahf where the rate of inflation should not be tied up to the cost of borrowing. As he suggested “*when a loan is paid back, then the rate of inflation is not considered according to Shari`ah. One can only claim back exactly the amount which was given as loans*”.

Dr. Muzammil Siddiqi⁷, however has a rather moderate view. With regard to interest on student loans he share the same opinion that it is prohibited but he however stressed that if students have no available options and they are in appalling needs to further their education, then based on the rule of necessity, taking the minimum amount of loans is permitted. He however reminded the Muslims that there is an urgent need to pay back the loans as soon as possible.

In Islam the prohibition Riba is clear. Quran has laid down strict injunctions with regard to interest on money. Surah Al Baqarah 275-276.

“*Those who devour usury will not stand except as stands one whom the evil one by his touch has driven to madness. That is because they say : ‘Trade is like usury, but Allah has permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past, “ their case is for Allah (to judge); but those who repeat (the offence) are companions” of the fire: they will abide therein (forever). Allah will deprive usury of all blessings, but will give increase for deeds of charity: for he loves not creatures ungrateful and wicked. Those who believe, and do establish regular prayers and

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⁵He is presently working as an independent Consultant in the field of Islamic Economics, Finance and Banking based in California, USA. Authored more than 25 books and monograph and more than 70 articles in the area of Islamic economics. Since 1999 he has been an English-speaking resource person for Islam-On-Line Website and dialogue.

⁶He is a teacher of various traditional Islamic sciences at Jamiah Uloom al-Qur’an and as a problem solver at the Institute of Islamic Jurisprudence,UK.

⁷is the President of the Fiqh Council of North America. He has served as the Chairman of Religious Affairs Committee of the Muslim Students Association in US and Canada; Chairman of the Department of Religious Affairs at the Muslim World League Office to the United Nations and US from 1976 to 1980. Presently serving as the Director of the Islamic Society of Orange County in Garden Grove, California.
regular charity, will have their reward with their Lord: on them shall be no fear, no shall they grieve. O you who believe! Fear Allah and give lip what remains of your demand for usury if you are indeed believers’. If you do not, take notice of war from Allah and His Messenger: but if you turn back, you shall have you capital sums: deal not unjustly, and you should not be dealt with unjustly. If the debtor is in difficulty, grant him time till it is easy for him to repay. But if you remit it by way of charity, that is best for you if you only knew. And fear the day when you will be brought back to Allah. Then shall be every soul be paid what it earned, and none shall be dealt with unjustly."

As in other parts of the world, in Malaysia, the discussion on the permissibility to charge a small percentage of interest was highly debated. Recently the National Fatwa Council of Malaysia has issued a decree that any interest on student loans is strictly prohibited. In other words PTPTN should not charge a certain percentage of interest based on the original principal borrowed but should otherwise imposed a service charge based on the cost of the maintaining the loans programme. Following the decree issued by the National Fatwa Council of Malaysia dated 28 July 2008, PTPTN then issued a circulation that effective from 1st of June 2008, the interest rate of 3% on loans for undergraduate and 5% for postgraduate degree will be replaced by 1% flat rate service charge or ‘Ujrah’. The move was highly praised by 1.14 millions borrowers especially the Muslim borrowers who have tried to avoid dealing with Riba.

3.0 STUDENT LOANS AS A METHOD OF FINANCING HIGHER EDUCATION IN MALAYSIA

Having been discussed different views and opinions from different Muslim scholars with regard to student loans, this section will look into the current scenario of student loans programme in Malaysia by giving particular attention to the extent of the use of loans as a method of financing higher education, its problems and a brief discussion on various approaches taken by the government to overcome these problems.

During 1980s there have been radical changes in the level and mechanisms of funding higher education institutions in many countries as pointed out by Woodhall (1989). Increasing cost of higher education and high demand have prompted many governments to resort to new strategies of financing higher education. Basically three strategies have been widely applied i.e:

a) Introducing or charging tuition fees
b) Charging students for board and lodging
c) Replacing scholarship and bursaries by student loans.

