

**Higher Education Policy Institute (HEPI) and
Joint Information Systems Committee (JISC)**

House of Commons Seminar: 24th February, 2010

The Financing of Higher Education

Bahram Bekhradnia (Chair):

Welcome to the second of this series of House of Commons seminars, organised and hosted jointly with JISC. The topic is The Financing of higher education, clearly a current topic, both because of the fee review that's in place, but also because of the impact of the economic crisis and the announcement of reductions - £450 million by HEFCE and the slightly worrying small print in the Pre-Budget Report of £600 million cuts, though it's unhelpful, I think, to assume it's all going to come from universities. Let's also remember that's on top of an increase in the unit of funding of 30% or so over the last ten years or so. Something like 40% of total university income in this country comes from non-Government sources, including the student fee, and that is very much higher than in other countries. That is not necessarily a good thing, because the scope for increasing that side of things is perhaps less than elsewhere.

Our speakers are Nicola Dandridge, who is Chief Executive of Universities UK, and Nick Barr, Professor of Public Economics at the LSE.

Nicola Dandridge:

Thank you very much for inviting me to speak today about HE funding and finance on behalf of Universities UK. As you may imagine, this is a subject which is absorbing a considerable amount of our time at UUK at the moment and I should say right at the outset that I'm not going to be setting out what UUK's position is on HE funding and finance. We're working through these issues at the moment and we have a big debate amongst our members on Friday this week to consider exactly these issues. Our work on this is being led by a task force made up of a number of Vice Chancellors from right across the sector, a representative group chaired by Glynis Breakwell, Vice Chancellor at Bath University, and our intention is to reach an informed policy position and, to the extent that we're able, to inform and contribute to the debate on this critically important issue of which, of course, this morning is a part.

As this audience will know, this subject raises some really thorny and difficult issues and I want to flag up some of them this morning, more by posing questions than by coming up with answers.

What I want to do this morning is first of all reiterate the case for public funding of higher education; secondly, move on to what the private sources are and where we're going with them; and thirdly, to make a few observations about the balance between public and private funding and the consequences of that balance. But before doing that, I should perhaps sound a note of caution: any presentation on this theme, including my own, may tend to refer to higher education as if it's one simple process. Universities are hugely complex things, providing a range of services from undergraduate provision, domestic and international graduate research, Masters, business engagement and many more, and each of these services has its own financial

and business model which can vary hugely within institutions and across the sector. It's very easy to slip into lazy shorthand about HE finance as if it's a single thing, and of course it isn't. It's a very complex ecosystem and obviously time doesn't permit us to go into the detail this morning, but forgive me if I start sounding rather simplistic.

What is the justification for public funding? I could, quite frankly, talk for a very long time on this because there are so many justifications for the public good of higher education. Firstly, we are, in the UK, a knowledge economy, or we are nothing. From Sainsbury's Race to the Top, Leitch, Higher Ambition and so on, there is a general consensus that, unless we are higher skilled, this economy will fail.

Second – economic benefit. Many of you will be familiar with UUK's arguments that universities are an investment, not a drain on public finances. A recent publication that we produced – The Impact of Universities on the UK Economy – analyses these issues in some detail. The Government's investment in undergraduate teaching realises an average of 11% return to the Treasury in terms of higher taxes paid by graduates, even without counting the economic impact of research and the value created by graduates we produce. UK universities generate £59 billion of output a year, we're a massive export industry worth more than £5 billion a year and universities are major employers, generating 2.6% of all the UK's full-time jobs. We make a very significant impact to the UK economy.

Thirdly, there's the international diplomatic and reputational advantage that accrues to the UK's huge success in higher education. By many measures it is second only to the US in the whole world. We argue that this is part of the UK's soft power and we cannot afford to lose it.

Fourthly, we're not just engines of economic investment. There is massive public good from universities in terms of social mobility and resolving some of the fundamental issues that face our society from climate change, food security, disease – research in many ways is the answer to these issues. Universities promote social mobility, underpin healthcare and contribute immeasurably to making the UK a place that people want to live. This is indirectly important to the economy.

This list could go on and on and I will stop there, but these are very powerful and persuasive public benefits.

