Funding Higher Fees: Some Implications of a Rise in the Fee Cap

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Background

1. In 2009 the Government will commission a review of the system of higher education funding and student support introduced in England in 2006, the main features of which were:

- the introduction of variable fees for full-time UK and EU undergraduates (up to a maximum of £3,300)[1]
- the provision of non-means-tested tuition fee loans up to this maximum – accruing a zero real-terms rate of interest and repaid as a proportion of graduate earnings – so that no student had to pay these fees upfront
- the introduction of substantial government maintenance grants for students from lower-income households
- the enhancement of the financial support (bursaries) provided by universities to lower-income students.

2. It is possible, although by no means certain, that the maximum fee that universities will be permitted to charge full-time UK and EU students (the fee cap) will rise following this review.[2] This report considers some of the implications of any such rise without a commensurate increase in commitment of public expenditure by the Westminster Government.[3] It does not discuss whether such a scenario would be the 'right' one in future, but it acknowledges the arguments that are likely to be made in favour of an increased fee cap and the cost to the Exchequer of maintaining current arrangements for student support.

3. The current system of higher education funding in England is, taken as a whole, possibly the most progressive in the world. It recognises that graduates have benefited from their higher education, so should pay; it involves no fee payment upfront so none are excluded because of parental means; it ensures that no one is required to repay loans if they are not earning sufficient to be able to do so; it protects the position of women and others taking a career break by writing off loans not repaid

[1] Note that all figures in this report are uplifted to 2010 levels using the latest measure of inflation for student loans (2.5 per cent).

[2] Under the terms of the Higher Education Act 2004, the earliest possible date for parliamentary approval of any such proposal is 1 January 2010.

[3] Note that throughout this report references to the Government and its expenditure relate to the Westminster Government only and not to the devolved administrations. This expenditure includes English-domiciled and EU-domiciled students only.

after a period; it provides maintenance loans for all and it provides for generous cash grants for poor – and indeed now not so poor – students.[4] In contrast to the United States, where detailed assessments of parental ability to pay are the bedrock of student finance, the English system is designed to keep assessed household contributions to a minimum. Household contributions are only assessed if students choose to apply for means-tested support (part of the maintenance loans and other supplementary benefits). The maximum assessed contribution from a family living in England with two children and income of £75,000 would be around £3,800 per year. The same family living in the US might be expected to pay around £14,000 per year towards the cost of their child's education.[5]

4. All this is admirable. However, it is expensive for the Government to provide support at this level, and if fee levels increase, it would become more expensive unless some modifications are made to the current system.

Impact of the 2009 review

5. Although the outcome of the 2009 review cannot be predicted, there are likely to be influential voices in both the higher education sector and the Government arguing for a rise in the maximum fee – the former to generate more revenue for their institutions and the latter to encourage the variability in fee levels that does not exist at present, and which they have said is needed to stimulate quality improvement. On the other hand it cannot be assumed that the Government will increase the amount it provides to subsidise the provision of fee and maintenance loans at no real rate of interest. This will be a difficult circle to square.

6. Even if it agrees to an increase in current fee levels, the Government is unlikely to sanction the operation of an entirely unregulated market by declining to set a fee cap. It is true that despite the concerns that some expressed when fees were first introduced in 1998, and again at the time of the 2006 reforms, the existence of fees has not had any noticeable impact on enrolment to higher education – by any social group (although it is still too early to form any definite conclusion about the 2006 reforms). Nevertheless, that does not mean that fees, whatever their level, would have no such impact in future. Part of the benign impact hitherto is undoubtedly due to the level at which the Government

[4] The latest reforms to student finance, announced in July 2007, expanded the definition of the poorest students by raising the income threshold for receipt of the full grant by around £7,000. These reforms also indicate an increased concern with the financial needs of students from middle-income families (with annual income of c.£40,000-c.£60,000), who from 2008 will become eligible for partial grants and enhanced loans.

[5] Details of this and other calculations in this summary report can be found in the full report, available at www.hepi.ac.uk.

subsidises loans for fees – ensuring that they accrue a zero per cent real terms rate of interest – and also the general repayment and grant and loan mechanisms. The Government has to continue to be deeply concerned with the level of fees – to do otherwise, and allow an unregulated market, would run counter to the direction taken by governments in almost every other country with tuition fees.

