Financing higher education in the UK: The 2003 White Paper

House of Commons Education and Skills Committee
Post-16 student support
Session 2002-03

Nicholas Barr

London School of Economics and Political Science,
Houghton Street,
London WC2A 2AE, UK

Tel: +44-20-7955-7482; Fax: +44-20-7955-7546;
Email: N.Barr@lse.ac.uk; http://econ.lse.ac.uk/staff/nb

'Financing higher education in the UK: The 2003 White Paper', House of Commons Education and Skills Committee, *The Future of Higher Education, Fifth Report of Session 2002-03, Volume II, Oral and written evidence*, HC 425-II, (TSO, 2003), pp. Ev 292-309.

Contents

Executive summary

1 Introductory matters 1

1.1 Points of agreement 1
1.2 Lessons from economic theory 2

2 Where things stood before the White Paper: a wedding & four funerals 3

2.1 The wedding 3
2.2 Four funerals 3
2.3 Reviving the corpse: the Barr/Crawford proposals 5

3 The White Paper strategy 6

3.1 Summary content 7
3.2 The White Paper strategy 1: promoting access 8
3.2 The White Paper strategy 2: the end of communism 10
3.4 Other praiseworthy elements 12

4 Making the strategy work 13

4.1 Actions to promote access 13
4.2 Ensuring communism stays dead 16
4.3 Matters for future consideration 17

5 Addressing public concerns 20

5.1 Worries about debt 21
5.2 Worries about variable fees 21
5.3 Worries about the public service ethos 23

6 Conclusion: two futures 23

References 25

Executive summary

1. This paper – a companion to Iain Crawford's and my earlier evidence to the Select Committee – offers a strongly supportive assessment of the White Paper strategy.

2. Section 1 establishes the background, including three lessons from economic theory: the days of central planning are gone; students should contribute to the costs of their degrees; and student loans have essential core features.

3. Section 2 assesses the present. The best element is income-contingent loans, introduced in 1998. The serious criticisms are (a) intrusive central planning, (b) complexity, (c) loans that are too small, and (d) interest subsidies whose considerable ill-effects include a deeply pernicious incidence.

4. The strategy that Iain Crawford and I have long advocated has three elements: deferred variable fees; loans that are large enough to cover all fees and realistic living costs; and active measures to promote access – measures that address both financial poverty and information poverty.

5. Section 3 assesses the White Paper strategy, which has two elements:

- *Redistribution from better-off to worse-off.* Those who can afford to pay more do so, releasing resources to promote quality and access, where 'can afford' refers to their income as a graduate, not their family circumstances as a student. Analytically, there are two sets of actions, a price increase (i.e. a move along the demand curve) and targeted transfers (shifting outwards the demand curve of poorer people). The strategy is thus deeply progressive. It shifts resources from today's best-off (who lose some of their fee subsidies) to today's worst-off (who receive a grant) and tomorrow's worst-off (who do not repay their loan in full).
- *The end of communism*, replacing it with a mixed economy. Variable fees (a) give universities an independent source of income and (b) strengthen incentives to competition. Thus the White Paper shifts the balance of power from the central planner and producers to the consumers – the students and employers. The resulting competition benefits students, the economy and the university system.

6. Section 4 discusses what needs to be done to ensure that the strategy is translated into action.

7. *Actions to promote access* are threefold. (a) A major effort to publicise what income-contingent loans mean. Key messages include: it is a payroll deduction, not debt; and students get higher education free – graduates make repayments. (b) Improving student support by increasing the grant and the maintenance loan. The latter might involve a second maintenance loan charging an interest rate equal to the government's cost of borrowing. (c) Ensuring proper powers and terms of reference for the access regulator.

8. *Ensuring communism stays dead* includes ensuring (a) that the fees cap does not stay in place so long that central planning returns through the back door, and (b) that there is a sustained increase in university income between now and 2010 to ensure the political sustainability of the strategy.

9. *Matters for future consideration.* The White Paper proposals will increase considerably the cost of the interest subsidy (currently £800 million per year). Loans will be larger, to cover tuition fees, increasing the cost of the interest subsidy proportionately. In addition, the repayment threshold will be increased from £10,000 to £15,000; this change

increases costs disproportionately. Thus the interest subsidy could cost as much as £1.2 billion per year. The section dissects the DfES defence of interest subsidies and concludes by outlining the much more strongly pro-access ways in which this money should be spent.

10. Section 5 discusses a series of worries: the new system will leave students with large debts; higher participation lowers the return to getting a degree; student debt will make it harder to get a mortgage; variable fees are inequitable; variable fees will harm access; variable fees will create a two-tier system; it is morally wrong to charge for higher education; this is the start of a slippery slope – next the national health service. These worries, it is argued, are understandable but misplaced.

11. The concluding section sketches out two futures, largely dependent on the political will to follow through.

12. *Failure to take off*. The story is of

- Failure to convince the public that this is not a case of heavy debt; political ructions continue; hence
- Inability to reduce the interest subsidy, hence insufficient resources to promote access and continuing rationing of loans, creating further political aggravation, hence:
- Inability to raise the fees cap, restoring communism and its companion, underfunding.

As a result, in five years time we are back in crisis, as in the incomplete reforms in 1997. But this time would be a final farewell to world-class universities.

13. *Take off*. With political leadership, the beneficial outcomes are self-reinforcing:

- Publicity and education get student debt from the overdraft bit of people's brain to the payroll deduction bit;
- In a calmer political environment, the interest subsidy can be reduced, freeing a large volume of resources for pro-access policies, further improving the politics of reform, hence
- The fees cap can be raised in stages, bringing in the benefits of competition and increasing resources.

The result is a vibrant, diverse and responsive system, at its best world-class, with strongly progressive funding.

Financing higher education in the UK: The 2003 White Paper[1]

Nicholas Barr[2]

1. This paper – a companion to Iain Crawford's and my earlier evidence to the Select Committee (Barr, 2002*a*,*b*,*c*,*d*,*e*; Crawford, 2002) – offers a strongly supportive assessment of the strategy in the White Paper (Department for Education and Skills, 2003).

2. Successive sections discuss:

- Introductory matters, including the many things everyone agrees about and (briefly) some lessons from economic theory.
- Where things stood before the White Paper: what is right with the current system, what is wrong, and the strategy Iain Crawford and I advocated in our earlier evidence.
- The White Paper strategy, and why it is profoundly correct.
- Making the strategy work, of which action to improve public understanding is the most important, hence the next section:
- Addressing public concern, in particular answering the legitimate (but largely misplaced) worries of students and their parents.
- A concluding section stresses the importance of political leadership and paints a picture of two contrasting futures.

1 Introductory matters

1.1 Points of agreement

1. Higher education in England and Wales (and to a lesser extent in Scotland) faces three fundamental and widely agreed problems: universities are underfunded, students are poor, and the proportion of students from the lowest two socioeconomic backgrounds has not changed significantly in 40 years. In 2002, 81 per cent of children from professional backgrounds went into higher education; the comparable figure for children from unskilled backgrounds was 15 per cent (Education and Skills Select Committee, 2002, p. 19). Thus higher education funding puts national economic performance at risk and sells the poor down the river.

2. There is also agreement about two core objectives: strengthening quality and diversity, both for their own sake and for reasons of national economic performance; and improving access, again for both efficiency and equity reasons.

3. Thus the argument is not about what we are trying to do but about the best way of doing it.

---

[1] This paper draws on Iain Crawford's and my 15-year collaboration, on assistance from Colin Ward and his team at the Student Loans Company on factual matters and administrative feasibility, and on recent work by the three of us advising the Hungarian government. Earlier versions were presented at a seminar on the White Paper organised by the University of London Union and in a lecture to the Liverpool Economic and Statistical Society. I am solely responsible for remaining errors.

[2] Professor of Public Economics, European Institute, London School of Economics and Political Science, Houghton Street, London WC2A 2AE, UK: Tel: +44-20-7955-7482; Fax: +44-20-7831-1840; Email: N.Barr@lse.ac.uk; http://econ.lse.ac.uk/staff/nb

1.2 Lessons from economic theory

4. Economic theory offers three strong sets of messages for the finance of higher education: the days of central planning have gone; students should contribute to the cost of their degrees; and well-designed student loans have core characteristics.[3]

5. THE DAYS OF CENTRAL PLANNING HAVE GONE. The argument against central planning of higher education, rooted in the economics of information, is fundamental to the White Paper strategy and to the debate about the nature of higher education, and hence needs to be set out fairly fully. To illustrate the essence of the argument, consider the following stylised facts about health care: consumers are imperfectly informed since health care is a highly technical subject;[4] the need for treatment is usually a result not of choice but caused by an external event, e.g. breaking a leg; and where someone needs treatment, there is only limited choice about what type of treatment. Much of the efficiency case for the NHS is based on those facts. With food, the story is very different. We are generally well-informed about what we like and its costs, hence we can do our own shopping. And though food is a biological necessity, there is an enormous range of choice over how we meet those needs.

