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POST-16 STUDENT SUPPORT

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Footnotes
In the footnotes of this Report, references to oral evidence are indicated by 'Q' followed by the question number. References to written evidence are indicated by the page number as in 'Ev 12'.

WEDNESDAY 24 APRIL 2002

Members present:

Mr Barry Sheerman, in the Chair

Mr John Baron	Ms Meg Munn
Mr David Chaytor	Mr Kerry Pollard
Valerie Davey	Jonathan Shaw
Jeff Ennis	Mr Mark Simmonds
Paul Holmes	Mr Andrew Turner

Memorandum from Dr Nicholas Barr (SS 09)

EXECUTIVE SUMMARY

1. This paper puts forward a strategy for achieving two objectives in higher education—improved access and increased quality—about which there is unanimous agreement.

2. Diagnosis. The introduction of income-contingent repayments in 1998 was a genuine and enormous advance. However, two strategic problems remain. First, income-contingency is little understood, causing unnecessary fear of debt (solutions are discussed in section 4.2). Second, all the funding problems of the current system go back—directly or indirectly—to the subsidised interest rate on student loans. Australia and New Zealand face identical problems for identical reasons.

3. Interest subsidies create three problems. They are badly-targeted, mainly benefiting high-earning graduates in mid career. They are expensive (a recently-developed model estimates conservatively that out of next year's lending to students of £2,500 million about £700 million will never come back because of interest subsidies). Third, because loans are so expensive, the Treasury rations them. Thus interest subsidies, like most subsidies harm the people they are meant to help. There was an experiment with subsidies called Communism. It did not work. The result is that loans are too small, leading to student poverty and extensive use of credit card debt; and loans are means-tested: thus parental contributions and upfront costs continue.

4. Prescription. If graduates pay an interest rate equal to the government's cost of borrowing (not the bank overdraft rate), repayments increase from about 50 per cent of total borrowing to about 85 per cent (the remaining 15 per cent shortfall being mainly due to low lifetime earnings), largely eliminating the fiscal impediment to expanding loans. The move is politically less difficult than it sounds. Interest rates are currently low, so that a move to the government's cost of borrowing involves only a small increase to the rate that graduates pay. Second, a graduate's monthly repayments depend only on her income; thus an increase in interest rates has no effect on monthly repayments, instead affecting the duration of the loan—making it clear that repayments are simply a form of targeted income tax.

5. Policies. Removing interest subsidies is the single essential key to solving current funding problems. The considerable resources thereby released underwrite the strategy for quality and access in section 4. The strategy has three mutually reinforcing elements: flexible fees, a wide-ranging loan system and active measures to promote access.

6. Flexible fees are necessary to reflect diversity, to arrest quality decline and to assist some redistribution of teaching budget towards institutions with more remedial teaching. Specifically, fees should be increased initially to £2,000, but with institutions free to charge less. All fees should be fully covered by a loan entitlement.

7. A wide-ranging loan system.

- Loans should be adequate to cover living costs and tuition fees, making higher education free at the point of use, thus addressing student poverty and freeing students from high-cost borrowing such as overdrafts and credit card debt.
- Loan entitlement should become universal, eliminating the unpopular and complex income test and, at a stroke, getting rid of parental contributions.

The combined effect of these twin elements is equivalent to bringing in universal grants in combination with an income-related graduate contribution (section 4.2). Additional options include extending loans to students in further education and to postgraduates.

8. Active measures to promote access. There are two impediments to access—financial poverty and information poverty. The strategy outlined in section 4.3 aims to address both.

- Grants and scholarships for students from poor backgrounds.
- Extra personal and academic support when students from poor backgrounds reach university.

— Raising the aspirations of schoolchildren.

— More resources earlier in the system, including financial support for 16–19 year olds.

Funding Higher Education: Policies for Access and Quality[1]

Nicholas Barr[2]

1. This paper sets out a strategy for promoting access and strengthening quality. Though explicitly about higher education, the arguments apply equally to the tertiary sector as a whole. Successive sections discuss:

— The many things we all agree about.

— Lessons from economic theory.

— Problems with current arrangements, and key elements of solutions, including an indication of the scale of the prize to be won.

— A policy strategy.

1. What we all Agree About

2. Since the finance of higher education is controversial, it is useful to start by setting out some large areas of unanimous agreement.

3. The problem. There is agreement, first, about two core problems:

— Students are poor because the system of support does not give them enough to live on. Two results follow: students have to turn to expensive overdraft and credit-card debt and/or to extensive part-time work; and the parsimony of support is an impediment to access for people contemplating university.

— Universities are poor, creating worries about quality. The UK would have to spend an extra £3.5 billion per year to reach the EU average.

4. Objectives. There is also agreement—strong and universal agreement—about two central objectives.

— Improved access. The socioeconomic mix in higher education has barely changed in 40 years. Everyone supports widening participation in the interests of social justice, and also for reasons of national economic performance.

— Improved quality. Again, there is no disagreement: the quality and diversity of higher education is important for its own sake, and for national competitiveness.

5. Four propositions. Resources are clearly key to achieving these objectives. To that end, the discussion of resources throughout the paper is based on four propositions.

— UK higher education needs substantial additional funding for reasons of national economic performance and because higher education is an important export industry.

— Funding on the necessary scale will not come from the taxpayer, given an ageing population, rising health expenditure, competition from other parts of the education sector and competitive global pressures.

— Reform will therefore be ineffective unless it can deliver an immediate and sustained injection of private funding. The way to achieve this is through a student loan scheme which can draw in private finance on fiscally attractive terms.

— Phasing out the interest subsidy on the current loan scheme is essential to that end. Interest subsidies are costly (about one-third of total lending never comes back because of their cost), distortionary and badly-targeted. Instead of paying an interest rate equal to the rate of inflation (as currently), graduates should pay a rate equal to the government's cost of borrowing (not the interest rate on bank overdrafts or credit cards). The considerable savings would be much better used to expand the loan system and for the explicit, targeted measures to promote access set out in section 4.3.

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[1] This paper draws on Barr (2001, Chs 10-14), and in part on work while a Visiting Scholar at the Fiscal Affairs Department at the IMF in Spring 2000. It also draws on collaboration on policy design with Iain Crawford for more years than either of us care to contemplate, on advice on factual matters and administrative feasibility from Colin Ward and his team at the Student Loans Company, and on recent work by the three of us on a project advising the Hungarian government. An earlier version was presented at a meeting of the Parliamentary Universities Group.

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2. Lessons from Economic Theory

6. Economic theory offers three strong sets of results, summarised here briefly.[3]

7. The days of central planning have gone, both for students and for higher education institutions. The system should empower the individual choices of students and potential students. The key theoretical question is whether students are well-informed or can become well-informed. My answer is yes. The role of government is not to plan student choices, but to make sure that students have easy access to timely, accurate and relevant information and—particularly for students from poorer backgrounds—also to advice.

8. The supply side should also be liberalised. Forty years ago, with an elite system, it was possible, as a polite myth, to assume that all universities were equally good and hence could be funded broadly equally. Today we have a mass system, meaning more higher education institutions, more students, and much greater diversity of subject matter—all changes which are warmly to be welcomed. As a result, however, the characteristics and the costs of different degrees at different institutions vary widely. Thus universities need to be funded differentially. In principle this could be done by an all-knowing central planner. In practice, the problem is too complex for that to be the sole mechanism. A mass system in an increasingly complex world needs a funding mechanism which allows institutions to charge differential prices to reflect their differential characteristics.

9. Supply-side liberalisation is not only necessary; it is also desirable. Increased competition between institutions will make them more responsive to student preferences. Some students will wish to study full-time but on an accelerated basis, for example studying for four terms per year rather than three; others, in contrast, will wish to study part-time, for example through evening courses. A system which can offer students and prospective students a wider range of choice is efficient; and the added option of part-time study while continuing to work also assists access.

10. Graduates should contribute to the costs of their degrees. A second strong result from economic theory is that higher education should not be free—its costs should be shared between the taxpayer and the graduate. There are two mutually reinforcing arguments.

11. We cannot afford free higher education. The argument is simple. Forty years ago, with a 5 per cent participation rate it was fiscally feasible to rely mainly on public funding to support a high-quality higher education system. The welcome expansion to a 35 per cent participation rate, with aspirations to a 50 per cent rate, however, mean that public funding has to be supplemented on a significant scale by private funding. This is all the more the case because:

12. We should not have free higher education. It is well-known that graduates on average have significantly higher earnings than non-graduates. The Dearing Report (National Committee of Inquiry into Higher Education, 1997, paragraph 18.13) suggests that "compared to those without higher education qualifications who were qualified to enter higher education, those with higher education qualifications:

- have higher employment rates;
- enjoy higher salaries;
- enjoy an average private rate of return of some 11 to 14 per cent".

13. Since higher education creates social benefits it is right that there should always be a taxpayer contribution. But given the robust evidence on private rates of return, excessive reliance on public funding is inefficient. It is also regressive, and hence unjust, since the major beneficiaries of free higher education are the predominantly middle-class participants. A government committed to improving access should not spray scarce taxpayer pounds indiscriminately across the entire student body but should instead target those resources on people for whom access is most fragile.

14. A well-designed student loan scheme has core features. The third set of conclusions from economic theory sheds light on the design of student loans. Four features stand out, summarised here only briefly (for fuller discussion, see Barr, 2001, Ch 12).

- Income-contingent repayments, ie loans with repayments calculated as x per cent of the graduate's subsequent earnings until she has repaid her loan, are fundamental. The arguments are now well-understood. Income-contingent repayments instantly and automatically respond to changes in earnings: people with low earnings make low repayments; and people with low lifetime earnings do not repay in full. The effect is to protect borrowers against excessive risk, with gains both in efficiency and in terms of access (see also Barr and Crawford, 1997, evidence to this Committee).
- Large enough to cover all living costs and all tuition fees. This feature makes higher education free at the point of use—the important advance made by the Cubie arrangements in Scotland. Students are no longer pushed towards expensive credit-card debt; and parental contributions can be abolished, a liberation both for students and their parents.

[3] For fuller discussion, see Barr (2001, Chs 11 and 12).

- An unsubsidised interest rate, as explained in section 3.3, is essential for fiscal reasons, for efficiency reasons, and in the interests of access.
- A capacity to bring in private funds. Student loans bring in private funding through students' subsequent repayments. However, there is a net saving to the taxpayer only when the scheme is mature, ie when the inflow of repayments from earlier cohorts of students matches or exceeds the outgoings to this year's borrowers. That process takes 15–20 years. If extra resources are needed immediately, it is desirable to have a loan scheme which brings in private money upfront, creating an immediate injection of private finance.

3. PROBLEMS WITH CURRENT ARRANGEMENTS[4]

3.1 *The good news*

15. Income-contingent loans, with repayments collected alongside income tax, were introduced for UK students starting their degrees in or after 1998. This move represents unambiguous progress and deserves loud applause.

3.2 *The bad news*

16. That, however, exhausts the good news. The problems described below were both predictable and predicted, eg Barr and Crawford (1997) in evidence to this Committee.

STUDENT SUPPORT: IMPEDIMENTS TO ACCESS

17. The system of student support impedes access in several ways.

18. Deficient loan design. The current scheme conforms with only one of the four criteria—income-contingent repayments—in paragraph 14. It fails the remaining three badly.

- The loan is too small to cover living costs; it is income tested, so that not all students are entitled to a full loan; and there is no loan to cover tuition fees. Thus the system incorporates upfront charges, students remain poor, and parental contributions continue. All these features impede access.
- The loan incorporates an interest subsidy. The resulting problems are discussed in detail in section 3.3.
- The scheme is capable of bringing in private finance but, because of the interest subsidy, only on fiscally unattractive terms, again, discussed further below.

19. Continued reliance on parental contributions. The problems of parental contributions merit additional discussion.

- As a philosophical matter, is it right to force young adults to depend on their parents?
- Student poverty: the scale and volume of unpaid contributions is well known.[5]
- Impediments to access: unpaid contributions cause some students to drop out, and the threat of unpaid contributions deters an unknown number of others from applying in the first place.
- Distorted choices: in other cases, parents pay the contribution, but with conditions attached: "we will pay, but only if you do a sensible subject."
- The previous three problems all have troubling gender and ethnic aspects, and the point is, if anything, even stronger in respect of spouse contributions.
- The income test necessary to assess parental contributions is intrusive and has high compliance and administrative costs.

20. Its gets worse! Assessment of family income has to take account of whether a student is making maintenance payments (a deduction from his assessable income) or is the recipient of maintenance payments (which may be an addition to his assessable income) (Department of Education and Skills, 2001, Ch 6,

[4] For assessment of systems of higher education finance in other countries (the USA, Australia, New Zealand, the Netherlands and Sweden), see Barr (2001, Ch 13). National Audit Office (2002) reaches very similar conclusions about the problems of the present system, in particular its failure to improve access.

[5] Barr and Low (1988), using data for 1982–3, found that about half of students entitled to parental contribution received less than they were supposed to, and the shortfall was substantial: students whose parents gave them less than the system supposed received only £53 of every £100 of assessed parental contribution. As a result, one student in thirteen remained below the poverty line even when income from all sources was included. Subsequent work based on 1992–3 data found that 37 per cent of students received less than the assessed parental contribution (Committee of Vice-Chancellors and Principals (1996, p 14), quoting an official survey). Callender and Kemp (2000, p 3) report that "By 1998/9, the proportion of students who failed to receive their full assessed parental contribution had doubled to three in ten students. The mean shortfall for these students (average assessed contribution minus average actual parental contribution) was £719".

paragraphs 54–58). And the relevance of a spouse's income raises the vexed issue of cohabitation: a woman whose husband has a high salary is not entitled to a full loan; nor is one whose partner has a high income—but that requires finding out whether or not a student is cohabiting. Paragraphs B117–8 of the guidance notes just cited are titled "Advice on identifying a cohabiting couple". Such factors—which should lie wholly outside the system of student support—are an inescapable concomitant of an income test.