7. Two levels of higher fee cap are therefore illustrated in this study – £5,000 and £7,000. Neither is considered the 'right' level, but both are considered to be reasonable assumptions for the purpose of illustrating the policy discussions in this report. The report also employs some working assumptions about the average fee for full-time UK and EU undergraduates in English higher education institutions under each of these fee caps, which are described in the full report.

The effect of higher fees: Government funding of student borrowing

8. The present arrangements for subsidising student borrowing are expensive for the Government. The most recent published estimates by the Government suggest that its Resource Accounting and Budgeting (RAB) charge on tuition and maintenance loans for English and EU students – in other words, the cost of providing these loans at no real rate of interest, requiring repayments only at rates graduates can afford when working, and writing off unpaid debts after 25 years – is likely to exceed £1.4 billion per annum in steady state. This is equivalent to at least 33 pence for every £1 of tuition fee loan – a 33 per cent subsidy – and 21 pence for every £1 of maintenance loan.[6] When the cost of maintenance grants is added to this, estimated taxpayer expenditure on student support for full-time English and EU undergraduates amounts to £2.5 billion per annum in steady state. By way of comparison, in 2003-04 total public spending by the then Department for Education and Skills on student support and on tuition fees for low-income students was £1.3 billion.

9. Even under the current fee regime these costs would increase if, for example, the Government were to reform the current system of funding for part-time students and instead offer them access to the same loans

[6] The latest published RAB figures from the Department for Innovation, Universities and Skills are available at http://www.publications.parliament.uk/pa/ld200506/ldhansrd/vo051110/text/51110-25.htm - 'Education Finance'. The RAB charge also includes deaths and defaults. DIUS has not yet published figures which reflect the estimated additional cost of the graduate repayment 'holidays' announced in 2007. The cost of these is difficult to predict since it will depend on how many students take up the option of a repayment 'holiday' and when they choose to do so but may lead to RAB charges on fee and maintenance loans of 36 per cent and 26 per cent respectively. Given the purpose of this report, which is to illustrate the issue rather than to provide firm figures, and the uncertainty of these estimates, this report uses the latest published figures on RAB percentages.

and grants on a pro-rata basis as full-time students.[7] The development of a system of funding appropriate to a changing landscape of higher education participation is a serious policy consideration. This report focuses, however, on a more specific issue: the implications for the current system of funding for full-time English and EU undergraduates implied by raising the fee cap. For the purposes of this report it is assumed that the Government will continue to commit current levels of public expenditure to student borrowing. The report does not, therefore, re-consider the arguments about the appropriateness of the current level of interest subsidy, which were, in any case, fully rehearsed at the time of the 2003 Higher Education White Paper, and which the Government rejected.

Future options

10. The discussion so far has shown how expensive the present arrangements are for the taxpayer. This report explores possible ways in which the Government could raise the fee cap without any increase in public expenditure beyond current commitments. Of course, it would be perfectly possible for the Government to continue to provide fully subsidised loans (although there are strong arguments against even the present level of subsidy). If the Government were willing to continue to subsidise fee loans in full, however, then the costs would be large. The RAB charge increases as the total debt rises, which means that the estimated 33 per cent RAB charge on current student tuition fee loans would increase with a higher fee cap. Based on the assumptions in this report, the RAB charge might increase by around £200 million per year with a fee cap of £5,000 and by £320 million with a cap of £7,000. That is effectively the base option, but it is not considered further here.

11. Putting on one side the possibility that the Government will be willing to increase the subsidy of student borrowing, four possible approaches (Options A to D below) are considered, each of which entails different measures to try and ensure stability in taxpayer costs.