6. These *technical* differences explain why we ensure access to health care by giving it to people (largely) free through the national health service; with food, in contrast, we ensure that a person (e.g. granny) has access to nutrition by paying her a pension and allowing her to buy her own food at market prices. This respects her freedom of choice. In contrast, food subsidies would be highly regressive.

7. Within this stylised context, the question is whether education is more like food or more like health care. My view is that school education is more like health care. Small children are not well informed. The need for education is externally imposed by legal compulsion. And, especially for younger children, the range of choice over curriculum is constrained. Hence there is a compelling case for publicly funded school education.

8. Higher education, in contrast, is more like food. Students are generally well-informed and can (and should) be made better-informed. There is genuine choice about whether or not to go to university – it is precisely that fact that has made taxpayer funding of higher education so regressive. Finally, the choice of which subject to study and at which university is large and growing.

9. On the demand side, therefore, it can be argued that students are well-informed, or potentially well-informed, consumers, and hence better able than planners to make choices which conform with their personal interests and those of the economy. Though that proposition is robust for the generality of students, there is an important exception: students from poorer backgrounds might not be fully-informed, with important implications, discussed below, for access in general and debt aversion in particular.

10. On the supply side, central planning, whether or not it was ever desirable, is no longer feasible. In response to technological change, advanced countries increasingly have mass higher education, meaning more universities, more students and greater diversity of subject matter. Thus the myth of parity of esteem and relative parity of funding is no longer sustainable. In principle, differential funding allocations could be made by an omniscient

[3] On the theoretical underpinnings, see Barr (1998a; 2001, Chs 10-13) or, much more briefly, Barr, 1998*b*.

[4] There is an important distinction between an information problem, soluble by giving more information, and an information-processing problem, where the problem is technically too complex for a layperson to solve even if given the necessary information. Health care faces significant information-processing problems.

central planner, but the problem is too complex for that to be the sole mechanism: mass higher education requires a funding regime in which institutions can charge differential prices to reflect their different costs and missions.

11. STUDENTS SHOULD CONTRIBUTE TO THE COST OF THEIR DEGREE. There are strong arguments that higher education creates benefits to society above those to the individual – benefits in terms of growth, social cohesion, the transmission of values, and the development of knowledge for its own sake. Those arguments suggest that taxpayer subsidies to higher education should be a permanent part of the landscape. I support those arguments. Equally, however, there is overwhelming evidence that students receive a significant private benefit from their degrees. Thus it is efficient and equitable that they should bear some of the costs. This leads to the third set of lessons from economic theory – the design of student loans.

12. WELL-DESIGNED STUDENT LOANS HAVE CORE CHARACTERISTICS.

- *Income-contingent repayments*, i.e. repayments calculated as *x*% of the borrower's subsequent earnings, collected alongside income tax, are essential. In efficiency terms, they protect the student from excessive risk; and because repayments are collected alongside income tax, they also protect the borrower from the risk of making an unsecured loan. In equity terms, the loan protects access because it has built-in insurance against inability to repay. Income-contingent repayments have a profound effect on higher education finance, one that is insufficiently understood by politicians and the public, and a topic discussed in detail in section 4.1.
- *Large enough to cover all fees and all living costs*, solving student poverty and promoting access by making higher education free at the point of use. Nobody has to make any upfront payments; nor are students forced to rely on their parents.
- *An interest rate broadly equal to the government's cost of borrowing*. The huge problems caused by interest subsidies are amplified in sections 2.2 and 4.3.

2 Where things stood before the White Paper: a wedding & four funerals

2.1 The wedding

13. The government has done one thing triumphantly right: since 1998 student loans have had income-contingent repayments collected by the tax authorities.

2.2 Four funerals

14. The bad news is that that is all the good news. The current system has at least four strategic flaws: central planning continues; the system is very complex; loans are too small; and loans attract an interest subsidy.

15. CENTRAL PLANNING CONTINUES IN THREE GUISES. First, there is price control in the form of a centrally-determined tuition fee (currently £1100 per year) for UK and EU students. There is also quantity control, i.e. control of student numbers, albeit recently slightly relaxed. Not the least of the resulting anomalies is that successful universities can be penalised.[5]

[5] 'Prince's university penalised for extra students: Prince William's university has been fined £175,000 for attracting too many students. Applications for St Andrews University leapt by 45 per cent after it was revealed that the prince planned to start his studies there last autumn. However, higher education funding rules penalise universities that exceed their recruitment targets' (*The Independent*, 29 March 2002).

Thus, in good Communist tradition, the central planner determines both price and quantity. In the same tradition, third, control is heavily bureaucratic. For example, the process for assuring teaching quality during the latter part of the 1990s involved vast amounts of paperwork; it also bore another hallmark of central planning – a counterproductive one-size-fits all set of procedures.[6] Having spent three years working for World Bank in the former-communist countries, it is ironical to find the last bastion of Stalinist central planning in my own back yard.

16. COMPLEXITY. The system of student support is so complicated that nobody understands it.[7] The problem has been made worse by the government's woeful failure to explain the system and, in particular, the nature of income-contingent loans. Complexity has major ill-effects: nobody can understand the system; it is a nightmare to administer; and complexity, *per se*, impedes access.

17. LOANS ARE TOO SMALL. The full loan is too small to cover living costs; not all students get the full loan; and there is no loan to cover fees, so that there are upfront charges. As a result, students are poor, forcing them to rely on their parents, to use expensive credit card debt, and/or to spend long hours earning money. These factors all impede access.

18. LOANS ATTRACT AN INTEREST SUBSIDY. The interest rate on student loans is equal to the inflation rate, i.e. a zero real rate. This is policy design of such cleverness that it achieves not a single desirable objective.

- The subsidy is enormously expensive, currently around £800 million per year.[8]
- It impedes quality. Student support, being politically salient, crowds out the funding of universities
- It impedes access. Loans are expensive, therefore rationed and therefore too small.
- It is deeply regressive, the main beneficiaries being successful professionals in mid career.

19. The last point bears explanation. The subsidies do not help students (graduates make repayments, not students). They help low-earning graduates only slightly, since unpaid debt is eventually forgiven. They do not help high-earning graduates early in their careers – with income-contingent loans, monthly repayments depend only on earnings; thus interest rates *have no effect on monthly repayments*, but only on the duration of the loan. Thus the major beneficiaries are successful professionals in mid career, whose loan repayments are switched off earlier because of the subsidy.

---

[6] The objection is not to teaching quality assurance – an important activity – but to the nature of the inspection process.

[7] As an example of complexity, see the notes about the operation of the income test by which a student's loan entitlement and tuition fees is assessed (Department for Education and Skills (2001), http://www.dfes.gov.uk/studentsupport/ss_admin/content/dsp_section_29.shtml, Chapter 6).

[8] The problem is made worse by arbitrage, i.e. students who do not need the loan borrowing as much as they are allowed and putting the money into a building society to make a profit. This was a major worry of a government inquiry in New Zealand (New Zealand Tertiary Education Advisory Committee, 2001, p. 14).

2.3 Reviving the corpse: the Barr/Crawford proposals[9]

20. Iain Crawford and I have long advocated a strategy with three elements.

21. DEFERRED VARIABLE FEES. Universities should be free to vary their tuition fees, subject to a cap. This brings in additional resources to improve quality, benefiting UK students and restoring the sector's considerable export potential. Students should be helped to pay the charges as described below. Of central importance, charges should be deferred: thus graduates make repayments, not students.

22. Thinking on fees can be muddled. Many people agree that higher education is a right, but it does not follow that it must always be free (food, equally, is a right, yet nobody demonstrates outside shops or restaurants). Another confusion is between social elitism, which is abhorrent, and intellectual elitism, which is both necessary and desirable. There is nothing inequitable about intellectually elite institutions. The access imperative is a system in which the brightest students are able to study at the most intellectually demanding institutions irrespective of their socioeconomic background.