Moving on, what about private income? I think it's worth, as Bahram has said, reminding ourselves that we are very much a mixed economy already with 60% of the total income coming from public funding sources, 40% from private. Of course, that percentage varies hugely across the sector, including one entirely privately funded institution. Even within publically funded universities, there is a huge amount of provision which is not regulated (postgraduate provision or part-time international students) and where fees come in large part from private sources. Universities have put great effort into diversifying income sources, particularly in relation to international student fees, but also from business collaborations. Universities are far less dependent on public funding now than they were ten years ago, and there is scope for increasing efficiencies further through shared services.

But how far can we take this? We do have to be cautious about the extent to which we can leverage additional private finance as the solution to HE funding concerns.

Take the commercialisation of intellectual property and other forms of knowledge exchange, and I'm going to quote here from Paul Wellings' submission to the HE Review in December 2008: "A policy framework pushing universities towards an alternative route, aiming to maximise financial returns to the university rather than social and economic benefits for society, Government and industry is, on the balance of probabilities, doomed to fail in the long run." Consider the fact that in 2001 in the USA, there were about 20,000 licenses between universities and business. Of these only 0.1% returned more than \$1 million in income to the university partner. Similarly in the UK, the British Technology Group and its predecessor, the National Research Development Corporation, protected more than 10,000 inventions, of which only about a dozen produced more than \$1 million return.

The same could possibly be said of international students. Although international student numbers have held up remarkably well over the last decade, there are serious questions to be raised in the medium and long term about the extent to which we can dominate the international market in the face of the increasingly fierce competition from abroad - not just Asia and US, but increasingly from Europe - particularly when those very countries are investing so heavily in their own higher education as opposed to disinvesting as we seem to be in this country.

Thirdly, direct investment by employers in education is another possible source of income which the Government often refers to, but there is, perhaps unsurprisingly, very little appetite for a compulsory levy on employers. The last thing we want to do is make our graduates less attractive to employers, and businesses are hardly in a position to generate much income themselves. Employer co-funding for bespoke provision is unlikely to be able to cross-subsidise other forms of undergraduate education.

Fourthly, on philanthropic donations, with considerable support from government we've done a huge amount in recent years to stimulate voluntary giving, but we have a very long way to go. Figures for 2007-08 suggest that 2.17% of sector income comes from endowments and investments from philanthropic donations. This was up from 1.84% in 2006-07. There is significant variation here. For instance, in Cambridge it's 5.48% of income in 2007-08, 4.5% at Oxford - they are, for obvious reasons, at the higher end of the market. But compare that with the US where, for example, Harvard endowment income accounted for 34% in 2007-08.

I don't mean to suggest in any sense that universities are passive or overly pessimistic in relation to the search for private sources of financial sustainability, but I think it is important to be realistic about how far we can go with private funding and reliance on alternative income streams.

Which brings me to student contributions. UUK is not yet in a position to comment in detail on future options here, but we will be doing so in the near future. We do think that some aspects of the current system urgently need reform and, in particular, the substantial cost to government of offering full interest subsidies on student loans, and the problem created by the substantial overall cost of student support. It is unsustainable in the long term and has restricted opportunities for growth in relation to other potential applicants wanting to come to UK universities at a time of unprecedented demand.

We've also seen the detrimental effect of the Government putting the student support budget and the HEFCE teaching grant in the same single funding envelope, with the increase in one, namely student support, coming out of institutional funding. In the UK, 26% of total investment in HE is spent on state student support and that doesn't even include the contributions made by universities themselves. So we do need to address this and work out how we can protect access to higher education, promote social mobility and widen participation – these are absolute fundamentals – but without hobbling the quality of undergraduate tuition and also making sure that we fund properly part-time student provision. I'm not going to go into any more detail on this because I know that this is going to be the theme of Nick's presentation.

So how do we determine what it is, if anything, that students (or rather graduates) should contribute to their tuition, and what the balance should be between public and private funding? My concern here is that when we approach this question of public and private funding, we seem to do so from a very pragmatic, British perspective. We look firstly at what the market will bear and then work backwards from there. It seems to me that that is quite dangerous if we don't first ask 'What sort of higher education sector do we want?' For instance, if we ask what the student market could bear, then the answer is quite a lot, but only the rich part of the market. The social cost of that sort of approach would be fundamental and huge and destructive.

