

Funding higher education: policies for access and quality

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Contents

Executive summary

1 What we all agree about	1
2 Lessons from economic theory	2
3 Problems with current arrangements	4
3.1 The good news	4
3.2 The bad news	5
3.3 The worst news: interest subsidies	8
4 The policy strategy	13
4.1 Flexible fees	13
4.2 A wide-ranging income-contingent loan scheme	14
4.3 Active measures to promote access	18
5 Conclusion	20
Annex 1: The student support system before and after 1998	21
Annex 2: An unsubsidised interest rate: how much extra for graduates?	23
Annex 3: An open-ended graduate tax: problems but no solutions	24
Annex 4: Legal issues	26
References	28

Executive summary

1. This paper puts forward a strategy for achieving two objectives in higher education – improved access and increased quality – about which there is unanimous agreement.

2. **DIAGNOSIS.** The introduction of income-contingent repayments in 1998 was a genuine and enormous advance. However, two strategic problems remain. First, income-contingency is little understood, causing unnecessary fear of debt (solutions are discussed in section 4.2). Second, all the funding problems of the current system go back – directly or indirectly – to the subsidised interest rate on student loans. Australia and New Zealand face identical problems for identical reasons.

3. Interest subsidies create three problems. They are badly-targeted, mainly benefiting high-earning graduates in mid career. They are expensive (a recently-developed model estimates conservatively that out of next year's lending to students of £2500 million about £700 million will never come back because of interest subsidies). Third, because loans are so expensive, the Treasury rations them. Thus interest subsidies, like most subsidies harm the people they are meant to help. There was an experiment with subsidies called Communism. It did not work. The result is that loans are too small, leading to student poverty and extensive use of credit card debt; and loans are means-tested: thus parental contributions and upfront costs continue.

4. **PRESCRIPTION.** If graduates pay an interest rate equal to the government's cost of borrowing (*not the bank overdraft rate*), repayments increase from about 50% of total borrowing to about 85% (the remaining 15% shortfall being mainly due to low lifetime earnings), largely eliminating the fiscal impediment to expanding loans. The move is politically less difficult than it sounds. Interest rates are currently low, so that a move to the government's cost of borrowing involves only a small increase to the rate that graduates pay. Second, a graduate's monthly repayments depend only on her income; thus an increase in interest rates has *no effect on monthly repayments*, instead affecting the duration of the loan – making it clear that repayments are simply a form of targeted income tax.

5. **POLICIES.** Removing interest subsidies is the single essential key to solving current funding problems. The considerable resources thereby released underwrite the strategy for quality and access in section 4. The strategy has three mutually reinforcing elements: flexible fees, a wide-ranging loan system and active measures to promote access.

6. *Flexible fees* are necessary to reflect diversity, to arrest quality decline and to assist some redistribution of teaching budget towards institutions with more remedial teaching. Specifically, fees should be increased initially to £2000, but with institutions free to charge less. All fees should be fully covered by a loan entitlement.

7. *A wide-ranging loan system.*

- Loans should be *adequate* to cover living costs and tuition fees, making higher education free at the point of use, thus addressing student poverty and freeing students from high-cost borrowing such as overdrafts and credit card debt.
- Loan entitlement should become *universal*, eliminating the unpopular and complex income test and, at a stroke, getting rid of parental contributions.

The combined effect of these twin elements is equivalent to bringing in universal grants in combination with an income-related graduate contribution (section 4.2). Additional options include extending loans to students in further education and to postgraduates.

8. *Active measures to promote access.* There are two impediments to access – financial poverty and information poverty. The strategy outlined in section 4.3 aims to address both.

- Grants and scholarships for students from poor backgrounds.
- Extra personal and academic support when students from poor backgrounds reach university.
- Raising the aspirations of schoolchildren.
- More resources earlier in the system, including financial support for 16-19 year olds.

Funding higher education: policies for access and quality¹

Nicholas Barr²

1. This paper sets out a strategy for promoting access and strengthening quality. Though explicitly about higher education, the arguments apply equally to the tertiary sector as a whole. Successive sections discuss:

- The many things we all agree about.
- Lessons from economic theory.
- Problems with current arrangements, and key elements of solutions, including an indication of the scale of the prize to be won.
- A policy strategy.

1 What we all agree about

2. Since the finance of higher education is controversial, it is useful to start by setting out some large areas of unanimous agreement.

3. THE PROBLEM. There is agreement, first, about two core problems:

- *Students are poor* because the system of support does not give them enough to live on. Two results follow: students have to turn to expensive overdraft and credit-card debt and/or to extensive part-time work; and the parsimony of support is an impediment to access for people contemplating university.
- *Universities are poor*, creating worries about quality. The UK would have to spend an extra £3.5 billion per year to reach the EU average.

4. OBJECTIVES. There is also agreement – strong and universal agreement – about two central objectives.

¹ This paper draws on Barr (2001, Chs 10-14), and in part on work while a Visiting Scholar at the Fiscal Affairs Department at the IMF in Spring 2000. It also draws on collaboration on policy design with Iain Crawford for more years than either of us care to contemplate, on advice on factual matters and administrative feasibility from Colin Ward and his team at the Student Loans Company, and on recent work by the three of us on a project advising the Hungarian government. An earlier version was presented at a meeting of the Parliamentary Universities Group.

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- *Improved access.* The socioeconomic mix in higher education has barely changed in 40 years. Everyone supports widening participation in the interests of social justice, and also for reasons of national economic performance.
- *Improved quality.* Again, there is no disagreement: the quality and diversity of higher education is important for its own sake, and for national competitiveness.

5. FOUR PROPOSITIONS. Resources are clearly key to achieving these objectives. To that end, the discussion of resources throughout the paper is based on four propositions.

- *UK higher education needs substantial additional funding* for reasons of national economic performance and because higher education is an important export industry.
- *Funding on the necessary scale will not come from the taxpayer*, given an ageing population, rising health expenditure, competition from other parts of the education sector and competitive global pressures.
- *Reform will therefore be ineffective unless it can deliver an immediate and sustained injection of private funding.* The way to achieve this is through a student loan scheme which can draw in private finance on fiscally attractive terms.
- *Phasing out the interest subsidy on the current loan scheme is essential to that end.* Interest subsidies are costly (about one-third of total lending never comes back because of their cost), distortionary and badly-targeted. Instead of paying an interest rate equal to the rate of inflation (as currently), graduates should pay a rate equal to the government's cost of borrowing (*not the interest rate on bank overdrafts or credit cards*). The considerable savings would be much better used to expand the loan system and for the explicit, targeted measures to promote access set out in section 4.3.

2 Lessons from economic theory

6. Economic theory offers three strong sets of results, summarised here briefly.³

7. THE DAYS OF CENTRAL PLANNING HAVE GONE, both for students and for higher education institutions. The system should empower the individual choices of students and potential students. The key theoretical question is whether students are well-informed or can become well-informed. My answer is yes. The role of government is not to plan student choices, but to make sure that students have easy access to timely, accurate and relevant information and – particularly for students from poorer backgrounds – also to advice.

8. The supply side should also be liberalised. Forty years ago, with an elite system, it was possible, as a polite myth, to assume that all universities were equally good and hence

³ For fuller discussion, see Barr (2001, Chs 11 and 12).

could be funded broadly equally. Today we have a mass system, meaning more higher education institutions, more students, and much greater diversity of subject matter – all changes which are warmly to be welcomed. As a result, however, the characteristics and the costs of different degrees at different institutions vary widely. Thus universities need to be funded differentially. In principle this could be done by an all-knowing central planner. In practice, the problem is too complex for that to be the sole mechanism. A mass system in an increasingly complex world needs a funding mechanism which allows institutions to charge differential prices to reflect their differential characteristics.