23. ADEQUATE AND UNIVERSAL INCOME-CONTINGENT LOANS. The loan should be large enough to cover fees and realistic living costs in full and should be available to all students. This package eliminates upfront fees (the Student Loans Company would send the fee payment directly to the university), so that higher education is free at the point of use, as in Scotland. It ends student poverty. It does away with parental contributions. It is simple for students and their parents to understand. And it is vastly simpler to administer than current arrangements. Even more fundamentally, as discussed in para. 53, the package is equivalent to restoring grants.

24. ACTIVE MEASURES TO PROMOTE ACCESS. A strategy for access has two elements: getting people into university, and helping low earners after university.

25. On the first, there are two causes of exclusion: financial poverty and information poverty. The latter is important and inadequately understood: as discussed earlier, students from poorer backgrounds may systematically be less well-informed, not the least of the resulting problems being debt aversion. Any strategy to encourage people to enter university therefore needs both to provide financial support and to increase information and raise aspirations. Scholarships (for example, higher education maintenance allowances) are vital; so are financial incentives to universities to widen participation; and so are extra resources to provide intellectual support at university for access students to make sure that, once they arrive, they get the support necessary to make the transition.

26. Action to inform school children and raise their aspirations is equally critical. The saddest impediment to access is someone who has never even thought of going to university. Action needs to start early, for example at age 12. Finally, problems of access to higher education cannot be solved entirely within the higher education sector. More resources are needed earlier in the system.[10]

27. A separate element is to help low earners after they leave university, discussed in section 4.1.

---

[9] This section draws on Nicholas Barr, 'Making universities universal', *Financial Times*, , 22 November 2002, p. 21.

[10] There is growing evidence that the roots of exclusion lie in infancy; see Polly Toynbee, 'Help toddlers, and then let students pay their own way', *Guardian*, 22 January 2003.

3 The White Paper strategy

28. Section 3.1 summarises the key funding elements in the White Paper. Seen through the eyes of lurid press coverage, the proposals look horrible – high fees, large debts. That view is thoroughly misleading. The White Paper strategy has two elements, each enormously important.

29. THE STRATEGY REDISTRIBUTES FROM BETTER-OFF TO WORSE-OFF. Those who can afford to pay more do so, releasing resources to improve quality and promote access, where 'can afford' refers to their income as a graduate, not to their family circumstances as a student. This approach is entirely consistent with the first and third legs of the Barr-Crawford strategy.

30. Economic theory is particularly useful at this stage to explain what is going on. The White Paper proposes two sets of actions (see Figure 1):

- A price increase, raising the average tuition fee from p_0 to p_1. This leads to a movement *along* the demand curve from *a* to *b*. Taken alone, this action obviously reduces demand and harms access. However (a) the fees are deferred for everyone, and (b), there are also:
- Targeted transfers to groups for whom access is fragile. This moves their demand curve *outward*, increasing their demand to *c*.

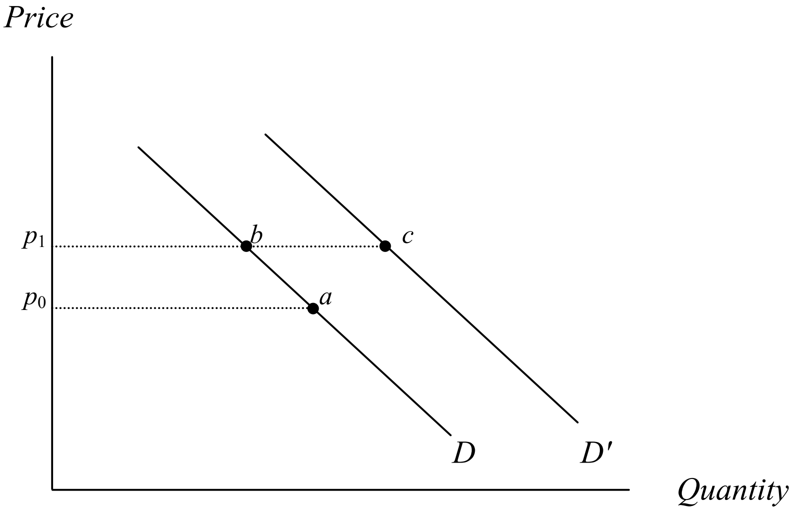

Figure 1: The White Paper's twofold strategy to promote access

31. Thus the White Paper strategy is deeply progressive. It shifts resources from today's best-off (who lose some of their fee subsidies) to today's worst-off (who receive a grant) and tomorrow's worst-off (who, with income-contingent repayments, do not repay their loan in full). The argument is explored in more detail in section 3.2.

32. THE STRATEGY ENDS COMMUNISM, replacing it with a mixed economy. Earlier discussion outlined the extent to which UK higher education is centrally planned. Variable fees reduce the power of the central planner by (a) giving universities an independent source of income and (b) strengthening incentives to competition. As with the end of communism,

the White Paper shifts the balance of power from the central planner and the producers to the consumers – the students and employers. Press reports around the time the White Paper was published suggest that the government adopted that strategy deliberately.[11] The argument is explained more fully in section 3.3.

33. Both elements of the strategy depend fundamentally on the prior existence of income-contingent loans and, to that extent, the Student Loans Company, who implemented the scheme successfully to a tight deadline, are among the unsung heroes behind the White paper.

34. Other praiseworthy elements in the White Paper are summarised in section 3.4.

3.1 Summary content

35. The White Paper is wide-ranging. Discussion here is limited to the funding proposals.

36. FEES. The term 'top-up fees' conflates three separate questions: should fees be the same at all universities or different; should students pay fees upfront or deferred; and should universities receive fees upfront or deferred? The White Paper answers all three questions correctly. From 2006:

- Fees will no longer be fixed at £1100 but variable between 0 and £3000, with institutions able to set their own fee levels within those limits.
- However, there will no longer be an upfront charge, since fees will be fully covered by a loan. Thus the proposal is for deferred variable fees.
- Universities, however, will receive the fee income upfront.

37. ACCESS.

- The White Paper brings back a grant of £1000 per year where family income (net of various deductions) is less than £10,000. There is discussion that the grant might be increased and the threshold extended.
- Fee remission continues, as at present. Thus people from poor backgrounds will not pay the first £1100 of any tuition charge. There is discussion of freeing at least some students from the entire £3000 charge.
- An Access Regulator will check that universities planning to charge fees above £1100 have well-designed plans to widen access and carry those plans out.

38. STUDENT SUPPORT.

- The existing arrangements for maintenance loans continue: the maximum loan remains unchanged, and entitlement continues to be income tested, i.e. parental contributions continue.
- Loans attract a zero real rate of interest, i.e. interest subsidies continue.
- The threshold at which loan repayments start will be raised (in 2005) to £15,000.

39. RESEARCH FUNDING will be more focussed, not least to protect the UK research base, to which the White Paper has an explicit commitment.

[11] See 'It's not a struggle for power', *Guardian*, 21 January 2003.

40. PUBLIC SPENDING is set to increase significantly over the next three years.

3.2 The White Paper strategy 1: promoting access

41. This section will conclude by arguing that deferred variable fees are a fundamental element in a strategy to promote access. To clear the ground, it is helpful first to develop three sets of arguments: the real barrier to access is earlier in the system; other ways of paying for higher education are unfair; and there are other ways of thinking about the White Paper proposals.

THE REAL BARRIER TO ACCESS: STAYING ON POST-16

42. The point can be made briefly. Of those with A levels good enough to go to university, 90 per cent do so, with no socioeconomic gradient – about 90% of middle-class people go on to university and about 90% of working class people. Thus the great disparity in participation occurs when people leave school at 16. A strategy for access therefore needs a range of interventions, including outreach to schools to raise the information available to and the aspirations of schoolchildren, additional resources to improve school education, and additional resources much earlier, e.g. nursery education. In short, £1 million spent raising GCSE scores does more for access than subsidising fees for people who would have gone to university anyway.

OTHER WAYS OF PAYING FOR HIGHER EDUCATION ARE UNFAIR

43. A GRADUATE TAX, i.e. an additional *x* pence tax on income tax until retirement (or for a fixed period such as 25 years), is unfair, and hence politically difficult, since repayments are unrelated to the cost of a person's degree. As discussed below, a graduate tax also perpetuates central planning.

44. FLAT FEES, i.e. the same fee at all universities, are unfair for two reasons. First, it is unfair if a student at Banbury University pays the same fee as one at Oxford.

45. Iain Crawford and I predicted the second unfairness in our evidence to this Committee's inquiry into the Dearing Report:

> '*Potential discrimination against British students*. 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).

