Financing higher education: Theory, policy and politics in England

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Conference on The Dearing Report 25 years on: Student loan reform in the UK - Did it work?

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1 How we got here

- 1990 Baker reform: introduction of loans, but the wrong loan (mortgage-type repayments)
- 1998 Blair reform 1: move to the right loan design (income-contingent repayments)
- 2006 Blair reform 2: loans and fees; a solid strategy, albeit leaving some unfinished business for the next reform
- 2012 Osborne reform: off the rails, ruthlessly exploiting a loophole in the way student loans enter the public accounts

Where we’ve go to: My punch line (stolen from Anna Vignoles)

- Right system, wrong parameters

2 Design issues

Why income-contingent repayments

- Friedman (1955): ICLs to address a capital market imperfection
  - Friedman's observation: returns to human capital higher than returns to physical capital
  - His diagnosis: lack of collateral made investment in human capital risky, leading to underinvestment
  - Policy implication: need to combine consumption smoothing with an element of insurance
  - ICLs provide insurance in two ways
    - Via income-continent formula (insurance against low current earnings); can also include
    - Forgiveness after *n* years (insurance against low lifetime earnings)
- Stantcheva (2017): in an optimal taxation setting argues that
  - The right approach is an income-contingent loan
  - But the designs in Australia, New Zealand, UK are suboptimal in that they protect borrowers during bad times but fail to collect more during good times
  - For the common pool to remain funded and be truly optimal, Stantcheva argues it must work both ways

What type of income-contingent

- Equity finance: repayments till death or retirement
  - Total repayment contingent on lifetime income
  - In PV terms higher lifetime earners repay more
  - This is Friedman’s approach
- Loan finance: repayments stop when borrower has repaid in full in PV terms
  - Thus PV of repayments is independent of lifetime income
  - Except for lifetime poor, ICLs affect the time path of repayments but not the total repayment
  - This is the approach in Australia and, prior to 2012, the UK
- Social insurance: repayments stop when borrower has repaid (say) 120% in PV terms; thus higher earners finance some or all of the loss on low earners
  - This is Stantcheva’s approach
  - New Zealand (1993-2000) had a social insurance element
  - UK since 2012 has badly thought-out elements of social insurance

But loans are only part of the story: ICLs as part of a strategy

- Strategy has deep roots both in economic theory and empirical evidence
- Three mutually-supporting elements
  - Element 1: finance universities primarily through a mix of tuition fees and taxpayer finance
    - Externality argument
    - Taxable capacity argument
    - Equity argument
  - Element 2: finance students through well-designed income-contingent loans to address credit constraints
  - Element 3: emphasis on policies earlier in the system, from nursery education onwards to address constraint of lack of prior attainment

Evidence on access: Lightning overview

- Early child development matters greatly
    - Important work by Lorraine, Anna, Gill, Claire and colleagues, from whom we'll hear much more later
    - Child's first 1000 days strongly influence life chances
    - August babies
- Major impediments to access to higher education
    - Liquidity constraints – largely addressed by ICLs
    - Lack of prior attainment
        - Major impediment is not getting good A level grades
        - Controlling for A level results, socioeconomic gradient vastly reduced
- Policy implication: target resources earlier in the system
- Not just education: '[Next Generation 2022: 'Why scouts select players based on 'the relative age effect']', Guardian, 24 October 2022

3 The 1990 UK reforms

- Top-up maintenance loans (£420 in first year)
  - Mortgage-type repayments: 60 equal annual instalments
  - Repayments could be deferred for 12 months where graduate’s earnings below 85% of national average
  - Zero real interest rate
- Problems
  - Did not fully address student poverty
  - Mortgage-type repayments
  - Zero real interest rate

Early writing

- Getting started
  - On the income-contingent principle
    - Nicholas Barr, *The Economics of the Welfare State*, 1st edn 1987, Ch. 13
  - UK policy debate
    - Private memo to the Secretary of State for Education, 15 July 1988
    - Nicholas Barr, ‘Student loans made easy’, *The Times*, 28 July 1988
    - ______ (1989), Nicholas Barr, *Student Loans: The Next Steps*, Aberdeen University Press
  - Critique of government’s proposals
    - ‘Disentangling the myths of the white paper’, *Financial Times*, 16 Nov 1988
    - ‘Baker’s Proposal: A Better Class of Drain’, *Independent*, 22 June 1989, p. 21
    - ______1993) ‘Alternative Funding Resources for Higher Education’, *Economic Journal*, Vol 103, No 418, May, pp. 718-728

