

The government's proposals for higher education funding and student finance – an analysis¹

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1. HEPI report number 49 described the Browne Committee's proposals for the reform of higher education funding and student finance. Just three weeks after the Browne Committee published its report, the government announced what it intended to do in response to the Committee's main proposals. Many of the recommendations have been accepted, some rejected, some modified and in some cases there will be further deliberations between now and the publication of a White Paper. The most radical proposal, a reduction in the universities teaching grant by 80 per cent, and its replacement by tuition fees that attract a real rate of interest, has been accepted.

2. In debates leading up to the government statement there have been different views about why change is needed. It has variously been presented as a necessity forced on the government as it looks for ways to reduce the deficit, but also as a means to enforce the principle that funding should follow the student, and so create a greater incentive for universities to improve their teaching. Also the 'progressive' nature of the repayment scheme is stressed. Whether the government proposals will achieve these objectives, and whether increasing tuition fees is the only – or even the best – mechanism, remain open questions. The one impact that the changes are sure to have is to increase the contribution of students to the cost of higher education, though even this turns out to be less clear cut than at first appears.

3. In this report we first provide a summary of the differences between the Browne Review and the government's proposals. We then look at whether these proposals meet the two main objectives: to reduce public expenditure and to improve the quality of university teaching by increasing student choice; we also examine the claim that the repayment scheme is progressive. Those who leave university without a qualification have been airbrushed out of the debate; we consider how the proposals will affect them. Finally we describe the likely responses to the changes of prospective students, universities and government.

The government proposals – how they differ from the Browne Review

4. In their most important respects the government's proposals follow Browne – and it should not be forgotten that Browne itself takes and builds upon the essential characteristics of the present system. Higher

¹ To save space this summary does not include references. These, and details of the modelling that underpin the conclusions are contained in the full report at www.hepi.ac.uk.

education remains free at the point of use; the government lends money to students to enable them to pay universities the fee that they charge for tuition; once they have left university (whether or not they have graduated) former students repay their loans through the tax system by paying a 9 per cent tax surcharge on income they earn above the threshold level set by the government; and once they have repaid their loans, repayments cease.

5. However, there are some important differences. In particular, the government has rejected Browne's proposal that there should be no maximum fee, and the consequential recommendation that fees above £6,000 per year should be subject to a sliding levy. The government has proposed a maximum fee of £9,000 with no levy.

6. The responses of universities have been mixed. Some – confident that they will be able to charge high fees – have welcomed the proposed new arrangements because they believe that they will be better off as a result, or at least that the increased fees that they receive will offset the reduction in government funding. Others, perhaps fearful that they will not be able to persuade students to pay the fees that will be required to enable them to continue to make high-quality provision, have been critical. Student bodies have been extremely hostile to the proposal that they should pay fees that on the face of it are likely to be between two and three times the present level.

7. Of more general concern has been the principle, strongly articulated by both Browne and the government, that the government ought not to fund universities directly, but that to the extent that government funding is provided it should be provided through the student. On this view the government provides the student with a voucher – or rather a loan that acts as a voucher – that the student carries to the university of their choice. Student choice, and the market as reflected through student choice, determines the funding of universities, and the government plays no direct role.

Will the proposals reduce the public contribution to HE?

8. We were critical of the Browne Committee for not setting out the assumptions behind their calculations or the methods used. We were therefore very pleased when the Department for Business, Innovation and Skills (BIS) provided a detailed explanation of what they did, and even the simulated data set which can be used to explore alternatives. This represents an unprecedented level of openness which should improve the level of debate. They are to be congratulated.

9. We do not need any sophisticated modelling to work out that in cash terms, the proposals will increase public expenditure through this parliament and into the next. The more difficult question is what will be

the long term cost of these loans, and this itself hinges upon the value of the repayments that will be received. This is measured as the Resource Accounting and Budgeting (RAB) charge. If no repayments are made the RAB charge is 100 per cent. If all the loans are repaid with interest at the government's cost of borrowing (currently 2.2 per cent), then the RAB charge is zero. If more than this is repaid, the RAB is negative.