46. TAX FUNDING has at least four problems.

47. *It does not work*. As discussed earlier, access has hardly improved in 40 years.

48. *It will not happen* – dream on. Higher education will always lose out to the national health service, nursery education and school education.

49. *It should not happen*. Higher education confers a benefit on society as a whole and to that extent has received – and should continue to receive – tax funding. Beyond that, however, tax funding is deeply regressive. If the money comes from general taxation, the taxes of the hospital porter pay for the degree of the old Etonian. If it is unfair for graduates to pay more of the cost, as the proponents of tax funding argue, it is even more unfair to ask non-graduate taxpayers to do so.

50. The counter-argument is to make direct tax more progressive. In 2003-4, an extra penny in the pound on the higher rate of income tax yields about £1.1 billion. Suppose government raised an extra £2.5 billion that way. The question that proponents of tax funding must then answer is: why should that money be spent on the best and the brightest who will disproportionately go on to become the richest, rather than on nursery education, vocational education, action to improve the staying on rate post-16, and more generous grants?

51. *It is not regressive by accident*. Some people argue that higher education should be treated as a tax-funded social good which a civilised country should offer. This is a beguiling vision, which was possible when higher education was a consumption good for a small number of people. But those times have gone. There are three steps in the argument:

- Technological advance means that mass higher education is essential for national economic performance.
- We live in a free society, so that people can choose how hard to work and can emigrate. Both facts impose limits on taxation, and those limits are reinforced by international capital mobility.
- Mass higher education, which is expensive, plus limited taxation leads to rationing of places and funding. The sharp elbows of the middle class come into play, leading to disproportionate middle-class use. Thus – systematically and predictably – excessive reliance on tax funding is regressive.

THERE ARE OTHER WAYS OF THINKING ABOUT THE WHITE PAPER PROPOSALS

52. It is possible to approach the White Paper proposals from a number of very different perspectives than their high-fees, high-debt portrayal in the press.

53. THE RESTORATION OF UNIVERSAL GRANTS. This perspective starts from the fact that higher education is largely free at the point of use. The Student Loans Company squirts money into the student's bank account to cover her living costs, and into the university's bank account to cover her tuition fees. Thus no-one is forced to pay any fees at the time he or she goes to university. The taxpayer continues – quite rightly – to pay part of the cost. But some of the costs, again rightly, are met by the income-contingent repayments of graduates. These repayments differ from tax in only two ways: they do not go on for ever; and they are paid only by people who have been to university and benefited financially from their degree. This is not a cheap intellectual stunt – income-contingent loans are logically equivalent to a grant financed by an income-related graduate contribution.

54. A CAPPED GRADUATE TAX. A graduate tax and income-contingent loan repayments are both payments levied on top of income tax. From the viewpoint of the individual graduate, the only difference is that with a graduate tax the duration of payment is fixed and

with an income-contingent loan variable. Thus loan repayments can be thought of as a capped graduate tax, i.e. a tax that is switched off once the graduate has paid a set contribution towards the cost of his or her degree.[12] Colloquially, graduates pay extra tax until each has paid his or her 'fair share'.

55. SOCIAL INSURANCE. Yet another perspective is to think of student loans as a modern example of the Beveridge principle. With pensions, we pay national insurance contributions now in order to get our pension later. Pensions are thus an example of consumption smoothing – a device that allows people to redistribute to themselves over their life cycle. Student loans are exactly that – students receive a 'pension' now to pay for their university education, repaid by their own contributions later in life. (It was for precisely that reason that my original (1988) proposal was for income-contingent repayments added on to national insurance contributions rather than income tax).

CORE ARGUMENT 1: VARIABLE FEES ARE FAIR

56. These arguments establish a strong case for the equity of the White Paper strategy.

57. WHAT IS NOT HAPPENING. Nobody is talking about making students pay the entire cost of their degree. Currently the maximum student contribution is 25 per cent of average teaching costs. Planned public spending on higher education in 2002-3 (Department for Education and Skills, 2002, Table 4.1) is £6.6 billion; fee income is of the order of £400 million. What the White Paper proposes is a change in that balance. Nor is anyone proposing upfront fees. The White Paper introduces *deferred* fees – a deliberate and fundamental part of the pro-access strategy.

58. THE EQUITY CASE.

- Variable fees resolve the serious inequities of tax funding, a graduate tax or flat fees.
- Those who can afford to pay a larger contribution to the cost of the higher education do so (where 'can afford' refers to their income after graduation, i.e. to outcomes).
- The system protects access in two ways: students face no upfront charges; and graduates repay only if their earnings warrant.
- The system actively promotes access because it frees resources to increase the staying-on rate post-16 and to restore grants, thus focusing resources on those who need help most, rather than spending wastefully on blanket subsidies.
- The core of the proposals, in short is two sets of actions, a price increase and targeted income transfers – as illustrated in Figure 1, not just a move along the demand curve, but a deliberate outward shift of the demand curve of poorer people.

3.3 The White Paper strategy 2: the end of communism

59. As well as being fair, variable fees have other major implications.

[12] For very clear exposition, see Alasdair Smith 'A fair and flexible tax on graduate', *Financial Times*, 6 December 2002.

CORE ARGUMENT 2: VARIABLE FEES MAKE FUNDING OPEN ENDED

60. If fees are set by government and are the same at all institutions, rising fee income can be offset by falling taxpayer contributions. Thus government controls the total volume of resources going into higher education – funding is closed-ended. Australia is a graphic example: government introduced centrally-set fees in 1989 to address a funding crisis; the system is now back in crisis. Equally, the introduction of fees in the UK has not netted any extra money.

61. Funding is closed-ended also with a graduate tax; government controls the volume of resources going into higher education, and universities compete in a zero sum game.

62. With variable fees, in contrast, if tax funding falls, each university has a policy response under its own control. Universities have an independent income source. The central planner no longer controls the funding envelope of the state-owned enterprise.

CORE ARGUMENT 3: VARIABLE FEES INTRODUCE COMPETITION

63. DIVERSITY AND CHOICE: SHIFTING THE BALANCE OF POWER. My support for competition is not ideological. Competition does not always improve outcomes. Most particularly, it is beneficial only where consumers and producers are well-informed. This, it was argued in section 1.2, is the case for universities, but not for school education. Thus competition in higher education matters greatly. Variable fees expose universities to more competition, empowering the choices of students, and indirectly also employers. The change in the balance of power is fundamental to creating a diversified system of higher education fit for purpose in a technological age. This is not an argument for law-of-the-jungle competition. Government has an important continuing role, but as regulator and setter of incentives, not as central planner.

64. The resulting changes will be significant. The days are gone when higher education consisted almost exclusively of 3 years of full-time academic study in institutions devoted to teaching and fundamental research. Diversity today has many dimensions:

- Period of study: it should be possible to study part-time (e.g. evenings), while staying in one's current job. Equally, accelerated study should be possible, e.g. studying over the summer to complete a degree in 2 or 2½ years, reducing living costs during the degree and facilitating earlier return into the labour market.
- Level of degree: there should be a seamless line of progression from sub-degree work to undergraduate and postgraduate degrees. Work to strengthen the integration of further and higher education should continue.
- Coverage of subject area: degrees can and should cover increasingly diverse areas.
- Type of training: degrees can offer academic training, vocational training, or both. This is nothing new – medical degrees are high-quality vocational training.
- Type of research: research can be fundamental, or applied, or to assist local economic development. All are important; all are properly part of higher education.

65. DIFFERENT VIEWS ABOUT THE END OF COMMUNISM. The potential benefits are large but so are the resulting changes. UK higher education is not, for the most part, an over-regulated industry in which most managers and workers are dying to throw off the shackles of regulation, but more like state-owned enterprises at the end of communism. A move to

stronger competition requires major adjustments by producers and consumers, creating political opposition and problems of adjustment to a new regime.

66. *Universities*. The supply side response is predictable. The White Paper strategy has profound implications for the management of universities. Thus many Vice-Chancellors would prefer a flat fee, albeit a higher one.[13] The elite (Poland, Hungary) welcome the new freedoms, but many institutions are unenthusiastic, seeing the new arrangements as more a threat than an opportunity.