21. None of this is an attack on family support: where families wish to help, such support should be applauded. The attack is twofold. Policy should not be based on an assumption that parents will support their children. Such an assumption may, at a stretch, have been valid for an elite system of higher education, regarded as a luxury good for middle-class families; it is invalid for mass higher education as an investment good, and totally inapplicable to expanding access. The policy is bad also because it forces students into dependence on parental contributions or spouse contributions, since there is no option to take out a larger loan in place of unpaid contributions.

22. Complexity. Annex 1 gives a very simplified explanation of the current system.[6] But student support in practice is so complex that nobody fully understands the system. Someone from a poor background pays no tuition fee and is entitled to a full loan. The assessment of a student's financial position is based on parental income for a younger student, or on his or her spouse's or partner's income. Parental or spouse income has two effects: as income rises, the tuition fee rises; once the fee has reached its maximum (£1,075 in 2001–02), the effect of additional parental income is to reduce the size of the loan to which the student is entitled. All students, however rich their parents or spouse, are entitled to a loan equal to about 75 per cent of the maximum loan except that scholarship and similar income, if high enough, can reduce loan entitlement below that 75 per cent minimum.[7] Such complexity has major ill-effects: students, prospective students, and their parents cannot understand the system; it is a nightmare to administer; and complexity, per se, impedes access.

23. Inadequate dissemination of information. Perhaps the greatest impediment to access is the fact that the wider public totally fails to understand income-contingent repayments. The scale of this ignorance cannot be exaggerated. Most people are completely unaware that loan repayments are de facto a form of income tax—but paid only by graduates and switched off once the graduate has repaid what he or she borrowed. In this respect, the Government is deeply culpable over its negligence in vigorously and repeatedly explaining this point. The resulting ignorance unnecessarily aggravates debt aversion and is a further impediment to access. The topic is taken up in detail in paragraphs 63–73.

Universities: Impediments to Quality

24. The post-Dearing arrangements are also bad news on the supply side.

25. Continued central planning. The strong theoretical case against central planning of higher education was alluded to earlier. Though nobody quarrels with the need for universities to be publicly and transparently accountable, there are few defenders of the particular mechanisms, of which the QAA and RAE are only the tip of the iceberg. In addition, there has been central control of the number of students at each university and of tuition fees—in other words, both price and quantity were determined by the central planner—a situation only partly eased by the proposed lifting of the numbers cap.

26. Such planning impedes quality. Also—and entirely unintended—it impedes access to UK students to the best universities. Again, this was predicted to this Committee:

> "A flat fee will continue the erosion of quality at the best universities, which face the biggest shortfalls. If this policy continues, the result will be to deprive British students of the chance of an internationally cutting-edge undergraduate degree in one of two ways. The quality of the best institutions might fall; British students could still get places, but the quality of the degree would be less. Alternatively, the best institutions will largely stop teaching British undergraduates (for whom they receive on average £4,000 per year) and will use the fees from foreign undergraduates (around £8,000 per year) to preserve their excellence. The government is considering trying to prevent British universities from charging additional fees to UK/EU students. Again, this is done for equity reasons; again, it ends up harming the very people it is aimed at helping, in this case by creating a situation where British students will find it harder and harder to get places at the best universities" (Barr and Crawford, 1997, paragraph 57).

27. Inadequate university income. The immediate post-Dearing arrangements brought universities not an extra penny, for the reasons explained in Barr and Crawford (1997), with worrying effects on quality. The story in 1997, in a nutshell, was as follows:

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[6] Without wishing to seem frivolous, I challenge Committee members to explain the operation of the income-test by which a student's loan entitlement and tuition fee are assessed, as set out in the guidance notes from the Department for Education and Skills (2001) to the Local Education Authorities, who administer the income test (http://www.dfes.gov.uk/studentsupport/ss—admin/content/dsp—section—29.shtml, Chapter 6).

[7] Originally, a student's loan entitlement was reduced pound for pound with any scholarship income in excess of £1,000 per year. The disregard was subsequently increased; in 2001–2 it is £4,000 (Department for Education and Skills, 2001, Table 5).

(a) Public spending on higher education would not go up (the budget said so).

(b) Parental contributions (ie private spending) would not go up (the Secretary of State said so).[8]

(c) Loans to students (the other potential source of private spending) counted in their entirety as public spending.

28. There has been some improvement since 1997. Public spending under (a) has increased; debt sales have brought in some private money under (c); and the move from cash-flow to resource accounting has further assisted under (c). These developments are all genuinely welcome; but they do not change the reality that, at its core, the system continues to be publicly funded; and given its greater political salience, student support has crowded out university income. The story in Australia is exactly the same (see Annex 3, paragraph 95), and for exactly the same underlying reason—the interest subsidy on student loans.

3.3 *The worst news: interest subsidies*

THE PROBLEM

29. It is important to understand the scale of the problems that interest subsidies cause.

30. What interest rate? First, it is important to be clear what I am not saying:

— At present graduates pay an interest rate equal to the rate of inflation. Press discussion of "market interest rates" evokes worries about high interest rates associated with credit cards and overdrafts. That is not what is meant. The interest rate which graduates should pay on their loans is the government's cost of borrowing, ie broadly the interest rate the Monetary Policy Committee announces.

— The attack is on blanket interest subsidies. A strong case can be made for targeted interest subsidies—for example someone who is unemployed or caring for young children or other dependants—to make sure that their debt does not spiral upwards. Mechanisms for such targeted assistance are discussed in section 4.2.

31. Why are interest subsidies such a problem? Interest subsidies are:

— Regressive. As explained in paragraphs 42 and 43, interest subsidies do not benefit students (who do not make repayments), nor low-earning graduates, but better-off graduates in mid-career.

— Expensive. Interest subsidies are enormously costly. Evidence from debt sales suggests that of all the money lent to students, about one-third never comes back because of the cost of interest subsidies. The scale of the resulting losses is discussed shortly. The high fiscal costs of loans create two further sets of ill-effects.

— Inimical to quality. Expensive student support crowds out university income; thus interest subsidies conflict directly with improved quality.

— Distortionary. Because loans are so expensive, the Treasury rations them. Thus interest subsidies, like most subsidies, create shortages—like rent control, they end up harming the very people they were meant to help. There was an experiment with price subsidies called Communism. It did not work.

32. In the case of loans, shortages manifest themselves in the following ways:

— The full loan is too small to cover a student's living costs, leading to student poverty.

— Loans are means-tested: as a result parental/spouse/partner contributions continue, and higher education involves upfront costs and charges.

— Loans are restricted, for example are not available to students in further education (impeding access), nor to postgraduates (putting national competitiveness at risk).

[8] "Today the Government announce a new deal for higher education, involving new funding for universities and colleges, free higher education for the less well-off, *no parent having to pay more than at present* and a fair system of repayment linked to ability to pay" (*Hansard* (Commons), 23 July 1997, col. 949) (emphasis added). "Our response to Dearing ensures that fees and maintenance together do not place an increased burden on middle-income families" (ibid., col 950).

TOWARDS A SOLUTION: THE SCALE OF THE PRIZE

33. In short, interest subsidies create a fiscal black hole which aggravates problems both of access and quality.[9] A move to an unsubsidised rate is not just a technicality—it is the single essential key to solving current problems of funding tertiary education. The considerable resources thereby released underwrite the array of major policy advances set out in section 4.

34. How much extra money? Suppose graduates pay an interest rate equal to the government's cost of borrowing rather than, as now, the inflation rate.[10] Do the resulting savings make the move worthwhile?

35. Barr and Falkingham (1993, 1996), using LIFEMOD, a microsimulation model, found that for every 100 the government lends, only about 50 is repaid. Of the missing 50, 20 is not repaid because of fraud, early death, and emigration (all of which have a relatively small effect), and mainly because some graduates have low lifetime earnings and so never repay their loan in full, and 30 is not repaid because of the interest subsidy. In other words, the interest subsidy converts nearly one-third of the loan into a grant.

36. Previous sales of student debt offer independent evidence. The debt was sold for about 50 pence per pound of its face value. Official estimates suggest that of the missing 50 pence about 15 pence was because of low lifetime income, etc, and 35 pence because of the interest subsidy. The evidence on the interest subsidy is compelling. The government did not use LIFEMOD; thus the official estimates and the simulation results reinforce each other.

37. A recent modelling exercise[11] offers further confirmation. The model is conservative in at least two ways. First, it assumes that the subsidised interest rate is 2.5 per cent, the unsubsidised rate 5 per cent, thus implicitly assuming that the real rate will stay as low as 2½ per cent throughout the lifetime of the loan. Second, the accounting of debt forgiveness is on an accruals basis, even though forgiveness normally occurs only at the end of the loan period.[12] The model takes as its starting point projected loan outgoings for the next academic year of £2,500 million.[13] With debt forgiveness of 15 per cent (ie assuming that 15 per cent of student borrowing will never be repaid because of low lifetime earnings, etc),[14] a move to an interest rate equal to the government's cost of borrowing would release sustainable savings of £700 million per year.[15] That sum could be used to finance additional grants and scholarships of up to £700 million. Alternatively, it could be used to underwrite an expanded loan system; with 15 per cent debt forgiveness, it would be possible nearly to triple the total amount of lending. Or the sum could be used for a combination of the two policies.

38. When will the money be available? It is necessary at this stage to distinguish the cash-flow costs of loans (ie the money which is required now, but which will eventually be repaid), from the fiscal costs (ie borrowing which will never be repaid). With the present loan scheme, for each 100 that students borrow (the cash-flow cost), roughly 50 will never be repaid (the fiscal cost). The argument above is that eliminating interest subsidies reduces the fiscal cost of loans from about 50 per cent to about 15 per cent. Though the Treasury will, of course, take cognisance of cash-flow costs, the abolition of interest subsidies makes it possible to have a loan system that is larger, but at the same time has smaller fiscal costs.

[9] Other countries are reaching a similar conclusion. New Zealand, having flirted with interest subsidies since 2000, are contemplating reversing that short-lived, ill-advised experiment. A government report published last November, concluded that:"Participation goals should continue to be supported through a Student Loan Scheme with income-contingent repayments as at present. The Commission believes, however, that the current policy of writing off interest on loans for full-time and low-income students while they are studying is not an effective use of the government's resources. While this policy has decreased the length of time taken to repay loans after graduation, it has also led to an increase in the number of students taking out loans and in the overall level of student debt. To compound matters, the policy has made it possible for learners to borrow money and invest it for private gain (arbitrage). Consequently, the Commission believes that this policy should be discontinued—or that, as a minimum, the incentives for arbitrage should be removed. Any savings accruing to the government as a result of modifying the current loan scheme should be reinvested in the tertiary education system and be used for the benefit of students" (New Zealand Tertiary Education Advisory Committee, 2001, p 14).

[10] Charging a market interest rate on income-contingent loans raises issues under the Consumer Credit Act. Solutions to the problem are outlined in Annex 4.

[11] The model was originally developed by the Chief Executive of the Student Loans Company as part of a joint LSE/SLC project advising the Hungarian Government, and has been adapted to simulate alternatives to the UK system.

[12] The calculations assume that a portion of the total debt forgiveness occurs each year, when repayments are due. This gives a higher assessment of the cost of forgiveness than one which reflects the real life position, where the level of forgiveness is known only at the end of the repayment period. The cost is higher because discounting for the loss of purchasing power over time is greater in the earlier years of repayment. The approach was adopted because it represents the most punitive accounting approach that can be taken for costs, depending on the resource accounting policy applied by the Treasury.

[13] This is the forecast figure for 2002-3 including income-contingent loans, mortgage loans and hardship loans (the latter two being small). The outturn for 2000–1 was £1,840 million, the forecast for 2001–2, £2,282 million.

[14] New Zealand, with longer experience of income-contingent repayments, uses an official estimate of 10 per cent in its public accounts.

[15] The gross annual saving from a move to an unsubsidised interest rate is £X million, considerably larger than £700 million. The figure of £700 million is the answer to the following question: the government wants to finance grants by selling bonds which are repaid after n years, where n is commensurate with the maximum duration of the student loan; if repayments, including interest, over n years is £X million, what is the maximum face value of the bonds? The answer is £700 million—the amount that can be spent on grants allowing for the cost of financing those grants. Thus the figure is a very conservative one.

39. Seen through the eyes of the Treasury, £700 million is the present value of the annual saving, and is thus a significant and sustainable long-run resource. Seen through the eyes of the Department for Education and Skills, however, the initial savings in cash-flow terms are small.[16] But higher education needs to benefit immediately from the long-run savings. That will require a deal between the Treasury and the Department for Education and Skills for an early injection of additional resources. One way to finance such a deal is by selling a further tranche of student debt, which could yield up to £2 billion. For the reasons explained in the previous paragraph, such a deal makes sense in both educational and fiscal terms.

40. Ensuring low fiscal costs is, of course essential. Once that is done, the Treasury can choose how to deal with the cash flow costs of the loan system. It could do so out of taxation: under resource accounting, the fiscal costs (ie lending that is not expected to come back) appears as current education spending, while expected repayments appear in the capital account as a financial asset.[17] With the present loan scheme, about half of lending to students is counted as spending out of the education budget. If there were no interest subsidy, only 15 per cent, or so, of total lending would appear as current education spending, and the 85 per cent expected repayment would appear in the capital account.