10. We have looked closely at the 'Browne' model with the revisions proposed by government, as it applies to three year degree programmes. Our conclusion is that the RAB charge estimates are lower than they should be – that is to say the savings that will accrue to the government will in reality be much lower than expected, and that far from a saving, there may even be a cost to the government. Our view is that a RAB cost of 50 per cent or higher is quite possible for a three year programme for students with a £9,000 fee and £4,000 maintenance loans per annum.

11. On the basis of our calculations, a RAB charge of 47 per cent would be break-even for the government – that is to say the new arrangements would be cost neutral compared to the present. A higher figure would imply an increase in the contribution from public funds, a lower RAB would imply that there were savings.

12. Some of the output from the model used to estimate the RAB looks optimistic. For example, the average male graduate earning is assumed to increase to £99,500 pa (in real terms, at 2016 prices) by the end of the repayment period. Looking into how the estimates were made, we have been able to make some suggestions as to why they are high. For example the model assumes equal numbers of male and female graduates; the reality is that there are many more female graduates than male, and on average females earn less.

13. Using a refined model we estimated what salary growth would correspond to the 47 per cent break-even figure. It turns out that reducing the average annual growth in real income from the 4.7 per cent based on the BIS assumptions to 3.5 per cent increases the RAB to 47 per cent. This lower growth figure seems to us to be entirely plausible, and there are also other reasons to suspect that even the results of the HEPI model are optimistic.

14. So the answer to the question, "will the proposals decrease the public contribution to HE" is, "it's too close to call, but they could actually easily lead to a small increase in the public contribution". The beneficiaries of such changes would be the institutions: taking account both of the government grant that universities receive from HEFCE at present and the fees they receive from students, those universities that charge £9,000 per year will benefit from an increase in income per student of £2,600. The increased cost will very likely be met not by the student but by the taxpayer. However, it will take some time to establish

whether the cost to the government is greater than has been allowed, and by that time, of course, it will be a problem for future generations of politicians and taxpayers.

15. This result may be inconvenient for different reasons. The government may be uncomfortable that the changes will do nothing, even in the long term, to reduce its expenditure (the question of reductions in the deficit is a different one – see below). The Opposition may be disappointed to lose the chance to criticise the government for cutting investment (though questions remain about the ideological and political basis for its policies), and institutions may be nervous about revealing that they can look forward to increased funding at a time of austerity.

Will the quality of teaching be improved?

16. In his statement and in his replies to the questions that followed, David Willetts, Minister for Universities and Science, made it clear that the motivation for the changes was not just to reduce public expenditure, but to drive up the quality of higher education by increasing the freedom of universities and allowing money to follow student choices.

17. This belief in the market – and the reliance on student choice and the resulting competition as the sole expression of the market at work – as the primary mechanism to drive up quality underpins both Browne's and the government's response. But such a belief is in many respects misleading and even simplistic. The fact is that higher education is a most imperfect market where choices are made for reasons that have nothing to do with quality or value for money. Moreover, as the Browne Committee recognised, the information necessary to drive choices in higher education is very largely absent. It is true that Browne recommended and the government has accepted that better information should be published to inform student choice, but welcome though this will be, it will take a great deal more to achieve good market conditions in higher education – students are likely to continue to select their institution for reasons that are often good ones but which do not follow economic orthodoxy.

18. Moreover, greater competition and responsiveness to student choice could easily be achieved through a change to the present method for distributing the block grant rather than shifting funding from grant to fees. The grants that universities receive are already governed to a large extent by their success in recruiting students. However, the current mechanisms for distributing grants are also designed to provide stability and to control public expenditure; their characteristics are not intrinsic to funding by grant rather than fees. If it were thought to be a good thing to increase competition and choice at the expense of stability – and that would be a perfectly reasonable political decision – then that could be achieved

without giving up the government's direct funding role to the extent that is now proposed.