67. *Teachers' organisations*. Again, the view is predictable. I was told by a senior official of the Association of University Teachers that lecturers at Luton and Oxford do the same job and hence should broadly be paid the same. This is like saying that David Beckham and the right-side midfield player at Torquay United should be paid broadly the same since both train four times a week and both play games that last for 90 minutes. It is true that the UK could go back to the days of the £20 per week ceiling on footballers' pay. But if we did, the best players would all end up in Serie A and Primera Division – England and Scotland would never again have a side capable of getting beyond the qualifying stage of the Champions League. The analogy is not frivolous – see para. 71, below.

68. *The student viewpoint*. To change the analogy, students, like Poles in 1990, see prices rising, but not yet any of the resulting benefits in terms of quality and range of products. Once the changes are in place, students should enormously prefer the new system, which transforms their power. The preferences of the consumer (students and employers) will have more weight than under central planning. Universities will face strong incentives to give them such things as accelerated courses, part-time courses and evening teaching.

3.4 Other praiseworthy elements

69. A number of other elements in the White Paper are less controversial, but also important.

70. The emphasis on teaching should be warmly welcomed. Like much else in the strategy, however, it will be important to make sure that its implementation operates via incentives and dissemination of information to teachers and students, rather than through the bureaucratic, intrusive and cost-ineffective methods of the former quality assurance regime.

71. The determination to protect the UK's research base is also important. One implication of the David Beckham analogy is that the UK would effectively hand over its research base to the USA. Some people might argue that there is no problem in doing so – perhaps the UK, like many other countries, can no longer afford world-class research on anything other than a small scale. There are reasons for resisting such an argument. First, the UK has a comparative advantage in research – it is an area in which the country has always punched above its weight. Second, though research findings in natural science are global, so that a solution developed in the USA applies equally here, much social science is country specific. For example, most US research into health finance explores the problems resulting from private medical insurance; UK research, more productively, explores how to devise systems of tax funding that maximise health outcomes and patient responsiveness. As noted above, however, research should not be regarded as a homogenous whole: fundamental research, applied research and research related to local development are all relevant; thought needs to be given to different ways of funding each.

[13] At a conference for politicians from the former-Soviet Union in early 1993, I was initially surprised at their enthusiasm for price liberalisation – until I realised that what they meant by 'price liberalisation' was higher prices set by administrators.

72. A third welcome element in the White Paper is the use of targeted loan write-offs, an excellent social policy tool. When applied to nurses and teachers, write-offs respond to low pay. If applied to doctors working in the national health service, write-offs could be used to address the issue of large loans resulting from long courses. Interestingly, the resulting incentives are strongest for people with larger debts. Thus graduates of the best universities will have stronger incentives than currently to go into teaching.

4 Making the strategy work

73. The previous section argued that the White Paper strategy is simultaneously equitable, promoting access by transferring resources from better-off to worse-off people, and efficient, promoting competition and hence diversity.

74. This section discusses what needs to be done to make sure that the strategy is translated into action. Section 4.1 suggests actions to promote access; section 4.2 is about ensuring that central planning stays dead; section 4.3 discusses matters for future consideration.

4.1 Actions to promote access

75. Action is needed in at least three areas if the White Paper is to succeed in widening access: (a) publicising *much* more effectively what income-contingent loans mean for individual students, (b) improving further the student support package, and (c) ensuring proper powers and terms of reference for the access regulator.

PUBLICISING WHAT INCOME-CONTINGENT LOANS REALLY MEAN

76. What is needed is a major public education campaign – not glib froth and bubble, but genuine information. It should include the following points.

77. KEY POINT 1: MOST OF THE COST OF TEACHING IS STILL PAID BY THE TAXPAYER. This needs to be stated firmly and repeatedly. Reducing the fee subsidy frees resources for use in better-targeted ways to promote access.

78. KEY POINT 2: INCOME CONTINGENCY CHANGES EVERYTHING. One of the roots of current problems is that David Blunkett responded to the Dearing Report in July 1997, at a time when the Inland Revenue had not yet agreed to collect repayments (which was not decided until November 1997), thus forgoing a golden opportunity to explain why the new loan scheme was dramatically better than the old one. Partly because of that timing problem, the government has been woeful in publicising income contingency; and the absence of such publicity has created a vacuum filled by a misplaced obsession with headline debt figures, fanned by lurid newspaper articles and at times, it has to be said, by scaremongering.

79. The result is what health economists call the 'worried well' – people who are worried that they are ill, though in reality they are not, but whose worries lower their quality of life. At least some debt aversion is of this sort. At a minimum, many parents worry about their child's debt in a way that they would not worry about their child's future tax liability.

80. Any campaign should explain the following facts about income-contingent loans:

- Repayments are like income tax in that people with low earnings make low repayments or no, repayments; and repayments instantly and automatically track changes in a person's pay packet.

- A larger loan has no effect on monthly repayments, only on duration; thus
- Higher fees do not affect monthly repayments, and
- Larger maintenance loans do not affect monthly repayments; equally
- A higher interest rate does not affect monthly repayments.

81. Ministers should stop talking about debt. Instead they should firmly establish the resulting key messages:

- It is a payroll deduction, not debt.
- Students get their higher education free – it is graduates who make repayments, and then only to meet part of the costs, and only if their earnings warrant.
- If it is unfair to ask graduates to pay more of the cost (as the proponents of tax funding argue), it is even more unfair to ask non-graduate taxpayers to do so.

82. The campaign should also increase understanding of the alternative perspectives discussed in section 3.2: income-contingent loans are close to restoring universal grants, or can be thought of as a capped graduate tax, or as an extension of social insurance.

83. KEY POINT 3: DON'T EXAGGERATE THE SIZE OF THE DEBT. Repaying a £20,000 loan is not that large when compared with other expenditure. It only seems large because people (and newspapers) focus on the *stock* of debt, rather than the *flow* of repayments. Yet we mostly think about expenditure in flow terms, so that cumulative totals seem shocking. On plausible assumptions a current graduate will pay (in cash terms) over a 40-year career:

- about £850,000 in income tax and national insurance contributions;
- £½ million on food, based on national average expenditure patterns in the Family Expenditure Survey;
- £25,000 if the basic rate of income tax rises by a penny in the pound.

84. As an alternative comparator, it is possible to pay off £10,000 of student debt in 11 years by giving up a smoking habit of 20 cigarettes per day.[14]

85. Quite rightly, no student loses sleep over a career tax debt of approaching £1 million, because he/she looks at such figures through the other end of the telescope – i.e. in terms of monthly, income-related repayments rather than cumulative totals. Student debt – given income-contingent repayments – should not be regarded as any different.

86. KEY POINT 4: STUDENT LOANS ARE NOT LIKE A BANK OVERDRAFT. This point follows from the previous one. A bank overdraft of £20,000 – short repayment duration, high interest rate – is seriously scary. But thinking of student debt like an overdraft is filing it in the wrong bit of the brain. Repayments are income-contingent, so the right place to file them is alongside income tax and national insurance contributions. Key message for students and parents – repayments should be thought of as a payroll deduction, not a final demand notice.

[14] The present value of buying a packet of cigarettes per day for 11 years is £10,000. Assumptions: cigarettes costs £4 per packet; real discount rate 5%. Given the interest subsidy on student loans, it would actually take less than 11 years to pay off £10,000 of student debt.

IMPROVING STUDENT SUPPORT

87. A parallel set of actions to ensure that the progressive purpose of the White Paper happens in practice is to improve the student support package.

88. IMPROVING THE SYSTEM OF GRANTS. As discussed earlier, students from poor backgrounds may be less well-informed and hence debt averse. Thus grants are an essential element in promoting access.

89. The full grant should be higher and the threshold for eligibility increased. Separate but related, anyone receiving an Educational Maintenance Allowance should automatically receive a grant. This policy promotes access by giving young people certainty at age 16 that they will receive financial support once they get to university; it is also administratively cheaper, reducing the need for a separate income test when a person starts university.

90. Thought should be given to some 'super grants' which pay the *entire* costs (tuition fees and all living costs) for the first year of a degree. Students from poor backgrounds may be unsure about whether university is right for them or about whether they are bright enough to cope. Super grants would give them a free first year, giving them the chance to become well-informed about their aptitudes and prospects. At that stage, students would have more confidence in taking out a loan to cover the rest of their degree.

91. INCREASING THE MAINTENANCE LOAN. The full loan is too small and – separately – the loan continues to be income tested, so that parental contributions remain. Both features are regrettable. Because loans are not enough to pay realistic living costs, many students face a combination of poverty, heavy and expensive indebtedness via credit cards/overdrafts, and excessive hours in part-time work. Debt aversion arises in part because student loans and credit-card debt become conflated in people's minds.