Integrating student loans into the wider economics of the welfare state

‘The mechanics of the scheme are simple. Students take out loans from the state, which they repay in the form of a graduate addition to the national insurance contribution.…

‘The scheme causes no major administrative problems. It will be cheap to implement and bad debts are minimized …’ (Nicholas Barr, ‘Student loans made easy’, *The Times*, 28 July 1988, p. 12)

‘Student loans, upon reflection, are very much in keeping with the spirit of the Beveridge system, one of whose main purposes is to enable individuals to be self-sufficient over their lifetime as a whole, by redistributing from themselves at one stage in their life cycle to themselves at another. That is what the national insurance retirement pension does. Student loans are precisely another such case. The student needs access to his/her future earnings; private capital markets are not able for technical reasons to supply such loans…; thus an arrangement which uses the national insurance mechanism is efficient. Student loans are just an up-front pension’ (Nicholas Barr (1989), *Student Loans: The Next Steps*, Aberdeen University Press, p. 65).

How many times does one have to say the same thing?

THE TIMES THURSDAY JULY 28 1988 12

Nicholas Barr offers an answer to the Whitehall wrangle

Student loans made easy

The White Paper on financing students in higher education has once again been delayed, mainly, it appears, because the Treasury and the DES cannot agree on how student loans can be introduced within existing public expenditure limits. Students, in consequence, will continue to be inadequately funded by the grant system and will have no systematic access to borrowing.

What is needed is a way forward which achieves the Government's educational objectives without higher public spending. The answer lies in a system of loans repaid via national insurance contributions.

The mechanics of the scheme are simple. Students take out loans from the state, which they repay in the form of a graduate addition to the national insurance contribution (NIC). To ensure that this involves no increase in public expenditure, the starting point is to set the level of next year's student grant in the usual way and, initially, to keep in place the system of parental contributions.

In addition, two changes would be announced: that henceforth 10 per cent of the grant, the percentage rising over time, will be repayable via the extra NIC; and that the parental contribution will be phased out as rising repayments make it possible to do so without increasing public spending. The system thus costs the same as current arrangements for about three years, at which point repayment revenues start to come in.

This approach is feasible for quite a modest increase in NICs. Consider a loan scheme designed initially to replace the parental contribution. To achieve this, a typical student would now require a loan of about £2,800 over a three-year degree. A 2.5 per cent additional NIC for someone earning £15,860 a year (the current upper earnings limit for NICs) yields about £400 which, at a 10 per cent interest rate, repays a £2,800 loan in 12 years.

Parental contributions can thus be abolished at no public cost via a 2.5 per cent additional NIC for the typical student, and pro rata more or less for those with larger or smaller loans. Once the system is well established, it can be extended to cover a larger proportion of the grant.

The scheme has major advantages over the current system and also over the various loan schemes already considered. The inefficient and greatly disliked parental contribution would be phased out, a popular move with parents and also with students. The phasing out can be achieved without any increase in public spending, and the process could be accelerated as public expenditure constraints permi ted, if the Government so wished.

There are other advantages. Since the student benefits from having a degree it is right that he or she should contribute towards its costs. Repayments based on national insurance are related to the student's subsequent income; thus a graduate nurse pays back very little, at least early in her career. This feature should be crucial to the wider political acceptability of any substantial reliance on loans.

The scheme causes no major administrative problems. It will be cheap to implement and bad debts are minimized (defaulting would certainly be considerably less than with commercial loans). The scheme requires only the insertion of the relevant clauses into the Finance Bill, not separate legislation.

Finally, the use of the national insurance mechanism is highly appropriate. The former student is paying for part of his or her degree, and so repayment properly takes the form of a contribution, which is an important aspect of national insurance. The resulting system is also a form of group insurance: the risk of borrowing to finance a degree is taken on by the generation of graduates as a whole, rather than by individual students, who are protected against unemployment and other contingencies. Since there are technical problems with private insurance for some risks (e.g. unemployment) it is *efficient* for the state to organize student loans this way.

An obvious question is why students should not be financed by commercial loans repaid like a mortgage. There are two arguments against mortgage-type repayments as the primary source of undergraduate finance. First, many students would be unable to obtain a long-term loan from a bank or building society. The solution is for the state to guarantee the loan. But Treasury rules require the *whole* of the guaranteed sum to be added to public expenditure (hence, it appears, the DES problems with the Treasury).

