Higher Education Policy Institute (HEPI)

House of Commons Seminar: 15th February 2011

The Financing of Higher Education

Professor David Eastwood:
It's early in the morning, so let me be clear. In the short time available to me this morning I want to do three things:

I want to hint at the curious history of higher education policy debate over the last generation, and suggest that it has tended to ignore the underlying development of a new political economy of higher education (a new funding model if you want to be more prosaic).

I will then revisit the recommendations of the Browne Review and offer a commentary on the way in which Browne's carefully-crafted recommendations have been revised, largely in ways that have attenuated market disciplines and made higher fees more rather than less likely.

I will end by suggesting that there are issues that need urgently to be revisited in the forthcoming White Paper.Lest anyone misunderstand my message, let me say at the outset that I admire the political courage of the Coalition Government in addressing the higher education funding challenge, just as I admired Labour's willingness to develop a new and essentially well-directed system of higher education funding in 2003-4.

What concerns me is that the counterpoint between policy formation and a fairly crude politics risks undermining what might yet be a sustainable approach to higher education for the next decade or more, and that is a prize worth having.

Let me now move to what has made HE policy so deeply political and so deeply contested in the last fifteen years. Underlying HE policy there has been, I think, a profoundly complacent assumption: that the excellence of our system is invulnerable. The achievement of higher education - producing a world class system on about half the front-line funding enjoyed by competitors – has not brought us the acclamation we might have expected, still less immunity from political interference or from an inclination to micro-manage institutions, and indeed a sector, that broadly manages itself rather well.Precisely because the quality of our system has been taken as a self-sustaining given, and the competiveness of international higher education has been overlooked, it has been prodigiously difficult to sell the hard choices that are urgently needed to sustain the system and its funding.

One consequence of this is that issues such as participation, access, and economic impact have taken precedence in the political debate over sustaining the *quality* of the system. All the political compromises that have been made, from the rejection of key aspects of Lord Dearing's 1997 report, through the concessions made in 2004 to get the HE Bill through, through the July 2007 changes to student support, to many of the changes made to Browne's recommendations, all have taken resource away from sustaining a high quality system. Some of these compromises might be justifiable as attempts to balance two public goods - access and quality - but there are serious questions as to whether the right balance has been struck.

It is, of course, an analytical commonplace that mass systems of higher education cannot be funded in the ways that elite HE systems were, and that an ineluctable consequence of the move towards mass higher education is that students must pay more.

What is less well understood is that we embarked on this road to a radically different political economy of higher education as early as the 1970s.

Maintenance grants were dramatically eroded in the 1970s as public expenditure pressures combined with the expansion of numbers in Higher Education to make the then systems of student support unsustainable.

When I arrived at university in 1977, from a far from affluent family, I enjoyed what was deliciously called ‘a minimum grant’. Grants gave way to loans in the 1980s, and in the 1990s government sought, unavailingly, to find private sector alternatives to all student support.

If the first consequence of a move towards mass higher education was that students contributed much more towards the cost of their <u>maintenance</u>, the next stage was that they would need to meet at least some of the costs of their <u>tuition</u>. That was a core issue for Dearing, and has dominated the public debate on higher education ever since. Had it been better understood that the debate on how to fund tuition was part of a funding trend reaching back to the 1970s, and supported in government by both parties, the debate might have been more informed and more constructive.
As it was, ‘free higher education’ has become an easy slogan of opposition parties, especially those who thought they could make electoral pledges to reduce the scale of their likely electoral defeat. ‘Free higher education’, as Nick Barr repeatedly reminds us, is code for ‘someone else pays’, and, in the case of higher education, those who pay are those who don’t benefit directly from higher education pay.