41. Alternatively, the Treasury could deal with the upfront cash flow costs by bringing in private money to finance the scheme. This can be done in various ways. The debt-sale approach has been extensively discussed (Barr and Falkingham 1993, 1996). There has been less exploration of front-end funding, which has two variants. With retail lending, individual students borrow from private lenders; thus student borrowing is individualized. With wholesale lending, the loans administration borrows private money in tranches of (say) £2 billion, which it then lends to students.[18]

42. Grasping the nettle. The scale of the prize is clearly enormous. But political worries about raising interest rates persist. These, however, should not be exaggerated.

— There is already growing support for removing interest subsidies (eg Piatt and Robinson, 2001).

— Interest rates are currently low; thus the interest rate would have rise by no more than 2½ per cent from the rate in the current loan scheme.

— A person's monthly repayments depend only on her income; thus interest rates have no effect on monthly repayments, but only on the duration of repayment. Once such a scheme has been introduced, this feature will become obvious to graduates.

— The wider public should understand who benefits from interest subsidies. Interest subsidies do not help students (it is not students who make loan repayments, but graduates); they do not help low-earning graduates, since unpaid debt is forgiven after 25 years; they do not help higher-earning graduates early in their careers (since monthly repayments are a fraction of earnings, and so are not affected by the interest rate); the only people they help are higher-earning graduates in mid career, whose loan repayments are switched off earlier because of the interest subsidies than would be the case without the subsidies.

43. In sum.

— Interest subsidies are targeted with exquisite accuracy: they benefit successful professionals in mid career. Thus the NUS position, defending interest subsidies, is arguing for continued subsidies for those who need it least at a time when they need it least, and the hell with today's struggling inner-city sixth-formers.

— Removing the interest subsidy finances policies to promote access and quality, thus helping students rather than graduates. The proposal is not to eliminate subsidies, but to replace blanket (ie untargeted) subsidies by targeted interventions.

— Income-contingent loans are simply a form of income-tax; and income-tax, together with a write-off after 25 years, bases loan repayments on outcomes, and hence targets subsidies accurately on graduates with low lifetime earnings.

Once students and their parents come to understand these point, their worries and, with them, much of the political hullabaloo, will recede—an issue discussed in detail in paragraphs 63–73.

[16] To oversimplify, if the interest rate students pay rises by 2.5 per cent, the extra interest in year 1 is 2.5 per cent x £2,500 million, ie £62.5 million. In year 2, the saving in cash-flow terms are double that sum, in year 3 triple, etc.

[17] Resource accounting has been introduced in the UK only recently. For a description of the way student loans are treated in the public accounts in New Zealand, which has had resource accounting for longer, see Barr (1997), evidence to this Committee.

[18] There has been extensive development work on front-end funding (see Barr, 2001, Ch 14). The result is not just academic theory, but has been extensively tested with the IMF, Eurostat, and financial market actors.

4. The Policy Strategy

44. This section sets out a strategy for access and quality with three elements:

- flexible fees, to address the quality issue, and to begin to free universities from unnecessary central planning;
- a wide-ranging loan scheme to empower choice for the generality of students;
- wide-ranging but targeted measures to promote access; these need to start early in the school system.

45. The three elements are a strategy, not just a bunch of ad hoc policies: they are designed to achieve explicit objectives, and the elements are mutually reinforcing. This does not mean that the policies below must be swallowed whole, but does mean that attempts indiscriminately to pick and mix will fail to achieve the policy's objectives.

4.1 *Flexible fees*

46. A medium-term aim. Flexible fees are both necessary and desirable for at least three reasons.

47. To address diversity. Historically, with a small tertiary system and a limited range of subjects, it was possible for central planners to determine funding levels for different institutions. Today, however, the higher education system is large, diverse and complex. As a result, (a) the necessary variation in funding is much greater than formerly and (b) the problem is now too complex for a central planner to have the sole power of decision about how resources should be divided between institutions. Thus institutions should have the freedom to set their own fee levels (that freedom could be constrained).

48. To arrest quality decline. Without higher fees, quality will continue to be eroded and, given flat fees, eroded most at the best institutions.

49. To prevent crowding out. At present, the best institutions tend to receive more funding for teaching in an attempt to protect their quality. This risks crowding out universities with a different mission. With higher fees, the best institutions could paddle their own canoes to a greater extent than currently, freeing resources for institutions which have to do more remedial teaching. Thus—an important and poorly-understood point—flexible fees benefit all tertiary institutions.

50. Arguments that do not stand up are of two sorts. It is sometimes argued that students should pay the full costs of tuition. That argument overlooks the significant (albeit hard-to-quantify) external benefits of higher education. There is a strong case for continuing taxpayer subsidy for tuition for all students. Other people argue the opposite—that tertiary education should be entirely funded from taxation. There may be a case for that policy for sub-university education, but, applied to higher education, the argument is flawed. The argument that university education should be free at the point of use (which I support), does not mean that there should be no charges. Free tuition is expensive, and its benefits accrue disproportionately to people from better-off backgrounds, who go on to be among the best-off. Thus free tuition is badly targeted; the money could do much more for access if spent in a way that directed resources specifically at those groups for whom access is most fragile and those who do not benefit financially from their degrees. Lowering tuition charges for higher education in other countries has not improved access. Conversely, introducing the Higher Education Contribution Scheme in Australia in 1989, with tuition charges paid via an income-contingent loan, did not harm access (Chapman 1997).

51. How high should the fee be? Taxpayer support plus tuition fees should cover the costs of teaching. At research-intensive universities, fees should be higher to the extent of the value-added in teaching by research-active people, but should not cross-subsidise research.

52. Pitfalls to avoid. Though flexible fees are desirable, there should be no "big bang" liberalisation. As a first step, the flat fee should be increased to £2,000.[19] However, institutions should be free to charge less if they wish, and the ceiling should be raised over time. As indicated below, any increase in the ceiling should be accompanied by an equal increase in the loan entitlement.

4.2 *A wide-ranging income-contingent loan scheme*

53. The second element in the strategy is a wide-ranging loan scheme. Discussion starts with policy options and then turns to a much-neglected aspect of loans—how to make sure that the public understands the nature of the beast.

[19] See, similarly, Piatt and Robinson (2001) and Council for Industry and Higher Education (2001).

POLICY OPTIONS

54. As explained in section 2, a well-designed loan scheme has four characteristics: income-contingent repayments; sufficient to cover all living costs and all tuition fees; with an interest rate equal to the government's cost of borrowing; and capable of bringing in private funds. A loan scheme of this sort opens up the following options.

55. Universal. If there is no interest subsidy there is no need to ration loans, which can therefore be made available as a universal entitlement. The administratively complex and politically unpopular means test disappears; so does the relevance of such factors as whether a student is married or cohabiting.

56. Adequate. For the same reason, the loan entitlement can be large enough to cover realistic living costs and all tuition fees.[20] A universal, adequate loan has major advantages.

- It eliminates student poverty.
- It makes higher education free at the point of use.
- It makes it possible to abolish parental contributions.
- It frees students from forced reliance on expensive credit card debt and/or the need for extensive part-time work, and thus in substantial measure addresses the worries of middle-class students and their parents, and also the (rightful) complaints by the NUS about the amount of high-cost student debt.
- It is simple for students and their parents to understand.
- It is vastly simpler to administer than current arrangements, since the administratively cumbersome and unpopular means test can be abolished.

There is no need to belabour the helpful political resonances of all these features.

57. Extending loans to other groups of students. The scheme could be extended to postgraduate students, starting to address worries about research capacity and national productivity. It could also become a universal entitlement throughout tertiary education, buttressing existing sketchy student support for further education and vocational training, thus contributing to access.

58. Protecting low earners is a clear priority. Income-contingent repayments do so automatically, since low earners make low repayments, and people with low lifetime earnings do not repay in full. Nevertheless, many people are afraid of rising debt, and interest subsidies were introduced to assuage those fears. As argued earlier, however, interest subsidies are a costly, non-transparent and ineffective way of promoting access, and benefit exactly the wrong people. The policies below are more transparent and better targeted ways of protecting low earners.

59. Scholarships, ie grants which do not carry an obligation to make income-contingent repayments.

60. Stopping repayments after 25 years. Scholarships help people at the start of the process. Complete debt forgiveness after (say) 25 years helps them at the end of the process.

61. Targeted interest subsidies based on current income. It is also possible to help people during the process. Under the simplest mechanism, anyone receiving a credit for national insurance contributions—someone who is unemployed or looking after young children—receives an interest subsidy. As an extension (as in New Zealand), anyone whose earnings are so low that his or her income-contingent repayment fails to cover the interest element, similarly receives an interest subsidy.

62. Conditional subsidies. The mechanism in the previous paragraph protects low earners and people with career breaks. However, some of the subsidies benefit people who subsequently have high earnings. Thus there are advantages in terms of fiscal cost and targeting to have a system which pays interest subsidies based on current income, but with a facility to claw back the subsidy element for people who end up with high lifetime income. A workable such scheme has been designed, which the Student Loans Company could administer without difficulty. Such a scheme has major advantages: it gives assistance at the time they need it to people with low income and/or with a career break, facilitating access and preventing people from worrying that their repayment obligation is spiralling upwards; but it is cost free, since the clawback mechanism ensures that only the lifetime poor keep the subsidy. It is also flexible: it would, for example, be possible to give conditional subsidies to some groups (eg someone who went travelling after graduation), but unconditional subsidies to others (eg someone looking after young children or elderly dependants—analogous to current proposals to assist teachers with their loan repayments).

[20] Extending loans to cover tuition fees raises issues under EU legislation. These are discussed in Annex 4.

UNDERSTANDING INCOME CONTINGENCY: SOME EQUIVALENCE PROPOSITIONS

63. Past failures adequately to explain income-contingent loans has created unnecessary disquiet. Medical practitioners sometimes talk about "the worried well"—people who are in good health, but whose life is made less happy by misplaced worries that they are not well. Analogously, it can be argued, "worried debtors" are concerned that student loans will be a millstone. Students perceive a large debt, but miss two important points of context. First, repayments are merely an addition to their future income tax. Thus the risk they take is no different from the risk we all face that at some time in the future the basic rate of income tax might increase (I am old enough to remember a 33 per cent basic rate). Second, they do not see how much they will pay over the years in income tax or national insurance contributions, nor what they will spend on food (or drink) over a 25-year period. None of these items cause people to worry, despite the fact that someone who starts on average earnings and remains on average earnings all his working life, will pay nearly £300,000[21] in income tax and national insurance contributions over a 35-year career, a topic discussed more fully in Annex 2.

64. Alongside the policy design in the previous paragraphs, it is thus imperative to explain what is going on. I am not at this stage digressing into political presentation, but want instead to point out some analytical equivalences which should inform explanation.

65. The following schemes are all analytically identical.

66. Scheme 1: An income-contingent loan. Earlier discussion described an income-contingent loan, for which graduates make repayments of x per cent of their earnings until they have repaid the loan at an interest rate equal to the government's cost of borrowing. What has been missing thus far in government action is a clear explanation that a person's loan repayments are, in effect, a form of income tax: a person's repayments track changes in his or her earnings instantly and automatically, and thus nobody repays more than he or she can afford.

67. The point is fundamental. Suppose we start from the argument (NUS, etc) that higher education should be paid out of taxation. But that means that the costs of higher education are paid by the generality of income recipients, including low earners, non-graduates, pensioners, and the like. It is widely acknowledged that this is unfair. To deal with that unfairness, some people have argued that higher education should be financed through a graduate tax, which can be thought of as additional income tax, but paid only by the beneficiaries of higher education. But a graduate tax has its own unfairness, since people with high lifetime earnings repay considerably more than they have borrowed (this is true of any successful professional, without having to refer to extreme cases like Mick Jagger or Stelios Haji-Ioannou).[22] To address the latter problem, it is suggested that a graduate tax should not have an indefinite duration, but should be capped, ie "switched off" once a person has repaid an agreed contribution towards the costs of his/her degree. An income-contingent loan is exactly that—it is a graduate tax which is capped at 100 per cent of the initial sum borrowed. Put another way, the only difference between a graduate tax and an income-contingent loan is the duration of repayment: with a graduate tax, repayment lasts (say) 25 years, regardless of how much a person has borrowed or repaid; with an income-contingent loan the duration of repayment bears an exact relation to the initial amount borrowed.

68. Thus income-contingent repayments can be described as repayment of debt. But with equal accuracy they can be described as a form of targeted income tax—targeted by being imposed only on graduates and by being "switched off" once the loan has been repaid. This is a form of taxation that is more efficient and fairer than funding via the entire body of taxpayers.

69. Scheme 2: Free higher education (CUBIE). If loans are universal and adequate to cover all living costs and all tuition fees, higher education is free at the point of use. Thus the system can be described as free higher education, paid for by a targeted income tax or a graduate contribution. To repeat, the only difference from tax funding is that (a) the tax is paid only by those who have been to university and (b) the additional tax is capped.

70. Scheme 3: Universal grants plus a graduate contribution. Suppose that all students receive a grant large enough to cover their living costs and tuition fees; and suppose that the system is financed by an extra x pence in the pound added to a person's income tax rate. The contribution does not go on for ever: it is "switched off" once a person has contributed an amount equal to the grant he/she received; and nobody pays for more than (say) 25 years. Thus the scheme is simple: there is a universal grant, financed by a graduate contribution payable for a maximum of 25 years, but for some people a shorter time.

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[21] In today's prices, assuming annual real earnings growth of 2½ per cent.

[22] As explained in Annex 3, a graduate tax has problems in addition to being unfair: it leads inescapably to continued reliance on public funding; it is a hypothecated tax; and it raises difficult boundary problems.

71. Two additional points specify the scheme precisely:

— The duration of the graduate contribution bears an exact relation to the amount of grant a student has received. Though administratively complex, this is precisely the task that the Student Loans Company currently performs: higher earners repay their grant more quickly; lower earners take longer and are further protected in the ways outlined in paragraphs 58–62; and nobody makes contributions for more than 25 years.