9. Supply-side liberalisation is not only necessary; it is also desirable. Increased competition between institutions will make them more responsive to student preferences. Some students will wish to study full-time but on an accelerated basis, for example studying for four terms per year rather than three; others, in contrast, will wish to study part-time, for example through evening courses. A system which can offer students and prospective students a wider range of choice is efficient; and the added option of part-time study while continuing to work also assists access.

10. GRADUATES SHOULD CONTRIBUTE TO THE COSTS OF THEIR DEGREES. A second strong result from economic theory is that higher education should not be free – its costs should be shared between the taxpayer and the graduate. There are two mutually reinforcing arguments.

11. *We cannot afford free higher education.* The argument is simple. Forty years ago, with a 5% participation rate it was fiscally feasible to rely mainly on public funding to support a high-quality higher education system. The welcome expansion to a 35% participation rate, with aspirations to a 50% rate, however, mean that public funding has to be supplemented on a significant scale by private funding. This is all the more the case because:

12. *We should not have free higher education.* It is well-known that graduates on average have significantly higher earnings than non-graduates. The Dearing Report (National Committee of Inquiry into Higher Education, 1997, para. 18.13) suggests that

'compared to those without higher education qualifications who were qualified to enter higher education, those with higher education qualifications:

- have higher employment rates;
- enjoy higher salaries;
- enjoy an average private rate of return of some 11 to 14 per cent'.

13. Since higher education creates social benefits it is right that there should always be a taxpayer contribution. But given the robust evidence on private rates of return, excessive reliance on public funding is inefficient. It is also regressive, and hence unjust, since the major beneficiaries of free higher education are the predominantly middle-class participants.

A government committed to improving access should not spray scarce taxpayer pounds indiscriminately across the entire student body but should instead target those resources on people for whom access is most fragile.

14. A WELL-DESIGNED STUDENT LOAN SCHEME HAS CORE FEATURES. The third set of conclusions from economic theory sheds light on the design of student loans. Four features stand out, summarised here only briefly (for fuller discussion, see Barr, 2001, Ch. 12).

- *Income-contingent repayments*, i.e. loans with repayments calculated as $x\%$ of the graduate's subsequent earnings until she has repaid her loan, are fundamental. The arguments are now well-understood. Income-contingent repayments instantly and automatically respond to changes in earnings: people with low earnings make low repayments; and people with low lifetime earnings do not repay in full. The effect is to protect borrowers against excessive risk, with gains both in efficiency and in terms of access (see also Barr and Crawford, 1997, evidence to this Committee).
- *Large enough to cover all living costs and all tuition fees*. This feature makes higher education free at the point of use – the important advance made by the Cubie arrangements in Scotland. Students are no longer pushed towards expensive credit-card debt; and parental contributions can be abolished, a liberation both for students and their parents.
- *An unsubsidised interest rate*, as explained in section 3.3, is essential for fiscal reasons, for efficiency reasons, and in the interests of access.
- *A capacity to bring in private funds*. Student loans bring in private funding through students' subsequent repayments. However, there is a net saving to the taxpayer only when the scheme is mature, i.e. when the inflow of repayments from earlier cohorts of students matches or exceeds the outgoings to this year's borrowers. That process takes 15-20 years. If extra resources are needed immediately, it is desirable to have a loan scheme which brings in private money upfront, creating an immediate injection of private finance.

3 Problems with current arrangements⁴

3.1 The good news

15. Income-contingent loans, with repayments collected alongside income tax, were introduced for UK students starting their degrees in or after 1998. This move represents unambiguous progress and deserves loud applause.

⁴ For assessment of systems of higher education finance in other countries (the USA, Australia, New Zealand, the Netherlands and Sweden), see Barr (2001, Ch. 13). National Audit Office (2002) reaches very similar conclusions about the problems of the present system, in particular its failure to improve access.

3.2 The bad news

16. That, however, exhausts the good news. The problems described below were both predictable and predicted, e.g. Barr and Crawford (1997) in evidence to this Committee.

STUDENT SUPPORT: IMPEDIMENTS TO ACCESS

17. The system of student support impedes access in several ways.

18. **DEFICIENT LOAN DESIGN.** The current scheme conforms with only one of the four criteria – income-contingent repayments – in para. 14. It fails the remaining three badly.

- The loan is too small to cover living costs; it is income tested, so that not all students are entitled to a full loan; and there is no loan to cover tuition fees. Thus the system incorporates upfront charges, students remain poor, and parental contributions continue. All these features impede access.
- The loan incorporates an interest subsidy. The resulting problems are discussed in detail in section 3.3.
- The scheme is capable of bringing in private finance but, because of the interest subsidy, only on fiscally unattractive terms, again, discussed further below.

19. **CONTINUED RELIANCE ON PARENTAL CONTRIBUTIONS.** The problems of parental contributions merit additional discussion.

- As a philosophical matter, is it right to force young adults to depend on their parents?
- Student poverty: the scale and volume of unpaid contributions is well known.⁵
- Impediments to access: unpaid contributions cause some students to drop out, and the threat of unpaid contributions deters an unknown number of others from applying in the first place.
- Distorted choices: in other cases, parents pay the contribution, but with conditions attached: 'we will pay, but only if you do a sensible subject.'
- The previous three problems all have troubling gender and ethnic aspects, and the point is, if anything, even stronger in respect of spouse contributions.

⁵ Barr and Low (1988), using data for 1982/3, found that about half of students entitled to parental contribution received less than they were supposed to, and the shortfall was substantial: students whose parents gave them less than the system supposed received only £53 of every £100 of assessed parental contribution. As a result, one student in thirteen remained below the poverty line even when income from all sources was included. Subsequent work based on 1992/3 data found that 37 per cent of students received less than the assessed parental contribution (Committee of Vice-Chancellors and Principals (1996, p. 14), quoting an official survey). Callender and Kemp (2000, p. 3) report that 'By 1998/9, the proportion of students who failed to receive their full assessed parental contribution had doubled to three in ten students. The mean shortfall for these students (average assessed contribution minus average actual parental contribution) was £719'

- The income test necessary to assess parental contributions is intrusive and has high compliance and administrative costs.

20. Its gets worse! Assessment of family income has to take account of whether a student is making maintenance payments (a deduction from his assessable income) or is the recipient of maintenance payments (which may be an addition to his assessable income) (Department of Education and Skills, 2001, Ch. 6, paras 54-58). And the relevance of a spouse's income raises the vexed issue of cohabitation: a woman whose husband has a high salary is not entitled to a full loan; nor is one whose partner has a high income – but that requires finding out whether or not a student is cohabiting. Paras B117-8 of the guidance notes just cited are titled 'Advice on identifying a cohabiting couple'. Such factors – which should lie wholly outside the system of student support – are an inescapable concomitant of an income test.

21. None of this is an attack on family support: where families wish to help, such support should be applauded. The attack is twofold. Policy should not be based on an *assumption* that parents will support their children. Such an assumption may, at a stretch, have been valid for an elite system of higher education, regarded as a luxury good for middle-class families; it is invalid for mass higher education as an investment good, and totally inapplicable to expanding access. The policy is bad also because it *forces* students into dependence on parental contributions or spouse contributions, since there is no option to take out a larger loan in place of unpaid contributions.