As in the case of Malaysia, financial stringency and the rapid growth of higher education sector (refer Table 1) has led the government to resort to student loans as a method of financing higher education replacing scholarships.8

Table 1: Total Enrolment at Public and Private Higher Institutions

<table>
<thead>
<tr>
<th>Level of Study</th>
<th>2000 Total</th>
<th>2005 Total</th>
<th>2010 Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Public</td>
<td>Private</td>
<td>Total</td>
</tr>
<tr>
<td>Certificate</td>
<td>105570</td>
<td>37391</td>
<td>94949</td>
</tr>
<tr>
<td>Diploma</td>
<td>208454</td>
<td>98953</td>
<td>131428</td>
</tr>
</tbody>
</table>

8 Before 1990’s student support scheme was normally in terms of scholarships.
In order to help students with higher education cost, in 1997, the Malaysian Government has established the National Higher Education Fund Corporation (NHEFC) or Perbadanan Tabung Pendidikan Tinggi Nasional (PTPTN) with its major role is to manage and distribute loans to students. The objective of its establishment is to subsidize part of the education fees and living expenses for the less advantaged socio-economic group. Table 2 shows total annual education loan for students based on types of institution entered, level of education, field of study and net income of parents/guardians of the student. Based on statistic in 2008, there are about 1.14 million PTPTN borrowers with the amount borrowed approximately RM23 billion. Table 3 shows the repayment period based on loan borrowed.

### Table 2: Total Annual Education Loan for a Student

<table>
<thead>
<tr>
<th>Institution</th>
<th>Level of Education</th>
<th>Field of Study</th>
<th>Full*</th>
<th>Partial*</th>
<th>Fee*</th>
</tr>
</thead>
<tbody>
<tr>
<td>IPTA/Polytechnic</td>
<td>First Degree</td>
<td>Science</td>
<td>RM6500**</td>
<td>RM3000**</td>
<td>RM1600**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Pharmacy, Dentistry/ Medicine</td>
<td>RM6500**</td>
<td>RM3000**</td>
<td>RM1800**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Arts</td>
<td>RM6500</td>
<td>RM3000</td>
<td>RM1100</td>
</tr>
<tr>
<td></td>
<td>Diploma</td>
<td>Science/Arts</td>
<td>RM5000</td>
<td>RM2500</td>
<td>RM1000</td>
</tr>
<tr>
<td>IPTS (except UNITAR, UNITEM, KYM)</td>
<td>First Degree</td>
<td>Science</td>
<td>RM16000**</td>
<td>RM13000**</td>
<td>Maximum RM10000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Arts</td>
<td>RM16000</td>
<td>RM13000</td>
<td>Maximum RM10000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Medicine/ Pharmacy/ Optometry/ Nursing</td>
<td>RM20000</td>
<td>RM20000</td>
<td>RM20000</td>
</tr>
<tr>
<td></td>
<td>Diploma</td>
<td>Science/Arts</td>
<td>RM5000</td>
<td>RM5000</td>
<td>Maximum RM5000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Allied Health</td>
<td>Maximum RM20000</td>
<td>Maximum RM20000</td>
<td>Maximum RM20000</td>
</tr>
<tr>
<td>IPTS (UNITAR)</td>
<td>First Degree</td>
<td>Science</td>
<td>RM10000**</td>
<td>RM8000**</td>
<td>RM8000**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Arts</td>
<td>RM10000</td>
<td>RM8000</td>
<td>RM8000</td>
</tr>
<tr>
<td>IPTS (UNITEM)</td>
<td>First Degree</td>
<td>Science</td>
<td>RM4200</td>
<td>RM4200</td>
<td>RM4200</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Arts</td>
<td>RM4200</td>
<td>RM4200</td>
<td>RM4200</td>
</tr>
<tr>
<td>IPTS (KYM)</td>
<td>First Degree</td>
<td>Science</td>
<td>RM3700</td>
<td>RM3700</td>
<td>RM3700</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Arts</td>
<td>RM10000</td>
<td>RM8000</td>
<td>RM6000</td>
</tr>
</tbody>
</table>

Note:
- * Determination of the full and partial loan and fees rate is based on the net income of the student’s parents/guardian.
- ** Not including the RM500 incentive for Sciences.