— Students for whom access is fragile are helped in the ways set out immediately below. The scholarships and other forms of financial help they receive do not make them liable for a graduate contribution.

72. Since the three schemes are equivalent, any is an accurate description of the system of student support. If this were better understood—particularly the very close relation of income-contingent repayments to tax funding—the problem of the "worried well" would be greatly diminished.

73. A point in conclusion: the equivalence arguments in the previous paragraphs are analytical and should be judged on the quality of their logic. They are not presentational arguments based on logical thin ice.

4.3 *Active measures to promote access*

74. Income-contingent loans measure ability to pay on the basis of where a person ends up, ie his or her subsequent income. This is the best approach for students from better-off backgrounds, who are generally well-informed about the benefits of tertiary education. However, students from socially-excluded backgrounds are typically badly informed. Precisely for that reason, a wide range of additional measures to promote access—the third leg of the strategy—is necessary.

75. Put another way, it is not only financial poverty which impedes access, but also information poverty. Any strategy for access therefore needs two elements:

— those which involve money, and

— those which involve information and raising aspirations.

The following are no more than indications of the scale of necessary actions.

76. Grants and scholarships in higher education. Money measures include scholarships for students from poor backgrounds. They could be based on parental income, but should also include money for schools and universities to award to students from poor backgrounds. There should be financial incentives to universities to widen participation; and universities would, in any case, wish to gather resources for scholarships to enable them to recruit the brightest students, regardless of their financial background.

77. For some students the biggest hurdle is to realise that they are good enough to do well in higher education: for them, scholarships which make their first year entirely free give them a risk-free opportunity to test their abilities and to become well-informed about higher education. Once such a student does well in the first year, he or she will be much more prepared to take out at least a partial loan for the rest of the degree.

78. Extra personal and intellectual support in higher education. A second ingredient in promoting access is extra personal and intellectual support, at least in the early days, for access students to make sure that, once a student starts at university, he or she gets the necessary support to make the transition. It is no good persuading someone to go to university if he or she is then allowed to sink without trace.

79. Raising aspirations of school children. Action is also needed much earlier. Information and raising aspirations are critical. The saddest impediment to access is someone who has never even thought of applying to university. The sorts of schemes involved include Saturday Schools, which bring schoolchildren from poor areas to university to study on Saturday mornings; summer schools, which do something similar during the summer vacation; visit days, when schoolchildren can visit a university; visits by academics to schools to make the idea of higher education more tangible; visits by current students, ideally from the same or a similar school, to schools in deprived areas; and mentoring of schoolchildren by current university students, preferably from a similar background. Such activities needs to start early, eg at age 12.

80. More resources earlier in the system. Problems of access to higher education cannot be solved entirely within the higher education sector. Thus more resources are needed earlier in the education system, which is where the real barriers to access occur.[23] This includes more resources for teaching. It also includes financial support for 16–18 year olds.

[23] Educational exclusion has a clear connection with broader social exclusion—for example, less than 25 per cent of children in care in the UK end up with any formal educational qualification.

5. Conclusion

81. At risk of sounding repetitive, the root of all the funding problems of the present system go back—directly or indirectly—to the interest subsidy on student loans.

— Interest subsidies aggravate the shortage of resources in the sector, compete with university funding, cause loans to be inadequate, crowd out expenditure to promote access, and are deeply regressive.

— Setting the interest rate that graduates pay equal to the government's cost of borrowing is the key to addressing all these problems and, on a conservative estimate, yields some £700 million per year. That sum is important for its own sake; it is even more important because a fiscally cost-effective loan scheme can leverage a much greater volume of private finance. Specifically, with no increase in long-run fiscal costs, it would be possible nearly to triple total lending, or to combine a smaller expansion of loans with additional grant expenditure.

— Grasping the nettle makes possible the policies for access and quality set out in section 4.

— The move is less difficult than it sounds—perhaps the political equivalent of the "worried well". In Sweden and the Netherlands graduates pay an interest rate broadly equal to the government's cost of borrowing, and the matter is not regarded as in any way noteworthy; and Australia and New Zealand are currently facing the same reality as the UK.

— In contrast, if the interest subsidy is not eliminated, we might as well all pack our bags and go home.

Annex 1

THE STUDENT SUPPORT SYSTEM BEFORE AND AFTER 1998

82. Table 1 summarises in simplified form (and with rounded numbers) the system of student support for students who started their degree between 1990 and 1997, and that for students who started their degree in 1998 or later.

83. The old system was introduced gradually. When fully phased in, it operated through:

(a) 50 per cent of student living costs from a mortgage-type loan;

(b) 50 per cent of living costs from a mixture of grant and parental contribution;

(c) no tuition fees paid by the student.

84. The arrangements since the 1998 have three components:

(a) an income-contingent loan;

(b) replacement of the grant by a loan entitlement which is partially income tested;[24]

(c) an income-tested tuition fee.

Table 1

STUDENT SUPPORT: THE SYSTEM UNTIL 1998 AND THE CURRENT SYSTEM

	Living expenses	*Tuition*
The system until 1998	50 per cent mortgage-type loan;50 per cent grant/parental contribution	Free
The current system		
"Poor" student	100 per cent income-contingent loan	Free
"Rich" student	Parental contribution of 25 per cent of living costs; income-contingent loan the rest	£1,000 flat-fee from parental contributions

85. To amplify the current system:

— "Poor" students (ie where parent/spouse net income is below about £18,000 per year) pay no tuition fee and are eligible for an income-contingent loan intended to cover 100 per cent of living costs.

— "Rich" students (whose parents' or spouse's net income is above about £34,000 per year) pay the full £1,000 fee. They are entitled to an income-contingent loan equal to 75 per cent of the maximum loan. It is assumed that the parental contribution pays the tuition fee and 25 per cent of living costs.

— In between, loan entitlement and fees are calculated on a sliding scale.[25]

[24] Poor students are eligible for "a maintenance loan of the same value as the current grant and loan package" (*Hansard*, (Commons), 23 July 1997, col. 950).

[25] Herein lies much of the complexity—for details, see Department for Education and Skills (2001) (http://www.dfes.gov.uk/studentsupport/ ss—admin/content/dsp—section—29.shtml, Chapter 6).

86. To illustrate these arrangements with a simplified numerical example, suppose that it is estimated that students need £4,000 to cover living costs, made up, under the old system (line 1 of Table 1) of a loan entitlement of £2,000 and grant/parental contribution of £2,000. Thus the maximum parental contribution (for a student not eligible for any grant) is £2,000.

87. Under current arrangements, a poor student is eligible for an income-contingent loan of £4,000 to cover living expenses, and does not have to pay a tuition fee. A rich student receives £2,000 in parental contribution, £1,000 to cover the tuition fee and £1,000 towards living costs, and is eligible for an income-contingent loan of £3,000 to cover remaining living costs.

Annex 2

AN UNSUBSIDISED INTEREST RATE: HOW MUCH EXTRA FOR GRADUATES?

88. What is the effect on repayments if graduates pay an interest rate equal to the government's cost of borrowing rather than (as currently) the rate of inflation?

89. Answer 1: Monthly repayments. The change has no effect on a graduate's monthly repayments. Since loans are income-contingent, repayments depend only a person's monthly income. Thus the higher interest rate affects the duration of repayments but not the amount of the monthly repayment.

90. Answer 2: Total repayments. On average, it is estimated that students will take 15–20 years to repay their loans (since the system of income-contingent repayments is new, estimates are all that we have). The model referred to in paragraph 37, estimates that at today's prices if a graduate takes 15 years to repay his loan, the extra interest payments on a loan of £12,000 from removing the interest subsidy is about £3,700. The comparable figure if he takes 20 years to repay is £4,700. Thus a plausible estimate of the additional interest repayments of an average student taking 17½ years to repay is £4,250.

91. Some comparators. These numbers need to be seen in context.

— With even a modest graduate premium (15 per cent) and real wage growth (including career progression) of 5 per cent, a graduate will earn £270,000 more than a non-graduate over a 35-year career. The extra interest payments are a minuscule price for those benefits.

— Over 35 years, a non-graduate on average earnings pays about £520,000 in income tax and national insurance contributions; with a graduate premium of 15 per cent, the equivalent figure for a graduate is about £600,000. Thus the additional interest payment is equivalent to a tax increase of about 0.7 per cent.

— Over the lifetime of the average loan, a graduate will spend on average £25,000 on alcohol. To spend £25,000 out of after-tax income a person paying basic rate income tax etc, has to earn £37,000. Thus it would be possible to finance the additional interest payments by having one booze-free day per week till the loan has been paid off.

92. The figures in the previous two paragraphs are in cash terms. The equivalent figures in present value terms, at a 5 per cent discount rate, are as follows. On a loan of £12,000, the present value of the extra interest payments is £2,880 over 15 years, or £3,350 over 20 years; thus the average student will pay around £3,115 in additional interest payments. Over a 35-year career, the extra earnings of a graduate are £105,000. The present value of the income tax and NICs paid over 35 years by a non-graduate on average earnings is £195,000; for a graduate the comparable figure is £228,000. The present value of expenditure on alcohol over 17½ years by an average graduate is £14,000, requiring pre-tax earnings of nearly £21,000.

Annex 3

AN OPEN-ENDED GRADUATE TAX: PROBLEMS BUT NO SOLUTIONS

93. An open-ended graduate tax (ie one which is paid for, say, 25 years irrespective of a person's earnings) creates major problems.

94. Continued reliance on public funding. Since a graduate tax is irredeemably a tax, it cannot be privatised. It merely continues public funding through a different route. Thus the flow of private finance via graduates' repayments is slow in coming, and hence does nothing to improve access or quality in the short term.

95. Even in the medium term, a graduate tax does not necessarily produce extra resources for higher education, since increasing flows of private finance in (say) 10 years time can be offset by reduced public funding. This is exactly what has happened in Australia, whose Higher Education Contribution Scheme (HECS) was introduced in 1989 with the express aim of increasing resources for higher education. That aim remains unfulfilled.

> "A year-long investigation into Australian higher education by a senate committee has found the nation's university system in crisis and in need of substantial public investment over the next 10 years."
>
> "The committee found that universities were seriously underfunded and were worryingly reliant on non-government sources of revenue, notably on fee income from foreign and local students" (*Times Higher Education Supplement*, 19 October 2001, p. 10).

96. In sharpest contrast, a well-designed loan scheme could bring in private funds from day one, in ways which avoid these problems.

97. Closes options which a loan scheme leaves open. As discussed in section 4, above, a scheme which avoids interest subsidies makes possible a wide variety of highly desirable options, such as making higher education free at the point of use—options which the fiscal cost of a graduate tax entirely rules out.

98. Unfair. A graduate tax is unfair (and hence politically unpopular) for several reasons:

- People are compelled to make continuing contributions, with no option to pay upfront if they wish.
- Those contributions are unrelated to the cost of their higher education.
- The contributions will be considerable for a successful professional, and can be enormous, eg for the Mick Jaggers or Stelios Haji-Ioannous of this world.

99. Hypothecation. What happens to the revenue from a graduate tax?

- If it is simply another source of income for the Consolidated Fund, it is a tax, pure and simple, and higher education continues to be publicly funded.
- If it is explicitly dedicated to higher education, it is a hypothecated tax—a mechanism which (with the exception of the national insurance fund) the Treasury has always regarded as an anathema. Any such move would be a major policy shift. Such a shift might be worth discussing if the potential gains are great, but that is not the case here.

100. Boundary problems. A graduate tax is (a) compulsory (contrast loans, where students can choose whether or not to borrow), and (b) binary (contrast loans, where students can choose how much to borrow), and thus creates major boundary problems as between:

- Different occupations. Do all UK students pay the graduate tax? Doctors? Nurses? Intending teachers? Once a group is granted an exemption, there will be pressure to extend it, and considerable difficulty in removing an exemption from any group.
- Different modes of study. Does the graduate tax apply equally to full-time and part-time students? What about Open University students?
- Different parts of the UK. A major problem arises because taxation operates on a UK basis but the responsibility for higher education is devolved. A graduate tax thus opens up a Pandora's box—for example, the Scottish Executive could ask for a different form of graduate tax, or could opt out altogether. If the graduate tax is not the same throughout the UK, would an English person who studied in Scotland pay the English rate or the Scottish rate? Would the answer be the same for a Scot who studied in England? Ditto Northern Ireland (over half of whose students attend universities in the Republic of Ireland or the mainland)?
- Different parts of the EU. Does the graduate tax apply to UK graduates who studied in other EU countries (or elsewhere); and how are EU students at UK universities treated?

101. All these boundary problems raise major practical problems for the tax authorities as well as creating a potential political minefield.

Annex 4

LEGAL ISSUES

Income-contingent Loans and the Consumer Credit Act

102. Though income-contingent student loans are not made under the Consumer Credit Act (CCA), it is desirable that they stay as close as possible to the Act and to other relevant financial legislation.

103. The problem is as follows. Under the CCA, loan agreements have to specify interest charges across the life of the contract. That is possible only if the repayment flow is known. This is not a problem for a conventional (mortgage-type) loan, but is not possible with income-contingent loans, where repayments depend on a person's (unknown) future income stream and hence have an unknown duration. The issue was sidestepped in 1997–98 by arguing that the current student loan, which is indexed to the retail price index, is below the low interest threshold for the CCA.[26] Since that threshold is low, an unsubsidised loan would almost certainly exceed it, if not now, then at some time in the future.

104. There are two potential avenues to resolving the problem:

(a) revise the CCA to accommodate income-contingent loans; or

(b) ensure that the legislation bringing in new student support arrangements explicitly excludes those arrangements from the CCA via Statutory Instrument.