22. COMPLEXITY. Annex 1 gives a very simplified explanation of the current system. But student support in practice is so complex that nobody fully understands the system.⁶ Someone from a poor background pays no tuition fee and is entitled to a full loan. The assessment of a student's financial position is based on parental income for a younger student, or on his or her spouse's or partner's income. Parental or spouse income has two effects: as income rises, the tuition fee rises; once the fee has reached its maximum (£1,075 in 2001/2), the effect of additional parental income is to reduce the size of the loan to which the student is entitled. All students, however rich their parents or spouse, are entitled to a loan equal to about 75 per cent of the maximum loan *except* that scholarship and similar income, if high enough, can reduce loan entitlement below that 75 per cent minimum.⁷ Such complexity has major ill-effects: students, prospective students, and their parents cannot understand the system; it is a nightmare to administer; and complexity, *per se*, impedes access.

⁶ Without wishing to seem frivolous, I challenge Committee members to explain the operation of the income-test by which a student's loan entitlement and tuition fee are assessed, as set out in the guidance notes from the Department for Education and Skills (2001) to the Local Education Authorities, who administer the income test (http://www.dfes.gov.uk/studentssupport/ss_admin/content/dsp_section_29.shtml, Chapter 6).

⁷ Originally, a student's loan entitlement was reduced pound for pound with any scholarship income in excess of £1000 per year. The disregard was subsequently increased; in 2001/2 it is £4000 (Department for Education and Skills, 2001, Table 5).

23. **INADEQUATE DISSEMINATION OF INFORMATION.** Perhaps the greatest impediment to access is the fact that the wider public totally fails to understand income-contingent repayments. The scale of this ignorance cannot be exaggerated. Most people are completely unaware that loan repayments are *de facto* a form of income tax – but paid only by graduates and switched off once the graduate has repaid what he or she borrowed. In this respect, the Government is deeply culpable over its negligence in vigorously and repeatedly explaining this point. The resulting ignorance unnecessarily aggravates debt aversion and is a further impediment to access. The topic is taken up in detail in paras 63-73.

UNIVERSITIES: IMPEDIMENTS TO QUALITY

24. The post-Dearing arrangements are also bad news on the supply side.

25. **CONTINUED CENTRAL PLANNING.** The strong theoretical case against central planning of higher education was alluded to earlier. Though nobody quarrels with the need for universities to be publicly and transparently accountable, there are few defenders of the particular mechanisms, of which the QAA and RAE are only the tip of the iceberg. In addition, there has been central control of the number of students at each university and of tuition fees – in other words, both price and quantity were determined by the central planner – a situation only partly eased by the proposed lifting of the numbers cap.

26. Such planning impedes quality. Also – and entirely unintended – it impedes access to UK students to the best universities. Again, this was predicted to this Committee:

'A flat fee will continue the erosion of quality at the best universities, which face the biggest shortfalls. If this policy continues, the result will be to deprive British students of the chance of an internationally cutting-edge undergraduate degree in one of two ways. The quality of the best institutions might fall; British students could still get places, but the quality of the degree would be less. Alternatively, the best institutions will largely stop teaching British undergraduates (for whom they receive on average £4000 per year) and will use the fees from foreign undergraduates (around £8000 per year) to preserve their excellence. The government is considering trying to prevent British universities from charging additional fees to UK/EU students. Again, this is done for equity reasons; again, it ends up harming the very people it is aimed at helping, in this case by creating a situation where British students will find it harder and harder to get places at the best universities' (Barr and Crawford, 1997, para. 57).

27. **INADEQUATE UNIVERSITY INCOME.** The immediate post-Dearing arrangements brought universities not an extra penny, for the reasons explained in Barr and Crawford (1997), with worrying effects on quality. The story in 1997, in a nutshell, was as follows:

- (a) Public spending on higher education would not go up (the budget said so).
- (b) Parental contributions (i.e. private spending) would not go up (the Secretary of State said so).⁸
- (c) Loans to students (the other potential source of private spending) counted in their entirety as public spending.

28. There has been some improvement since 1997. Public spending under (a) has increased; debt sales have brought in some private money under (c); and the move from cash-flow to resource accounting has further assisted under (c). These developments are all genuinely welcome; but they do not change the reality that, at its core, the system continues to be publicly funded; and given its greater political salience, student support has crowded out university income. The story in Australia is exactly the same (see Annex 3, para. 95), and for exactly the same underlying reason – the interest subsidy on student loans.

3.3 The worst news: interest subsidies

THE PROBLEM

29. It is important to understand the scale of the problems that interest subsidies cause.
30. WHAT INTEREST RATE? First, it is important to be clear what I am *not* saying:
- At present graduates pay an interest rate equal to the rate of inflation. Press discussion of 'market interest rates' evokes worries about high interest rates associated with credit cards and overdrafts. That is not what is meant. The interest rate which graduates should pay on their loans is *the government's cost of borrowing*, i.e. broadly the interest rate the Monetary Policy Committee announces.
 - The attack is on *blanket* interest subsidies. A strong case can be made for *targeted* interest subsidies – for example someone who is unemployed or caring for young children or other dependants – to make sure that their debt does not spiral upwards. Mechanisms for such targeted assistance are discussed in section 4.2.
31. WHY ARE INTEREST SUBSIDIES SUCH A PROBLEM? Interest subsidies are:
- *Regressive*. As explained in paras 42 and 43, interest subsidies do not benefit students (who do not make repayments), nor low-earning graduates, but better-off graduates in mid-career.

⁸ 'Today the Government announce a new deal for higher education, involving new funding for universities and colleges, free higher education for the less well-off, *no parent having to pay more than at present* and a fair system of repayment linked to ability to pay' (*Hansard* (Commons), 23 July 1997, col. 949) (emphasis added). 'Our response to Dearing ensures that fees and maintenance together do not place an increased burden on middle-income families' (*ibid.*, col. 950).

- *Expensive.* Interest subsidies are enormously costly. Evidence from debt sales suggests that of all the money lent to students, about one-third never comes back because of the cost of interest subsidies. The scale of the resulting losses is discussed shortly. The high fiscal costs of loans create two further sets of ill-effects.
- *Inimical to quality.* Expensive student support crowds out university income; thus interest subsidies conflict directly with improved quality.
- *Distortionary.* Because loans are so expensive, the Treasury rations them. Thus interest subsidies, like most subsidies, create shortages – like rent control, they end up harming the very people they were meant to help. There was an experiment with price subsidies called Communism. It did not work.

32. In the case of loans, shortages manifest themselves in the following ways:

- The full loan is too small to cover a student's living costs, leading to student poverty.
- Loans are means-tested: as a result parental/spouse/partner contributions continue, and higher education involves upfront costs and charges.
- Loans are restricted, for example are not available to students in further education (impeding access), nor to postgraduates (putting national competitiveness at risk).

TOWARDS A SOLUTION: THE SCALE OF THE PRIZE

33. In short, interest subsidies create a fiscal black hole which aggravates problems both of access and quality.⁹ A move to an unsubsidised rate is not just a technicality – *it is the single essential key to solving current problems of funding tertiary education.* The considerable resources thereby released underwrite the array of major policy advances set out in section 4.