I was at a dinner last night at which the point was made that the three most popular undergraduate courses from a student perspective are Law, Psychology and Business Management. Now I'm a lawyer myself, but the prospect of the UK graduate market being dominated by psychologists and business management folk and lawyers is profoundly depressing. What kind of society would that lead to? What about STEM? What about Humanities? What about Languages and the Arts? It's an obvious point and a rather trite one, but, nonetheless, if we leave things to the market it can be a damaging outcome for the UK as a whole.

Then, of course, there's the very difficult question of the consequences of a real market in fees. The Policy Exchange publication, *More Fees Please*, is a very interesting paper which, perhaps unsurprisingly, advocates more of a market in student fees. But we do have to think about the consequences for the sector – what impact would there be on social mobility, on the student experience, on progression of graduates into research careers, on research-led teaching, on international recruitment, on the retention and career development of researchers? We could end up with an impoverished higher education sector if we allow the debate to be determined by an unregulated market. I don't think anyone is advocating this, but the way the argument is often presented is "What can we afford?" rather than "What do we want?" What kind of education sector do we want, to what extent should it serve students' wishes, and to what extent should it address public concerns? If we're not careful, those fundamental elements of the public good with which I started my talk could be damaged irrevocably.

I should add that, if we are engaging in a debate about the appropriate balances between the public and private, any changes to fee levels would raise some very important associated questions about the nature and purpose of HEFCE teaching funding. Changes here could mean re-designing the HEFCE funding model. We're into very difficult and uncertain territory.

This is, of course, a huge theme and I'm conscious of time, but we've got to be prepared to discuss these very difficult and often politically sensitive considerations. It will have to be a public debate, and students and the public have to take part - there is a danger that it will end up being an inward-facing debate within the sector. UUK is planning to play its part, ensuring that, so far as we can, we are providing the evidence and the analysis for it, and also engaging and contributing to the public facing debate about what kind of HE sector we want. We are very interested in people's views and I am very much looking forward to hearing your comments and observations on some of the points that I've raised this morning.

Professor Nicholas Barr:

I should start with an apology to those of you who have heard me saying very similar things before, but there are things that need to be said. I'm going to talk briefly about objectives, then talk about the current strategy and why it is the way it is, and then spend most of my time talking about what I would like to see the review of higher education recommend.

Objectives are to strengthen the quality of teaching and research for all the reasons that Nicola's talked about, widen participation, and protecting the autonomy of higher education and the fisc.

Current strategy is rooted in economic theory and I draw three sets of conclusions from economic theory. First of all, competition between universities helps students. Is competition always a good thing? No it's not. Competition is beneficial where you have reasonably well-informed consumers. So a key question in all this is, "How well informed are students?" My view is they are well informed, they can and should be made better informed and there is a significant interaction here between the student information agenda and the quality assurance agenda.

Second lesson is that graduates should share in the costs of their degrees. Note I say 'graduates' should share, not 'students'. Students should not pay for higher education, but graduates who are the beneficiaries of higher education, should. There are public benefits from higher education which Nicola has talked about, but there are also very substantial private benefits, not just in terms of higher earnings but, at least as important when I meet my ex-students, they really enjoy their work. So job satisfaction is a hugely important private benefit.

Students are broke, so students can't pay. So that brings you to the third lesson from economic theory - students should get higher education free, graduates should repay. That means you need a system of student loans, with a few core characteristics: income contingent repayments - there is a lot of theory justifying why that is the only sensible way to organise our borrowing to finance investment in human capital; the loan should be large enough to cover fees and living costs so that higher education is genuinely free to the student; and thirdly, and a topic to which I shall come back, the loan should attract an interest rate related to the government's cost of borrowing.

That gives us a strategy that looks in principle very much like the strategy we've got. How do you pay for universities? A mix of taxpayer support and variable fees. How do students pay for this? They don't, it's free at the point of use, and that's where the loan system comes in. If the world consisted only of middle class students, that would be an ideal strategy. Students go to university free, they pay for it out of a

loan, universities get fees that graduates repay. But the world isn't like that. There are students who are not from middle class backgrounds. There are students from backgrounds where university doesn't cross their radar, so that's where you need the third element in the strategy.