Approach (b) presents no obvious problems: a loan which charges the government's cost of borrowing is within the spirit of the CCA; the process in (b) is simpler and quicker than (a); and it leaves it open subsequently to amend the CCA if the government so wished.

Loans for Fees and Compliance with EU Legislation

105. At present, UK students are eligible for a loan which covers (part of) their maintenance, but not their tuition fees. If loans covered fees, it would be illegal to deny loans to students from other EU countries studying in the UK.[27] A court case is currently testing whether it is legal to deny such students access to maintenance loans. In considering the coverage of loans, the following points are relevant.

106. Loans to cover fees are highly desirable because they make higher education free at the point of use. Thus the issue of EU-compliance should be addressed in the medium term; and it might have to be addressed in the short term even for maintenance loans, depending on the outcome of court case mentioned above. The problem should not be exaggerated. The loan contract that students currently sign entitles them to income-contingent repayments while within the UK tax net, but requires them to make mortgage (or similar) repayments if they work abroad. This process is already embedded in the procedures of the Student Loans Company and works well. In the short run it could be extended to EU students.

107. A better starting point is to note that foreign students are a good thing, not a bad thing. Higher education is—and should continue to be—a major UK export industry whose benefits are both direct (income from overseas students) and indirect (future UK exports). A properly designed loan scheme is self-funding apart from non-repayments from the lifetime poor, which introduce a social policy element into the scheme. Extending the scheme to EU students is thus feasible on the basis that each government agrees to cover the social policy element of loans for its own citizens.

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[26] The England, Wales and Northern Ireland Teaching and Higher Education Act 1998 (THEA 1998), s22(4) and s22(9) provide that Secretary of State may only charge compound interest rates required to maintain the value in real terms of the outstanding amounts of the loan, which shall at no time exceed the "specified rate for low interest loans". This "specified rate for low interest" is defined in s22(9) as the rate specified for exemption purposes under s16(5)(b) of the Consumer Credit Act 1974 (CCA 1974). The Scotland Teaching and Higher Education Act 1998, s29 inserts amendments to the Education (Scotland) Act 1980, (ESA 1980). The ESA 1980 s.73B(6) includes the same provision as s.22(9) of the THEA 1998, and therefore defines the low interest rate as a rate that will ensure exemption under the CCA 1974.

[27] The post-Cubie arrangements in Scotland, by ensuring that students face no upfront charges, in effect extends loans to cover fees, thus raising serious problems of compliance with EU law.

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Examination of Witnesses

DR NICHOLAS BARR and MR IAIN CRAWFORD, London School of Economics, were examined.

Chairman

140. Good morning. Can I thank Dr Barr and Mr Crawford for being patient with us. I have explained that the Committee has been under some pressure to complete our Inquiry into Individual Learning Accounts, which, we are happy to say, by coming in very early this morning and going a little late, we have now completed, and can I congratulate the Committee, as well as apologise. Can I say, first of all, that I would like to make a declaration of interest, that Nick Barr and I and Iain Crawford, we all have known each other for many years, in fact, Nick and I were at the London School of Economics together, and I am a governor of the London School of Economics; so I think I have made that quite clear. We are, as they say, old chums. I usually say to my old friends, that does not mean to say that I will not push you harder than anybody else who comes before this Committee; but welcome. As you know, this Committee is looking again, as you know, we looked at access and retention in higher education a year ago, and we have taken that report down and are looking at it again, in the light of the Government's decision to have a cross-departmental inquiry into student finance. We have taken some evidence on this, and we are now again trying to conclude the updating of our report. Now, Professor Barr, we have been very interested in hearing and reading your contributions to this very important debate on student finance, and what we are trying to discover, as a Committee, is precisely what is the best system that would encourage students across the piece to come into higher education and stay in higher education. And can I start by saying, there seem to be two academics that most of this Committee have heard develop their arguments in this area; one is yourself and the other is Professor Claire Callender, from the South Bank University, who has done a deal of work on this. What are the essential differences between the sorts of conclusions that yourself and Claire Callender are coming up with?

(*Dr Barr*) I think Professor Callender is looking specifically at impediments to access, and looking at what the data show about that, which is a fundamentally important part of the picture. The work that Iain Crawford and I have been doing has been looking at the funding picture more broadly, on the grounds that if the objectives are access and

[**Chairman** *Cont*]

quality, both need resources, but resources are scarce, therefore one of the key things you need to make sure you do is avoid giving money where it is not needed, in order that you can use it for where it is needed. So the part of my evidence that directly links to the work of Claire Callender is the last section of my paper, where I set out a strategy with three legs. One, flexible fees. Secondly, a good loan scheme, meaning adequate and universal, and I am happy to come back to that. Third, active measures to promote access, not just in terms of money, though partly in terms of money, but also in terms of extra personal and intellectual support for students when they reach university, but recognising that impediments to access happen much earlier than 18, or 17, they go back into schooldays. Therefore if you are serious about access you need to do an awful lot of raising of aspirations and consciousness-raising in schools. But the core of the argument is, all those things need resources, the resources should be targeted at the group that Professor Callender has been studying, and not spread indiscriminately across mainly middle-class students, and via interest subsidies. Which is the main reason I went into such length about the horrors of the interest subsidy on student loans, it is not that I have any problem about being kind to students, I am very keen on being kind to students, but interest subsidies are actively hostile both to access and to quality.

141. Given there is a difference between yourself and Professor Callender, now let me give you a chance to say, in a nutshell, because there are an awful lot of people who will be following the proceedings of the Committee who have not read your research, in a nutshell, what is a message that you would like to put over to the broader audience?

(*Dr Barr*) Three points. First of all, it is impossible to exaggerate the importance of income-contingent repayments, that the Government brought in, in 1998; enormously important. An implication is, student loans, repaid by income-contingent repayments, is logically equivalent to grants paid for out of taxation, with only two differences. First of all, the "tax" is paid only by people who have been to university, not by poorer people, not by people who have not been to university. Secondly, unlike a tax, it does not go on for ever, but gets switched off. So, key point one, loans with income-contingent repayments are equivalent to a grant paid for out of a targeted, income-related graduate contribution. Key point two, the contribution is small. I did some sums, after the Budget; the 1 per cent addition to National Insurance contributions that the Chancellor brought in, in the Budget, comes pretty close to paying off a full student loan. So the contribution that is required to repay is very small. And the third point, and the one that I really want to emphasise, is the single, critical, policy change that we are arguing for is that the interest rate that students pay on their loans should be raised from the rate of inflation, as it is currently, to the Government's cost of borrowing, not the credit card rate, the bank overdraft rate, but to the Government's cost of borrowing. And I would be grateful, at some stage, for a chance to explain just how horrible interest subsidies are in the effects that they have on both access and quality.

142. Lord Dearing thinks that the Government got it all wrong, in terms of their response to his original inquiry in 1997, and, in a sense, the policy they adopted, where it ended up in giving a massive subsidy to the professionals, the middle-classes, penalising the poorer students; would you agree with that analysis by Lord Dearing?

(*Dr Barr*) Absolutely. Interest subsidies, first of all, they are fiscally expensive, they are horrendously expensive. Secondly, because they are expensive, the Treasury rations loans, so they are too small, so students are poor, and that itself is an impediment to access. Third, because student support is politically salient, money for students crowds out money for institutions, so interest subsidies are directly hostile to quality. And fourth, and critically, you have to ask, who benefits from interest subsidies; interest subsidies benefit one group, and one group only, successful professionals in mid career. Just to explain that. Interest subsidies do not help students, because students do not make loan repayments, only graduates make loan repayments. Secondly, they do not help low-earning graduates, because loans are forgiven after 25 years, so anyone with low earnings will not repay in full. They do not help high-earning graduates early in their careers, because, with income-contingent repayments, the monthly repayment of a graduate depends on his, or her, earnings, and on nothing else. So the interest rate only affects the duration of repayments. So the only people who benefit are high-earning graduates in mid career, whose loan repayments stop after, let us say, ten years rather than after 12 years, the 12 years it would take if they had to pay an unsubsidised rate. So interest subsidies are targeted with exquisite precision on the very last group who need help; it gives it to the people who need it least, at the time they need it least. So the NUS position, defending interest subsidies, is arguing for continued subsidies for those who need it least, at the time they need it least, and the hell with today's inner-city sixth-formers. So—very expensive, goes to the wrong people, would do much better being used for the sorts of policies that Professor Callender has been advocating.

(*Mr Crawford*) I think it is worth keeping in mind the scale of this as well. My understanding of the present circumstances is that, for every pound which is lent to a student, 35p is written off, because that will be the cost of the interest subsidy. So it is not a trivial amount of resource, and it is certainly an amount of resource which we both profoundly believe could be better used somewhere else.

Mr Shaw

143. We know the Government are conducting the review at the moment with the DfES, the Treasury, the Inland Revenue; have you made a contribution to that review, have you been asked to make a contribution?

(*Dr Barr*) We have always taken the view that we will talk to anybody who is prepared to talk to us. We have also taken the view that, as academics with academic freedom, if we have views we will feed them into the system; so we have made our views known by sending in documents.

[**Mr Shaw** *Cont*]

144. The Treasury have not actively pursued you?

(*Mr Crawford*) We have had, informally, discussions with officials and politicians, over the last 12 months.

145. As a direct result of the announcement of the review?

(*Mr Crawford*) I think, over the years, we have probably talked to Ministers and Shadow Ministers, whoever was in Government, and often to their officials, it has been an ongoing dialogue probably for about 12 or 14 years now, as the Chairman is aware. Yes, we have spoken informally to some of the advisers in the Treasury.

146. Interest rates are low, at the moment, and you say that, but interest rates go up and down, sometimes they go up horrendously, to 15 per cent; how would that impact upon your proposal?

(*Dr Barr*) If the interest rate goes up, the student's monthly repayment remains X per cent of his, or her, earnings and does not change at all; all that changes is the duration of the loan. So, just to give an idea of some of the numbers, I have been calculating some of the numbers, if you take the graduate on average earnings plus a small graduate premium, over a 40-year career, he, or she, will pay in income tax and National Insurance contributions about £825,000; so we are talking about huge—

147. Was that before or after the Budget?

(*Dr Barr*) That was before. So we, all of us, will pay over the rest of our careers hundreds of thousands of pounds in tax; the loan repayment will go on for a bit longer, or a slightly shorter time, depending on the evolution of interest rates, but it does not dig into people's monthly living standards, it is merely a question of the duration of the loan. So if interest rates go up, as they might well do over the longer term, at least for some periods, then that would tend to extend the duration of loans a bit; but, remember, all loans are forgiven after 25 years, so it is not going to hit anybody very hard.

148. There is one other question; a slight departure from it. If you were the Chancellor and you had a small pot of money for student finance, how high up on the list of priorities would be expanding the EMAs to post-16 students on your list?

(*Dr Barr*) I think that, if the objectives are access and quality then you have a lot of students from middle-class backgrounds who can pay their own way through university, via a well-designed loan scheme, which will have very little fiscal cost; so they can pay, to a significant extent, for their own living expenses and a contribution towards tuition fees without much of a burden to the taxpayer. That then frees up taxpayer money to do two things: one to improve the quality both of tertiary education and school education, and I am sure we all support that; secondly, it would free up money to promote access both through scholarships at the university level for students from poor backgrounds but also at the school level, and EMAs would be very much part of the picture. But one point I would like to make, if you look at the causes of exclusion, there are two causes, shortage of money is one, shortage of information is another; so any strategy for access needs to target financial resources where they are needed, but you need a huge effort on information, consciousness-raising in schools, etc. So EMAs are important, and I would support them, but alongside that you need to do a lot more to inform schoolchildren from poorer backgrounds.

Ms Munn: I am very interested in this, and it is all very fascinating, but if we come back to one of the problems about whether people go, this issue about perception and what people think is going to happen, and I can entirely understand when you suddenly start saying, "Let's have a proper interest rate," whatever that is, rather than a subsidised one, and students say "Oh, my goodness, that's greater cost;" and that is part of the issue. So I would like you just to try to address how we deal with perception, you might say that is not your business, but, also, do you think partly this is about the culture that is around in this country, because the culture actually of having student loans is relatively recent? And, if you look to the Continent, I know, when I was a student, 20-plus years ago, and going to France and Germany, people had loans then, and that was understood, and it did not seem to stop students there actually going on for years, studying. And if you look at the culture in the United States, which I am less familiar with, but my main familiarity comes from programmes like ER, where the doctors are all running round, saying, "I've got these X loans," but, again, it is part of the culture and it seems to be a pay-off for it. I do not know how good an indication of culture it is, it is probably more about my culture of watching.

Chairman: This is becoming a very long question.

Ms Munn: Can you look at those two issues, perception and culture?

Chairman

149. Ignore ER, please?

(*Dr Barr*) Let me start and then I will hand over to Iain. The Government brought in income-contingent loans in 1998, which is a huge, enormous tick, it was incredibly important, but the quality of the dissemination and explanation of what the Government have done beggars belief, in its awfulness; people simply do not understand—

Mr Pollard

150. Can you be a little clearer?

(*Dr Barr*) When I did a new edition of my book, I asked for the same crackerjack OUP copy editor I had had the previous time round; she has children of university-going age, both the old loan scheme and the new loan scheme. When she did the new edition, she was gobsmacked to learn that her youngest child would be receiving income-contingent loans; this is one of the best and the brightest of OUP, who simply did not know. So, key point one, one has to explain, and the way to explain it is to say, what we are urging the Government to do is to raise student loans so that they are enough to cover all living costs and all tuition fees, so higher education is free at the point of use; from the students' point of view, it looks like bringing back a grant. And then you say, "We're bringing back universal grants, just like you asked us, you're going to pay for it, out of taxation, but this tax will not be imposed on everybody, it will be imposed

[**Mr Pollard** *Cont*]

only on students who go to university and, unlike a tax, it won't go on for ever, eventually it will be switched off." So, with absolute truth, no fudging, no skull-duggery, you can say, universal grants, paid for out of a graduate contribution, and then people focus on the extra few pence in the pound they will be paying on top of their income tax for a period of years, rather than a headline figure of debt, which scares people quite unnecessarily. As I say, if you say to a graduate, "You're going to pay over £800,000 in taxation over a 40-year period," they do not lose any sleep over that, taxation is something you do as you go along.