Even were this difficulty to be resolved, the fundamental criticism of commercial loans is that they waste talent, since many students from poorer families would be discouraged from going to university. Borrowing to finance a degree is much more risky than borrowing to buy a house: the prospective student is by no means sure what he is buying; there is a substantial risk (or at least a perceived risk) of failing the degree outright; and many students are far from clear what return the degree migh bring. These problems apply with particular strength to children from less privileged backgrounds. Income-related payments thus accord with the Government's objective of encouraging inter-generational mobility.

The scheme is also compatible with the Government's desire to keep taxes low. For those above the upper earnings limit, the extra contribution is equivalent to a lump-sum tax, with the efficiency advantage of not distorting the choice between jobs.

The Government, in conclusion, should recognize the advantage and the political popularity of NIC-based repayments; the opposition parties should drop their resistance to *any* sort of loan scheme; and the Treasury and DES should take up these proposals as a basis for a mutually acceptable accommodation.

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But we shouldn’t complain too much

In *The Economics of Welfare* (1920),‘one of Pigou’s key contentions was that there were certain economic activities whose costs and benefits operated outside the reach of the market: what he called “external effects” and are now known as “externalities” ....

‘Pollution was one of Pigou’s hallmark examples. “Smoke in large towns,” he wrote, “inflicts a heavy uncharged loss on the community in respect of health, of injury to buildings and vegetables, of expenses of washing clothes and cleaning rooms, of expenses for the provision of extra artificial light, and in many other ways.” For Pigou, these “uncharged losses” accrued quietly and insidiously, hidden by products of everyday economic life. Pollution caused major damage, but that damage was not explicitly catalogued as such on any balance sheet. The result was that polluters exacted a silent cost on society' (Ian Kumekawa (2022), The impulse to inquire’, *Royal Economic Society Newsletter*, Issue 199, October, p. 20).

4 Starting to put things right: The 1998 Dearing reforms

- 1990-95 British officials did not support ICLs
- Regarded ICLs as sound academic theory but portrayed Iain Crawford (my companion-in-arms) and me as naïve about policy realities
- Australia not only talked about ICLs but implemented them; and with HECS in place Iain and I could point out to British officials that, 'What you are saying is that the UK tax authorities are less competent than the Australian ones'. And answer came there none
- Also many hours in the House of Commons Press Bar
- 1997: Dearing Committee unanimously supported ICLs

The Dearing reforms

- The reforms
  - The HUGE step forward: income-contingent loans
  - 9% of income above £10,000 per year
  - Forgiveness after 25 years
  - Tuition fees of £1,000 per year, income tested
- Deviations from ideal
  - Zero real interest rate on loans
  - No loan to cover fees
- Evidence to Dearing

- Nicholas Barr and Iain Crawford (1996) ‘Funding Higher Education in an Age of Expansion’, Submission to the National Committee of Inquiry into Higher Education (the Dearing Committee), published as ‘Funding Higher Education in an Age of Expansion’, *Education Economics*, 1998, Vol. 6, No. 1, pp. 45-70
- ______ and ______ (1997), ‘The Expenditure Classification of Lending to Students’, Second Submission to the National Committee of Inquiry into Higher Education (the Dearing Committee)

Comparison with Australia

- Australia
  - Chapman writing late 1987
  - Handed to Minister John Dawkins
  - Wran Committee set up
  - Reported April 1988
  - HECS started 1989
- UK
  - Barr writing 1985, published summer 1987
  - Operational brief to Minister (Kenneth Baker) July 1988
  - Active campaigning with Iain Crawford1988 onwards
  - ICLs introduced September 1998
- Why did it take the UK so long?
  - Lack of senior political support
  - A government with a preference for private institutions
  - Insular attitude (polite wording) of the then Education Department – in sharp contrast with openness of their Australian counterparts

5 Building on 1998: The 2006 reforms in England

- The reforms
  - Variable fees of up to £3000 per year
  - ICLs
    - 9% of income above £15,000
    - Loans extended to cover fees
    - Loans to cover living costs increased
    - Zero real interest rate
    - Forgiveness after 25 years
- Deviations from ideal: zero real interest rate (the correct political judgement at the time)
- Evidence ahead of the reforms
    - Nicholas Barr (2002), '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,
    - ______ (2003), 'Higher education funding', *Oxford Review of Economic Policy*, Vol. 20, No. 2, Summer 2004, ISSN 0266-903-X, pp. 264-283

The reforms got it broadly right

Followed the strategy outlined in slide 7

- Financing universities: mix of variable fees and taxpayer support
- Addressing credit constraints: ICLs to cover fees and living costs
    - ICL formula insures against low current income
    - Forgiveness after 25 years (subsequently 30) insures against low lifetime income
- Widening participation: continuation of policies earlier in the system to address prior constraints

What happened after the 2006 reforms?