⁹ Other countries are reaching a similar conclusion. New Zealand, having flirted with interest subsidies since 2000, are contemplating reversing that short-lived, ill-advised experiment. A government report published last November, concluded that:

'Participation goals should continue to be supported through a Student Loan Scheme with income-contingent repayments as at present. The Commission believes, however, that the current policy of writing off interest on loans for full-time and low-income students while they are studying is not an effective use of the government's resources. While this policy has decreased the length of time taken to repay loans after graduation, it has also led to an increase in the number of students taking out loans and in the overall level of student debt. To compound matters, the policy has made it possible for learners to borrow money and invest it for private gain (arbitrage). Consequently, the Commission believes that this policy should be discontinued - or that, as a minimum, the incentives for arbitrage should be removed. Any savings accruing to the government as a result of modifying the current loan scheme should be reinvested in the tertiary education system and be used for the benefit of students' (New Zealand Tertiary Education Advisory Committee, 2001, p. 14).

34. HOW MUCH EXTRA MONEY? Suppose graduates pay an interest rate equal to the government's cost of borrowing rather than, as now, the inflation rate.¹⁰ Do the resulting savings make the move worthwhile?

35. Barr and Falkingham (1993, 1996), using LIFEMOD, a microsimulation model, found that for every 100 the government lends, only about 50 is repaid. Of the missing 50, 20 is not repaid because of fraud, early death, and emigration (all of which have a relatively small effect), and mainly because some graduates have low lifetime earnings and so never repay their loan in full, and 30 is not repaid because of the interest subsidy. In other words, the interest subsidy converts nearly one-third of the loan into a grant.

36. Previous sales of student debt offer independent evidence. The debt was sold for about 50 pence per pound of its face value. Official estimates suggest that of the missing 50 pence about 15 pence was because of low lifetime income, etc., and 35 pence because of the interest subsidy. The evidence on the interest subsidy is compelling. The government did not use LIFEMOD; thus the official estimates and the simulation results reinforce each other.

37. A recent modelling exercise¹¹ offers further confirmation. The model is conservative in at least two ways. First, it assumes that the subsidised interest rate is 2.5%, the unsubsidised rate 5%, thus implicitly assuming that the real rate will stay as low as 2½% throughout the lifetime of the loan. Second, the accounting of debt forgiveness is on an accruals basis, even though forgiveness normally occurs only at the end of the loan period.¹² The model takes as its starting point projected loan outgoings for the next academic year of £2,500 million.¹³ With debt forgiveness of 15% (i.e. assuming that 15% of student borrowing will never be repaid because of low lifetime earnings, etc.),¹⁴ a move to an interest rate equal to the government's cost of borrowing would release sustainable savings of £700 million per

¹⁰ Charging a market interest rate on income-contingent loans raises issues under the Consumer Credit Act. Solutions to the problem are outlined in Annex 4.

¹¹ The model was originally developed by the Chief Executive of the Student Loans Company as part of a joint LSE/SLC project advising the Hungarian Government, and has been adapted to simulate alternatives to the UK system.

¹² The calculations assume that a portion of the total debt forgiveness occurs each year, when repayments are due. This gives a higher assessment of the cost of forgiveness than one which reflects the real life position, where the level of forgiveness is known only at the end of the repayment period. The cost is higher because discounting for the loss of purchasing power over time is greater in the earlier years of repayment. The approach was adopted because it represents the most punitive accounting approach that can be taken for costs, depending on the resource accounting policy applied by the Treasury.

¹³ This is the forecast figure for 2002-3 including income-contingent loans, mortgage loans and hardship loans (the latter two being small). The outturn for 2000-1 was £1840 million, the forecast for 2001-2, £2282 million.

¹⁴ New Zealand, with longer experience of income-contingent repayments, uses an official estimate of 10% in its public accounts.

year.¹⁵ That sum could be used to finance additional grants and scholarships of up to £700 million. Alternatively, it could be used to underwrite an expanded loan system; with 15% debt forgiveness, it would be possible nearly to triple the total amount of lending. Or the sum could be used for a combination of the two policies.

38. WHEN WILL THE MONEY BE AVAILABLE? It is necessary at this stage to distinguish the *cash-flow* costs of loans (i.e. the money which is required now, but which will eventually be repaid), from the *fiscal costs* (i.e. borrowing which will never be repaid). With the present loan scheme, for each 100 that students borrow (the cash-flow cost), roughly 50 will never be repaid (the fiscal cost). The argument above is that eliminating interest subsidies reduces the fiscal cost of loans from about 50% to about 15%. Though the Treasury will, of course, take cognisance of cash-flow costs, the abolition of interest subsidies makes it possible to have a loan system that is larger, but *at the same time* has smaller fiscal costs.

39. Seen through the eyes of the Treasury, £700 million is the present value of the *annual* saving, and is thus a significant and sustainable long-run resource. Seen through the eyes of the Department for Education and Skills, however, the initial savings in cash-flow terms are small.¹⁶ But higher education needs to benefit immediately from the long-run savings. That will require a deal between the Treasury and the Department for Education and Skills for an early injection of additional resources. One way to finance such a deal is by selling a further tranche of student debt, which could yield up to £2 billion. For the reasons explained in the previous paragraph, such a deal makes sense in both educational *and* fiscal terms.

40. Ensuring low fiscal costs is, of course essential. Once that is done, the Treasury can choose how to deal with the cash flow costs of the loan system. It could do so out of taxation: under resource accounting, the fiscal costs (i.e. lending that is not expected to come back) appears as current education spending, while expected repayments appear in the capital account as a financial asset.¹⁷ With the present loan scheme, about half of lending to students is counted as spending out of the education budget. If there were no interest subsidy, only 15%, or so, of total lending would appear as current education spending, and the 85% expected repayment would appear in the capital account.

¹⁵ The gross annual saving from a move to an unsubsidised interest rate is £X million, considerably larger than £700 million. The figure of £700 million is the answer to the following question: the government wants to finance grants by selling bonds which are repaid after *n* years, where *n* is commensurate with the maximum duration of the student loan; if repayments, including interest, over *n* years is £X million, what is the maximum face value of the bonds? The answer is £700 million – the amount that can be spent on grants allowing for the cost of financing those grants. Thus the figure is a very conservative one.

¹⁶ To oversimplify, if the interest rate students pay rises by 2.5%, the extra interest in year 1 is 2.5% x £2500 million, i.e. £62.5 million. In year 2, the saving in cash-flow terms are double that sum, in year 3 triple, etc.

¹⁷ Resource accounting has been introduced in the UK only recently. For a description of the way student loans are treated in the public accounts in New Zealand, which has had resource accounting for longer, see Barr (1997), evidence to this Committee.

41. Alternatively, the Treasury could deal with the upfront cash flow costs by bringing in private money to finance the scheme. This can be done in various ways. The debt-sale approach has been extensively discussed (Barr and Falkingham 1993, 1996). There has been less exploration of front-end funding, which has two variants. With retail lending, individual students borrow from private lenders; thus student borrowing is individualized. With wholesale lending, the loans administration borrows private money in tranches of (say) £2 billion, which it then lends to students.¹⁸

42. GRASPING THE NETTLE. The scale of the prize is clearly enormous. But political worries about raising interest rates persist. These, however, should not be exaggerated.