(*Mr Crawford*) Though there has been a new headline figure, because the NatWest annual survey of student finance and student debt came out this week. I was at a seminar with them yesterday, and with some graduates, and the headline figure is now £10,000. I agree entirely with Nick's criticism of the Government, but, to be fair, I think the problem was that the Dearing Report came out, the then Secretary of State responded to it, but at that stage clearly he had not got the agreement via the Treasury to introduce income-contingent loans, income-contingent loans were introduced about four or five months later, when the heat of the debate had passed, and it did not ever get across, in the way that it would have been useful if it had. So the focus is on the net debt. Now, the previous loans system was a mortgage style loans system, once you passed a threshold you paid X pounds per month. The seminar was very interesting yesterday; £10,000 student debt, is this good or bad, well, it depends entirely on what sort of debt it is. Now, if it is bank overdraft debt, or credit card debt, it could be anywhere between 5 and 20 per cent. So let us assume a student debt is £10,000, at the moment it is probably going to be about £5,000 at zero real interest from the Student Loans Company, and another £5,000 at, say, 10 per cent. Now, if you take away the expensive subsidy from a student loan, by going to the Government rate of borrowing, where we are talking of, what, 2½ per cent, you will then be able to lend students as much as they need, actually their aggregate interest rate charge probably will drop. But what is interesting, if you talk to real students and graduates, is that they also do what everybody else does, which is buy electronic goods on credit cards, etc.; students have debts because they believe they are going to earn enough to pay back the cost of a small motorcar, or whatever piece of hi-fi equipment they buy, just like anyone else. And the problem with this student debt headline figure is, I think you have got to disaggregate what is the state subsidy debt, as opposed to what is expensive credit card debt, and what debt is incurred that they need to incur in order to be students, as opposed to what debt are they incurring to be consumers like everyone else of their generation at the time. So it all gets conflated into this large headline figure, which definitely works against us all, in trying to get across to people that, particularly people who have got little family history of higher education, whose parents might well be quite heavily debt-averse, I think that politicians and commentators such as ourselves have got to work really very hard to get across the new kind of student loan is not one that is going to end up with court orders because you missed a month's payment, and all of the horrors that parents typically worry about when their offspring are getting into debt. And I think there really does have to be some efforts in getting over this headline debt figure as the great horror of the reforms, because it is not like that when you look at it in detail.

Mr Simmonds

151. How does the Government's target of 50 per cent of the population going on to higher education complicate the calculations that you have made in your proposals; does it make a difference, and does it exacerbate the problem that exists?

(*Dr Barr*) The more students you have the more important it is to have a system that allows middle-class students, at least, so far as their living costs are concerned, to stand on their own feet, in fiscal terms. So a 50 per cent participation rate—sorry, I will put this more simply. If you have got an e"lite system, if you have got only three per cent of people going to higher education, the taxpayer can cop the lot with no problem; and the more you want to have a mass system, which is a trend that we both want and we welcome, the more important it is to have a system where middle-class students can, at least for their living costs, pay their own way through a decent loan scheme, freeing up taxpayer resources for quality and to promote access. So, in a way, the 50 per cent target accentuates the need for the sorts of policies we are advocating.

152. The solution that you seem to have arrived at is that to get a higher interest rate the debt levels will be greater, although they will be paid off over a longer period of time. Does that find a solution to the problem that currently exists, that many potential students, from less well-off backgrounds, do not go on to higher education because they are afraid of the levels of debt that they are actually going to get into; and I do not quite understand how your solution would get round that problem?

(*Dr Barr*) If you get rid of the interest subsidy, you can make loans larger, so that students have enough to live off, without huge fiscal costs, and that deals with middle-class students; you can then use the taxpayer resources you save for precisely the students you are talking about, grants, scholarships, things like that. So ours is a plea for targeting. Interest subsidies are like taking a knob of butter and spreading it very thinly over an enormous slice of bread, and we are saying that is a crazy way to spend that huge sum of money, you should be targeting it on those who need it most.

(*Mr Crawford*) Let me come back to the sums here; 35p in the pound interest subsidy, if you are lending next year probably in the order of £2 billion.

(*Dr Barr*) Two and a half billion, next year.

(*Mr Crawford*) That is giving you upwards of three-quarters of a billion, which you can then use. I think we are both clearly of the same mind. If you want kids to get into university, first of all, they have got to have A levels, and that requires levels of parental support whilst they are in the school system. If you want actually to give money away that way then look at giving it away in a more imaginative fashion, to keeping people on from underprivileged backgrounds, to keeping people on at school from 16-18, so that actually they can gain the

[**Mr Simmonds** *Cont*]

qualifications to get into the higher education system. I would argue that probably we are losing more people at that part of it than we are deterring from going on.

Chairman: I think the Committee would agree with that.

Paul Holmes

153. Partly carrying on from what you were saying, one of the great problems is trying to get the children from working-class, socially-disadvantaged families into higher education, and the percentage going to higher education has not really changed in the last 30 years, from that sort of view. It seems to me that your suggestion, that the way to encourage them in is to say to them, "You can have a bigger debt, you're going to pay it off at a higher interest rate and we're going to make you pay higher tuition fees as well, especially for the more prestigious universities you go to," that is hardly, to me, it would seem, going to create with them an impression that, "Oh, yes," higher education is a thing for them. Now your answer to that partly is scholarships and grants, but you do not put a detail in the summary we have got here; so what sort of level of students are you talking about, what per cent, 10, 20, 30, 40 per cent, are going to get these free scholarships, free grants, where they are not repaying anything at all?

(*Dr Barr*) What we were trying to do here was set out a sensible strategy, not go into the sort of detail that would need the numbers, that this Committee has access to, that the Treasury has access to. But, I think, to come back to the point about the money; next year, the Student Loans Company is going to lend £2½ billion, 35 per cent of that is going to go down the gurgler in interest subsidies, that is £800 million. The question is, if you have got £800 million to spend, do you want to use it for the exclusive benefit of future successful professionals in mid career, which is what interest subsidies do, or do you want to use it to promote access and quality; and I am sure that we all agree, it is crazy to spend £800 million benefiting successful professionals in 15 years' time, that money does not help a single student or a single schoolchild. And the answer is, you use that money to help schoolchildren, to help students from poor backgrounds at university. It may well be that if there is a rational loan scheme it makes more sense for the Treasury to come up with more taxpayer money to promote access than it has up to now. With a system like this, if I were Chancellor, I would be blowed if I would want to spend more money on higher education finance, when so much of it goes to the wrong people; get the targeting right and there is a much stronger case for taxpayer support for those who really need it, and that would be a case that I would very strongly support.

154. The devil is in the detail though. If you are saying that we overcome the problem with the poor students by giving them some grants and scholarships, but we do not know quite what that would be, if it ends up being 10 per cent of students, that is hopeless. In Wales, they have introduced, it is 40 per cent of students who will get free grants, effectively; and there have got to be some figures on that and on what sort of percentage you are going to hit, if it is going to be a realistic proposal?

(*Dr Barr*) The present system takes £800 million and blows it on mid career, successful professionals. Any targeting must do better than that. Will it be as much as you or I would want to do, possibly not, but at least it is better than the present system; and the better it becomes the more it becomes rational to make a plea to the Chancellor for more taxpayer resources.

155. Finally, you look at the students who fall more in the grey area, or students who are coming from more affluent backgrounds, but we are wanting lots of those students, we need, what is it, 60 per cent more maths graduates to go on to be maths teachers, because of the massive shortage of maths teachers in schools. They are going to look at the salaries they get as a teacher in the public sector, or as a social worker, or as a nurse, and they are going to look at the size of the repayments and the fees, and everything, that you are saying you are going to increase, and they are going to say, "We're not going to work as teachers and social workers and nurses." How do you overcome that problem?

(*Mr Crawford*) We are not advocating increasing the size of anybody's repayments, merely a slight extension of the duration.

156. I think that is a play on words, really; they are going to repay a lot more, however you slice it?

(*Mr Crawford*) Not at all. The Government did a very, very important thing, when it moved away from the old mortgage style repayments to income-contingent. So the Government set what proportion of your income is then taken away to repay your student loan. All the interest subsidy does is shorten the period that you pay it, it makes no difference to the amount that you pay. So no teacher, under what we are advocating, would pay a penny more per month from their salary than they are doing now, they would pay it for just a little bit longer.

Mr Simmonds

157. But the total will be bigger, for so many years longer?

(*Dr Barr*) The total will be bigger, and if there is a desire to increase the number of maths teachers, it would make perfect sense for the Government to say, for every year that somebody teaches maths, 10 per cent of their debt will be repaid by the taxpayer. So that would be a sensible way of doing it.

(*Mr Crawford*) If you have, particularly in the public sector, shortages like that then this 800-odd resource gives you a lot of resource to do a lot of very selective targeting, which can change over time. But this is a matter of detailed policy; what we are arguing is, unless you reform the mechanism you are not going to have this resource then to decide where and how best to target it.

Mr Chaytor

158. Is not the logic of your argument also that the maximum 25 years repayment period should be abolished as well?

(*Dr Barr*) The answer is, that is a genuine policy issue that one could debate. The 25-year forgiveness means that—maybe one should not—

159. Let me put the question this way. Have you done a calculation to work out the extent of the deadweight involved in limiting the repayment period to 25 years?

(*Mr Crawford*) We have, both of us, been working in various countries, we have been advising them; we have been working in Hungary, and they have just had an election this weekend, and part of the feature of the election debate was the massively popular student loan system. To be fair, there was no grant system to start with, so anything was better than the situation they found themselves in. But that system, you repay until you have repaid it all, right up till retirement, but, equally, it has got no starting threshold, they do not have the income tax thresholds that we have, so you pay a very much smaller proportion than our students are paying because you have got a threshold, and you pay it right the way through. And it is very simple, it is very straightforward, and during all the debates in their election, which ended at the weekend, it was massively popular. The Government was claiming a lot of credit for it and not trying to pretend somehow it had not done it.

160. But the previous Government lost the election, surely?

(*Dr Barr*) But not because of the loan scheme.

(*Mr Crawford*) Absolutely not. It is an important point. There was an all-party consensus that this had been a very good thing to do.

161. A second thing then, and this is following on Paul's questions really. I accept the logic of your argument completely, but the virtue of your argument is that three-quarters of a billion pounds, on current figures, will be released for targeting. Now I just want to pursue the implications of the other strand of your argument, that tuition fees should be rolled up within the loan system, and that what you call flexible fees, and what other people would call top-up fees, should be encouraged. To what extent would this three-quarters of a billion, or 35 per cent deadweight, be gobbled up by the extension of flexible fees, and would we not see an increasing proportion of this deadweight be taken up by the decisions of universities and colleges, such as yours, to increase their fees dramatically from the current £1,050 a year?

(*Mr Crawford*) If I can pick up this one point, briefly, then leave this one to Nick. There is a difference between top-up fees and flexible fees.

162. What is the difference?

(*Mr Crawford*) You have now reached a point where there is no supply side problem, there are as many university places now as there is demand. Flexibility could indicate prices going down as well as up, because there will be competition for students, if there is a shortage of students for the places. So top-up fees were discussed in terms, if you like, of the élite, including our institution, simply because what these institutions are paid to provide a student education is substantially less than cost. However, if there is going to be a competition for, let us say, the non-research-based institutions, and there is going to be a shortage of student numbers, I think you could very easily see flexibility both ways in pricing. So I think the situation has gone beyond the debate of top-up fees that you perhaps were referring to at the beginning.

163. Okay; but there are two other issues there, are there not? One is the question of the research-based universities' capacity to recruit infinite numbers of students from overseas, it is not just the competition within the British market; and the other is the question of the proportion of the fee that the student is expected to pay, because the rough proportion of over 25 per cent of the average notional fee could equally be changed, could it not? Under your model, people would not be expected to pay their £1,050 or £1,075, they will be expected to pay 100 per cent of the actual fee; let us tease that out a little bit?

(*Dr Barr*) There is a very strong case for a taxpayer tuition subsidy for all students, for all time; some of it should be paid for by the taxpayer, because higher education has growth benefits, benefits not just to the individual. But, in addition, going to university benefits the individual student. Therefore it is right that he, or she, should make a contribution; whether 25 per cent of the average cost is the right figure or not one could have a protracted debate about. Our point is the following, that having one fee for all universities is central planning that works badly. With a mass system, we want diversity, there is diversity of mission, which is enormously important, higher tuition fees are necessary to arrest quality decline, higher tuition fees are also necessary because—I hope the Chairman, as an LSE governor—will not criticise me for saying this, universities like LSE could do more to stand on our own feet, if we could charge somewhat higher fees, freeing up resources for access universities that have more expensive teaching costs because they have more remedial teaching. So another reason for flexible fees is to prevent crowding out. Now, just to come back to your point about the loan; sorry, two points. First of all, we are against big-bang deregulation of fees, we favour flexible fees, we would like to see a move in that direction but phased over time. Second point; if loans are properly designed, they have very small fiscal costs, in which case there is no problem about extending loans to cover those additional tuition fees.

