



THE 2012 REFORMS OF HIGHER EDUCATION FINANCE IN ENGLAND

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Introduction

This article gives a (mostly gloomy) assessment of the 2012 reforms of higher education finance in England, which are a retrograde step from the 2006 reforms of the Blair government.¹

After introductory discussion, the second section summarises lessons from economic theory and empirical evidence, which set the scene for explanation of the Blair reforms in the third section. The fourth section assesses the 2012 proposals. The conclusion argues that the 2012 reforms are unsustainable and foreshadows the next reform.

Higher education finance in England has seen considerable change.

In 1990, the government introduced loans with fixed monthly repayments to supplement tax-financed grants that covered living costs.

Reform in 1998, following the Dearing Report (National Committee of Inquiry into Higher Education, 1997), introduced annual tuition fees of GBP 1,000 and loans with income-contingent repayments (i.e. repayments calculated as x percent of the borrower's subsequent income, collected alongside income tax) to cover living costs but not fees.

Reform in 2006 introduced variable fees of up to GBP 3,000 but, importantly, covered by a loan, so that nobody had to pay upfront charges (for assessments *ex ante* and *ex post*, see Barr 2004; 2010a).

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¹ Though the student loan system applies to the UK, the rest of higher education is organised separately in England, Scotland, Wales and Northern Ireland. This paper considers only the reforms in England.

Reforms in 2012 raise the maximum fee to GBP 9,000, make changes to the design of the student loan, withdraw most taxpayer support for teaching in the arts and humanities and the social sciences, and abolish Education Maintenance Allowances and AimHigher targeted at disadvantaged schoolchildren.

Higher education matters for the transmission of knowledge and skills, the promotion of core values and the pursuit of knowledge for its own sake. More recently, it has come to matter also for national economic competitiveness and for individual life chances. This article assesses the reforms in terms of three specific objectives: quality (higher), participation by different socioeconomic groups (wider) and size, i.e. the number of students in higher education (larger). The first two are widely accepted. The third is often overlooked. Size is relevant to the Lisbon objectives, in terms both of European competitiveness and social mobility. Implicit in these objectives are several value judgements: that higher education has intrinsic importance; that national economic performance matters; and that widening participation is important.

Economic theory and empirical evidence

*Lessons from economic theory*²

Lesson 1: Graduates should contribute to the cost of their degree. Higher education creates social benefits above those to the individual, including the transmission of values, social and political engagement and economic growth, justifying continuing taxpayer subsidies. That these are difficult to quantify does not invalidate the argument. But graduates also receive private benefits (Blundell et al. 2005), including higher average earnings and (often overlooked) more enjoyable jobs. It is therefore both efficient and equitable that the beneficiaries should bear some of the costs. However, students are credit constrained. Efficient consumption smoothing suggests that they should bear those costs when they can afford them, as graduates. This leads directly to the second set of lessons.

² For fuller discussion, see Barr 2004; 2012, Ch. 12.

Lesson 2: Well-designed student loans have core characteristics. Loans should have income-contingent repayments. The original argument was set out by Friedman (1955; on why loans rather than a graduate tax, see Barr 2010b), who noted that borrowing to finance investment in human capital, in contrast with a home loan, offers no physical collateral. Thus lenders charge a high risk premium, and borrowers also face considerable risk, leading to sub-optimal investment in human capital. Income-contingent repayments protect borrowers from excessive risk, and collection via the tax system reduces the risk to lenders of making an unsecured loan.

Additionally, loans should be large enough to cover fees and realistic living costs, thus addressing credit constraints and assisting access by making higher education free at the point of use.

A third feature is that loans should charge an interest rate related to the government's cost of borrowing. The UK, like some other countries, charges a zero real interest rate. Since that is less than it costs the government to borrow the money, loans include a blanket interest subsidy – in present value terms not even the best-off graduates repay their loan in full. With a loan like that in the UK, with (a) income-contingent repayments and (b) forgiveness of any balance unpaid after 25 years, interest subsidies are unambiguously badly designed.