- There is already growing support for removing interest subsidies (e.g. Piatt and Robinson, 2001).
- Interest rates are currently low; thus the interest rate would have rise by no more than 2½ per cent from the rate in the current loan scheme.
- A person's monthly repayments depend only on her income; thus interest rates have *no effect on monthly repayments*, but only on the duration of repayment. Once such a scheme has been introduced, this feature will become obvious to graduates.
- The wider public should understand who benefits from interest subsidies. Interest subsidies do not help students (it is not students who make loan repayments, but graduates); they do not help low-earning graduates, since unpaid debt is forgiven after 25 years; they do not help higher-earning graduates early in their careers (since monthly repayments are a fraction of earnings, and so are not affected by the interest rate); the only people they help are higher-earning graduates in mid career, whose loan repayments are switched off earlier because of the interest subsidies than would be the case without the subsidies.

43. IN SUM.

- Interest subsidies are targeted with exquisite accuracy: they benefit successful professionals in mid career. Thus the NUS position, defending interest subsidies, is arguing for continued subsidies for those who need it least at a time when they need it least, and the hell with today's struggling inner-city sixth-formers.
- Removing the interest subsidy finances policies to promote access and quality, thus helping students rather than graduates. The proposal is *not* to eliminate subsidies, but to replace blanket (i.e. untargeted) subsidies by targeted interventions.

¹⁸ There has been extensive development work on front-end funding (see Barr, 2001, Ch. 14). The result is not just academic theory, but has been extensively tested with the IMF, Eurostat, and financial market actors.

- Income-contingent loans are simply a form of income-tax; and income-tax, together with a write-off after 25 years, bases loan repayments on outcomes, and hence targets subsidies accurately on graduates with low lifetime earnings.

Once students and their parents come to understand these point, their worries and, with them, much of the political hullabaloo, will recede – an issue discussed in detail in paras 63-73.

4 The policy strategy

44. This section sets out a strategy for access and quality with three elements:

- flexible fees, to address the quality issue, and to begin to free universities from unnecessary central planning;
- a wide-ranging loan scheme to empower choice for the generality of students;
- wide-ranging but targeted measures to promote access; these need to start early in the school system.

45. The three elements are a strategy, not just a bunch of ad hoc policies: they are designed to achieve explicit objectives, and the elements are mutually reinforcing. This does not mean that the policies below must be swallowed whole, but does mean that attempts indiscriminately to pick and mix will fail to achieve the policy's objectives.

4.1 Flexible fees

46. A MEDIUM-TERM AIM. Flexible fees are both necessary and desirable for at least three reasons.

47. *To address diversity.* Historically, with a small tertiary system and a limited range of subjects, it was possible for central planners to determine funding levels for different institutions. Today, however, the higher education system is large, diverse and complex. As a result, (a) the necessary variation in funding is much greater than formerly and (b) the problem is now too complex for a central planner to have the sole power of decision about how resources should be divided between institutions. Thus institutions should have the freedom to set their own fee levels (that freedom could be constrained).

48. *To arrest quality decline.* Without higher fees, quality will continue to be eroded and, given flat fees, eroded most at the best institutions.

49. *To prevent crowding out.* At present, the best institutions tend to receive more funding for teaching in an attempt to protect their quality. This risks crowding out universities with a different mission. With higher fees, the best institutions could paddle their

own canoes to a greater extent than currently, freeing resources for institutions which have to do more remedial teaching. Thus – an important and poorly-understood point – flexible fees benefit *all* tertiary institutions.

50. ARGUMENTS THAT DO NOT STAND UP are of two sorts. It is sometimes argued that students should pay the full costs of tuition. That argument overlooks the significant (albeit hard-to-quantify) external benefits of higher education. There is a strong case for continuing taxpayer subsidy for tuition for all students. Other people argue the opposite – that tertiary education should be entirely funded from taxation. There may be a case for that policy for sub-university education, but, applied to higher education, the argument is flawed. The argument that university education should be free at the point of use (which I support), does not mean that there should be no charges. Free tuition is expensive, and its benefits accrue disproportionately to people from better-off backgrounds, who go on to be among the best-off. Thus free tuition is badly targeted; the money could do much more for access if spent in a way that directed resources specifically at those groups for whom access is most fragile and those who do not benefit financially from their degrees. Lowering tuition charges for higher education in other countries has not improved access. Conversely, introducing the Higher Education Contribution Scheme in Australia in 1989, with tuition charges paid via an income-contingent loan, did not harm access (Chapman 1997).

51. HOW HIGH SHOULD THE FEE BE? Taxpayer support plus tuition fees should cover the costs of teaching. At research-intensive universities, fees should be higher to the extent of the value-added *in teaching* by research-active people, but should not cross-subsidise research.

52. PITFALLS TO AVOID. Though flexible fees are desirable, there should be no 'big bang' liberalisation. As a first step, the flat fee should be increased to £2000.¹⁹ However, institutions should be free to charge less if they wish, and the ceiling should be raised over time. As indicated below, any increase in the ceiling should be accompanied by an equal increase in the loan entitlement.

4.2 A wide-ranging income-contingent loan scheme

53. The second element in the strategy is a wide-ranging loan scheme. Discussion starts with policy options and then turns to a much-neglected aspect of loans – how to make sure that the public understands the nature of the beast.

POLICY OPTIONS

54. As explained in section 2, a well-designed loan scheme has four characteristics: income-contingent repayments; sufficient to cover all living costs and all tuition fees; with

¹⁹ See, similarly, Piatt and Robinson (2001) and Council for Industry and Higher Education (2001).

an interest rate equal to the government's cost of borrowing; and capable of bringing in private funds. A loan scheme of this sort opens up the following options.

55. UNIVERSAL. If there is no interest subsidy there is no need to ration loans, which can therefore be made available as a universal entitlement. The administratively complex and politically unpopular means test disappears; so does the relevance of such factors as whether a student is married or cohabiting.

56. ADEQUATE. For the same reason, the loan entitlement can be large enough to cover realistic living costs and all tuition fees.²⁰ A universal, adequate loan has major advantages.

- It eliminates student poverty.
- It makes higher education free at the point of use.
- It makes it possible to abolish parental contributions.
- It frees students from forced reliance on expensive credit card debt and/or the need for extensive part-time work, and thus in substantial measure addresses the worries of middle-class students and their parents, and also the (rightful) complaints by the NUS about the amount of high-cost student debt.
- It is simple for students and their parents to understand.
- It is vastly simpler to administer than current arrangements, since the administratively cumbersome and unpopular means test can be abolished.

There is no need to belabour the helpful political resonances of all these features.

57. EXTENDING LOANS TO OTHER GROUPS OF STUDENTS. The scheme could be extended to postgraduate students, starting to address worries about research capacity and national productivity. It could also become a universal entitlement throughout tertiary education, buttressing existing sketchy student support for further education and vocational training, thus contributing to access.

58. PROTECTING LOW EARNERS is a clear priority. Income-contingent repayments do so automatically, since low earners make low repayments, and people with low lifetime earnings do not repay in full. Nevertheless, many people are afraid of rising debt, and interest subsidies were introduced to assuage those fears. As argued earlier, however, interest subsidies are a costly, non-transparent and ineffective way of promoting access, and benefit exactly the wrong people. The policies below are more transparent and better targeted ways of protecting low earners.

²⁰ Extending loans to cover tuition fees raises issues under EU legislation. These are discussed in Annex 4.

59. *Scholarships*, i.e. grants which do not carry an obligation to make income-contingent repayments.

60. *Stopping repayments after 25 years*. Scholarships help people at the start of the process. Complete debt forgiveness after (say) 25 years helps them at the end of the process.