The advocates of ‘free higher education’ from 1997 onwards have never produced a costed plan. Hence that curious moment in the summer of 2010 when myriad ‘opponents of fees’ and former advocates of ‘free higher education’ came out in support of a graduate tax, a policy that would have seen graduates with unlimited fiscal liabilities and certainly a policy that would have seen them paying more than under the Browne proposals they sought to oppose.Indeed it has been striking how courageous *governments* have been in promoting new systems of higher education funding. Labour did legislate on Dearing, albeit in a less enlightened way than Dearing had recommended. More strikingly Labour in 2004 and the Coalition in 2010 were unflinching in seeking to promote change in higher education funding at very considerable parliamentary risk. I have so far sought to locate the 2010 debate on Browne and funding in a much longer history. Only by understanding the curiously contested history of higher education policy over the last generation can we understand the striking politics of 2010. In an important sense, this was a *dénouement* no-one anticipated. Imagine, if you will, the counter-factual.Browne was commissioned – like Dearing – on a bi-partisan basis, after extensive discussions between the two main parties. The reasons for this were not far to seek. It was universally acknowledged within government that the current student funding regime was unsustainable. That was partly because the costs of the 2006 system were under-estimated, and the costs of the 2007 changes hardly estimated at all.

As the squeeze came on public expenditure, the effect of overspends in student support was a constant erosion of the teaching grant. The effects of the system, if not checked, would have been a massive erosion of teaching funding and quality. And this was apparent even before the consequences of the 2008 global crisis kicked in.Thus the expectation was that Browne would recommend change, and must seek a sustainable alternative. Almost certainly that new system would be a radical elaboration of the 2006 system rather than a repudiation of it. The imperative for change thus created an imperative that Browne would, at least substantially, be implemented. Hence the bi-partisan nature of its commission.

The interactions between Lord Browne's Review and the changed and changing political environment were complex. John Browne was insistent throughout that his was an independent review. The Review's independence mattered to John, as it did to all of us on the Review Group.

Interestingly the many journalistic attempts to suggest that the Review's independence was somehow a sham have been unavailing. Indeed the more journalistic critics have pressed the more reluctantly impressed they have been by the Review's insistence on gathering evidence, on taking evidence in public, of operating with a very diverse reference group, and on developing solutions rather than reinforcing prior assumptions.
In the light of what was to come, Browne's guiding principles and principal recommendations were interesting. Its recommendations might be briefly summarized:

1. The separation of maintenance and tuition
2. Higher education's remaining free at the point of delivery
3. Proportional graduate contributions
4. Treating part-time students on the same basis as full-time students
5. Creating a market that would be shaped by informed sturdiest choice
6. Using student choice as the principal driver of quality
7. Eliminating unmet qualified student demand
8. Freeing up numbers in the system
9. Developing a soft cap on fees and introducing the principle of risk-sharing between institutions and government over funding.

Put like this, the radicalism and long-term vision of Browne is clear, as is the extent to which the Browne proposals were amended or, in some cases, put into abeyance to secure political support. At least as interesting was the rapidity with which the Browne proposals started to be amended.

Thus the Browne Report more-or-less immediately became the subject of an intensely political process. The inevitable consequence was that the checks and balances, central to Browne's vision, became weakened. Take the issue of the cap.

Browne envisaged what I have called a soft cap, in essence a sliding scale where institutions charging above £6,000 would share the risk of non-repayment by, in essence, indemnifying government on the basis of the RAB charge. At first sight this seemed complex - it is amazing how few actually understand even the basic principles of public accounting; on second blush some universities protested this was objectionable –

why should they pay a 'levy', they were entitled to charge what they wanted, with government carrying the whole risk premium: in the event this was a self-defeating naivety or a breathtaking example of pure welfarism; and on third blush this seemed to critics a licence for universities to charge unlimited fees, well into five figures.

Anyone who bothered to reflect carefully on the proposal would have concluded: that the principle of risk sharing over a basic fee was legitimate, would create market responsibility, would ensure that the system was stable and sustainable, and would give both a soft cap to the fee and real scatter in fees charged. Almost certainly the median fee under the Browne proposal would have been lower than those which will emerge under the current twin cap system. I understand the political logic that drove the Coalition to the twin caps. I understand rather less why the Sector rushed to embrace it; but above all we must understand that the logic was a political logic, which was profoundly at odds with the underlying logic of the system that Browne was seeking to promote.Take next the issue of numbers. Browne – rightly in my view – took pride in finding a funding model that would enable the system to continue to expand, perhaps by as much as a further 10%.

I have long held that, in systems such as ours, when you approach 50% participation you will meet all qualified demand, and the system will be self- equilibrating.

Thus Browne would have envisaged institutions setting fees where there was no unmet demand i.e. no artificial constriction of supply which would enable providers to charge an above market-price fee without significant hazard.