### Table 3: Student Loan borrowings and Repayment Period

<table>
<thead>
<tr>
<th>LOAN BORROWINGS</th>
<th>REPAYMENT PERIOD</th>
</tr>
</thead>
<tbody>
<tr>
<td>RM 10,000 and below</td>
<td>60 months</td>
</tr>
<tr>
<td>RM 10,001 – RM 22,000</td>
<td>120 months</td>
</tr>
<tr>
<td>RM 22,001- RM 50,000</td>
<td>180 months</td>
</tr>
<tr>
<td>RM 50,001 and above</td>
<td>240 months</td>
</tr>
</tbody>
</table>


A study carried out by the National Higher Education Research Institute of Malaysia (normally known as IPPTN), shows that among 99,877 PTPTN loan borrowers, 71% of them are Bumiputeras. Among Bumiputeras, the ethnic Malays is the largest group, therefore we can safely say that the largest ethnic group benefited from student loans scheme is the Malays who are majority Muslims.

Like any other student loans in other countries PTPTN suffered from the problem of non-repayment by its borrowers. From the total number of borrowers of 1.14 million in 2008, 49% of them failed to pay back the amount borrowed which total up to RM708 million. The same study by IPPTN also revealed that about 59% of the defaulters are Malays. Many people believe that the problem of defaulting is attributed to the financial inability of the defaulters but the real factors are yet to be studied. Students have voiced out that the 3% interest charged on student loan is too high and burdensome. Following numerous complaints made by the borrowers with regard to interest on student loans and subsequently the decree by the National Fatwa Council of Malaysia, PTPTN then issued a new circular that the current interest rate of 3% for undergraduates and 5% for postgraduates to be revised effective on 1st June 2008. The new rate which is considered as ‘Ujrah’ or service charge is a 1% flat rate. Table 4 shows the comparison of total charge between the 3% based on reducing rate and a service charge of 1% flat rate. The amount

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9 Bumiputra or Bumiputera (Malay, from Sanskrit Bhumiputra; translated literally, it means "son of the soil"), is an official definition widely used in Malaysia, embracing ethnic Malays as well as other indigenous ethnic groups such as the Orang Asli in Peninsular Malaysia and the tribal peoples in Sabah and Sarawak. (Wikipedia Encyclopedia).
of loan paid has been reduced remarkably between 47% and 48%. Furthermore under the reducing rate method, students who did not settle their instalments on time will end up paying more. The move to revise the calculation on rate charged has somehow brought good news to PTPTN borrowers.

**Table 4: Comparison between charge based on 3% reducing balance per annum and service charge of 1% flat rate per annum**

<table>
<thead>
<tr>
<th>Total Loan (RM)</th>
<th>Repayment Period</th>
<th>Total charge base on 3% reducing balance per annum</th>
<th>Total Service Charge at 1% flat rate per annum</th>
<th>Total Reduction Amount (RM)</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>(b)</td>
<td>(c)</td>
<td>(d)</td>
<td>(e)</td>
<td>(f)</td>
</tr>
<tr>
<td>5,000</td>
<td>5 years</td>
<td>474</td>
<td>250</td>
<td>224</td>
<td>47%</td>
</tr>
<tr>
<td>10,000</td>
<td>5 years</td>
<td>948</td>
<td>500</td>
<td>448</td>
<td>47%</td>
</tr>
<tr>
<td>15,000</td>
<td>10 years</td>
<td>2,940</td>
<td>1,500</td>
<td>1,440</td>
<td>49%</td>
</tr>
<tr>
<td>21,000</td>
<td>10 years</td>
<td>4,116</td>
<td>2,100</td>
<td>2,016</td>
<td>49%</td>
</tr>
<tr>
<td>48,000</td>
<td>15 years</td>
<td>13,829</td>
<td>7,200</td>
<td>6,629</td>
<td>48%</td>
</tr>
<tr>
<td>64,000</td>
<td>20 years</td>
<td>24,470</td>
<td>12,800</td>
<td>11,670</td>
<td>48%</td>
</tr>
<tr>
<td>100,000</td>
<td>20 years</td>
<td>38,235</td>
<td>20,000</td>
<td>18,235</td>
<td>48%</td>
</tr>
<tr>
<td>150,000</td>
<td>20 years</td>
<td>57,354</td>
<td>30,000</td>
<td>27,354</td>
<td>48%</td>
</tr>
</tbody>
</table>