Since the argument is central to assessment of the 2012 reforms it is worth amplifying. Firstly, the subsidy is expensive. In the UK, nearly one-third of all lending to students never comes back simply because of the interest subsidy. Secondly, because of the resulting fiscal cost, loans are too small, harming access. Thirdly, the subsidies crowd out university income, putting quality at risk and, more recently, leading to a cap on student numbers, hence a shortage of university places. Finally – and counterintuitively – the subsidies are regressive. Graduates with low monthly earnings are protected by income-contingent repayments, and those with low lifetime earnings by forgiveness after 25 years. Interest subsidies do not help high-earning graduates early in their careers: with income-contingent loans, monthly repayments depend only on earnings; interest rates affect only the duration of the loan. Thus the major beneficiaries are successful professionals in mid-career, whose loan repayments are switched off earlier because of the subsidy than would otherwise be the case. Shen and Ziderman (2009) give an interna-

tional perspective on the high cost and bad targeting of blanket interest subsidies

Lesson 3: Competition is beneficial. In most countries, higher education has been centrally planned. With the sharp increase in the range of subjects taught central planning is no longer feasible or desirable. The argument has its roots in the economics of information. Students (in contrast with school children or people with complex medical problems) are well-informed, or potentially well-informed, and hence better able than planners to make choices which conform with their interests and those of the economy. An important exception concerns people from poorer backgrounds, with implications, discussed below, for the design of policies to widen participation.

Lesson 4: Government has an important continuing role. The argument for competition does not negate a continuing role for government (Barr 2012, section 12.4.5). Government should provide continuing taxpayer support to higher education; ensure that there is a good loan system; adopt, encourage and mandate policies to widen participation; regulate the system, for example ensuring that there is effective quality assurance; set incentives by offering larger subsidies for subjects the government wishes to favour, and larger subsidies for some students; and redistribute within higher education.

Evidence on the determinants of participation

The evidence points to two central drivers of participation: credit constraints, and constraints with earlier roots (for fuller discussion, see Barr 2012, section 12.4.4).

The primary role of student loans is to address credit constraints. Though the UK has had income-contingent loans since 1998, discussion continues to conflate credit-card debt, which is unforgiving, with student loans, which are a payroll deduction (Table 1).

Constraints with earlier roots arise in several ways, largely manifesting themselves in poor school grades. In 2002, when students from poor backgrounds paid no fees, 81 percent of children from professional backgrounds in England went to university; the comparable figure for children from manual backgrounds was 15 percent (Education and Skills Select Committee, 2002, p. 19). However, about 90 percent of students with good high school gradu-

Table 1

Student loan repayments effective 2012

Annual earnings	£21,000	£25,000	£30,000	£50,000
Income tax (monthly)	£215	£282	£365	£824
National Insurance contributions (monthly)	£134	£174	£224	£361
Loan repayments (monthly)	£0	£30	£87.50	£217.50

Note: the deductions for income tax and national insurance are calculated from the tax schedules for 2012-13, see <http://www.uktaxcalculators.co.uk/>.

Loan repayments are calculated from the loan repayment formula (9% of income above £21,000 per year).

ation grades went to university, irrespective of their background. In other words, controlling for attainment, the socioeconomic gradient in participation largely disappears (for fuller discussion, see Chowdry et al. 2010).

Many commentators argue that ‘debt aversion’ harms access, but studies are frequently flawed because they fail to control for attainment, and thus wrongly attribute to the credit constraint problems that have their roots in the attainment constraint.

The resulting strategy

Economic theory and empirical evidence point to a strategy with three parts:

- Element 1: quality and size: universities should be financed from taxation (lesson 1) and tuition fees (lessons 1 and 3). Fees give institutions more resources and, through competition, combined with quality assurance, help to improve the efficiency with which those resources are used. However, students generally cannot afford these costs, hence:
- Element 2: loans to address credit constraints: loans with income-contingent repayments should make higher education free at the point of use (lesson 2), addressing problems of participation for well-informed students with good school attainment.
- Element 3: policies to address constraints on participation that have earlier roots, notably lack of attainment, imperfect information and low aspirations.

To achieve multiple objectives, policy needs multiple instruments. Tuition fees *combined with* policies to address credit constraints and earlier constraints on participation address all three of quality, access and size. To economists, these elements are totally familiar: higher fees move people back up their demand curve; the pro-access policies shift the demand curve of people from disadvantaged backgrounds outwards.

The 2006 reforms

The strategy

The 2006 reforms were based explicitly on the three-part strategy just outlined.³

Fees. Instead of the previous fixed tuition charge of GBP 1,000, universities could choose what fee to charge up to GBP 3,000 per year.

