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The Higher Education White Paper: The Good, the Bad, the Unspeakable – and the Next White Paper[1]

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Abstract

This article argues that reforms of higher education finance for undergraduates in England introduced by the Blair government in 2006 provided a progressive strategy for achieving the central objectives of higher education of quality (better), access (wider) and size (larger). Reforms in 2012 are a not a strategy but a collection of ad hoc arrangements. They include the good (a higher fees cap, a higher interest rate on student loans, better information and improved support for part-time study), the bad (abolishing most taxpayer support for teaching in the arts and humanities and the social sciences, and raising excessively the threshold at which loan repayments start) and the unspeakable (abolishing Education Maintenance Allowances and AimHigher). The reforms are fiscally costly and hence perpetuate the central problem of capped student numbers, and will not stand the test of time. The concluding section outlines the next White Paper.

Keywords

Higher education finance; Student loans; Income-contingent repayments; Interest subsidies; Debt aversion; Widening participation; Credit constraints; Prior-attainment constraint; Imperfect information; Debt aversion

Introduction

The system of student loans and tuition fees has been presented as a betrayal of progressive political promises and as a consequence of ideologically driven spending cuts. This article argues that well-designed reform of higher education finance is part of a profoundly progressive strategy. In contrast, policies based on simplistic ideas about how to widen participation betray the young, particularly from disadvantaged backgrounds.

Specifically, this article argues that the strategy of fees fully covered by income-contingent loans is the right one; that the 2006 reforms for undergraduates in England were a genuine strategy and a foundation on which to build; and that the 2012 reforms are a retrograde step, and will not be sustainable.

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After introductory discussion, successive sections discuss lessons from economic theory, evidence on the determinants of participation, and the resulting strategy, all of which underpin discussion of the 2006 reforms. Against that benchmark, the next section summarizes the recommendations of the 2010 Browne Review and the government's response, assesses the proposed changes and explains why they are unsustainable. The concluding section outlines what the next White Paper should say.

Thumbnail history

Higher education finance in England has seen considerable change.

In 1990, the government introduced mortgage-type loans to supplement maintenance grants (for assessment, see Barr 1989).

Reform in 1998, following the Dearing Report (National Committee of Inquiry into Higher Education 1997), introduced tuition fees of £1,000 per year, together with loans with income-contingent repayments (i.e. repayments calculated as *x* per cent of the borrower's subsequent income, collected alongside income tax) to cover living costs but not fees (for assessment, see Barr and Crawford 1998).

Reform in 2006 introduced variable tuition fees of up to £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).

Reforms in 2012 raise the fees cap to £9,000, make changes to the design of the loan system, abolish most taxpayer support for teaching in the arts and humanities and the social sciences, and abolish Education Maintenance Allowances and AimHigher.

Objectives

Higher education has multiple objectives.[2] It matters – and continues to matter – to transmit knowledge and skills, to promote core values including freedom and tolerance and to pursue knowledge for its own sake. More recently, with advancing technology, it has come to matter also for national economic performance and for individual life chances. Higher education finance is important not for its own sake, but because it is an essential ingredient in enabling universities to fulfil their roles.

The analysis in this article translates these purposes into three policy goals which underpin all the reforms listed above: improving quality, widening participation, and increasing the size of the sector. The first requires little discussion. The second, which is given added weight by the impact of higher education on life chances, is also widely agreed. The third is often overlooked. Size is important to ensure that Britain invests sufficiently in skills. Failure to do so risks being overtaken by South Korea.[3] Size also assists access: if there is a shortage of places, the most disadvantaged are at greatest risk of being crowded out. As discussed below, size is relevant also for quality. 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.

The twofold criticism of the 2012 reforms is simple: they will not achieve those objectives; and with the modifications described in the final section, they could do so.

Lessons from Economic Theory

The underpinning economic theory, set out more fully in Barr (2004; 2012: chs 3 and 12), is summarized here in terms of four propositions.