<u>Option A</u>

12. One approach (Option A) would be for the Government to continue to make fully subsidised loans available for the whole tuition fee (up to the maxima considered here of £5,000 and £7,000) but for part of the fee paid by students to be used to cover the cost of subsidising additional loans. Any institution charging average fees above the current maximum

[7] The Secretary of State for Innovation, Universities and Skills recently announced an overarching review of the English higher education sector, with a view to developing a 10-15 year framework for its expansion and development. Some consideration of the appropriate resources to support an increase in the proportion of part-time students is likely to feature in this review (see http://www.dius.gov.uk/speeches/denham_hespeech_290208.html).

would pass to the Government – possibly by a reduction in the HEFCE grant – a sum equivalent to the estimated RAB charge on additional borrowing. This would effectively mean that some of the additional income from students would be channelled to the Government, and back to students via a higher loan subsidy.

13. Table 1 illustrates the effect of this option for an institution of average size charging the maximum permissible fee on all its courses under the scenarios of a £5,000 and £7,000 fee cap. It shows the net increase in total fee income compared with the total under the current fee cap and the proportion of new fee income retained when the amount passed to the Government is taken into account.

Table 1: Impact of Option A on fee income for average institution

Current fee cap		
	£3,300 fees	**£3,300 fees**
Total fee income (£m)	23.5	23.5
Revised fee cap		
	£5,000 fees	**£7,000 fees**
Total fee income (£m)	35.6	49.8
New fee income (£m)	12.1	26.3
Gross increase in fee income	51.5%	112.1%
Estimated additional borrowing (£m)	9.3	20.3
Amount passed to Government (£m)	3.8	8.6
Net increase in fee income	35.2%	75.3%
Proportion of new fee income retained by institution	68.3%	67.2%

14. This arrangement would reduce the net benefit to an institution charging £5,000 fees from an additional 51.5 per cent (compared to its income from fees of £3,300) to 35.2 per cent. With fees of £7,000 the net benefit would decrease from 112.1 per cent to 75.3 per cent. Such an institution would therefore retain 68.3 per cent of the new fee income with a £5,000 fee cap and 67.2 per cent with a £7,000 cap. This option could be attractive to students, as it would use a portion of the fee they pay to subsidise their loans. But it is safe to predict that universities would oppose such an arrangement, which would eat into the benefit they would derive from charging a higher fee.

Option B

15. An alternative approach, which would allow institutions to retain all of any new income from fees, would be to offer students unsubsidised loans to cover the cost of fees above £3,300 per year (Option B). A student on a three year course might therefore, when they graduate, have up to three loans to repay at two different rates of interest: the first two would be the loan for the first £9,900 of the total fee and the total loan for

maintenance, both of which would accrue interest only at the rate of inflation. The third would be a loan for the additional fee above £3,300 per year (a 'top-up' loan), which would accrue a real rate of interest. The rate of interest on the 'top-up' loan for students pursuing the most expensive courses might therefore be substantially higher than the rate of interest on the remaining loans. Under the income-contingent repayment system, the actual amount of real terms interest payable on the top-up loan by an individual graduate would depend both on the amount borrowed and on the individual's earnings.

16. This option would mean that graduates of courses charging higher fees could face both larger loan debts and additional interest payments. Because students from lower-income households would be more likely to meet the cost of any higher fee through the top-up loan rather than through household contributions, one disadvantage of this option is that it might reduce the likelihood of these students choosing courses for which the highest fees are charged. It might be necessary therefore to consider modifying the current mechanisms of student loan repayments – for example, by increasing the proportion of monthly income repaid towards the loan – to reduce the interest payable.

17. The introduction of differential terms for student borrowing would have other problems. For example, the taxpayer could end up paying more if financially literate students with a substantial institutional bursary or household contribution towards maintenance costs nevertheless took out additional maintenance loans, which would be available on more favourable terms, in order to cover the total cost of fees through subsidised loans.

<u>Option C</u>

18. A third approach (Option C), which would prevent some students paying such high rates of interest on part of their loans, would be to spread the current level of subsidy across the whole of the higher borrowing that follows from a higher maximum fee – without making a distinction between loans up to £3,300 and those above this level. All students would take out all their loans – for fees as well as maintenance – on the same terms. Table 2 illustrates the effect this would have on the value of the subsidy (RAB charge) as a proportion of total borrowing and, therefore, the real rate of interest implied for any student borrowing.