I think we have the right strategy, but each of the three elements has pressure points. The first element – fees – there is pressure on the fees cap, which is politically very sensitive. Universities want more resources but there are pressures from students, quite justifiably, concerning the quality of student experience. When I talked to one of the student leaders at LSE he said, “When you advocated variable fees in 2006, you argued this would help to improve quality. We haven't seen that.” And it's a fair point. The second pressure point is on loans - the interest subsidy, which is very costly in financial terms and as a result costly in policy terms. But again, it's politically sensitive because there's a lot of misunderstanding about what's involved. And the third element in the strategy – policies to widen participation – the stress point there is that everybody ‘knows’ that the way you widen participation is to increase grants for students at university – but this is wrong. So the pressure there is that there is political pressure on the wrong policies.

The review of higher education should be recommending policies to address each of these pressure points. First of all a major publicity campaign to explain how student loans work; secondly, fixing the interest subsidy problem thus allowing expansion of the loan system; thirdly, action on the fees cap; finally, continue action to widen participation.

First of all – explaining student loans. We need to fight misinformation, disinformation, scaremongering, “high fees, high debt” tabloid headlines. People conflate Student Loan Company debt with credit card debt. So the first message is, higher education is free to the student. It drives me absolutely nuts when I hear radio commentators saying, “Oh parents have got to be saving now because of the costs of going to university.” Students shouldn't have to pay a penny – if loans were large enough they wouldn't have to pay a penny. Also, loans have income contingent repayments, so we're not talking about credit card debt, we're talking about payroll deduction. Income contingent repayments automatically protect graduates with low monthly earnings, forgiveness after 25 years protects graduates with low lifetime earnings and strongly benefits women. It's a graduate tax that stops after a maximum of 25 years and, for most people, significantly earlier. And we must keep the scale of the debt in context. If my child had a £20,000 credit card debt, I would be having sleepless nights, and so would you. But this is not credit card debt, it's a payroll deduction and it needs to be set alongside the £1 million that a typical graduate will pay over a full career in income tax and National Insurance contributions.

The second policy should be to expand the loan system. This policy has two elements - fix the interest subsidy problem, then use the savings to expand the loan system. There are two wrong interest rates for student loans. One is the zero real rate we currently have, equal to the rate of inflation – that's too low. On the other hand, what's called “commercial” interest rate, the rate on credit card debts, is too high and no sensible person has ever advocated that. But a zero real interest rate is devastating. It costs a fortune. Of every £100 the Student Loans Company lends out this year, between £30-£35 won't come back just because of the cost of the interest subsidy. I used to argue that that impeded quality because student support crowded out

university income, but it's got worse. It now crowds out not only quality, but quantity – a shortage of places. At the moment the interest subsidy is at least a co-defendant in that with other sources of budgetary restriction. The interest subsidy also impedes access. Loans are expensive so the Treasury rations them. Loans are too small. If loans are too small, then students need to rely on earnings, and this can be a deterrent to applicants from poor backgrounds. And finally, and to me worst of all, it's deeply regressive – it benefits exactly the wrong groups of people. In a conventional loan scheme with fixed monthly repayments, if you have an interest subsidy, that reduces monthly repayments and it helps low earners. But with our loan scheme, repayments are income contingent with forgiveness after 25 years, and that completely changes the argument. Who benefits from the interest subsidy? Well, it's not students because they don't make loan repayments. It's not low-earning graduates, because they are protected by income contingent repayments and, if they are poor over the long term, by 25 year forgiveness. It's not high-earning graduates early in their career because they are protected by income contingent repayments. The effect of the interest subsidy means that somebody might finish repaying after ten years, when, without the interest subsidy, they would carry on for eleven years. It simply shortens the duration of repayments, mainly for successful professionals in mid-career.

(Looking at PowerPoint graphs)

These numbers come from the Institute for Fiscal Studies. The block on the left looks at women, the block on the right at men, with income quintiles along the bottom. The red columns show who benefits from forgiveness after 25 years and the yellow columns show who benefits from the interest subsidy. It's the low earning quintiles, and particularly women, who benefit from forgiveness after 25 years, and this is enormously important, well-targeted social policy. The people who benefit from the interest subsidy are disproportionately the higher earners.

