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Nicholas Barr: Interest subsidies on student loans are the root of all evil

Even before the cuts in higher education were announced last week, not everyone who wanted a university place could get one. Politicians of all parties are keeping a low profile, waiting for Lord Browne's review of higher education later this year. The review will look at a range of issues, including whether tuition fees should increase. Less immediately newsworthy, it will also discuss reforms to student loans.

At present, student loan repayments are based on a graduate's monthly earnings, just like income tax and national insurance contributions, but usually much smaller. Any loan outstanding after 25 years is forgiven. The system is like a graduate tax that lasts for a maximum of 25 years, and for most people significantly less.

The interest rate on student loans equals the rate of inflation, less than it costs the government to borrow the money. The aim of the subsidy, widening participation, is spot on; and with conventional loans the policy can make sense - an interest subsidy would help first-time house buyers by reducing monthly repayments. Income-contingent repayments turn the argument upside down: a lower interest rate has no effect on monthly repayments, but it shortens the duration of the loan. In a system with income-contingent repayments and forgiveness after 25 years, an interest subsidy achieves no single desirable objective. First, the subsidy is enormously expensive. Close to one-third of all lending to students never comes back simply because of the subsidy, a cost this year of about £1.2 bn.

Then, because loans are expensive they are too small, and there are no loans for part-time students, both problems harming access. Moreover, the interest subsidy crowds out university income, putting quality at risk. Over the past two years the problem has not only been quality but quantity: the cost of interest subsidies conspires with other fiscal pressures to explain the current shortage of university places.

Finally, the subsidies are deeply regressive because they do not help students (graduates make repayments, not students). They help low-earning graduates only slightly - a graduate with low monthly earnings is protected by income-contingent repayments, and one with low lifetime earnings by forgiveness after 25 years. They do not help high-earning graduates early in their careers who, again, are protected by income-related repayments. The major beneficiaries are successful professionals in mid-career, whose loan repayments are switched off sooner because of the subsidy than would otherwise be the case. This is the very last group of people that policymakers intended to help.

So, a zero real interest rate is the wrong one; it is too low. The commercial rate - the rate of interest on an unsecured individual loan, such as for credit cards - is too high.

The right rate is broadly equal to the Government's cost of borrowing, for example, the rate of interest on government bonds, with targeted interest subsidies for those with low earnings. In addition, there is a strong case for phased forgiveness of loans for some public service workers, for example state school teachers and nurses.

The argument for a higher interest rate is often misinterpreted because its effect is deeply counterintuitive: *a higher interest rate does not increase monthly repayments*, only extends the duration of repayments. The only effect of a higher interest rate is to increase, say, a 10-year graduate tax into, say, an 11-year graduate tax. In addition, as they receive a write-off after 25 years, *a higher interest rate has no effect on low earners*.

Raising the interest rate is the only way to improve the system. There should be larger loans for existing recipients: the loan to cover living costs should be increased, and if fees are increased, the increase must be fully covered by an increased loan entitlement. The system should be expanded to cover new groups, particularly part-time students and postgraduates.

Eventually, the system should extend to tertiary education and training more broadly. It would also be desirable to offer a full loan to all students, so that they no longer have to rely on parental contributions.

Interest subsidies sound nerdy and boring but fixing the problem offers huge gains. Bigger loans free students from credit card debt. Loans for part-time students address a shameful inequity and are essential for widening skills - and loans for postgraduates are key to deepening skills.

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