92. The maintenance loan should be increased. However, as discussed in section 4.3, the continuing interest subsidy makes any such move costly. One way out is as follows:

- Suppose realistic living costs outside London are £6000.
- The government should offer *all* students a second maintenance loan of £*X*, where £*X* is the amount that brings a student's total maintenance package to £6000, eliminating student poverty and getting rid of compulsory parental contributions. [15]
- The interest rate on the second loan should equal the government's cost of borrowing.

93. The politics of such a move should not be problematic:

- Students would welcome the improvement in their standard of living.[16]
- They would also welcome the fact that they could borrow at the government's borrowing rate rather than the credit card rate.
- The proposal is *in addition* to the proposals in the White Paper, hence does not make any student worse off than the White Paper. This makes it difficult for the National Union of Students (NUS) to argue against it.

94. OTHER IMPROVEMENTS. Restoring debt forgiveness after 25 years gives well-targeted protection to people with low lifetime earnings; the topic is taken up in section 4.3.

[15] Though beyond the scope of this paper, similar loans should be offered to postgraduate students.

[16] The LSE student leadership has argued strongly that the maintenance loan should be increased.

Ensuring proper powers and terms of reference for the access regulator

95. Improving access has various dimensions including (a) increasing the aggregate number of people from poor backgrounds at university and (b) improving their distribution across universities. Different mechanisms are needed for each of these tasks: incentives much more likely to deliver the policy objectives than excessive use of regulation and bureaucratic forms of control.

96. Defining the access regulator's powers and terms of reference is therefore complex, and should take cognisance of points like the following:

- Universities can decide to whom to make an offer but cannot control who actually turns up (many applicants do not meet the conditions). The access regulator might therefore want to focus on offers as well as registrations.
- Universities have little information about applicants' backgrounds. Perhaps the regulator should ensure that UCAS collects the necessary data and, subject to safeguards, that universities have access to it.
- What variables should the regulator use to define targets: social class, type of school, race? If all are relevant, what are the relative weights for each?

97. Some of the regulator's tasks are clearer.[17] One is to ensure that a system of credit transfer is in place. Second, the regulator should mandate universities to publish on their web site timely and accurate data allowing prospective students to make informed choices. Those data should include dropout rates and the fraction of graduates who find relevant employment within a given period after graduation.[18] Such transparency has two sets of benefits: information enables students to make better choices; and information is generally a more powerful and cost-effective form of quality assurance than bureaucratic procedures.

98. A third suggestion is that the regulator's web site should show current and past public spending on higher education in a form intelligible to the wider public. This does not prevent the government clawing back taxpayer funding as fee income rises, but ensures that such changes are transparent. Universities should be transparent to assist the choices of the public; so should government.

4.2 Ensuring communism stays dead

99. The second leg of the White Paper strategy is a more competitive environment for higher education. Ensuring that the policy intent takes place requires (a) consideration of the fees cap and (b) a sustained real funding increase over the medium term.

Relaxing the fees cap

100. The fees cap 'will apply throughout the life of the next Parliament, and it will rise annually in line with inflation so that it keeps its real value' (White Paper, para. 7.31).

101. The fees cap needs to be:

---

[17] This is a very incomplete list, intended only to illustrate useful areas of action.

[18] While the policy is clear, its implementation requires much careful work, the difficulty of which should not be underestimated. That does not mean that the work should not take place, but that the task should be regarded as ongoing, not one with a speedy once-and-for-all solution.

- High enough (a) to pay the best universities the rate for the job and (b) to bring in competition.
- Low enough (c) to ensure that the White Paper proposals are politically sustainable: the issue here is to give students and their parents time to adjust, and (d) to give universities time to put in place management suitable for a competitive environment.

102. Given these criteria, the initial cap of £3000 is probably right. However, its duration – the life of the next Parliament – is too long. If the cap is too low for too long, a critical bulk of universities will charge the maximum, approximating a system of flat fees. The result will be (a) to reintroduce closed-ended funding and (b) to restore central planning by the back door. As in the former-communist countries, change must be irreversible.

ENSURING A SUSTAINED INCREASE IN UNIVERSITY INCOME

103. In the medium term, the mechanism for achieving more resources is through variable fees. However, taxpayer clawback over the next 10 years (as in Australia) puts quality at risk. From 2006, students will face higher fees than their predecessors. If the quality of their student experience fails to match those higher fees, the new arrangements could come under political threat. Generous tax funding during the initial phase is therefore essential.

4.3 Matters for future consideration

REDUCING THE INTEREST SUBSIDY

104. As with fees cap, it is important to introduce reforms that are politically sustainable. Even so, it is worth having another look at the interest subsidy, since its cost considerably dilutes the redistributive power of the proposals, putting at risk the first leg of the White Paper strategy.

105. WHAT IS WRONG WITH THE INTEREST SUBSIDY? As discussed in section 2.2, the blanket interest subsidy achieves not a single desirable objective: it is enormously expensive; it encourages arbitrage; it impedes quality, since expensive student support tends to crowd out the funding of institutions; it impedes access, since it is the cost of the interest subsidy which is the direct cause of loans being too small; and it is deeply regressive, the main beneficiaries being successful professionals in mid career.

106. The White Paper proposals make the costs of the interest subsidy – currently £800 million per year – even more salient. The proposals will increase that figure considerably for two reasons.

- Loans will be larger, to cover tuition fees. This change increases the cost of the interest subsidy *proportionately* to the increase in loan outgoings.
- The repayment threshold will be increased from £10,000 to £15,000. This change increases the cost of the interest subsidy *disproportionately*.[19]

Thus the cost of the interest subsidy could easily increase to £1.2 billion *per year*.[20] As noted earlier, that expenditure is targeted with exquisite accuracy on exactly the wrong people at exactly the wrong time.

---

[19] The argument is straightforward: the higher threshold benefits two groups of graduates: low earners, with total earnings under £15,000 *and* high earners. Thus the higher threshold covers a very dense part of the earnings distribution, hence is very costly.

107. THE DEPARTMENT'S ARGUMENTS – FAIL, DO NOT ALLOW TO RESIT. In evidence to the Select Committee (2002, pp. Ev. 48-56), the NUS argued that because loans have income-contingent repayments, lower earners repay more slowly, and thus pay more interest than higher earners; reducing the interest subsidy, the NUS argues, harms lower earners. The Department's response to the Select Committee's Sixth Report, takes the same line:

> '... if a real rate of interest is charged, the effect is highly regressive. The effect is that graduates on lower incomes, since they pay for a longer period, will pay more in interest. And those that earn the least will pay the most. So it is clear that the effect of an interest subsidy ... targets the subsidy rather well, in direct proportion to income. Those who benefit most from the subsidy are those who earn the least' (Select Committee on Education and Skills, 2003, para. 30).

> '... It would of course be possible to devise a complex system whereby the interest rate charged is reduced for those on lower earnings and on career breaks. However, such a system would be significantly more complex and expensive to administer and still would only have the effect of channelling the subsidy back to those people – ie on lower earnings – who are the principal beneficiaries of the subsidy at the moment' (*ibid*., para. 31).

108. Given the huge cost of interest subsidies, the Department's argument about their incidence is worth dissecting.

109. *Answer 1*. Taken at face value it is true that lower earners repay more slowly and thus end up paying more interest. The question then is how to protect low earners. The basis of the Department's argument is that to protect the poor, the commodity should be subsidised for everyone. This is the Old Labour argument for postwar food subsidies, which did, indeed, help the poor by giving them cheaper bread, but helped the rich much more by giving them cheaper smoked salmon. Blanket interest subsidies, analogously, help low earners but, as explained in para. 19, the major beneficiaries are graduates whose repayments stop after (say) 10 years with an interest subsidy rather than after 12 with a real interest rate, and those who take out loans only to benefit from the arbitrage opportunity.

110. The Department argues that 'those who benefit most ... are those who earn the least' (para. 30). Separately, it argues that targeted interventions '... only have the effect of channelling the subsidy back to those people – ie on lower earnings – who are the principal beneficiaries of the subsidy at the moment' (para. 31). Both arguments are – quite simply – wrong: they ignore the much larger total benefit for the great bulk of graduates who repay their loans in full. The same resources would do much more to help the poor if spent in ways, discussed below, that do not leak out to the latter group.