19. On the other hand, it is difficult to see how students could be given greater freedom to attend the university of their choice – and consequently that universities should be allowed to recruit as many students as apply to them – while maintaining control over public spending (bearing in mind that increasing student numbers will cost the government money because of the RAB cost).

20. The key questions in relation to the desire to increase the freedom of students and universities therefore are not about fees as such, but the government's attitude towards the risks of greater instability across the sector and to losing or at least weakening control of public expenditure. It is clear that it is prepared to accept the risks of greater instability, but ceding control of public expenditure is unlikely given the Treasury's traditional attitudes, let alone in present economic circumstances.

21. So the key question is how increased freedom for universities is going to be squared with controlling public spending which, with a loans system, necessarily entails controlling student numbers. The Browne Committee made a proposal, but that has been widely criticised as being unworkable. And the Minister had nothing to say about this, other than that it was something the government was working on. Without any idea as to how this question is to be answered, the intention to increase the freedom of students and universities is no more than a wish.

Is the repayment system progressive?

22. Much of the discussion around the Browne proposals has centred on whether various repayment schemes are "progressive"; whether those former students with higher earnings will pay more or less than those on lower incomes. The issue can get highly technical with the choice of discount rate affecting which scheme is the more progressive. It is a little surprising that such a lot of attention should be given to these somewhat secondary matters rather than the substantive issues, in particular whether making students pay a larger contribution to tuition is wise or fair, and whether it is philosophically and politically right that the state should effectively withdraw from funding higher education directly, and rely on student fees (albeit with the state contributing by making repayable but part subsidised loans to students).

23. It is in this context that increasing the interest rate from the 2.2 per cent proposed by Browne to 3.0 per cent can be seen as positive. Of course no students pay less as a result of the increased interest rate, but those on low incomes are relatively better off since their repayments are mainly determined by their income, not the fee level or interest rate. Also,

assuming it does not lead to any change in behaviour, increasing the interest rate will help public finances by reducing the RAB charge.

24. The increase in interest charges only goes part way to compensate for the cost to the government of the raised repayment threshold, and the indexing of that threshold to earnings. These are very costly, but they do concentrate benefits on those on lower incomes. It is these elements of the new package that enabled the Minister to claim that, "a quarter of graduates – those on the lowest incomes – will pay less overall than they do at present." The figures in Table 1 show how this works out.

Table 1: Repayments for former students on the lowest incomes

	Current System	New system	
		'Threshold' fee	Maximum fee
Fee	£3290	£6000	£9000
Maintenance Loan	£4000	£4000	£4000
Total loan	£21,870	£30,000	£39,000
Repayment	£14,000	£10,678	£10,967

Notes: Created using unmodified BIS Ready Reckoner with default parameter setting for the new system. For the current system the repayment period, repayment thresholds and interest levels were changed accordingly. The repayments are shown as discounted by inflation (2.75%) to the year 1 of the repayment period.

25. Not only does the higher debt from the higher fees not generate higher payments, but for those on low incomes, on average going to a £9,000 fee university for three years only costs £289 more than a £6,000 fee university. For low earners, the higher threshold levels mean that their total contributions are determined more by their income than the fee level or interest rate.

26. The figures in Table 1 show that, on average those graduates in the lowest quartile of incomes will pay less. But it should be noted that this is an average. Not all those in the lowest quartile will pay less. Indeed 17 per cent of those on lower incomes who pay fees of £9,000 will pay more than they would under the current system. Nevertheless, in moving from the current system most of those in the lower income quartile will pay less, while those on high incomes will pay more, and to this extent the system is progressive.

27. At the other end of the earnings spectrum one consequence of the higher interest rate is that, for typical sets of conditions, about 15-30 per cent of former students are expected to make repayments that have a Net Present Value of more than they have borrowed after allowing for inflation and the government's cost of borrowing. There will be an increased incentive for these high earners to pay back their loans early and avoid the interest payments. That poses a problem for the government, since requiring 'rich' students to pay more is one feature of the new system that makes it relatively 'progressive'. And if wealthy students pay up-front a

smaller proportion of students in the high income brackets will contribute to the RAB cost. No doubt it is with these considerations in mind that the government is consulting on introducing charges for former students who pay off their loans early.