Between 2006 and 2012:

- Tuition fee income +87%
- Number of grants and loans +25%
- Number of students +20%
- Number of applicants from most disadvantaged background, strikingly +53%

Critical element was support from strong Education Minister

Characteristics of ideal minister

- Bright enough to understand a strategy
- Sufficiently well-motivated to want to implement it
- Sufficiently a political big beast to prevent it being cherry picked

6 Muddying the waters: The 2012 reforms

- The reforms
  - Fees went up to £9,000, covered by ICLs
  - Interest rate on loans went up (0% real to 3% real)
  - Repayment threshold raised to £21K and in 2017 to £25K
  - Forgiveness after 30 years
- Result
  - Larger loans (because higher fees)
  - Larger loss on loans: 2018-19 (i.e. before) projected loss **47%**
- Evidence ahead of the reforms
  - Nicholas Barr (2010*a*), 'Paying for higher education: What policies, in what order?' and 2010*b*) 'Interest subsidies on student loans: A better class of drain', Submissions to the Independent Review of Higher Education Funding and Student Finance (the Browne review)
  - ______ and Neil Shephard (2010), 'Towards setting student numbers free', December
  - Nicholas Barr (2012), 'The Higher Education White Paper: The good, the bad, the unspeakable – and the next White Paper', *Social Policy and Administration*, Vol. 46, No. 5, October 2012, pp. 483–508

Why these reforms: Exploiting an accounting loophole

- Because of the way student loans entered the public accounts
  - Government income artificially inflated **this yea**r
  - As a result the eventual loss on loans is larger but does not hit measured public spending **for 30+ years**
  - Political incentive obvious: use resulting gain in the public finances for politically popular purposes, e.g. tax cuts, leaving the fallout for later governments
  - Major UK supermarket fined £125 million for a similar accounting practice
- For simple explanation, see N. (2019), ‘A beginner’s guide to student loans in the public accounts’, Wonkhe
- Much squawking by experts, leading to reform announced in 2018 (ONS 2018, 2020)
- For policy nerds next slide gives simple explanation of the loophole

The accounting loophole

- The backdrop:
  - 3-year student starting in 2012; repayment started in April 2016
  - Forgiveness (after 30 years) April 2046
- What counts as government income this year? Interest due this year is high because
  - Loans are larger because of higher fees
  - 3% real interest rate
  - On all outstanding loans balances
  - Where interest is calculated as interest ***due*** this year whether or not paid.
  - What counts as a cost this year?
    - Write-off, which is small, the only write-offs being because of early death
    - Makes sense for conventional loan where shortfall crystalises immediately, but not where that happens only after 30 years
- In short, an accounting fiddle to flatter public spending figures

7 What next: An outline sketch

- A holistic view of tertiary education (Augar)
- Granular delivery: more flexible pathways
    - Mix of higher, further and technical education in an individual's accumulation of skills
    - Time path of accumulation of academic credit
    - Modes of delivery, including part-time/full time
    - See Martin and Furiv (2022)
- Granular finance (necessary to support granular delivery)
- Greater emphasis on pro-access policies earlier in the system

8 Some UK policy conclusions

- Right strategy: variable fees covered by income-contingent loans, with pro-access policies earlier in the system
- Wrong parameters:
  - Taxpayer support for teaching (too low);
  - Fees cap (too high)
  - Interest rate (too high)
  - Threshold level of income at which loan repayments start (too high);
  - Spending on widening participation earlier in the system (too low)
- The conference essay question: Did it work?
  - Yes: ICLs work in an administrative sense
  - Yes: results in slide 19 (larger numbers, improved participation)
  - No: political process leading to faulty parameters

Some conclusions

- Politics matters big time
    - Getting an initial coherent strategy in place; AND
    - Sustaining it over time
- Focus mindset on flow of repayments, not stock of debt (‘HECS’, not ‘loan repayments’)
- ‘Pub economics’ – fees and loans harm access
    - A vampire that won’t die
    - Need to say the same thing many times
- Populism
    - A pressure that won’t go away (ditto PAYG pensions), e.g. to raise repayment threshold
    - Thus desirable to have solid monitoring institutions, e.g. the OBR, IFS

Selected references: Barr

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