1. Who should pay? Graduates should contribute to the cost of their degree

Higher education creates social benefits beyond those to the individual – benefits in terms of growth, the transmission of values and shared culture, and the development of knowledge for its own sake, justifying continuing taxpayer support. However, graduates also receive private benefits (Blundell *et al.* 2005) – higher earnings on average, more satisfying jobs, greater enjoyment of leisure – making it efficient and fair that they bear some of the costs. However, people should bear those costs when they can afford them, as graduates, not when they are students, hence proposition 2.

2. How should they pay? Well-designed student loans have core characteristics

Loans should have income-contingent repayments.[4] They should be large enough to cover fees and realistic living costs, so that students face no upfront charges. Third, loans should charge an interest rate that covers the government's cost of borrowing. In the UK, the rate of interest on student loans has been the rate of inflation (i.e. a zero real interest rate). Since this is less than it costs the government to borrow the money, all graduates receive a subsidy. That subsidy has no merits and the following four vices (see also, Independent Review of Higher Education Funding and Student Finance 2010: 41).

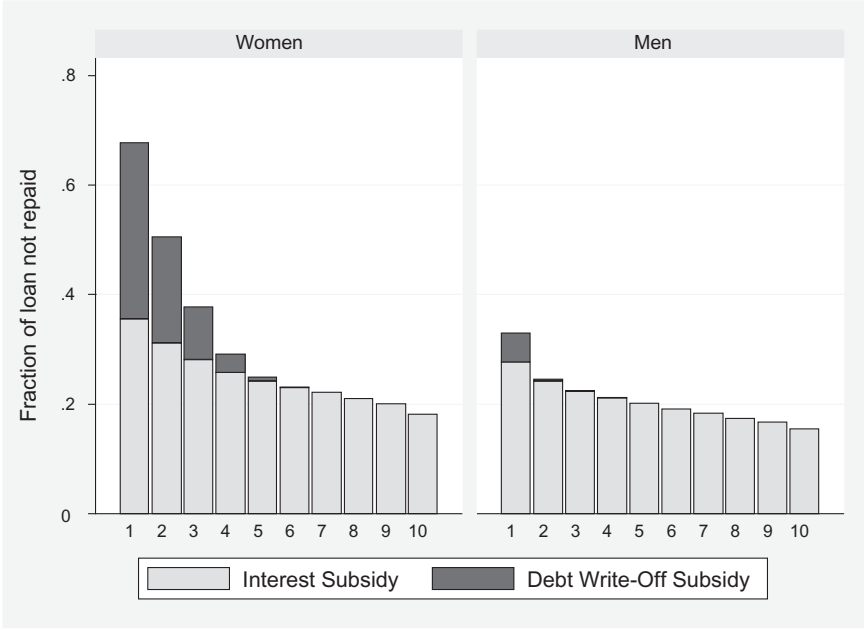
Cost. A well-designed loan system protects low earners in two ways. Income-contingent repayments protect graduates with low current earnings, and forgiveness of any outstanding loan after (say) 25 years, protects those with low lifetime earnings. The resulting losses are well-targeted social spending and a deliberate feature of the system. The interest subsidy is an additional cost, which is high for three reasons: because the subsidy applies to all borrowers, for the entire loan, for the entire duration of the loan; because the duration of the loan is long; and because students who do not need the money may borrow as much as they can and save the money, making a profit on the interest rate. These high costs lead to further ill effects.

Impediments to quality and size. Within a given budget, the interest subsidy crowds out finance for teaching and research, putting quality at risk. More dramatically, the cost of the interest subsidy is directly implicated in the current shortage of university places.

Impediments to access. Because loans are expensive, they are rationed. They may not cover tuition fees; they might cover only part of living costs; they may

Figure 1

Pre-2012: Subsidy as per cent of total loan, by decile of lifetime earnings



Source: Barr and Johnston (2012: figure 2) using data on salary paths from the Institute for Fiscal Studies.

exclude groups such as part-time and postgraduate students, and students in sub-degree tertiary education. The effects are worst for students from poor backgrounds, with less access to family support.