Browne also recognized that, as the Treasury was funding the system, it would not accept an open-ended or unlimited liability. Hence Browne sought a mechanism that would enable the Treasury to cap total HE expenditure in any one year, but students would be free to seek admission to any institution that would accept them, subject to that institution's view of how many students it wished to accept. Thus some high quality institutions might expand, expanding thereby real student choice.

That, too, would mean that all institutions would need to reflect carefully on quality and market position, and price accordingly. The system itself would not constrain student choice by numbers planning.The mechanism for accomplishing this in Browne was the tariff system. A two-tier system where, in any one year, any applicant achieving a minimum UCAS tariff (let us say two Es of their equivalent) would be guaranteed public support for their higher education. They would then have a *de facto* voucher to use in any institution that would accept them. There would be a separate allocation of funded numbers, distributed to institutions by bidding, that would be available to students who came through non-tariffed routes, access programmes, and APEL, where institutions, as now, believed they had the potential to benefit from higher education.

The cry went up: but the Secretary of State will demine who goes to university! I have a small and a rather large quibble with this. My small quibble is that the Secretary of State would do nothing of the sort, merely set a minimum level of achievement at which applicants would be *guaranteed* funding for their higher education.

Many more would gain admission and funding, and most would end up at the institution of their choice, given the constraints of their prior educational achievement and potential.
But my major quibble is: what on earth do you think happens under the current system. The Secretary of State determines in any one year how many people will be funded, and the Funding Council decides how many should goes to each institution, give or take a flexibility margin. The effect is radically to attenuate student choice. HEFCE operates a managed voucher system on behalf of the government. I genuinely thought everyone in HE understood that. I now regret I made so generous an assumption.

So the tariff mechanism was dropped, and the emerging market was thus doubly constrained by controls on fees and controls on numbers. As a result, institutions can and will price with a quasi guarantee that an excess of demand and rigid quotas will mean the system continues to squeeze applicants into all institutions like a grand toothpaste tube.I could go on, but time presses. Let me simply observe that, as the Browne recommendations were modified to maximize political support and to diffuse opposition, there was a parallel process, especially when the protests took to the streets, where many groups that had pressed for major policy changes before Browne was commissioned conveniently forgot what they had previously insisted were axiomatic. Thus Browne got little credit for offering a new deal to part-time learners, which many had regarded as the most important issue before Browne was launched.

Similarly those institutions and groups who had campaigned for an expansion of the system were silent on Browne's vision for an expanded system, and deplored its embracing the only funding method likely to achieve that.

Thus a Coalition faced with the cruel internal political dilemma, and an HE sector that thought it could cherry-pick without doing real violence to the proposals, ensured that what went through – politically brave though it was – left a series of unanswered questions.

So, in a very real sense, the Coalition has unfinished HE business, and business it cannot kick into the long grass. It recognises this in its commitment to producing a White Paper, though, we are now told, a White Paper with more than a tinge of Green. Market disciplines and student choice will have to be made real, so a mechanism for freeing the flow of numbers will need to be found.
Structural realignment remains a priority, and I trust that the White Paper will foreshadow the radical evolution of HEFCE rather than the creation of a new body or bodies. We still need a new approach to widening participation and access, which recognises that the real systemic failing is at 16 – or even before – and thus shifts the political debate away from pillorying higher education towards making progression into higher education a priority for all schools.

And, above all, we must move to a position where short-term political interests are prevented from deliberately misrepresenting the funding system to the disadvantage of students in general and widening participation students (who now have a terrific deal) in particular.

And, above all, I hope we can return to the clarity of the Browne funding decision.

The funding system should be clear. Students pay nothing for tuition, and there is a progressive and affordable system of graduate contributions. Graduates who benefit from their higher education and can afford to contribute do so; those who are not in a position to contribute, for whatever reason, do not. Maintenance is a separate issue, and students from disadvantaged background should be generously supported, as Browne envisaged.

But what they need is maintenance support, not fee waivers or fee bursaries. For as long as maintenance support and deferred tuition costs are elided, the system will be misunderstood and an avoidable disincentive to participation will persist.

There is thus much that a White Paper ought to pick up. Browne offered an integrated vision for higher education funding, the shape of the system, and patterns of participation.