The method of calculating the service charge is shown as below:

**Formula for service charge:**

\[
\text{Service Charge} = \text{Total Loan Approved} \times \text{Rate of Service Charge} \times \text{Repayment Period}
\]

\[
\text{Total Loan Paid} = \text{Total Loan Approved} + \text{Service Charge}
\]

For example, to calculate a service charge for new applicant at the diploma level in IPTA with total education loan of RM10,000 is

\[
\text{Service Charge} = 10,000 \times 1\% \times 5 = 500.
\]

Thus the total loan paid amounted to RM10500 i.e the principal amount plus the service charge of RM500.

With regard to the problem of defaulting among the PTPTN borrowers, the situation has become severely intolerable that the government then implemented several measures to overcome the problems. Among the measures taken include having the names of the defaulters blacklisted which resulted in graduates failed to apply for any loans offered by commercial bank, requesting students to have individual file number issued by the Inland Revenue as to make loan recovery easier to administer and banning the defaulters from going overseas. All these measures have been regarded by many as some kind of punishment from the government and have been extremely criticized as they further worsen the condition of the graduates who are already burdened by debts.
4.0 DRAWBACKS OF STUDENT LOANS SCHEME

The popularity of loan as a method of financing higher education is fully acknowledged, however many studies on student loans have cited the drawbacks of this scheme. Among those drawbacks are:

a) **Insufficient funds for Financing Higher Education**

Assymetric information is one of the biggest problems that arose in the capital market. The very nature of human capital investment further exacerbates the problem of assymetric information. Unlike investment in other physical goods, investment in higher education involves no collateral except the human capital itself. The returns from investment in human capital expand for a long period in the future and involve an element of uncertainty. In this case the student will have more information about his abilities and intention compared to anyone else. Therefore the investor who finances the student will be at a disadvantage. The result is that involvement of private capital in higher education will remain marginal.

b) **Underinvestment in Higher Education.**

Most student loans are of mortgage type loans where the instalments are in fixed amount regardless of the future income of the graduates. However, as mentioned, investment in human capital involves the element of uncertainty in which future earnings depend on many factors such as unpredictability of future demand and supply of labour and other economic conditions. In earlier discussion of human capital investment, Becker (1964) and Schultz (1971) did mention about the effect of uncertainty of future income. A study by Levhari and Weiss (1970) suggested that increased uncertainty decreases human capital investment. This is due to the fact that individuals will be reluctant to take up the loans as they cannot ensure of their future incomes. In addition there is no company in the private market that is willing to provide insurance to insure against their future loss. All these factors (uncertainty and absence of insurance) will lead to underinvestment in higher education.

c) **Inequality of Opportunity to Invest in Higher Education**

Relating to uncertainty and absence of insurance market, many studies show that the extent of underinvestment in higher education will be more prevalent among the less advantaged socio-economic group. In many instances poor students are more reluctant to borrow compared to rich students and hence this will create inequality in terms of access to higher education.

d) **The existence of the elements of Riba as a Deterrent to Borrowing among Muslims.**

Interest accrued on student loans even though in certain cases is so low that it is just equivalent to the rate of inflation has raised important issues in terms of its permissibility (Shariah-Compliant) among Muslim students. Many Muslims now are looking for alternative modes of financing and some of them are reluctant to take up student loans to finance their higher education.