28. Also relevant is that university fees will still be lower than those charged by independent schools, and many parents will no doubt be able and willing to pay university fees up front. So far, there is no declared intention to make a charge for not taking out a loan. If no charge is imposed, students from such families will pay less for their tuition than most of those students who take the best part of a working lifetime to pay off their debt. This is a detail, but it will enable the political charge that the student funding regime is not progressive, since the rich will be able to avoid taking loans that attract real rates of interest.

29. So is the system progressive? Yes, in part, because those former students on lower incomes pay less, but there will be those who argue that it is not, because the wealthy can avoid the interest charges that the well paid graduate from an ordinary background will have to pay.

Debt and drop-outs

30. Throughout his statement the Minister referred to 'graduate' repayments. We must assume that, like Lord Browne, by 'graduates' he means 'former students'. This may seem to be a pedantic point, but referring to 'former students' as 'graduates' colours the argument.

31. The reality is that there will be large numbers of former students without any higher education qualifications with large loans. The number of people in this position is likely to increase, firstly because loans will in future be provided to part-time students, where non-completion rates are much higher, and, secondly, because the financial incentives for institutions to ensure that students complete their year of study will be reduced. Under the current arrangements, students who do not complete their year of study are not included when calculating a university's grant. With fees universities will retain a part or the whole of the fee that replaces the grant. The penalty that a university suffers if a student drops out will be reduced, if not removed.

32. The response to these concerns from those with faith in market mechanisms is likely to be that universities will be under pressure to ensure that they maintain low dropout rates because this is one of the things that students will take into account in making their choices. But such an argument only shows the weakness of being over-reliant on student choice. Research commissioned by HEFCE (and cited by Browne) found that prospective students did not see much value in the non-completion information that is currently made available. They think that if a student drops out it is because he is lazy; it would not apply to them.

What will potential students do?

Whether to go to university

33. The Browne review concluded that, "if fees can be deferred, then participation can be protected", but the evidence produced by the Institute of Fiscal Studies (IFS) that was cited in support of this conclusion is somewhat different.

"Our results indicate that a £1,000 increase in loans or grants is not sufficient to counteract the impact of a £1,000 increase in fees – the coefficient on fees is significantly higher than both loans and grants."

34. As noted in our response to the Browne review, we have a number of reservations about this research, but if we take its conclusions at face value an increase in fees to £9,000 would reduce demand for HE by about seven percentage points. This does not take into account the changes in the package of maintenance loans and grants, though the expected impact of these other changes is small. The problem with the IFS study is that the changes over the last decades, on which they have based their conclusions, not ideal as 'natural experiments'. So when the £1,000 fee was introduced students from wealthy backgrounds were entitled to an extra £1,000 loan, ostensibly for maintenance, but that would be seen by most as a technicality. Students from poor backgrounds were also entitled to this loan, and did not have to pay the fee, but the non-repayable grant that they had previously received was cut by £1,000. So disentangling the effects of changing grants, loans and fees is problematic.

35. There must be a prospect that some students will balk at paying a fee of up to £9,000 for a course that is likely to lead to rather uncertain financial benefits. And to the extent that the decision to go to university is an economic one, then it makes sense that the more expensive it becomes the more likely it will be that some students will be put off by the cost. However, the penalty for not going to university is and will continue to be considerable. Although it will always be true that some young people would do far better in financial terms not to have gone to university, these cannot be identified in advance. For most, even with the increased fee, going to university will still be a better bet than not going – at least they will have the opportunity to compete for better paid jobs whereas that opportunity would not even be open to them otherwise.