From this genuinely innovative approaches to quality and regulation might have emerged in a more truly diverse system where student choice was real rather than rhetorical.

The political compromises have taken us some distance from that vision. Some, I appreciate, welcome this, though what we have, and their underdeveloped alternatives, hardly yet represent a coherent vision still less as workable system.
The political space in which the White Paper is being developed is still shaped by the bruising aftermath of 'the fees debate'; and I worry that too much will be a matter of what 'we can get through', too little 'what we ought to do'.Let me record my gratitude and admiration to those who have unflinchingly championed the need for a sustainable system of funding a high quality higher education system which genuinely enhances widening participation and opportunity. Lest it seem ungrateful, let me end by reminding us all that there is still more to do, and we would do it so much better if we remembered the profundity of the issues rather than possibilities of partisanship.
I remain hopeful we will together seize the moment, but hope, as someone reminded us a little while ago, requires audacity.

Professor Nicholas Barr:

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Second Speaker – Professor Nicholas Barr:
Good morning everybody, it's a pleasure to be here. Having said that, I'm a sucker for happy endings and this is not a story which up to now has had a happy ending.

Let me start off with objectives. I think we all agree about quality - we need to improve; access – we need to widen access, not just posture about it but really widen it; and size – it's essential for a whole lot of reasons that we don't have excess demand for places. And just to put my own ideology on the table, I'm on the side of students but, most particularly, on those young people who ought to go to university and don't.

So a brief background on financing Higher Education. Just to remind people that these policies don't just happen by accident. Three lessons from economic theory are relevant. Lesson 1 – competition between universities helps students. Lesson 2 – graduates should share in the costs of their degree. Not students. Students don't pay any money. Graduates should share in the cost of their degree. That implies a good system of loans. The third lesson is about the design of student loans, and we know that a good loan system has core characteristics: income contingent repayments an interest rate related in some sensible way to the Government's cost of borrowing, and large enough to cover fees and ideally also realistic living costs. Now, I'm happy to argue those till the cows come home.

The 2006 strategy was rooted in those theoretical lessons, and you can represent the 2006 strategy as having three elements. The first element – paying for universities, variable fees, but deferred, so paid by graduates not by students. The argument is that variable fees promote quality first by bringing in more resources, and second by strengthening competition, creating incentives to use those resources well.

The second element is student support through income conti ngent loans, making Higher Education free, or largely free, to the student. It's graduates who repay.

The third element is active measures to widen participation, and here I get very crabby about the emphasis on bursaries. As David has indicated, all the evidence says that the real problems, the real barriers to participation, are much, much, earlier, going back to early child development. So if you're serious about participation, of course you need to do things at 18+, but 18+ is the tail. The dog - the real problem - is 0-18. What you end up with is not a free market – no sensible person has ever advocated a free market for Higher Education – but a regulated market with a major and continuing role for Government, including continuing taxpayer support for Higher Education (Government please note); to regulate the system through some form of fees cap, and to ensure that there is effective quality assurance; to set incentives – how much competition you have, which can vary by subject; to redistribute within Higher Education – this should not be a system in which winner takes all, so you have a continuing redistributive role for Government to ensure that there is a good loan scheme and to promote policies to widen participation.

So, access I've already talked about. There's something I've already mentioned here – pub economics – something that's obviously true and everybody knows it's true, but actually it's false. Pub economics argues that free Higher Education widens participation. You have only to look at England's shameful participation rate in the days that David has referred to when there were no tuition charges and there were grants, to see that free Higher Education does not widen participation. Access, as I have said, is much more a 0-18 than an 18+ problem. And one of the more encouraging outcomes – in fact, a wonderful outcome – of the 2006 reforms, is last year's HEFCE Report which finds that young people from the 09/10 cohort, living in the most disadvantaged areas, are around 30% more likely to enter Higher Education than they were five years previously. So this isn't just theory – there have already been some powerful advantages.

Which then brings me on to the essay question that Bahram set – 'Browne and the Government's Response' – and I want to start off with what Browne gets right. I'm not going to go into the details. I only want to discuss the core strategic elements.

The key, tremendously important and good thing about Browne is it's a genuine strategy. It's got a series of principles, it's got a series of components that combine together to achieve those principles, so this is a genuine strategy.