So, what should be done? Interest rates should be related to the Government's cost of borrowing, there should be targeted interest subsidies for people with low earnings. All this is administratively entirely feasible – they have them, I know, in Sweden and the Netherlands, and I was involved in a project designing such a loan scheme for the Hungarian Government. Positive real interest rates are politically entirely feasible, and in those countries they are not a topic for discussion, they are taken for granted. A higher interest rate on student loans adds not a brass farthing to any graduate's monthly repayments, it simply extends the duration of the loan. It turns a ten year graduate tax into an eleven year graduate tax, but does not raise anyone's monthly repayments. Currently almost all of the graduates in the bottom quintile of graduate earners qualify for forgiveness after 25 years. If you raise the interest rate it has no effect on that quintile - the poorest graduates – at all.

So, what are the policy gains? If you address the interest subsidy problem, it makes it possible to expand the loan system - larger loans for existing recipients, a higher loan to cover any increase in the fees cap, and a more realistic maintenance loan. It would also make it possible to expand the system to cover new groups, such as part-time students – it seems to me an outrage that there is no loan available for part-time students - and UK postgraduates. We say higher education is part of the knowledge economy, but don't provide loans for UK postgraduates – that's absolutely nuts. So fixing the interest subsidy problem is not just a nerdy point of detail, it unlocks important policy gains.

The third element is action on the fees cap. The cap needs to be high enough to bring in significant extra resources and to create genuine competition, but low enough to retain the political sustainability of the strategy. So I am cautious about how much the cap should go up at the moment. There is an interaction between what happens on the fees cap and the success of the strategy to explain the system to the public. If people still see student loans as credit card debt, then room for manoeuvre on the fees cap is very limited, but there is again a point that people need to be reminded of. The bottom quintile of graduate earners qualify for forgiveness after 25 years. Increasing the fees cap therefore means it has no effect on that group. They won't repay the loan that covers the higher fee. So again raising the fees cap is socially progressive, it does not penalise the poor. The only issue about the fees cap is whether it should be conditional on anything. Last time around, for political reasons, the increase in fees was tied to bursaries. I think that was the wrong conditionality - an increase in the fees cap should be tied to acceptance by universities of robust processes for quality assurance.

The fourth thing the review of higher education should be recommending is more and better policies to widen participation. Some of you have heard me talk before about "pub economics". Pub economics is something that's obviously right which everybody knows is right, but it's actually wrong. Pub economics argues that it is obvious that free higher education widens participation.

(Looking at PowerPoint histogram)

What determines participation? The answer is attainment in school. The top pair of bars in the histogram shows participation in higher education by students with the very best A Levels and, as you can see, participation is in the high 90s. The second pair shows participation by students with good, but slightly less good A Levels and participation there is around 90%. The better your A Levels or equivalent, the more likely you are to go to university.

Now come back to the top pair. The light blue is participation by students from middle class backgrounds, the dark blue is participation by students from the lowest three socio-economic groups. It's A Level performance that drives participation, therefore if you are serious about participation you should treat it as a 0-18 problem much more than an 18+ problem. Participation fails when someone leaves school at 16, usually for reasons that go back much earlier. I have two small grandchildren – I see how important those early years are. I have a lot of sympathy for something that Charles Clarke said when he lost his rag at a student debate in 2004: "If I were a real socialist," he said, "I wouldn't spend a penny on higher education, I'd spend it all on nursery education."

Have fees hurt participation? The answer's no. Last year, total applications in England rose by nearly 12%, and applications from the bottom three socio-economic groups rose by a staggering 27%. Is this because last year the recession was starting to bite? No, the averages from 2002-2008 show England +4.3%, from the lowest socio-economic groups +6.5%, higher than any of the other countries in the United Kingdom. A recent HEFCE report found that students from the poorest backgrounds are 30% more likely to go to higher education today than five years ago. That's a staggering improvement.

I agree with what Nicola said – we need a regulated market, not a free market. We do have market forces, but also there's a continuing, permanent important role for government. One needs a balance. Economic theory gives us very powerful messages.