164. This is the heart of my problem then. So what you are saying is that it is in the design of the loan scheme that you will be able to accommodate the implications of the research universities increasing their fee?

(*Dr Barr*) If you want to promote access and quality, it is our view that higher education should be free at the point of use; that was one of the important things that Cubie achieved in Scotland, that students do not have to pay a penny up front, that is enormously important, but that means that the loan has to be large enough to cover living costs and tuition fees, and certainly we support that unambiguously.

[**Mr Chaytor** *Cont*]

165. But then, if you are saying that the issue of flexible fees is dealt with by increasing the size of the loan, how does that then not become a deterrent to students from low-income families, in the first place? And how do we still enable students from low-income families to go to Oxbridge, LSE, Imperial, UCL, and so on?

(*Dr Barr*) By not taking the current huge amount of taxpayer money and spraying it indiscriminately over all students, but taking it and giving it to those students to whom we want to give additional help. So that, again, it is the same targeting argument, that, of course, there should be scholarships. Everybody talks about scholarships, but where does the money come from; our argument is, a lot of it comes, £800 million, just like that, simply by charging a rational interest rate on student loans.

166. Finally, in the *Daily Mail's* frame of thinking, you are not only clobbering middle-classes by doing away with their interest-free loans but you are clobbering them by making them pay the full cost of their fees at the élite universities?

(*Mr Crawford*) Not the full cost.

167. But a move in that direction?

(*Mr Crawford*) At the moment, most of the research-based universities, particularly the LSE, as your Chairman will be well aware, are teaching undergraduates, British Government-funded, undergraduate students; it costs us more than we are paid to do it. This is not sustainable, in the long run. The School itself has, yes, a large number of overseas students, but mainly on the post-graduate side, but if the LSE had not been able to do that then the quality for all of the students, including the Government-funded UK students, would have declined rapidly.

Chairman

168. Is it not the case that, if you take an international comparison, families, reasonably well-off families anyway, pay less as a percentage towards their children's higher education than in most other countries, it is a very small percentage here?

(*Dr Barr*) That is right. But, to answer your question, yes, we are saying middle-class students should, on average, pay more, but they need to be clear that the way they make their graduate contribution is in the form of an income-contingent repayment, which is like a tax except it is paid only by people who go to university, and it is not for the rest of their life, it is for only a limited duration. Therefore it is not a big impediment, but, yes, they will pay more, and they should pay more; and I think that is an absolutely defensible case to make to promote access and quality. Otherwise, you are saying to the middle-class, "You are saying it is right that the truck-driver should pay for the degree of the Old Etonian;" now Old Etonians might say that, but there is no reason why we have to go along with it.

(*Mr Crawford*) You have already paid the price for this. Institutions like the LSE have not expanded their undergraduate numbers, so people are already not going to those institutions, because of this pricing mechanism.

Valerie Davey

169. Following on from there, they do not really end up with a range of fee costs, and, again, students looking and saying, "That's more expensive, I can't go there." It is simplistic, I know, for me to say that, but that is the perception, from, again, this perception idea, that it is too expensive, it is too expensive at the moment to go to certain universities because the living costs are greater. Now, with all these different ingredients in the costs, you again phase out, you are going to get at Oxford and Cambridge even more people (a) who have got money, mainly, yes, who have got money, it will be entry by income again?

(*Mr Crawford*) We have an entirely centrally-planned system. British higher education, up until certainly the last change of Government, was the perhaps classic example of central planning left, since the fall of the Berlin wall. Universities work on a centrally-fixed price, at that time they had target numbers, and they were fined enormously for failing by a single digit, if they went over the target number. Two important changes, the most important changes since this Government came to power, I think, are the move to income-contingent loans, which has massively improved the condition of the loans side of it, and the fact that we have now reached a point where, for the first time in history, there are at least as many places in aggregate as there are people who want them. But we have still got some of the worst elements of that, and I think there are a number of ways that price flexibility will work, other than as you described. For example, there are a lot of mature students in the system, there are a lot of people coming back into higher education, having been in the workplace; they do not necessarily all want to spend three years, with long vacations. Some institutions, I suspect, will appeal to different parts of the market and do accelerated degrees with shorter vacations, if this was allowed; it does not work at the moment because we are all paid per student per annum. So there has to be a flexibility not just in the pricing. Then we think you will find that a very bright student might decide to do an accelerated undergraduate degree at one of the less élite institutions and give themselves a bit more time perhaps to go and do a Masters at another institution. I think that diversity would spring up; all sorts of different ways of delivering what we are delivering will come about. Now that we have actually got to the point where universities are going to have to compete for students, in a way that they have never had to do before, I think you will find all sorts of imaginative variations will come. And I think universities themselves will be trying to persuade the funding bodies and Government to let them deliver the packages in ways that they have not been doing so far. At the moment, you have got the conventional three-year course, long holidays, or you have got the OU, and not a lot in-between.

170. I have got no problem with that, I agree, and I think this Committee has done a lot of work now in HE, and the need for flexibility, the need for students to study a year, work a year, study a year, a whole range of things can come in. But if there is no understanding of a unit cost per student which the Government is actually paying, we, as taxpayers—it

[Valerie Davey *Cont***]**
just so happens I have identical twins, one of whom went to university and one who did not, and you can imagine the debate that goes on in our household as a result of that. So I have understood a lot of these arguments and I take them on board, but I still think that, the perception for many people of the difference in the cost of these courses, why should I, as a taxpayer, pay for a student at a university where it is twice as expensive, and it will be twice as expensive, eventually, at some and not the others, if we are not careful, why should I, as a taxpayer, be contributing to that?

(*Dr Barr*) Your concern is, will the more costly universities deter students from poor backgrounds. At the moment, the major deterrent is loans are too small, students perceive high headline costs, but it is the worst of all worlds, they see £10,000 debt and that deters them, because they do not understand income-contingency, but they still do not have enough to live off, so they are forced onto expensive credit card debt, and working long hours to earn money, etc. If you move to a rational model where loans do not have to be rationed, then you can say to students, and this is a critical perception point, "Go to university, it will be free at the point of use, you won't pay a penny up front, go to Oxford, to go LSE, go to your local university, whichever, you'll sign a bit of paper, you'll get your degree, and once your earnings cross a certain point you will pay and add on to your income tax for a period of years; and if you don't earn very much you wont repay very much." It is, from that point of view, entirely performance-related, "If you do well you'll repay more; if you don't do well, you wont repay." There is virtually no risk for the student in this, it is a one-way bet, if they do badly they do not repay. But that only works if you can say to students, "It's free at the point of use;" that means loans have to cover living costs and tuition fees.

Valerie Davey: But I the taxpayer, that was the other side of the argument, why should I have to pay, if it had been my other daughter, why am I paying for this youngster, or this older person, to take a degree at that university, rather than get the basic tuition to do the job, which in the longer term will give them as good an income?

Chairman: And, of course, if your daughter became an apprentice and never had any taxpayer subsidy at all,—

Valerie Davey: Interestingly enough, they are both earning the same.

Chairman

171. Interesting.

(*Dr Barr*) The technical literature is not fully definitive on this, but I think most experts agree, if you go to Oxford or Cambridge or LSE or Imperial or University College London, yes, they will charge higher tuition fees, but most of the additional benefit is for the student, rather than social benefit; it is not clear that the teaching side of LSE contributes more to national economic performance than the teaching side of other types of university. That is another argument for saying flexible fees paid for by an additional loan entitlement; so, for example, if we stick with the 25 per cent, average teaching cost £4,000, taxpayer subsidy per student £3,000, any tuition fee above £3,000—£4,000, £5,000, £6,000—is covered by the loan entitlement, in which case, the taxpayer pays the same for a student at the University of East London as at Oxford, and the rest is done through the loan.

Jeff Ennis

172. I think, obviously, the Committee seems to have a problem with this flexible fees system, Chair, which I think I have. Going back to Mr Crawford's earlier comments about the fact that the fees can go up as well as down, depending on the actual higher education establishment, will it not be perceived as an admission, if a higher education institution reduced its fees, by the students, that it was delivering a second-class higher education course? Will not that be the actual perception that people come out with, particularly people in the press, for example?

(*Mr Crawford*) People in the press, or, indeed, and perhaps more importantly, employers. We cannot, I think, pretend that all of our higher education institutions are the same. If you go to graduate fairs and look which graduates certain employers are looking for, the labour market already makes such distinctions. And, indeed, interestingly, when the first announcement of the £1,000 fee came out, there was one of the new universities actually suggested coming in at under the £1,000, and they were heavily slapped down by the then Secretary of State for that. I think the reality of some universities not being able to fill all of the places they have currently got will, under such a regime, rapidly be reflected in price competition. I see no reason why higher education is incapable of entering into price competition, like everyone else. Now that you have got a surplus of places over students, there will be movements of price down as well as up, inevitably.

(*Dr Barr*) Can I just very briefly follow on from that. If we look at clothes, cars, food, all sorts of quality variations, the important thing is that consumers and employers know what is going on, we know that Volvos might be better than Fords, some restaurants are better than others, people make choices. So long as they are well-informed choices, so long as students know what they are doing when they make choices, as employers already increasingly know, I think it is right and proper that there should be a range of different institutions. The press might say "higher quality, lower quality," I do not think of it that way; there is life of the mind type higher education, there is vocational type higher education, they are different, one is not better than the other, there is a range. And I think price would be part of that; and so long as there is good information about the outcomes of different degrees, where students go on to get jobs, etc., I do not think that there is a problem about that.

173. But is not your system, Dr Barr, in danger of making too wide a choice for the consumer, by having all these variations, and what have you?

(*Dr Barr*) No. We are saying, fees should be liberalised, but gradually, not big-bang, not the sky is the limit; supposing they were allowed to be sort of within a band and the band could be widened over time, as experience grows. So I am not saying the Government should have no role whatever on fees:

[**Jeff Ennis** *Cont*]

we are just saying the role should not be one fee entirely determined and the same for all universities; universities should have some freedom, and we could then discuss how much that should be, initially, and how rapidly it should widen.

(*Mr Crawford*) And the differences would not be just quality, there would be, as I said earlier, different ways of delivering it, different sorts of time-frames. OU to Oxford, there is a lot of room for variation within these extreme points that we are not exploring now.

(*Dr Barr*) To make one point very clear, we are, both of us, totally opposed to total, instant fee deregulation, that would be very silly.

Mr Chaytor

174. Leaving aside the issue of the fact that Ford actually took over Volvo, and what the implications of that might be, is not there a contradiction in your argument, that, on the one hand, you are arguing for greater fee flexibility, but by rolling up the tuition fee within the loan scheme you are disguising, from the students' point of view and the parents' point of view, the implications of that fee flexibility, because it will become less of an issue as the fee is to be paid over 25 years?

(*Dr Barr*) We are saying, the fee at LSE will be £6,000, and that is explicit and open, but we are also saying, the way the loan is designed, you will repay that in full, but only if you do well enough in terms of your earnings.

175. Yes, exactly, but by repaying it over the 25-year period then it becomes less of an issue in terms of consumer choice, because the sharp implications of consumer choice are disguised over a longer period of time?

(*Dr Barr*) I think people should be able to make choices and those choices should be empowered by the financial capacity to make those choices, as ours are when we take out a mortgage to buy a house, which is an area where markets work well; but degrees are more risky than houses, therefore you need to give borrowers more protection than you do to homeowners, therefore income-contingent. But it is not hiding it, it is saying it is a fee of £6,000—

Chairman

176. Dr Barr, the fact is though, you can have your two cases totally distinct, you can have your new form of student loan distinct from changing it into a flexible fee structure?

(*Dr Barr*) Separate arguments.

177. Are you saying though that the Government, by an inappropriate choice, in 1998, has wasted £700 million a year, and what is the total cost of that, by spending money on the wrong people?

(*Dr Barr*) It is an easy calculation. Look at the total amount of money that the Student Loans Company has disbursed to students since 1990, because it was a problem with the old system as well; about 35 per cent of all that money has disappeared, mainly to the benefit of successful professionals in mid career.

Mr Baron

178. Very briefly, can I just ask, is not the simplest way of approaching this, and being slightly devil's advocate here, and that is, in order to target help to those that most need it, every family has to put in an income tax form, in this country, and simply graduate the help that is given to children depending on your income tax bracket? And it would seem that then the risk with regard to whether one institution is more expensive than any other would be borne by that particular family may be a consideration, without having to look for necessarily choice of the individuals concerned. I sense that there is just a little bit too much complication here, and that a lot of money has been wasted in the past. What are your thoughts on that?

(*Dr Barr*) We are saying, first of all, taking 35 per cent of the money and giving it to the wrong people is daft, it should be targeted. The question then is, what is the most effective way of targeting. Now parental income is a rather blunt weapon. It may be that some of the money should be spent on grants tested on parental or spouse income; but there are a lot of students who are poor whose parents are not necessarily poor. Therefore, I would be against using your model as the only way of targeting assistance on student support; it might well be possible for some students, but I think you need to give discretion to headteachers, you need to give incentives to universities to recruit students from poorer backgrounds. So the "how" of targeting, and this is back to Paul Holmes's point, the devil is in the detail, targeting to promote access is difficult, the determinants of exclusion are complex. Anyone who says targeting is easy, I think, is wrong; one therefore needs a range of mechanisms and scope for experimentation. Your mechanism, as a sort of base mechanism, might well work, but I would be against it if it were the only one.