The second good point is the attempt to set numbers free which, in many ways, I see as the core of Browne. Why is setting numbers free central? Well, we've got three objectives – quality, size and access. Setting numbers free is central to all three of those. If you have excess demand for places, then the effects of competition on quality are hugely diminished, so having enough places is important for quality. It's obviously important for size. At a time when international competition is increasing, to under-invest in human capital is shooting ourselves in the foot as a nation. And, thirdly, setting numbers free is relevant for access – if numbers are scarce, guess who's going to get the places? So that's fundamental.

Higher tuition fees – another element that Browne gets right. More resources for university, stronger competition, less discrimination against home students. The present arrangement, where British universities get £5-6,000 for a home student and a lot more for an overseas student, is not necessarily the best incentive if you want to encourage universities to give home students education. And, finally, higher tuition fees reduces somewhat the middle class subsidy, so are less regressive. And the fourth 'good bit' in Browne that I want to mention is raising the interest rate on student loans. I could go on about this at length. Interest subsidies on student loans are targeted with exquisite accuracy on the very last group of people who policy makers wanted to help, they help successful professionals in mid-career and virtually nobody else.

So, that's the good news.

What did Browne and the Government's response get wrong? Well, what I'm going to do is slightly naughty. Browne was reporting against a background of horrendous fiscal constraint and it took that as a binding constraint. And I'm going to say 'What would Browne have recommended -, what should it have recommended - if you could relax the fiscal constraints a bit?' So I'm going to assume a slight relaxing of fiscal constraints. The first thing that was mistaken was abolishing the teaching grant for the non-STEM subjects – Arts, Humanities and Social Sciences. This is something that the Government has sought to justify. To me, the argument is very simple. If an activity creates an external benefit and you just leave it to the market with no subsidies, the market will under-produce. It will produce too little. If you believe, as I deeply do, that Higher Education in the Arts, Humanities and Social Sciences does have a social benefit in addition to- over and above - the private benefit, then if you don't subsidise it you are going to get too few people going to university. It's as simple as that. So if you don't subsidise it, you have worries about numbers going, you have worries about quality.

The next problem is that the system fails to set numbers free. And there are several reasons for that. First of all, the loan scheme is still very leaky. I will come back to that, but don't believe me, HEPI has done the numbers. Now, if the loan system is leaky, if a lot of repayments don't come back: that's a major problem because it runs directly counter to the attempt to set numbers free and, as I've said, setting numbers free is important both for its own sake and because of the link to quality, access and size.

Next problem – a level playing field for private providers has much to commend it, but if numbers are fixed, then private providers and current universities are competing in a zero sum game. Expansion by private providers is at the expense of current universities.

The last of my major complaints is the abolition of Education Maintenance Allowances and Aimhigher. For anyone who knows anything about the determinants of participation, it is central that you put effort in there. One can argue about whether EMAs and Aimhigher are necessarily the best way of doing it, but saving money there, and pretending at the same time you are widening participation, is simply wrong.

So, as I say, not a story with a happy ending so far. What do we do to take things forward? I'm going to suggest two strategic policy directions. First, partially restore the teaching grant for the Arts, Humanities and Social Sciences; and secondly take a series of steps to make the loan system less leaky.

Partially restoring the teaching grant; the simplest way to do so is to restore teaching grant at a level between zero and the current level (I'm not saying it's got to go back to the current level), but arrange it as a block grant. Let me tell you where this is headed. If you want to set numbers free, you need a world where, in principle, if a university recruits an extra student, there is no additional cost to the taxpayer, so zero marginal cost to the taxpayer. If you have the teaching grant arranged as a block grant, then if a university expands, the expansion won't necessarily attract more teaching grant. The way it would work is that the Funding Council would set an annual budget and invite bids from universities. Agreements could be for 3-5 years to assist planning. That offers a mechanism for providing block teaching grant. There are then things you can do. There are good arguments for saying there could and should be a larger teaching grant for universities that charge lower fees and which attract more students from poor backgrounds. That gets into arguments about differential price elasticities – and I can see your eyes glazing over immediately so I won't go there – but it doesn't have to be the same block grant at all universities. You could have a tapered teaching grant. So it offers a mechanism for providing block teaching grant, it allows the sector to expand, it allows the Funding Council some influence over the shape of expansion which is important, but it also allows the Treasury to control the size of the Higher Education budget.