Loans. The 1998 system provided an income-contingent loan to cover living costs, but with no loan to cover fees. The 2006 reforms introduced a loan to cover fees. Loans for fees and living costs charged an interest rate equal to the rate of inflation, so the system incorporated an interest subsidy for all graduates.⁴ Any loan that remains unpaid after 25 years is forgiven.

Policies to widen participation. The 2006 reforms restored tax-financed grants, required universities that charged GBP 3,000 to provide students from poor backgrounds with financial assistance, and established an Office for Fair Access.

Crucially, other reforms tackled inequalities earlier in the system.

- Policies targeting early childhood included Sure-Start, which provided child care and training for mothers on low incomes; a National Child Care Strategy made affordable child care more available; and nursery school and pre-school places were increased.
- Increased emphasis on basic skills included a Literacy Hour and Numeracy Hour.

³ Barr (2004). In a comprehensive OECD study, Santiago et al. (2008) reach the same conclusion.

⁴ The arguments against blanket interest subsidies were understood and accepted by government. The decision to retain interest subsidies was based on the political calculation that otherwise the proposal would be rejected. This reading was correct: in the key Parliamentary vote, at a time when the Blair government had a majority of 160, the Bill passed by 5 votes.

- Education Maintenance Allowances provided financial support for students from poor families from age 16 to encourage them to stay at school.
- AimHigher sought to improve the information of schoolchildren and to raise aspirations.

Outcomes

Notwithstanding widespread misgivings, the 2006 reforms had beneficial effects. Tuition fees brought in significant additional resources, and the trend in applications continued upwards. Participation improved sharply: the conclusions of a study by the Higher Education Funding Council for England (2010) are worth quoting at length.

“... there is no indication ... that changes to HE [higher education] tuition fees or student support arrangements have been associated with material reductions in the overall HE participation rate” (para. 23).

“Substantial, sustained and materially significant participation increases for the most disadvantaged areas across the 04:05 to 09:10 cohorts are found regardless of whether educational, occupational or income disadvantage is considered. Typically, young people from the 09:10 cohort living in the most disadvantaged areas are around +30 percent more likely to enter higher education than they were five years previously (04:05 cohort)” (para. 28, emphasis added).

“Trends in social statistics – such as HE participation rates – that are associated with deeply rooted differences in advantage do not usually show rapid change. A set of robustness and credibility checks give confidence that the analysis in this report is faithfully describing HE participation trends. In particular, the unusually rapid increases in HE participation recorded since the mid-2000s for young people living in disadvantaged areas are supported by changes in the GCSE attainment [public exams at around age 16] of the matching cohorts of young people” (para. 31, emphasis added).

Unfinished business

Though a major advance, the 2006 reforms left unfinished business.

On fees, the stress point was the cap of GBP 3,000. Almost all universities charged the maximum, so there was little price competition, muting competitive incentives to quality.

On loans, the stress point was the costly and regressive interest subsidy. Though not evident in 2006, the major distortion was a cap on total student numbers which came about when the fiscal cost of loans collided with the economic crisis. In 2010, about 210,000 students – 30 percent of total applicants – were unable to find a university place.

The Browne Review (Independent Review of Higher Education Funding and Student Finance 2010) was set up with cross-party political support to address these issues.

The 2012 reforms

The Browne review and government's response

According to a leader in *The Guardian* (13 October 2010, p. 32), “The scheme devised by Lord Browne is in many ways a development of (and a vindication of) Labour's existing tuition fee system ...”.⁵

The Browne review was a genuine strategy designed to address the shortage of university places (Barr 2010c). However, the government cherry picked the Browne recommendations, so that the result is no longer a coherent strategy.

The government's response came in two parts, an announcement in November 2010 and a later White Paper (Department for Business Innovation and Skills (2011a; b).

Fees. The reforms followed Browne in abolishing taxpayer support for teaching in the arts and humanities and the social sciences. Partly as a result, the fees cap was raised to GBP 9,000.

Loans. The reforms introduce a real interest rate, in most cases 2.2 percent, broadly the government's long-run cost of borrowing. Nevertheless, loans continue to be expensive for two reasons discussed below: the level of income at which graduates start to repay is too high; in addition, universities had an incentive to charge GBP 9,000, since the costs of unrepaid loans falls not on the university but on taxpayers. A major purpose of the White Paper was to counter-act that effect by strengthening competition within a student numbers constraint. Because of the cost of loans, constraints on student numbers remain, with adverse effects also for quality and access.