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10 Theoretical studies on this issue include Wallace and Ihnen (1975), Kodde and Ritzen (1985) and Bell (1984).
11 Due to increasing numbers of complaints among Muslim Students in the UK with regard to student loans and a call for Shariah-Compliant financial services, Islamic Bank of Britain, HSBC and Loyds TSB are now offering numerous financial services with Loyds TSB offering Islamic Student Account.
5.0 ALTERNATIVES TO STUDENT LOANS

The prohibition of Riba shows that Islam stresses on the importance of establishing justice and eliminating exploitation in any kind of transactions. With regard to students financing it is high time that other alternative methods of financing higher education should be made available to Muslim students. In this regard we believe that equity-like instruments to replace student loans where returns to investors no longer depend on a pre-defined interest rate but on earnings of the student are called for. The idea of equity-like financing of higher education has long been discussed such as by Friedman & Kuznet (1945) and Friedman (1962). The idea by Friedman had an impact on student loans, in which his idea has been translated into an income contingent loan scheme and a graduate tax. We will discuss these two methods in turn.

a) Income Contingent Loans

Income contingent loans as the name suggests is a student loans scheme where repayment is a certain percentage of the borrowers’ annual income making the repayment period endogenous. A critical characteristic of income contingent loan is that the collection of debts depends on the borrowers’ future capacity to pay. This kind of mechanism ensures two significant advantages compared to the mortgage type loan namely default protection and consumption smoothing. As mentioned the drawback of mortgage type loans is the possibility that it will deter potential student from borrowing since students have to pay an open-ended proportion of their income whereas the returns from their human capital investment are uncertain. Income contingent repayment, on the other hand limits this burden. In terms of its implementation, Australia has adopted the scheme in which the collection of debts is done through the tax system. The scheme is known as Higher Education Contribution Schemes (HECs). The introduction of the scheme was followed by New Zealand in 1992.

b) Graduate Tax

The idea behind the implementation of a graduate tax is to fund higher education with specific tax revenues derived from graduates who benefit directly from higher education. The tax upon graduates is considered as the repayment of the costs of their education. The graduate tax is considered as an equity contract in the sense that it allows the government to finance the cost of education and later on claims on part of students’ future incomes (return on their investment) through tax. The concept behind the graduate tax is similar to that of deferred fees in which instead of loans now the government provide grants to cover costs of higher education. Graduates will only have to repay after graduation and when receiving earning from their employment. However, unlike loan schemes, the arrangements for the graduate tax are such that graduates will pay a proportion of their income throughout their working life. The repayments are made through the tax system and are linked to ability to pay. The higher the earning the more graduates have to pay. Due to the nature of the graduate tax, certain group of people might ending up paying more than the cost of their higher education (subsidising less successful graduates). Similar to income contingent loan, it provides insurance for students against any risk of failure from their investment in higher education. So far there is no single country that has applied graduate tax in its pure form.

12 Friedman and Kutznet (1945), Friedman (1962) and Garcia-Penalosa and Walde (2000) suggested that with the presence of adverse selection due to the capital market imperfections and the absence of insurance market to insure human capital risk, equity finance is the optimal way of financing education.
To further discuss the alternative method of financing higher education for Muslim students, this paper will draw on these two types of financing with more emphasise given to a graduate tax. The fundamental reason is that an income contingent loan still charges interest, only that the repayment period of the amount of interest plus the principal is endogenous. Therefore to our understanding, this type of financing in essence is still not Shariah-Compliant. On the other hand a graduate tax provides rather distinct features in which its fundamental characteristics can be boiled down to match up or be suited with the Shariah principle. In discussing this issue we are mindful that we are not in the position of giving a decree or fatwa that this equity financing is fully Shariah-Compliant but however we hope that this idea will be taken up seriously as to enhance further the discussion for the benefits of Muslims in general.

In our opinion the concept of equity financing can be translated into the concept of ‘mudharaba’ which is based on profit sharing principle. The owner of the capital provides funds to the capital user (in this case the student) on the condition that the profits generated (future income) will be shared between them. In the case of loss (unemployed) the owner of the capital will bear the loss. The willingness on the part of the owner of the capital to bear the loss justifies a share in the profit. One might argue that it is not fair that only the owner of the capital bears the loss, but we must remember that the students also lose all their hard works and efforts during their study period.