Table 2: Impact of Option C on student borrowing

	£3,300 cap	£5,000 cap	£7,000 cap
FULL SUBSIDY			
Total combined fee & maintenance loan (£m)	5,160	5,640	5,920
Combined RAB charge on total fee & maintenance loans	26.3%	27.5%	28.3%
Cost of combined RAB charge on total fee & maintenance loans (£m)	1,360	1,550	1,680
REDUCED SUBSIDY			
Total combined fee & maintenance loan (£m)	5,160	5,640	5,920
Combined RAB charge on total fee & maintenance loans	26.3%	24.1%	23.0%
Cost of combined RAB charge on total fee & maintenance loans (£m)	1,360	1,360	1,360
Reduction in subsidy	0.0%	12.6%	19.2%
Estimated rate of interest on any student loan	0.0%	0.3%	0.5%

19. Because the RAB charge increases with the level of debt, the reduction in the subsidy is more substantial with a £7,000 fee cap than with a £5,000 fee cap. Under the assumptions in Table 2, maintaining the current level of taxpayer subsidy on fee and maintenance loans (approximately £1.4 billion) with a fee cap of £5,000 would require the overall subsidy to reduce from 27.5 per cent to 24.1 per cent of the value of the total loan. This is equivalent to a 12.6 per cent reduction in the total subsidy. With a £7,000 fee cap the subsidy would reduce from 28.3 per cent to 23.0 per cent of the total loan, which is equivalent to a 19.2 per cent reduction in the subsidy.

20. This would mean that all students would pay a small real rate of interest, including those not paying a higher fee. On the assumption that a 100 per cent reduction in the original subsidy would require an interest rate of around 2.5 per cent then a proportional real terms interest rate with fee caps of £5,000 and £7,000 and a reduced subsidy would need to be around 0.3 per cent and 0.5 per cent respectively.

21. This model would therefore entail those paying lower fees subsidising those paying higher fees. This approach might well encounter some resistance from students, since it would result in increased costs for all students, including those opting for cheaper courses, in order to help pay for those on courses charging the higher fees. The additional borrowing associated with each above-inflation rise in the average fee charged across the sector would reduce the subsidy and increase standard interest rates for all students.

Option D

22. A final scenario (Option D) is one in which the Government allows the maximum fee level to rise but there is no government loan beyond the current fully subsidised maximum. This would mean that, in contrast to the previous three options, some students would no longer be able to defer all of their fee payments as they would not have access to sufficient loans to do so.[8] This option would certainly require substantial institutional financial assistance to ensure that these students were not excluded because of financial constraints. Option D might therefore require more detailed assessments of a household's ability to pay or at least some evidence-based guidance as to what might constitute reasonable expected contributions from households at different income levels.

23. It might be thought that Option D has little to commend it. However, this option might be attractive to the Government if it was felt that additional upfront payments, household contributions and institutional financial assistance were more likely to gain parliamentary support than an increase in student borrowing and the changes to the present system that this might require.

Fee waivers

24. The issues surrounding institutional bursaries and maintenance support more generally are not addressed in this report. However, if part of the fee had to be paid upfront (Option D in the foregoing analysis) then some system of fee waivers would be necessary to ensure that potential students without the available means to pay part of the fee upfront were not prevented from attending those universities that charged higher fees. This could eat substantially into the benefit that universities derived from higher fees.

25. Unlike Option D, the other options for covering the higher fee that have been discussed (Options A-C), assume that the full fee will be covered by a government loan of some kind. From a strictly logical perspective therefore, it might be thought that there would be no need for students from lower-income households to receive fee waivers as part of a package of financial support, since the higher fee could be covered by additional borrowing, repayable only when the student had graduated and was working.

26. However, students from lower-income households would be taking a greater risk than their peers from better off families: if their earnings

[8] Although as with Option B, some students might use maintenance loans to pay all or part of any additional fee. Again this would risk increasing taxpayer expenditure above current levels.

after graduation were lower than anticipated they would have no family cushion, and even while they were at university they would have less prospect of family support. Government and universities would be concerned that such students might be deterred from applying to the most expensive courses by the additional cost incurred, even if this cost were deferred until after graduation.