⁵ www.guardian.co.uk/commentisfree/2010/oct/13/lib-dems-university-fees-cable.

Participation. As discussed below, action to widen participation was negative.

The rest of this section evaluates the resulting system (for fuller discussion, see Barr 2011a; b). The good elements are the increase in the fees cap; the increase in the interest rate on loans; improving information for prospective students; and improved support for part-time study. The bad elements are the withdrawal of taxpayer support for teaching; the large increase in the loan repayment threshold, leading to the cap on student numbers; and the retrograde steps in policies to widen participation.

Progress

Raising the fees cap. From 2012, universities can charge up to GBP 9,000. Two questions arise: should there be a fees cap; and, if so, is it right to increase it?

The case for variable fees is that they (a) bring in additional resources and (b), in combination with robust quality assurance, strengthen competitive incentives to use those resources efficiently. The argument for some form of regulation of fees is that though universities compete in terms of teaching, some are also selling access to the student's network of peers. Thus they are selling a positional good, giving them an element of monopoly power which, it can be argued, partly explains the very high fees at some US universities.

Why, then, is it right to increase fees? The cap of GBP 3,000 was too low: it brought in additional resources but not enough, and produced no variation in price, muting competitive incentives. However, the increase is too large. First, abolishing taxpayer support for teaching in most subjects is mistaken; as argued below, positive taxpayer support could be accompanied by a lower fees cap. Secondly, change should avoid large shocks, allowing people time to adjust their expectations and plans, particularly for long-term policies like student loans and pensions.

Raising the interest rate on student loans. From 2012, the default real interest rate on student loans will be 2.2 percent, broadly the government's cost of borrowing over the long run, structured as follows.

- During student days: a real interest rate of three percent;
- Graduates with total income below GBP 21,000 per year: a zero real interest rate;

- Graduates with total income between GBP 21,000 and GBP 42,000 per year: 2.2 percent rising gradually to three percent;
- Graduates with incomes above GBP 42,000: three percent.

The new structure has a series of desirable characteristics. By reducing the fiscal cost of loans, it is an essential element in relaxing the constraint on student number. Moreover, graduates with annual incomes above GBP 42,000 pay slightly above the government's cost of borrowing and hence repay slightly more than they borrowed, partly covering part of the loss on low-earning graduates. The loan thus incorporates a social insurance element.⁶

More and better information for prospective students. The government broadly followed the Browne recommendations. Quality assurance is necessary (a) where consumers are not sufficiently well-informed to provide their own quality assurance, particularly (b) where the cost of mistaken choice is high. Thus, where consumers can understand the information, a natural approach is to make information readily available.

A bright 16-year-old will ask questions like 'will it be fun?', 'will I be well taught?' and 'will I get a good job?'. In the reforms, an important part of quality assurance is mandatory publication of information that addresses those questions, e.g. data such as evaluation by students and others of teaching quality; surveys of the student experience more broadly; and next destination statistics – a market test of employers' views of quality. The various data should have common definitions, and should be audited.

Information also has a matching purpose. Over time the demand for skills has increased, as has the diversity of skills; in addition labour-market relations have become more fluid. Given diversity of objectives, degree subjects, academic approaches, modes of study, financial constraints and labour-market constraints, information has a key role in matching students and courses.

Improved support for part-time study. The reforms make fees loans available to students studying at least 25 percent of full time. Widening part-time options is another element in matching, and also

⁶ For fuller discussion of combining student loans with social insurance, see Barr (2010d).

assists participation by offering students a low-cost experiment. Someone who is uncertain might not take the risk of full-time study. The option to dip one's toe in the water (evening or online study) assists participation.

Regress

Abolishing taxpayer support for teaching. The reforms follow Browne in largely replacing taxpayer support for teaching (known as the T grant) by a larger loan entitlement.

The policy is mistaken because it ignores the external benefits of higher education. Without a subsidy, demand will be below its efficient level: if universities increase fees by the full amount of lost subsidy, too few students will apply; if universities do not increase fees to cover lost subsidy, the risk is an inefficient reduction in quality.

A major driver for this policy is that replacing T grant by loans reduces the budget deficit as measured by the Public Sector Borrowing Requirement (PSBR). Suppose that it is estimated that 30 percent of lending is not repaid. If total lending is GBP four billion, GBP 2.8 billion, the part that will be repaid, is excluded. Only the estimated non-repayment of GBP 1.2 billion is included in the PSBR.