36. Moreover, the loans that the government provides to enable students to pay their fees will be heavily subsidised (though the extent of the subsidy has been played down by the government); and the repayment terms are comparatively generous. As a result students in the future will actually be better off day to day than in the past (they will pay less each month, though they will pay for longer). So if the new arrangements are

properly explained then the disincentive may be less than is feared by some.

37. The reality is that we cannot safely extrapolate from the introduction of fees in 1998, and then their increase to current levels, to predict the effect of the new arrangements. It seems quite plausible that some potential students will be deterred from entering higher education, but we do not know how many. Their actual impact will depend to a large extent on perceptions. To the extent that loans are not distinguished from ordinary debt from banks, then fees will act as a deterrent. How the new arrangements are described and "sold" will be crucial.

Which university to go to

38. While the decision whether to go to university or not may follow normal price elasticity – the higher the price to potential students, the lower the demand – the same cannot be said for the decisions students make once they have made up their minds to go to university: that is in choosing which institution and course to apply for. University places may be Veblen goods: raising their price makes them more desirable by raising their status and prestige. Recent research suggests this is the case in the USA.

"increases in tuition also contributed to improved admissions indicators, even though tuition is not necessarily connected with institutional quality... Clearly, then, students and/or parents must view high tuition as reflecting some positive aspect of institutions, whether it be prestige, quality, or a combination of the two."

39. The government's expectation is that fees above £6,000 will only be set "exceptionally". Suppose things turn out as they expect. Will prospective students make a choice on price, or will they, as now, apply to the most selective universities that they are qualified for. To what extent are their choices likely to be affected by a variation in fees of up to £3,000 per annum (assuming that no university charges less than £6,000)? The evidence from the USA suggests that there a higher fee makes the institution more rather than less attractive. This is likely to apply to the UK as well, particularly as students in the UK will not be spending 'real money'. The amount they actually pay will depend on how much they earn, as much or more than what the notional fees are, making it more likely they will view higher fees as better.

40. As we saw from Table 1, the cost of an extra £9,000 (3 x £3,000) in extra fees for low earners is, on average less than £300. So price competition – even if a range of fees is charged – is far from certain. That is one reason the new system will create much less of a market than at first appears likely, and it is unwise to rely on market forces to provide the benefits that markets might otherwise provide.

What will institutions do?

41. The government believes that only in "exceptional cases" will universities charge more than £6,000. Indeed the £6,000 fee level is described as a "graduate contribution threshold". However the government also says that it will be up to each university to decide what to charge. The statement that fees above £6,000 will be exceptional must therefore be based on what the government thinks universities will decide.

42. Those institutions that are over-subscribed will charge £9,000 without hesitation. Those that have struggled to recruit students will initially be more cautious, but, within a few years, we believe that almost all universities will charge the maximum £9,000 fee. No doubt, as now, some further education colleges will charge less than the maximum, and so may a small number of higher education institutions, but our expectation is that the great majority of students will be charged the maximum fee within a few years. It is worth recalling that the introduction of the £3,000 fee cap did not create the differentiated market that many had predicted.

43. In order to replace the HEFCE grant universities will have to charge fees of about £7,000. We think it unlikely that many universities will accept Lord Browne's invitation to make "efficiency gains" and charge a lower fee: the "efficiencies" will be seen for what they are – worse student: staff ratios and fewer books in the library.

44. There are at least three good reasons to charge a further £2,000. First, charging lower fees risks being identified as a low quality or low prestige institution. Secondly, given that the loans involve a significant subsidy – perhaps as much as 50 per cent – the higher fee means accessing further available public funds: £2,000 additional fee will only in effect cost the student £1,000 – the government will pay the other £1,000. Finally, if student demand is weak, the extra revenue can be spent on bursaries and scholarships. If £2,000 extra is charged the university can give it all back to the student as a scholarship.

45. Universities that choose to set fees above £6,000, that is all institutions that are not prepared to see a cut in their unit of resource, will have to enter an agreement with OFFA on "progress each year towards their access benchmarks as calculated by the Higher Education Funding Council".