So that's strategic change 1 – bring back the teaching grant in some form, but as a block grant.

The second strategic direction is to make loans fiscally neutral. The Browne Report recommended that a real interest rate of 2.2% should be the default rate with a zero real rate for graduates with lower earnings, and the Government has since added a somewhat higher real rate on earnings above £41,000. So we've now got a real rate of interest on a good chunk of loans. Secondly, the recommendation was to increase the threshold at which repayments start from £15,000 to £21,000 which is nudging up towards average earnings, indexing that repayment threshold of £21,000 to changes in earnings, and forgiving any loan that hasn't been repaid after 30 years rather than 25.

Is that good or bad? The answer is 'Yes'. Some good bits, some bad bits. The first adjustment is to minimise leakage. First of all, you have to make sure that graduates with good careers repay their loan in full. Under the present system, the bottom 20% of graduate earners don't repay in full. Under the new system, Nick Clegg has said up to 60% of graduates don't repay in full. Now that starts to me to sound like a mixture between a loan and a grant. I can see no case for having a loan system as leaky as that. There is no need for that. You should not have a grace period during student days. Students should pay interest on their loans from the day they take out the loan. Grace periods are expensive, horribly expensive, and again badly targeted – they benefit the wrong group of people.

The repayment threshold should be raised over time in the light of performance of the loan system. If you index the repayment threshold of £21,000 to average earnings, you are reducing monthly repayments of all graduates, including the highest earners. It's badly targeted, it hugely undermines the performance of the loan scheme: it's a dangerous hostage to fortune. So what I'm saying is that this £21,000 threshold at which repayments start should either rise with prices or should stay where it is and be revised periodically in the light of the performance of the loan system. I won't bore you with those details. But that's the first strategic direction with loans – minimise leakages. The question then is, if you want a system where the marginal cost of additional students is zero, then who is going to pay the remaining loss on the loan? Remember, a loan with income contingent repayments is designed deliberately so that graduates with low life-time earnings don't repay in full. So the thing is designed to have a loss and that loss, if the loan is well designed, is well targeted social policy. If the Treasury has to pay that loss, expanding student numbers gets the Treasury interested and they start to ration numbers again. So we need a way of imposing that loss on not-the-taxpayer.

There are two mechanisms in principle to achieve this. One is that the losses should be paid by graduates through a national cohort risk premium. That's the way we repay our car loans. The interest rate we pay on our car loan has a risk premium loaded onto it, whereby those who repay cover the losses on those who don't. This is, I think, a rather more worthy cause. This is one way of bringing in more money. The problem is you can't put too much weight on it. If you put too much weight on it, then you have a system where every university has an incentive to charge a fee of £9,000 because it knows that its low earning graduates won't repay in full, and so do its low earning graduates. Alistair Smith had a lovely piece in The Times Higher a few weeks ago where a keen young Dean was going up to the Vice Chancellor and saying, "I've got it. We need £9,000 degrees aimed at pensioners." (Who aren't going to repay in full ...) So you can't push that one too far. The other way you can finance the loss is a variant of the Browne Review: the loss is paid by universities via a university-specific insurance premium, and there are ways of doing that. My bottom line is that the way you make loans zero cost to the Treasury in the long run is (1) you make the loans less leaky; (2) you cover the loss through a mixture of a national cohort risk premium on fees up to £7,000, and on fees above that - you have actuarial university-specific insurance. So that's the second strategic direction.

Finally, strengthen policies that really widen participation - so stop banging on about bursaries please; restore EMAs and Aimhigher or policies that do the same thing; think about innovative things like full first year scholarships. If somebody has got good A Levels, but is reluctant to go to university because they don't know whether they are good enough, give them a full first year scholarship. At the end of the first year they'll know whether they are flying or not and, if they are, then they are prepared to take out the loans for the rest of their degree; forgivable loans for some professions, notably doctors; and, finally, strengthen qualifications and pay of nursery school teachers. There's a long list of things one could do on that. The only point I want to make is, if you are serious about widening participation, then you need a very broad array of activities and they need to go back a very long way.

Thank you very much.