

Education and Borrowing Constraints: Tests vs Prices

Raquel Fernández*
NYU, NBER and CEPR

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Abstract

This paper examines the properties of exams and markets as alternative allocation devices under borrowing constraints. Exams dominate markets in terms of matching efficiency. Whether aggregate consumption is greater under exams than under markets depends on the power of the exam technology; for a sufficiently powerful test, exams dominate markets in terms of aggregate consumption as well. The positive effects of income taxation are analyzed and the optimal allocation scheme when wealth is observable is derived. The latter consists of a fellowship scheme in which markets set school prices but the government gives out fellowships based on need and the ability to obtain a given exam score.

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