61. *Targeted interest subsidies based on current income*. It is also possible to help people during the process. Under the simplest mechanism, anyone receiving a credit for national insurance contributions – someone who is unemployed or looking after young children – receives an interest subsidy. As an extension (as in New Zealand), anyone whose earnings are so low that his or her income-contingent repayment fails to cover the interest element, similarly receives an interest subsidy.

62. *Conditional subsidies*. The mechanism in the previous paragraph protects low earners and people with career breaks. However, some of the subsidies benefit people who subsequently have high earnings. Thus there are advantages in terms of fiscal cost and targeting to have a system which pays interest subsidies based on current income, but with a facility to claw back the subsidy element for people who end up with high lifetime income. A workable such scheme has been designed, which the Student Loans Company could administer without difficulty. Such a scheme has major advantages: it gives assistance at the time they need it to people with low income and/or with a career break, facilitating access and preventing people from worrying that their repayment obligation is spiralling upwards; but it is cost free, since the clawback mechanism ensures that only the lifetime poor keep the subsidy. It is also flexible: it would, for example, be possible to give conditional subsidies to some groups (e.g. someone who went travelling after graduation), but unconditional subsidies to others (e.g. someone looking after young children or elderly dependants – analogous to current proposals to assist teachers with their loan repayments).

UNDERSTANDING INCOME CONTINGENCY: SOME EQUIVALENCE PROPOSITIONS

63. Past failures adequately to explain income-contingent loans has created unnecessary disquiet. Medical practitioners sometimes talk about 'the worried well' – people who are in good health, but whose life is made less happy by misplaced worries that they are not well. Analogously, it can be argued, 'worried debtors' are concerned that student loans will be a millstone. Students perceive a large debt, but miss two important points of context. First, repayments are merely an addition to their future income tax. Thus the risk they take is no different from the risk we all face that at some time in the future the basic rate of income tax might increase (I am old enough to remember a 33% basic rate). Second, they do not see how much they will pay over the years in income tax or national insurance contributions, nor what they will spend on food (or drink) over a 25-year period. None of these items cause people to worry, despite the fact that someone who starts on average earnings and remains on

average earnings all his working life, will pay nearly £300,000²¹ in income tax and national insurance contributions over a 35-year career, a topic discussed more fully in Annex 2.

64. Alongside the policy design in the previous paragraphs, it is thus imperative to explain what is going on. I am not at this stage digressing into political presentation, but want instead to point out some analytical equivalences which should inform explanation.

65. The following schemes are all analytically identical.

66. SCHEME 1: AN INCOME-CONTINGENT LOAN. Earlier discussion described an income-contingent loan, for which graduates make repayments of $x\%$ of their earnings until they have repaid the loan at an interest rate equal to the government's cost of borrowing. What has been missing thus far in government action is a clear explanation that a person's loan repayments are, in effect, a form of income tax: a person's repayments track changes in his or her earnings instantly and automatically, and thus nobody repays more than he or she can afford.

67. The point is fundamental. Suppose we start from the argument (NUS, etc.) that higher education should be paid out of taxation. But that means that the costs of higher education are paid by the generality of income recipients, including low earners, non-graduates, pensioners, and the like. It is widely acknowledged that this is unfair. To deal with that unfairness, some people have argued that higher education should be financed through a graduate tax, which can be thought of as additional income tax, but paid only by the beneficiaries of higher education. But a graduate tax has its own unfairness, since people with high lifetime earnings repay considerably more than they have borrowed (this is true of any successful professional, without having to refer to extreme cases like Mick Jagger or Stelios Haji-Ioannou).²² To address the latter problem, it is suggested that a graduate tax should not have an indefinite duration, but should be capped, i.e. 'switched off' once a person has repaid an agreed contribution towards the costs of his/her degree. *An income-contingent loan is exactly that* – it is a graduate tax which is capped at 100% of the initial sum borrowed. Put another way, the only difference between a graduate tax and an income-contingent loan is the duration of repayment: with a graduate tax, repayment lasts (say) 25 years, regardless of how much a person has borrowed or repaid; with an income-contingent loan the duration of repayment bears an exact relation to the initial amount borrowed.

68. Thus income-contingent repayments can be described as repayment of debt. But with equal accuracy they can be described as a form of targeted income tax – targeted by being imposed only on graduates and by being 'switched off' once the loan has been repaid. This is

²¹ In today's prices, assuming annual real earnings growth of 2½%.

²² As explained in Annex 3, a graduate tax has problems in addition to being unfair: it leads inescapably to continued reliance on public funding; it is a hypothecated tax; and it raises difficult boundary problems.

a form of taxation that is more efficient and fairer than funding via the entire body of taxpayers.

69. SCHEME 2: FREE HIGHER EDUCATION (CUBIE). If loans are universal and adequate to cover all living costs and all tuition fees, higher education is free at the point of use. Thus the system can be described as free higher education, paid for by a targeted income tax or a graduate contribution. To repeat, the only difference from tax funding is that (a) the tax is paid only by those who have been to university and (b) the additional tax is capped.

70. SCHEME 3: UNIVERSAL GRANTS PLUS A GRADUATE CONTRIBUTION. Suppose that all students receive a grant large enough to cover their living costs and tuition fees; and suppose that the system is financed by an extra x pence in the pound added to a person's income tax rate. The contribution does not go on for ever: it is 'switched off' once a person has contributed an amount equal to the grant he/she received; and nobody pays for more than (say) 25 years. Thus the scheme is simple: there is a universal grant, financed by a graduate contribution payable for a maximum of 25 years, but for some people a shorter time.

71. Two additional points specify the scheme precisely:

- The duration of the graduate contribution bears an exact relation to the amount of grant a student has received. Though administratively complex, this is precisely the task that the Student Loans Company currently performs: higher earners repay their grant more quickly; lower earners take longer and are further protected in the ways outlined in paras. 58-62; and nobody makes contributions for more than 25 years.
- Students for whom access is fragile are helped in the ways set out immediately below. The scholarships and other forms of financial help they receive do not make them liable for a graduate contribution.

72. Since the three schemes are equivalent, any is an accurate description of the system of student support. If this were better understood – particularly the very close relation of income-contingent repayments to tax funding – the problem of the 'worried well' would be greatly diminished.

73. A point in conclusion: the equivalence arguments in the previous paragraphs are analytical and should be judged on the quality of their logic. They are *not* presentational arguments based on logical thin ice.

4.3 Active measures to promote access

74. Income-contingent loans measure ability to pay on the basis of where a person ends up, i.e. his or her subsequent income. This is the best approach for students from better-off

backgrounds, who are generally well-informed about the benefits of tertiary education. However, students from socially-excluded backgrounds are typically badly informed. Precisely for that reason, a wide range of additional measures to promote access – the third leg of the strategy – is necessary.

75. Put another way, it is not only financial poverty which impedes access, but also information poverty. Any strategy for access therefore needs two elements:

- those which involve money, and
- those which involve information and raising aspirations.

The following are no more than indications of the scale of necessary actions.

76. GRANTS AND SCHOLARSHIPS IN HIGHER EDUCATION. Money measures include scholarships for students from poor backgrounds. They could be based on parental income, but should also include money for schools and universities to award to students from poor backgrounds. There should be financial incentives to universities to widen participation; and universities would, in any case, wish to gather resources for scholarships to enable them to recruit the brightest students, regardless of their financial background.