Thus replacing T grant of GBP 4,000 per student by a loan has the following effect.

- A million students each attracting a T grant of GBP 4,000 increases PSBR by GBP four billion.
- A loan of GBP 4,000 for a million students increases PSBR by GBP 1.2 billion.

Thus replacing T grant by a loan entitlement reduces PSBR by GBP 2.8 billion. The main motive for replacing T grant by loans is an accounting trick. There is an apparent decline in public spending, but at the cost of distorting higher education policy.

Raising the threshold at which loan repayments start. The government followed the recommendation of the Browne Review that the formula for loan repayments should be changed. Under the 2006 arrangements, graduates repay nine percent of income above GBP 15,000 per year. Under the reforms, the repayment threshold is increased to GBP 21,000 and is indexed to earnings. Any loan balance that remains outstanding after 30 years will be forgiven.

The higher threshold has profound ill-effects. The change is expensive because it reduces monthly repayments by GBP 540 per year (i.e. nine percent of GBP 6,000). That is true for someone earning GBP 21,000; it is also true for someone earning GBP 121,000. With lower monthly repayments, more graduates will not repay fully within 30 years. Thus the higher threshold leads directly to the cap on student numbers.

Amplifying costs, the higher threshold creates an upward bias in fees. The cost of non-repayment by graduates of a small local university do not fall on the university but on taxpayers, giving all universities an incentive to charge higher fees. Thus the average fees that universities announced were higher than the government had assumed, an outcome that was both predictable and predicted.⁷ The White Paper (Department for Business Innovation and Skills 2011b) is an attempt, within a numbers cap, to exert downward pressure on fees (for a critique, see Barr 2011b).

As well as being costly, the higher repayment threshold also has distributional effects that are not as progressive as presented. Graduates earning below GBP 21,000 (presumably the intended beneficiaries) benefit least; and anyone earning GBP 15,000 or less does not benefit at all. In addition, the resulting restriction in student numbers particularly harms students from disadvantaged backgrounds. Thus the policy is badly-targeted: the focus of political discussion was on the cohort of graduates, ignoring the policy's wider distributional effects.

The main reason for the policy was to give political cover to the Liberal Democrats. The reality is that increasing the repayment threshold (a) gives least benefit to low earners, (b) is expensive, and hence (c) leads to restriction of student numbers. Indexing the threshold to earnings locks in this regressive pattern.

Adverse effects on participation. Earlier discussion stressed the importance of prior attainment, and pointed to the improvements that followed the 2006 reforms. The 2012 changes are deeply retrograde.

The reforms abolish Education Maintenance Allowances and AimHigher and make cuts to

⁷ Barr and Shephard 2010, para. 22; Smith and Smith (2010) illustrate the point by considering a degree with GBP 9,000 fees targeted at old-age pensioners.

SureStart – the very policies which address problems of participation at their source. Whether or not there was a case for reforming those policies, abolition is a major error, and calls into question the commitment to widening participation.

A second problem, excessive focus on grants (i.e. non-repayable support to university students), to a significant extent targets resources at the wrong part of the problem. The error is not just an exercise in academic logic chopping. In failing to distinguish credit constraints and constraints with earlier roots, policy is based on the wrong diagnosis and therefore leads to the wrong prescription. It spends money on ‘free’ higher education rather than on addressing the constraints on participation that arise much earlier, and thus spends money on a policy that does not work. Beyond subsidies commensurate with external benefits, when did it make sense to subsidise a superior good?

Politicians talk loudly about widening participation. Their policy actions do not support their words.

Conclusion

In the 2006 system the interest subsidy makes loans fiscally expensive. The reforms rectify that problem, but loans continue to be fiscally expensive because of the large increase in the repayment threshold. Thus the new system creates the same problem – the cap on student numbers – for the same reason – the high cost of loans. As a result, there is substantial excess demand for places. Thus, “universities are not competing for students [...]. Instead, students are competing for places”.⁸

In sum, the reforms are (a) expensive, (b) restrict student numbers and (c) weaken the policies that widen participation. They will not stand the test of time. When the time comes, I am happy to volunteer an article on the 2016 White Paper, in which the resources currently spent on a fiscally incontinent loan system should be diverted to restoring some taxpayer support for teaching, adjusting the design of the loan system so as to relax the constraint on student numbers, and strengthening policies to widen participation.

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⁸ Economist, 4 February 2012, <http://www.economist.com/node/21546003/print>.

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