As in other contracts, it is however advisable that all conditions pertaining to the contract are clearly specified as to avoid any disputes in the future. The major issue for the owners of the capital is the effectiveness of the legal framework to protect their rights. In this respect equity contracts require the legal protection for example from bankruptcy law.

There are many advantages of equity financing or human capital contracts over loans such as:

i) **Allowing more funds to Flow into Financing Higher Education**
As mentioned, the problem of assymetric information which is typical due to imperfections of information in capital market is further exaggerated caused by the intangible nature of human capital and the element of uncertainty against future income.\(^{13}\) This phenomenon has created barriers that prevent the flow of private capital in the form of loans into higher education. In essence human capital cannot be a collateral and therefore it limits the flow of funds into this type of investment. In contrast to loan financing, equity finance can be introduced in such a way the investors have the share in the profit i.e the future income of the graduates. The idea that the investors can have the share in the success as well as the failure will ensure that the financing for risky projects can still be secured. Therefore it allows more funds to flow to this type of investment.

ii) **Provides Insurance against Future Uncertainty**
The very nature of equity finance is that repayment depends on earning, thus adjusts to student capacity to pay. This type of financing will provide insurance against future uncertainty and will encourage more investment in higher education. For example, during the time of high unemployment or recession. With regard to investors some might argue that this type of financing may create the problem of moral hazard among students but to our understanding this problem is minimal.\(^{14}\)

\(^{13}\) The discussion on capital market failure and insurance problems can be found in Nerlove (1972,1975), Barr (1991,1993), Chapman (1997), Garcia-Penalosa and Walde (2000).

\(^{14}\) For further reading please refer to Jacobs & Wijnbergen (2005).
iii) Increase Efficiency in Higher Education Market.

In equity financing, risky projects come with high returns. The same applies in investment in higher education. The price of human capital contract is basically defined as a percentage of students’ future expected income. The higher is the expected income the lower is the rate charged. In this case for example, investors of the capital will charge high rates for fields of studies with low demand in the job market (high risk) and vice versa. This mechanism will ensure the efficiency of higher education market where the relative economic value of certain field of study is properly assigned. The same thing goes to institutions. In the case where any particular institution is highly regarded as having good reputation in terms of the quality of its students (low risk), then the students who enter that institution will benefit from low rates of percentage charged. Other benefits of equity financing include reduction in the problem of defaulting since payments are adjusted with income, more equitable allocation of funds among students from various financial backgrounds as no collateral is needed during application and insurance against future uncertainty will eliminate worries especially among poor students.

Having been discussed the advantages of introducing equity contract, there are of course challenges as well. Palacios (2002) pointed out few challenges as follows:

i) The willingness on the part of the students to enter into such contract when there are other available options. By giving an example of Tuition Postponement Program offered by Yale, Palacios (2002) explained how that program has been abandoned due to the introduction of much cheaper federally guaranteed student loans.

ii) There will be ethical issues involved with regard to the sharing of profit on students’ future income in which certain people might liken it to partial slavery.

iii) The successful implementation of equity contract is very much dependent on the effectiveness of the legal framework to protect the right of both parties i.e. the students and the owner of the capital. In this case, how effective the legal framework can be is still open to question.

iv) The rate to be charged to students will depend on the expected students’ future income. In this context it is quite difficult for the owner of the capital to estimate the expected students’ future income. In such a case there should be a certain effective mechanism on how the expected future income will be determined.

6.0 CONCLUSION

With increasing cost and high demand for higher education, governments around the world have resorted to cost recovery where students now bear a larger portion of cost towards their education. Scholarships and grants have been replaced with student loans, giving them less available choices to finance their education at cheaper prices. The issue becomes more challenging for the Muslim students when they are compelled to take up the interest-bearing student loans as there are no other available options. In this paper, we try to throw up the idea on how equity financing as suggested by Friedman (1962) can be used as an option. It is the right time that Muslim Scholars can sit together and consider this option as an alternative to student loans.
REFERENCES