77. For some students the biggest hurdle is to realise that they are good enough to do well in higher education: for them, scholarships which make their first year entirely free give them a risk-free opportunity to test their abilities and to become well-informed about higher education. Once such a student does well in the first year, he or she will be much more prepared to take out at least a partial loan for the rest of the degree.

78. EXTRA PERSONAL AND INTELLECTUAL SUPPORT IN HIGHER EDUCATION. A second ingredient in promoting access is extra personal and intellectual support, at least in the early days, for access students to make sure that, once a student starts at university, he or she gets the necessary support to make the transition. It is no good persuading someone to go to university if he or she is then allowed to sink without trace.

79. RAISING ASPIRATIONS OF SCHOOL CHILDREN. Action is also needed much earlier. Information and raising aspirations are critical. The saddest impediment to access is someone who has never even thought of applying to university. The sorts of schemes involved include Saturday Schools, which bring schoolchildren from poor areas to university to study on Saturday mornings; summer schools, which do something similar during the summer vacation; visit days, when schoolchildren can visit a university; visits by academics to schools to make the idea of higher education more tangible; visits by current students, ideally from the same or a similar school, to schools in deprived areas; and mentoring of schoolchildren by current university students, preferably from a similar background. Such activities needs to start early, e.g. at age 12.

80. MORE RESOURCES EARLIER IN THE SYSTEM. Problems of access to higher education cannot be solved entirely within the higher education sector. Thus more resources are needed earlier in the education system, which is where the *real* barriers to access occur.²³ This includes more resources for teaching. It also includes financial support for 16-18 year olds.

5 Conclusion

81. At risk of sounding repetitive, the root of all the funding problems of the present system go back – directly or indirectly – to the interest subsidy on student loans.

- Interest subsidies aggravate the shortage of resources in the sector, compete with university funding, cause loans to be inadequate, crowd out expenditure to promote access, and are deeply regressive.
- Setting the interest rate that graduates pay equal to the government's cost of borrowing is the key to addressing all these problems and, on a conservative estimate, yields some £700 million per year. That sum is important for its own sake; it is even more important because a fiscally cost-effective loan scheme can leverage a much greater volume of private finance. Specifically, with no increase in long-run fiscal costs, it would be possible nearly to triple total lending, or to combine a smaller expansion of loans with additional grant expenditure.
- Grasping the nettle makes possible the policies for access and quality set out in section 4.
- The move is less difficult than it sounds – perhaps the political equivalent of the 'worried well'. In Sweden and the Netherlands graduates pay an interest rate broadly equal to the government's cost of borrowing, and the matter is not regarded as in any way noteworthy; and Australia and New Zealand are currently facing the same reality as the UK.
- In contrast, if the interest subsidy is not eliminated, we might as well all pack our bags and go home.

²³ Educational exclusion has a clear connection with broader social exclusion – for example, less than 25% of children in care in the UK end up with any formal educational qualification.

Annex 1: The student support system before and after 1998

82. Table 1 summarises in simplified form (and with rounded numbers) the system of student support for students who started their degree between 1990 and 1997, and that for students who started their degree in 1998 or later.

83. The old system was introduced gradually. When fully phased in, it operated through:

- (a) 50 per cent of student living costs from a mortgage-type loan;
- (b) 50 per cent of living costs from a mixture of grant and parental contribution;
- (c) no tuition fees paid by the student.

84. The arrangements since the 1998 have three components:

- (a) an income-contingent loan;
- (b) replacement of the grant by a loan entitlement which is partially income tested;²⁴
- (c) an income-tested tuition fee.

Table 1: Student support: the system until 1998 and the current system

	Living expenses	Tuition
The system until 1998	50% mortgage-type loan; 50% grant/parental contribution	Free
The current system		
'Poor' student	100% income-contingent loan	Free
'Rich' student	Parental contribution of 25% of living costs; income-contingent loan the rest	£1000 flat-fee from parental contributions

85. To amplify the current system:

- 'Poor' students (i.e. where parent/spouse net income is below about £18,000 per year) pay no tuition fee and are eligible for an income-contingent loan intended to cover 100% of living costs.
- 'Rich' students (whose parents' or spouse's net income is above about £34,000 per year) pay the full £1000 fee. They are entitled to an income-contingent loan equal to 75% of the maximum loan. It is assumed that the parental contribution pays the tuition fee and 25% of living costs.
- In between, loan entitlement and fees are calculated on a sliding scale.²⁵

86. To illustrate these arrangements with a simplified numerical example, suppose that it is estimated that students need £4000 to cover living costs, made up, under the old system

²⁴ Poor students are eligible for 'a maintenance loan of the same value as the current grant and loan package' (*Hansard*, (Commons), 23 July 1997, col. 950).

²⁵ Herein lies much of the complexity – for details, see Department for Education and Skills (2001) (http://www.dfes.gov.uk/studentssupport/ss_admin/content/dsp_section_29.shtml, Chapter 6)

(line 1 of Table 1) of a loan entitlement of £2000 and grant/parental contribution of £2000. Thus the maximum parental contribution (for a student not eligible for any grant) is £2000.

87. Under current arrangements, a poor student is eligible for an income-contingent loan of £4000 to cover living expenses, and does not have to pay a tuition fee. A rich student receives £2000 in parental contribution, £1000 to cover the tuition fee and £1000 towards living costs, and is eligible for an income-contingent loan of £3000 to cover remaining living costs.

Annex 2: An unsubsidised interest rate: how much extra for graduates?

88. What is the effect on repayments if graduates pay an interest rate equal to the government's cost of borrowing rather than (as currently) the rate of inflation?

89. ANSWER 1: MONTHLY REPAYMENTS. The change has no effect on a graduate's monthly repayments. Since loans are income-contingent, repayments depend only a person's monthly income. Thus the higher interest rate affects the duration of repayments but not the amount of the monthly repayment.

90. ANSWER 2: TOTAL REPAYMENTS. On average, it is estimated that students will take 15-20 years to repay their loans (since the system of income-contingent repayments is new, estimates are all that we have). The model referred to in para. 37, estimates that at today's prices if a graduate takes 15 years to repay his loan, the extra interest payments on a loan of £12,000 from removing the interest subsidy is about £3700. The comparable figure if he takes 20 years to repay is £4700. Thus a plausible estimate of the additional interest repayments of an average student taking 17½ years to repay is £4250.

91. SOME COMPARATORS. These numbers need to be seen in context.

- With even a modest graduate premium (15%) and real wage growth (including career progression) of 5%, a graduate will earn £270,000 more than a non-graduate over a 35-year career. The extra interest payments are a minuscule price for those benefits.
- Over 35 years, a non-graduate on average earnings pays about £520,000 in income tax and national insurance contributions; with a graduate premium of 15%, the equivalent figure for a graduate is about £600,000. Thus the additional interest payment is equivalent to a tax increase of about 0.7%.
- Over the lifetime of the average loan, a graduate will spend on average £25,000 on alcohol. To spend £25,000 out of after-tax income a person paying basic rate income tax etc., has to earn £37,000. Thus it would be possible to finance the additional interest payments by having one booze-free day per week till the loan has been paid off.

92. The figures in the previous two paragraphs are in cash terms. The equivalent figures in present value terms, at a 5% discount rate, are as follows. On a loan of £12,000, the present value of the extra interest payments is £2,880 over 15 years, or £3,350 over 20 years; thus the average student will pay around £3,115 in additional interest payments. Over a 35-year career, the extra earnings of a graduate are £105,000. The present value of the income tax and NICs paid over 35 years by a non-graduate on average earnings is £195,000; for a graduate the comparable figure is £228,000. The present value of expenditure on alcohol over 17½ years by an average graduate is £14,000, requiring pre-tax earnings of nearly £21,000.