111. *Answer 2*. The whole point of income-contingent repayments is that they tailor monthly repayments to ability-to-pay by automatically extending loan duration for lower earners. Someone who buys a house for £100,000 will pay more interest if she opts for a 25 year mortgage with lower monthly repayments than a 15 year mortgage with higher monthly repayments. Income-contingent repayments do this automatically. It is, of course, entirely possible to solve the 'problem' by moving back to mortgage repayments (e.g. equal annual repayments for (say) ten years, regardless of income); thus loan duration, and hence interest payments, are the same for all students with a given size of loan. The cure, however, is far worse than the disease.

---

[20] A precise figure would require a fairly sophisticated modelling exercise which takes account of the distribution of graduate earnings.

112. *Answer 3*. A range of mechanisms do much more to protect the poor than blanket interest subsidies:

113. USING THE RESOURCES BETTER. £1.2 billion per year could finance the following pro-poor policies.

114. *More assistance for poor students at university.*

(a) A larger grant; also making grants an automatic extension of Educational Maintenance Allowances.

(b) Raising the income threshold below which people qualify for a grant.

(c) Offering a 'super grant', covering all costs, to some students in their first year.

115. *Better support for the generality of students*.

(d) Increasing the full maintenance loan so that it covers realistic living costs.

(e) Abolishing the income test; all students are eligible for full loan, thus abolishing compulsory parental contributions.

116. *More generous assistance for people with low incomes after graduation*.

(f) Freeze the real value of debt for people with low income (i.e. a *targeted* interest subsidy), covering low-income workers and people who are unemployed.

(g) Women caring for young children or elderly dependants could receive the same targeted subsidy. Even better, government could signal its support for such activities by writing off 5 per cent of the person's outstanding debt.

(h) Write off (say) 10 per cent of the debt of nurses in the national health service and teachers in the state education system for each year of service.

(i) Restore debt forgiveness after 25 years (a feature of the pre-1998 arrangements), thus offering protection to people with low lifetime earnings. In present-value terms the cost of giving up repayments in later years is small.

117. ADMINISTRATIVE COSTS. The Department argues that such mechanisms are 'complex and expensive to administer'. That argument does great disservice to the Student Loan Company's administrative capacity. Policies (a) and (b) are already in the White Paper; and Policy (c) adds to cost, if at all, only by introducing additional selection criteria. Policy (d) has no impact on administrative costs and Policy (e) enormously *reduces* them by eliminating the current costly and cumbersome income test. That income test is not accidental; it is necessary precisely *because* of the interest subsidy, whose fiscal cost creates an imperative to ration loans. Policy (h) is already in the White Paper and Policy (i) extends what is already in place for the old, mortgage-style loans – an administrative feature cheaply and automatically accommodated in the Student Loan Company's computer system.

118. That leaves Policies (f) and (g). The key is to ensure that any targeting mechanism does not impinge on employers or the Inland Revenue. The way to achieve this is through the Student Loans Company's computer system. As discussed in my earlier evidence,

> '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' (Barr, 2002*a*, para. 61).

Each year the Student Loans Company recalculates each borrower's outstanding loan balance by adding on interest charges and deducting repayments. The way to give a targeted subsidy is through an adjustment whereby the outstanding balance of someone with low earnings is not increased by more than the inflation factor.[21] Such an arrangement will, of course, involve additional administrative costs, but almost entirely the one-off cost of developing some additional code for the Student Loan Company's computer system; the marginal administrative cost per low-earning graduate is negligible.

119. In short, neither the claim of complexity nor of high administrative cost stands up. The correct argument is the other way round: eliminating the blanket interest subsidy, by making it possible to eliminate the income test for loans, would significantly *reduce* administrative costs.

120. THE POLITICS OF CHANGE. The idea of raising the interest rate to the government's cost of borrowing is less radical than it sounds.

- The Netherlands and Sweden charge a positive real rate, a matter that is never discussed in those countries because it is taken for granted.
- A higher interest rate does not add a penny to any student's monthly repayments.
- A higher interest rate has no effect on the headline debt figure.
- Now would be a good time for such a move, since change involves only small increase in the nominal interest rate.
- A commitment by government to spend all the extra resources from charging a higher interest rate on the targeted interventions above would make it harder for the National Union of Students to argue against the move without laying themselves open to the charge of fighting to protect middle-class perks using access as a fig leaf, in reality behaving more like the National Union of Graduates.

5 Addressing public concerns

121. Students, their parents and politicians have a series of understandable and legitimate worries, which is precisely why the public information campaign advocated in section 4.1 is so vital. This section outlines those worries and tries to show that, for the most part, they should not be exaggerated.

- The new system will leave students with large debts.
- Higher participation lowers the return to getting a degree.
- Student debt will make it harder to get a mortgage.
- Variable fees are inequitable.
- Variable fees will harm access.
- Variable fees will create a two-tier system.

---

[21] The analysis draws on a project advising the Hungarian government. To illustrate a simple system, let OLB(0) = outstanding loan balance at the start of year 0, R = the annual interest rate on student loans, DELP = price inflation over the year, and ICR = the graduate's income-contingent repayment that year. The change in a person's outstanding loan balance is

OLB(1) = (1+R)*OLB(0) - ICR

In principle, a targeted interest subsidy requires only one extra line of code:

If ICR < R*OLB(0), OLB(1) = OLB(0)*(1+DELP)

- It is morally wrong to charge for higher education.
- This is the start of a slippery slope.

5.1 Worries about debt

122. THE NEW SYSTEM WILL LEAVE STUDENTS WITH LARGE DEBTS. As discussed above:

- Income-contingent loans change everything because monthly repayments are exactly matched to the graduate's income. Thus student debt should be regarded as a payroll deduction, not a final demand notice.
- The debt is not large – it only seems large because of the misplaced emphasis on the headline debt figure. Under plausible assumptions a graduate will pay £850,000 in cash terms in income tax and national insurance contributions over a 40-year career. People do not lose sleep over that. Nor do they lose sleep over an increase in the basic rate of tax by a penny in the pound, though in cash terms it adds £25,000 to a person's tax bill over 40 years.
- Student loans are not like a bank overdraft, since repayments are added to income tax. Thus it is just as plausible to regard the new arrangements as a universal grant, repaid out of subsequent taxation if the graduate's earnings are high enough; or as a graduate tax that is eventually switched off; or as a form of national insurance contribution.

123. HIGHER PARTICIPATION LOWERS THE RETURN TO GETTING A DEGREE, LEAVING PEOPLE WITH UNSUSTAINABLE DEBT. It is true that rising supply generally leads to a fall in price. But that is not true if demand rises as well. There are strong grounds for arguing that in an information age the demand for skills is higher than ever, and rising – which is why the graduate earnings premium has thus far shown no signs of falling. However, since repayments are income-contingent, if earnings are lower than expected, loan repayments will also be lower. In addition, it is worth noting that the graduate earnings premium leaves out non-monetary returns like job satisfaction, a particular feature of graduate employment.

124. STUDENT DEBT WILL MAKE IT HARDER TO GET A MORTGAGE. Lenders are normally interested in a person's income net of deductions like income tax, national insurance contributions and similar outgoings such as loan repayments. Thus on the face of it (a) loan repayments would reduce borrowing capacity, but (b) not by much since a graduate's monthly repayments, by definition, are a relatively small fraction of his/her earnings. On the other hand, (c) a graduate's income will generally be higher because he/she has a degree and (d) lenders regard graduates as good risks; for both reasons, even allowing for loan repayments, a person's borrowing capacity will generally be higher with a degree than without. Finally, it should be remembered that non-graduates also have debt, e.g. for cars.[22]

5.2 Worries about variable fees

125. VARIABLE FEES ARE INEQUITABLE. There are weighty counter-arguments.

- The core reason why variable fees are fair is that, by levying a larger contribution from people who can afford to pay, they make it possible to target transfers on people for whom access is most fragile.

---

[22] Some people worry about debt aversion, others that that student loans will reduce the ability to raise a mortgage. Both are legitimate concerns, but they are logically incompatible, hence cannot be used simultaneously about the same people.

- Variable fees also contribute to diversity and choice. This is efficient. And it also contributes to access: for example, universities will respond to demand by putting on part-time and evening courses, making it easier and cheaper to get a degree.
- It is efficient and equitable for the taxpayer to finance the social benefits and the beneficiary to finance his private benefits. Since the latter are higher at some universities than others, students at those universities should pay more.[23]
- Excessive reliance on tax funding is unfair. Tax funding has done nothing to improve the social mix in higher education. Beyond a certain point, it is deeply regressive. The revenue from higher taxation promotes access most powerfully if spent on nursery education and action to improve the staying on rate post-16.
- Flat fees are unfair. They discriminate against British students getting into the best universities; and it is unfair to charge a student at Banbury University the same as one at Oxford.
- A graduate tax is unfair – what a person repays bears no relation to the cost of his or her degree.