46. If a university does not make adequate progress it will be directed to spend "a proportion of the income from contributions over £6,000" on specified access activities. This proposal is unlikely to deter institutions from raising their fees to the maximum. Universities will do whatever they need to do to satisfy OFFA. OFFA was established in the 2004 Act to satisfy those (mainly Labour and Liberal Democrat) MPs who were

concerned that raising the fee to £3,000 would deter access. No university has yet failed to satisfy OFFA, and there is no reason to expect any to do so in future. There is, therefore, every reason to expect most universities to increase their fees towards £9,000 – not immediately, but over time.

What will the government do?

47. The government's expectation is for most fees to be set at £6,000. In answer to a question in the House the Minister also revealed that its expectation was for student numbers to remain flat, though a system to control student numbers has yet to be described. Finally, as we have seen, the estimates of the costs of the loans look at best uncertain and at worst highly optimistic.

48. So if the sector responds as we expect, with most fees eventually set at £9,000, the public expenditure costs will be much higher than expected both because the government has understated the RAB cost and because fees (and therefore the government's loan obligations) will be much higher than anticipated. And there are good reasons to expect student demand to increase over the next decade or so, putting political pressure on the government to allow numbers to rise.

49. If student numbers increase, or the costs of the loan subsidy increase, both of which are likely, what will government do? A number of relatively straightforward actions are available, which would make what appear at present to be relatively generous loan repayment arrangements far less generous in future. The main instruments would be to

- Lower the threshold in real terms at which loans begin to be repaid – the government's commitment at present is to maintain the threshold at £21,000 in real terms;
- Increase the rate of interest that is paid on the loans;
- Increase the rate at which incomes above the threshold are 'taxed' from the presently proposed 9 per cent;
- Increase the period over which repayments must continue to be made (proposed to increase from the present 25 to 30 years).

50. An alternative would be to reduce further the government's direct funding of universities, removing the limited support that it is at present proposed to continue providing for science subjects, and even perhaps reducing HEFCE's grant for research.

Why have the government and the Browne committee gone down this road?

51. This analysis has shown that the approach taken by the government cannot be expected to save significant sums of money – indeed, it is as

likely that in the long term the government's proposals will cost more than they will save. But to be fair the government makes it clear that cost saving is not its only aim, though it is one of them.

52. The idea of the withdrawal of the state from the direct funding of universities is deeply ideological. Because of the considerable government subsidy that the new arrangements involve, it is not as if the government is withdrawing from funding higher education or higher education teaching in particular. So it is not as straightforward as a belief that the state has no business in funding such activity. It is instead driven by the belief that the market – and in particular student choice as the manifestation of the market at work – is the best way of ordering things, and to the extent that government funding is to be provided it should be provided in such a way as to increase student choice. Through this other benefits like quality improvement and cost reductions will follow.

53. Even if such a belief in market mechanisms were well founded, the problem for the government at present – a problem that the Browne Committee recognised but was unable to offer a plausible mechanism to resolve – is that public expenditure constraints will make it very difficult for student choice to be exercised in an unfettered way. Student numbers will have to be constrained as long as there is a public cost for every student that is recruited. That is a conundrum that the government has not yet resolved but which is critical for the coherence of the philosophical justification for its proposals.

54. There is another reason. The government's entire economic strategy is based around reducing public borrowing. Borrowing to give grants to universities counts as public borrowing. Borrowing in order to make loans to students does not count as public borrowing, to the extent that the government can show a stream of income to offset the loans. It is smoke and mirrors, and it provides an extraordinary reason for changing the whole basis for the financing and organisation of the university system.

55. In making available the modelling tool that it developed for the Browne Committee, the government has facilitated a level of scrutiny that has not previously been possible. Considering the relatively simple case of those graduating from a three year course, we have concluded that estimates of the RAB that have been used to develop policy are likely to be over-optimistic. If we are right – as we believe – then this undermines both the government's case that the new arrangements will make savings in public expenditure, and also the case it has made to the financial markets that they will reduce public sector borrowing.