27. One way of addressing this would be to provide fee waivers to students in receipt of substantial government grants. Table 3 shows what this would mean in terms of additional financial support for students at illustrative income levels, and with fees of £5,000 and £7,000, if students in receipt of the full grant received a full fee waiver on any fee above the current maximum and those with incomes up to around £41,800 received a partial waiver proportionate to their grant.[9]

Table 3: Fee waivers proportionate to government grant

Residual household income (£)	Fee waiver (£5,000 fee)	Fee waiver (£7,000 fee)
26,270	1,700	3,700
27,500	1,581	3,441
30,000	1,340	2,916
32,500	1,098	2,390
35,000	856	1,863
37,500	703	1,530
40,000	635	1,381
41,800	585	1,272

28. Table 4 below shows the effect of these fee waivers on institutions of average size charging the maximum permitted fee on all courses. The table shows the estimated cost of fee waivers with £5,000 and £7,000 fees and the proportion of new fee income retained by such institutions once these payments to students are taken into account. The cost of these fee waivers would naturally depend on the distribution of incomes among the student body. Table 4 therefore illustrates the different effects on fee income for an institution with a 'standard' distribution of student incomes (an average proportion from low income households); an institution with a significant number of students concentrated at the 'high end' of the income distribution (and thus a small proportion of students from low-income households); and an institution with a significant number of students concentrated at the 'low end' of the income distribution (and thus a large proportion of students from low-income households).

[9] An explanation of the method for determining these fee waivers is available in the full report.

Table 4: Cost of fee waivers to average institution

	Fee waivers with £5,000 fees	Fee waivers with £7,000 fees	Proportion of new fee income retained by institution
'Standard' income distribution	5.0	11.0	58.3%
'High end' concentration	2.4	5.1	80.5%
'Low end' concentration	6.4	14.0	46.8%

29. Table 4 shows that the estimated cost of the fee waivers described above might leave an average institution with less than 60 per cent of any new fee income. Even an institution with relatively few low-income students would spend around 20 per cent of any additional fee on these measures. It can be seen, therefore, that the level of student support that any post-2009 fee increase will require will substantially attenuate the benefit to universities charging a higher fee. In addition, of course, if Option A were the chosen approach for restraining the cost to government of increased student loans, then the benefit to institutions would be reduced further.

Conclusion

30. The present arrangements for student contributions to the funding of universities are highly progressive, but expensive: every £1 of fee loan costs the taxpayer at least 33 pence. So the greater the total amount of fee raised by universities, at present, the greater the Government's financial commitment. It cannot be taken for granted that the Government will be willing to increase this commitment, even if universities are permitted to charge higher fees in future.

31. This report has therefore examined how the system might be modified in ways that would allow for a higher fee cap but without increasing the public spending commitment to student support. The first option considered here would involve a portion of the income from institutions charging higher fees being used to help pay for continued fully subsidised loans. The remaining three options discussed in this report involve some move away from the principle of a fully subsidised loan for students up to the maximum fee.

32. One of the options considered would require students to pay part of the fee upfront. This would represent a major break with the principles of the 2006 reforms, which established that no student would have to rely on their family for any part of the cost of tuition. Additional institutional

support would therefore be vital to help ensure that no student is excluded from a course because of financial constraints.

33. In fact, it is suggested here that some form of fee waivers might be appropriate even if loans remain available up to the maximum fee permitted. This is because students from poor families are taking a greater risk than students from better-off families when they take on the commitments implied by going to university. For example, if future income is not realized at the hoped-for level, then that will hit students from poor families harder than others. They are taking a greater risk in a very real sense and it is not simply a question of attitudes to debt; it is real and differential risk. That, of course, is the case under the present fee regime, but would become more of an issue if fees rise. The report has therefore briefly explored the financial implications of providing fee waivers in proportion to the government grant on any fee above the current maximum to students from lower-income households. It concludes that the benefit to universities that charge a higher fee post-2009 would be greatly attenuated by the level of fee waivers that would be required.

34. Although this report considers only the impact of a rise in the fee cap, in reality, the 2009 review is bound to consider the arrangements for student support as well. The impact on institutions and on students themselves of the expected levels of institutional financial aid under a variable fee regime deserves detailed consideration, and is something that will be explored further in a forthcoming HEPI report.