126. VARIABLE FEES WILL HARM ACCESS, PARTICULARLY TO THE BEST UNIVERSITIES. Again, the counterarguments are weighty.

- They are not upfront fees, but deferred fees. Thus higher education is free to the student. Only graduates makes repayments.
- The White Paper strategy has two elements: higher fees, which on their own would reduce demand, particularly of people from low-income backgrounds, *plus* grants and fee remission and similar targeted transfers to students from poor backgrounds, shifting their demand curve outwards.
- Subsequent loan repayments are income-contingent; thus going to a better university does not affect the size of monthly repayments, but their duration.
- Universities are interested in bright students not rich students. Thus it is in their interests to have scholarships.[24] And such activities will be buttressed by the Access Regulator.
- 90% of people with good enough A level go on to university; the key factor harming access is leaving school at 16.
- The argument that variable fees will deter students is to some extent patronising: it implies that middle-class students are bright enough to understand the value of going to one of the best universities, but poorer students are not.

127. VARIABLE FEES WILL CREATE A TWO-TIER SYSTEM. This argument is based on a myth: we already have 100-tier system. To pretend that all universities are equally good is a case of the Emperor's new clothes. We know that some universities are better than others, and that some degree confer greater earning power than others. Not only is it a myth; it is a dangerous myth. If we continue to treat Oxford and Banbury as the same, the risk is that they will

[23] The market test for this proposition is to ask students at Oxford why they did not apply to Banbury University.

[24] LSE currently redistributes over £4 million per year in scholarship funds and is actively seeking to enlarge that figure.

become the same. This would lead to exactly the result the White Paper sets out to avert – handing over the UK research base to the USA.

128. More positively, diversity and choice are good things in their own right. Fifty years ago, transatlantic flights were the province of a rich elite, with all seats first class. Today mass aviation has made world travel an everyday reality. It is true that the cheaper seats are less roomy and the food less good, but economy passengers travel in the same plane and arrive at the same time as first class passengers, i.e. do not fly in dangerous rust buckets and only on slow planes. The effect has been enormously to widen opportunities for large numbers of people. The analogy with higher education is apt.

5.3 Worries about the public service ethos

129. IT IS MORALLY WRONG TO CHARGE FOR A BASIC RIGHT LIKE HIGHER EDUCATION. I agree with the value judgement that access to higher education is a basic right, but that does not mean that it has to be free. Access to nutrition is a basic right, yet nobody argues that it is wrong to charge for food. The moral imperative is not about *instruments* (e.g. prices) but about *outcomes*, i.e. the imperative that a bright person should be able to go to the best university irrespective of his or her current financial circumstances.

130. THIS IS THE START OF A SLIPPERY SLOPE – NEXT STOP SCHOOLS AND THE NATIONAL HEALTH SERVICE. Section 1.2 made it clear that the argument against central planning of higher education is rooted in the economics of information. The same body of theory supports continued public funding of health care and school education.

6 Conclusion: two futures

131. THE STRATEGY. The White Paper aims to do two fundamentally important things.

- *To shift resources from today's well-off to today's and tomorrow's worst off*. Those who can afford to pay more do so, releasing resources for targeted transfers.
- *To end communism*. Variable fees create competition, shifting the balance of power from the central planner and producers to consumers.

132. Will the White Paper succeed? The answer depends on whether the political will is there to follow through with the policies that make the strategy work, in particular to:

- Improve information about the deal for students. ***The single most important and immediate task for government is to create understanding that repayments are not debt, but a payroll deduction, i.e. a form of tax, or national insurance contribution***.
- Reduce the interest subsidy to release resources for the access strategy.
- Relax the fees cap over time to ensure that the end of communism is irreversible.
- Implement these policies effectively. That means maximising the use of information and incentives, and using regulation in a light-handed way. Heavily bureaucratic controls put at risk the gains from a more competitive environment.

133. OUTCOME 1: FAILURE TO TAKE OFF: A POLITICAL DOWNWARD SPIRAL. The story in this case is of:

- Failure to convince students and their parents that this is not a case of heavy debt; political ructions continue. Hence
- Inability to reduce the interest subsidy, hence insufficient resources to promote access and continuing rationing of loans by the Treasury, further aggravating the politics of higher education finance, and hence
- Inability to raise the fees cap, restoring communism and its companion, underfunding.

As a result, in five years time we are back in crisis, as in the incomplete reforms in 1997. But this time round would be a final farewell to world class universities.

134. OUTCOME 2: TAKE OFF: A VIRTUOUS POLITICAL SPIRAL. With political leadership, the beneficial outcomes are self-reinforcing.

- Publicity and education get student debt from the overdraft bit of people's brain to the payroll deduction bit.
- In a calmer political environment, it is possible to reduce the interest subsidy, freeing a large volume of perversely-targeted resources to do the many pro-poor, pro-access policies outlined in section 4.3, hence further improving the politics of reform, hence,
- The fees cap can be raised in stages, bringing in the benefits of competition and increasing resources for universities.

The result is a vibrant, diverse and responsive system of higher education, at its best world-class, with strongly progressive funding matching the brightest students with the best universities irrespective of their socioeconomic background.

References

Barr, Nicholas (1998*a*),*The Economics of the Welfare State*, 3rd edition, Oxford: Oxford University Press, and Stanford, Calif.: Stanford University Press.

Barr, Nicholas (1998*b*),'Towards a "Third Way": Rebalancing the Role of the State', *New Economy*, Vol. 4, No. 2, pp. 71-6.

Barr, Nicholas (2001), *The Welfare State as Piggy Bank: Information, Risk, Uncertainty, and the Role of the State*, Oxford University Press.

Barr, Nicholas (2002*a*), 'Funding Higher Education: Policies for Access and Quality', House of Commons, Education and Skills Committee, *Post-16 Student Support*, Sixth Report of Session 2001-2002, HC445, (TSO, 2002), pp. Ev 19-35.

Barr, Nicholas (2002*b*), 'Supplementary Memorandum: Funding Higher Education: Policies for Access and Quality', *ibid*. pp. Ev 45-47.

Barr, Nicholas (2002*c*), 'Where Do the £800 million Appear in the Government Accounts?', *ibid*. p. Ev 47.

Barr, Nicholas (2002*d*), 'Comments on DfES evidence, 13 May', *ibid*. pp. Ev 130-33.

Barr, Nicholas (2002*e*), 'Response to Margaret Hodge's Letter of 27 May to the Education Select Committee', *ibid*. pp. Ev 133-4.

Barr, Nicholas and Crawford, Iain (1997), ‘The Dearing Report, the Government's Response and a View Ahead', in *Third Report: The Dearing Report: Some Funding Issues, Volume II, Minutes of Evidence and Appendices, House of Commons Education and Employment Committee, Session 1997–98*, HC241-II (TSO), pp. 88–103.

Crawford, Iain (2002), Supplementary Memorandum, , House of Commons, Education and Skills Committee, *Post-16 Student Support*, Sixth Report of Session 2001-2002, HC445, (TSO, 2002), pp. Ev 44-5.

Department for Education and Skills (2001), *Higher Education Student Support in England and Wales 2001/02: Chapter 6: Assessing Financial Entitlement* (http://www.dfes.gov.uk/studentsupport/ss_admin/content/dsp_section_29.shtml, Chapter 6)

Department for Education and Skills (2002), *Annual Report*, London: TSO (http://www.dfes.gov.uk/deptreport2002/)

Department for Education and Skills (2003), *The Future of Higher Education*, Cm 5735, London: TSO. http://www.dfes.gov.uk/highereducation/hestrategy/

Education and Skills Select Committee (2002), *Post-16 Student Support*, Sixth Report of Session 2001-2002, HC445, London: TSO.

Education and Skills Select Committee (2003), *Post-16 Student Support: Government response to the Sixth Report from the Education and Skills Select Committee, Session 2001-2*, Second Special Report of Session 2002-3, HC440, London: TSO.

New Zealand Tertiary Education Advisory Committee (2001), *Shaping the Funding Framework: Fourth Report of the Tertiary Education Advisory Committee: Summary Report*, Tertiary Education Advisory Committee, Wellington, New Zealand, November (http://www.teac.govt.nz/fframework.htm).