(*Mr Crawford*) A very brief point now on this. One of the effects of the student loan being so heavily subsidised is that it is rationed, it is rationed in two ways; it has a ceiling on it, which means, basically, it is not enough for anybody to actually survive on, but, equally, it brings you to the parental means-testing mechanism, in the first place. Now I have always thought that that was an anomaly, because 18 year olds are classified as independent adults for virtually everything else in society. I am not convinced that parental means-testing should carry on. If your loans are not being subsidised by the taxpayer, why not give them to all students, take them out of the parental means-testing; there are bad things that happen from parental means-testing, there are some parents who should pay but do not, there are some parents who do pay but put on such strings as to where you go, what you study, etc. I think that the beauty of income-contingency is, effectively, you are means-testing the outcome, the student repays according to their financial success and they are the beneficiaries of higher education. I would like to move as far away from parental means-testing as possible at that stage, albeit I would rather see a large chunk of this three-quarters of a billion, or whatever it is, targeted back at the school end for poor families, when they are still dependants, when they do need parental encouragement, not just financial but

[Mr Baron *Cont*]

simply to stick in at school and make the best of it; that is where I think the parental, the family wealth needs to be taken into account. I would far rather take away the subsidy and allow any undergraduate free access to the student loan system, without means-testing at all, there is no reason to means-test it at that stage.

179. I take on board what you have said there, but is there not a danger, and are we not seeing it now, that, despite the fact that we are trying to backload the loan, as it presently operates, it is still discouraging students from poorer backgrounds to take up the system, as we have seen from the mistargeting of the funds?

(*Dr Barr*) That is partly, as I said, that people do not understand; there needs to be a lot more information. To come back to the general point about access, to oversimplify, there are two groups of students, those who are well-informed and those who are not. Those who are well-informed and understand income-contingent loan entitlement, they know what they are doing when they go into higher education, these are the mainly middle-class students. Students who are not well-informed, there is financial exclusion, there are information causes of exclusion, you need to target the resources to help those. As I have said, the mechanisms for targeting, one needs a range, one needs both. In both cases, one needs to have lots of information, so students understand what is going on, and the way you get the resources for access is by eliminating the interest subsidy; and I would be interested in whether the NUS is prepared to defend continuing subsidies for successful professionals in mid career.

Chairman

180. I am afraid we have to end it there. Can I say thank you very much, Professor Barr and Dr Crawford, it has been a very good session, and I hope you will be available for any further information we need to seek over the next couple of weeks?

(*Dr Barr*) With pleasure.

Chairman: Thank you very much; thanks for your attendance.

Supplementary memorandum from Mr Iain Crawford (SS 10)

FACTORS EXACERBATING STUDENT POVERTY: REAL AND PERCEIVED

1. It is unanimously agreed that the current student support package is too small and needs to be enlarged. In addition, policy should address two factors—one real and one perceived—that additionally and unnecessarily exacerbate student poverty, and create misinformation.

— *Student inexperience in financial management.* The lack of experience, knowledge and self discipline, in handling personal finance of a significant number of new undergraduates is a contributory factor to student poverty. While accepting that the state student support package is inadequate, the lack of ability to manage personal finance makes the problem worse for a large proportion of students.

— *Inadequate information.* Lack of authoritative information on available state and commercial financial support mechanisms means that ignorance and scaremongering are real deterrents to access and create an unjustified sense of discontent amongst participants.

SUGGESTED MEASURES: STUDENT LOAN PAYMENTS

2. State Student Loans should be paid monthly rather than three times per year. Students would give their bank account details when applying for their loan; loans would be paid by electronic transfer. It is unreasonable to expect students, many of whom are without experience of the world beyond school, to manage their money in the way that it is paid to them at present, when most adults rely on regular monthly or even weekly payments.

3. It should be administratively possible to move to such a system. In the new Hungarian system, loans are paid in monthly instalments, with a double-payment in the first month to cover such things as rent deposits, new textbooks etc.

4. Such a change would help to remove some of the "end of term" student poverty. It would also marginally improve the Student Loans Company's cash flow.

SUGGESTED MEASURES: INFORMATION

5. It is clear, from research by commercial banks and others, that there is a lack of knowledge and understanding of Student Loans Company (SLC) loans among prospective students. This is partly because of changes since the system was introduced, partly because of disinformation promoted by opponents of the system, and partly because of a general paucity of personal finance knowledge amongst secondary school and sixth form students.

6. There is an urgent need for a campaign to educate prospective students, their parents and advisors about all aspects of student financial support, as well as advice on budgeting and personal finance management. As discussed in paragraphs 75–79 of Nicholas Barr's submission, there are two impediments to exclusion—shortage of money and shortage of information. That evidence (paragraph 79) stresses the importance of making sure that prospective students are well-informed about the educational side of universities; a co-equal element is to make sure that they are well-informed about the financial side. The activities outlined below are therefore not a minor PR element, but a fundamental part of any well-conceived strategy to promote access.

7. Commercial banks spend a great deal of time and resources trying to address the information gap with their student customers. The retail banks' motivation is entirely commercial: they regard the student market as very important, and spend hundreds of pounds per account on marketing, free overdrafts and other inducements.

8. It is not in the commercial interest of banks for students to keep getting into budgeting problems. It adds to banks' administrative costs and, if they get too strict, risks losing customers who in the long run would be very profitable.

9. There is, therefore, scope for such a campaign to be sponsored jointly by the Government/SLC and the retail banks. Since banks are prepared to expend substantial resources on the student market, it is likely that they would be prepared to co-operate with Government in a campaign to educate secondary school students about state support and personal banking. Indeed which retail bank could afford to be seen not participating in such an exercise? In a joint campaign, the Government and the banks could mutually reinforce their messages.

10. Some commercial banks are already working on projects in schools. They all have a lot of information on student spending and borrowing patterns. Through their campus branches and specialist student centres they talk to thousands of students and they spend a lot of money finding out what students want and need.

11. While it should be assumed that banks will behave in their own commercial self-interest, it should be recognised that their interests can coincide with those of students and government, in that they can promote access by explaining that finance should not be a worry.

12. Substantial financial resources and research data are available for such a joint information campaign. This would enable government to bury the disinformation and to promote the reality of the loan scheme—in particular the low interest rate and the income-contingent repayment system which removes all the normal risks attached to commercial debt. It would enable the banks to educate their prospective customers to their mutual benefit. Both banks and government could explain the difference between commercial rates and the government rate of borrowing!

Dr Iain Crawford

May 2002

Supplementary memorandum from Dr Nicholas Barr[28] (SS 11)

THE INTEREST SUBSIDY ARGUMENT IN A NUTSHELL

1. In 2002–03, the Student Loans Company will lend £2,500 million. The cost of the interest subsidy (some 35 per cent of total lending) is around £800 million.

2. If interest rates are held to the rate of inflation, the resulting subsidy does not benefit a single student, but only successful professionals in mid career. The argument is worth spelling out:

- Interest subsidies do not help students (graduates make repayments, not students).
- They do not help low-earning graduates, since unpaid debt is eventually forgiven.
- They do not help high-earning graduates early in their careers—with income-contingent loans, monthly repayments depend only on earnings; thus interest rates have no effect on the size of monthly repayments, but only on the duration of the loan.
- The only people they help are higher-earning graduates in mid career, whose loan repayments are switched off earlier because of the interest subsidies than would be the case without them.

3. Thus the question is whether we want to spend £800 million on helping wealthy people become wealthier, or whether we would rather use it to promote access through targeted student support, and improved quality through more resources to education institutions.

4. Note that this line of argument goes a long way to solving the political problems of raising the interest rate on student loans to the government's cost of borrowing (not "commercial rates") discussed in the parallel note by Iain Crawford.

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THE NUS POSITION

5. The objective of the NUS is "targeting money effectively". There is complete agreement about that objective.

6. However, the NUS puts forward the following argument (paragraphs 188 and 213 of their oral evidence) against abolishing interest subsidies. With income-contingent repayments, higher earners repay more quickly and lower earners more slowly. Thus lower earners pay more interest in total than higher earners. Thus raising the interest rate on student loans harms lower earners. There are three answers.

7. *Answer 1.* As a proposition in logic the statement is true. But the basis of the argument is that in order to protect the poor you subsidise the commodity for everyone. This is the postwar argument for food subsidies: food subsidies did, indeed, help the poor, but they helped the rich much more. The same resources could do much more to help the poor if spent in a way that did not leak out to the rich.

8. *Answer 2.* The whole point of income-contingent repayments is that they tailor monthly repayments to ability to pay by automatically extending loan duration for lower earners. Someone who buys a house for £100,000 will pay more interest if she opts for a 25 year mortgage with lower monthly repayments than a 15 year mortgage with higher monthly repayments. Income-contingent repayments do the same thing automatically.

9. It is, of course, entirely possible to solve the NUS's "problem" by having mortgage repayments (eg equal annual repayments for (say) 10 years, regardless of income); thus loan duration, and hence interest payments, are the same for all students with a given size of loan. That cure, however, is vastly worse than the disease.

10. *Answer 3.* There is a range of mechanisms (my main written evidence, paragraphs 58–62) for helping low earners which are much more effective than blanket interest subsidies:

— Income-contingent repayments automatically project low earners (the argument above).

— Grants for students from poor backgrounds mean that such students have no loan, or a smaller loan.

— Targeted interest subsidies based on current income. The attack on blanket interest subsidies is not an attack on targeted interest subsidies. It would, as examples, be possible to pay an interest subsidy to people who are unemployed or looking after young children. Such targeted interest subsidies are both possible (as currently in New Zealand) and desirable.

— Conditional subsidies. It would also be possible to pay interest subsidies to people with low current earnings, but to claw them back if they subsequently become high earners. Design work for the Hungarian Government established that such an arrangement presents no administrative problems.

11. Any or all of the mechanisms in the previous paragraph help low earners much more effectively than blanket interest subsidies.

WHAT NEXT?

12. Make the cost of interest subsidies transparent. Expenditure on interest subsidies is currently buried in the overall cost of government borrowing, and hence does not appear in the education budget. The most minimal reform is to make spending on interest subsidies an explicit line item in the education budget. A major advantage is to make the high cost of interest subsidies visible. In addition, figures on expenditure on student support, by correctly including the cost of interest subsidies, would be more accurate and more readily comparable with earlier years.

13. Abolish the blanket interest subsidy for all the reasons given above.

14. Ensure that the education budget benefits from its abolition. This is the issue discussed in main evidence, paragraphs 38–41. The core of the issue is that the figure of £800 million referred to above is the present value of the savings from moving to the government's cost of borrowing, but the savings in cash-flow terms are small in the early years. To ensure that the withdrawal of blanket interest subsidies leads to an immediate increase in spending on access and quality, a deal will be needed between the Treasury and DfES to accelerate the cash flow. As noted in paragraph 39, one way to finance that deal would be to sell a further tranche of student debt, yielding up to £2 billion.

FURTHER POINTS

15. Some analytical equivalences. The following are logically equivalent:

— An income-contingent loan.

— A grant plus an income-related graduate contribution.

— A grant paid for out of taxation, except that the tax (a) is paid only by people who have been to university, and (b) does not go on for ever.

Though analytically identical, the three representations clearly have major differences in terms of perceptions. The companion document by Iain Crawford suggests a way of addressing the perception problem.

16. The balance between loans and grants should be variable, not an either-or proposition:

— Middle class students would be entitled to an income-contingent loan sufficient to cover all living costs and tuition fees, thus making higher education free at the point of use (the Cubie advance).

— A student from a poor background would receive a grant. Depending on the size of the grant, he or she might also need to take out a loan—but a smaller loan.

— A student from a particularly vulnerable background might receive a full grant, and would therefore not need to take out a loan at all.

17. Tuition fees.

— All the previous discussion about loans can be decoupled from the fees issue.

— There is a strong case for a move towards flexible fees (which can be higher or lower than the present tuition fee).

— However, deregulation of fees should be phased, not "big bang".

Dr Nicholas Barr

May 2002

Further supplementary memoradum from Dr Nicholas Barr (SS 13)

WHERE DO THE £800 MILLION APPEAR IN THE GOVERNMENT ACCOUNTS?

1. Earlier evidence to the Select Committee argued that raising the interest rate on student loans from the current zero real rate to the government's cost of borrowing would save between £700 and £800 million on next year's total lending to students of £2,500 million.

2. It is important to be clear where that money appears in the government accounts.

The Cost of Write-Offs: an Item in the Education Budget

3. The DfES have argued that they are not aware of any such saving. The figure that appears in the Education Budget is around £200 million or slightly more, the cost of student loans write-offs—an amount that reflects lending that will never come back because of low income, early death, and the like. Apart from a small amount of fraud, the greater part of this figure should be regarded as social policy spending—it gives relief to those graduates who do not do well financially out of their degree and is thus well-targeted. While future policy changes might reduce this figure somewhat, it is expenditure which, in the main, contributes to access. This is the only figure of which the DfES has cognisance, since it appears as a line item (or several line items) in the Education Budget.

The Cost of the Interest Subsidy: An Element in the Overall Cost of Government Borrowing

4. The figure of £800 million is an entirely separate item. It is the cost of the interest subsidy—an item of expenditure separate from and additional to the write-off. Unlike the write-off, this expenditure is deeply regressive—indeed is inimical to access.

5. Two points are noteworthy about the £800 million figure.

— It does not appear in the Education Budget, but is lost in the overall cost of government borrowing. If it appears anywhere, it is part of the Treasury's internal accounting. The fact that it does not appear anywhere in the public accounts does not diminish its importance—this figure represents real resources.

— The figure is the present value of what would be saved by charging students the government's cost of borrowing. In cash flow terms, the savings are small in the early years, becoming large only later. Since the purpose of raising the interest rate is to promote access and quality, the extra resources (or a large fraction of them) should benefit the Education Budget (a) directly and (b) now. This can be done, but will require a deal between the Treasury and DfES. As argued in paragraph 39 of my main evidence, one way to accelerate the cash flow is by selling a further tranche of student debt, which could yield up to £2 billion.

Dr Nicholas Barr

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