Annex 3: An open-ended graduate tax: problems but no solutions

93. An open-ended graduate tax (i.e. one which is paid for, say, 25 years irrespective of a person's earnings) creates major problems.

94. CONTINUED RELIANCE ON PUBLIC FUNDING. Since a graduate tax is irredeemably a tax, it cannot be privatised. It merely continues public funding through a different route. Thus the flow of private finance via graduates' repayments is slow in coming, and hence does nothing to improve access or quality in the short term.

95. Even in the medium term, a graduate tax does not necessarily produce extra resources for higher education, since increasing flows of private finance in (say) 10 years time can be offset by reduced public funding. This is exactly what has happened in Australia, whose Higher Education Contribution Scheme (HECS) was introduced in 1989 with the express aim of increasing resources for higher education. That aim remains unfulfilled.

'A year-long investigation into Australian higher education by a senate committee has found the nation's university system in crisis and in need of substantial public investment over the next ten years.

'The committee found that universities were seriously underfunded and were worryingly reliant on non-government sources of revenue, notably on fee income from foreign and local students' (*Times Higher Education Supplement*, 19 October 2001, p. 10).

96. In sharpest contrast, a well-designed loan scheme could bring in private funds from day 1, in ways which avoid these problems.

97. CLOSES OPTIONS WHICH A LOAN SCHEME LEAVES OPEN. As discussed in section 4, above, a scheme which avoids interest subsidies makes possible a wide variety of highly desirable options, such as making higher education free at the point of use – options which the fiscal cost of a graduate tax entirely rules out.

98. UNFAIR. A graduate tax is unfair (and hence politically unpopular) for several reasons:

- People are *compelled* to make continuing contributions, with no option to pay upfront if they wish.
- Those contributions are unrelated to the cost of their higher education.
- The contributions will be considerable for a successful professional, and can be enormous, e.g. for the Mick Jagers or Stelios Haji-Ioannous of this world.

99. HYPOTHECATION. What happens to the revenue from a graduate tax?

- If it is simply another source of income for the Consolidated Fund, it is a tax, pure and simple, and higher education continues to be publicly funded.
- If it is explicitly dedicated to higher education, it is a hypothecated tax – a mechanism which (with the exception of the national insurance fund) the Treasury has always regarded as an anathema. Any such move would be a major policy shift. Such a shift might be worth discussing if the potential gains are great, but that is not the case here.

100. BOUNDARY PROBLEMS. A graduate tax is (a) compulsory (contrast loans, where students can choose whether or not to borrow), and (b) binary (contrast loans, where students can choose how much to borrow), and thus creates major boundary problems as between:

- *Different occupations.* Do all UK students pay the graduate tax? Doctors? Nurses? Intending teachers? Once a group is granted an exemption, there will be pressure to extend it, and considerable difficulty in removing an exemption from any group.
- *Different modes of study.* Does the graduate tax apply equally to full-time and part-time students? What about Open University students?
- *Different parts of the UK.* A major problem arises because taxation operates on a UK basis but the responsibility for higher education is devolved. A graduate tax thus opens up a Pandora's box – for example, the Scottish Executive could ask for a different form of graduate tax, or could opt out altogether. If the graduate tax is not the same throughout the UK, would an English person who studied in Scotland pay the English rate or the Scottish rate? Would the answer be the same for a Scot who studied in England? Ditto Northern Ireland (over half of whose students attend universities in the Republic of Ireland or the mainland)?
- *Different parts of the EU.* Does the graduate tax apply to UK graduates who studied in other EU countries (or elsewhere); and how are EU students at UK universities treated?

101. All these boundary problems raise major practical problems for the tax authorities as well as creating a potential political minefield.

Annex 4: Legal issues

INCOME-CONTINGENT LOANS AND THE CONSUMER CREDIT ACT

102. Though income-contingent student loans are not made under the Consumer Credit Act (CCA), it is desirable that they stay as close as possible to the Act and to other relevant financial legislation.

103. The problem is as follows. Under the CCA, loan agreements have to specify interest charges across the life of the contract. That is possible only if the repayment flow is known. This is not a problem for a conventional (mortgage-type) loan, but is not possible with income-contingent loans, where repayments depend on a person's (unknown) future income stream and hence have an unknown duration. The issue was sidestepped in 1997/8 by arguing that the current student loan, which is indexed to the retail price index, is below the low interest threshold for the CCA.²⁶ Since that threshold is low, an unsubsidised loan would almost certainly exceed it, if not now, then at some time in the future.

104. There are two potential avenues to resolving the problem;

- (a) revise the CCA to accommodate income-contingent loans; or
- (b) ensure that the legislation bringing in new student support arrangements explicitly excludes those arrangements from the CCA via Statutory Instrument.

Approach (b) presents no obvious problems: a loan which charges the government's cost of borrowing is within the spirit of the CCA; the process in (b) is simpler and quicker than (a); and it leaves it open subsequently to amend the CCA if the government so wished.

LOANS FOR FEES AND COMPLIANCE WITH EU LEGISLATION

105. At present, UK students are eligible for a loan which covers (part of) their maintenance, but not their tuition fees. If loans covered fees, it would be illegal to deny loans to students from other EU countries studying in the UK.²⁷ A court case is currently testing whether it is legal to deny such students access to maintenance loans. In considering the coverage of loans, the following points are relevant.

106. Loans to cover fees are highly desirable because they make higher education free at the point of use. Thus the issue of EU-compliance should be addressed in the medium term; and it might have to be addressed in the short term even for maintenance loans, depending on the outcome of court case mentioned above. The problem should not be exaggerated. The loan contract that students currently sign entitles them to income-contingent repayments while within the UK tax net, but requires them to make mortgage (or similar) repayments if

²⁶ The England, Wales and Northern Ireland Teaching and Higher Education Act 1998 (THEA 1998), s.22(4) and s.22(9) provide that Secretary of State may only charge compound interest rates required to maintain the value in real terms of the outstanding amounts of the loan, which shall at no time exceed the 'specified rate for low interest loans'. This 'specified rate for low interest' is defined in s.22(9) as the rate specified for exemption purposes under s.16(5)(b) of the Consumer Credit Act 1974 (CCA 1974). The Scotland Teaching and Higher Education Act 1998, s29 inserts amendments to the Education (Scotland) Act 1980, (ESA 1980). The ESA 1980 s.73B(6) includes the same provision as s.22(9) of the THEA 1998, and therefore defines the low interest rate as a rate that will ensure exemption under the CCA 1974.

²⁷ The post-Cubie arrangements in Scotland, by ensuring that students face no upfront charges, in effect extends loans to cover fees, thus raising serious problems of compliance with EU law.

they work abroad. This process is already embedded in the procedures of the Student Loans Company and works well. In the short run it could be extended to EU students.

107. A better starting point is to note that foreign students are a good thing, not a bad thing. Higher education is – and should continue to be – a major UK export industry whose benefits are both direct (income from overseas students) and indirect (future UK exports). A properly designed loan scheme is self-funding apart from non-repayments from the lifetime poor, which introduce a social policy element into the scheme. Extending the scheme to EU students is thus feasible on the basis that each government agrees to cover the social policy element of loans for its own citizens.

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