Interest subsidies are badly targeted. They do not help students (graduates make repayments, not students); and they help low-earning graduates only slightly, since they are protected by income-contingent repayments and, for graduates with low lifetime earnings, eventual forgiveness. In an income-contingent system, the only effect of a higher interest rate is to increase the duration of the loan, with no effect on monthly repayments. Consider a high earner who repays his or her loan in 10 years with the interest subsidy, rather than 12 years with a higher interest rate. The benefit from the interest subsidy occurs in years 11 and 12, when he or she no longer has to make repayments. Thus the major beneficiaries are successful professionals in mid-career. This is not the group the policy was intended to help.

The logic is borne out by empirical evidence. Figure 1 shows estimates of non-repayment by decile of the lifetime earnings distribution. Forgiveness after 25 years (the darker shading) accurately targets the lowest deciles. In

contrast, *given 25-year forgiveness*, the interest subsidy (the lighter shading), has all the disadvantages just discussed. The top decile receives an average subsidy of nearly 18 per cent of their total loan. Not even the best-off graduates repay their loan in full. These results are not idiosyncratic. The high cost and bad targeting of interest subsidies is shown internationally by Shen and Ziderman (2009).

3. How should quality be pursued? Competition in higher education is beneficial

The economics of information suggests that competition is useful where consumers are well-informed. Thus the quality of information and the ability of potential students to use it are central. The simple argument, however, needs qualification. Students from disadvantaged backgrounds are often not well-informed, with implications for widening participation discussed later. Second, the beneficial effects of competition require robust quality assurance. The argument is not that students are perfectly informed, but that in a system with considerable (and desirable) diversity of subject matter, the combination of competition and quality assurance will produce better outcomes than a central planning approach.[5] Third, and less well-understood, it is necessary to have sufficient university places – competition does little to promote quality in a shortage economy. Finally, to argue for competition is not to argue for an unconstrained market.

4. Government has an important and continuing role

The argument for competition does not negate a major role for government in at least six areas (Barr 2012: section 12.4.5). Government should provide taxpayer support for higher education. It should ensure that there is a good loan system. It should adopt, encourage and mandate policies to widen participation. It should regulate the system by ensuring that there is robust and effective quality assurance and through a fees cap (both discussed later). It should set incentives by offering larger subsidies for subjects it wishes to favour, and larger subsidies for some students. And it may redistribute within higher education.

The Determinants of Participation

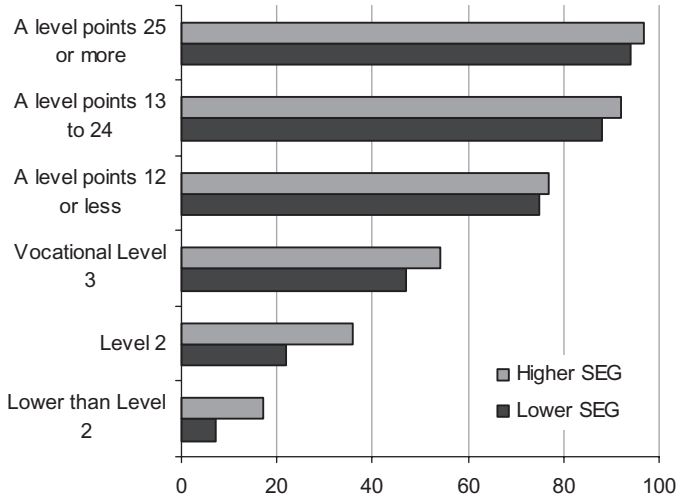
What I call 'pub economics' relates to something that is obviously right and everybody knows is right – but is wrong. The assertion that 'free' higher education widens participation is just such an argument. What hinders participation is not primarily price (i.e. fees), but a series of other constraints, in particular lack of prior attainment (i.e. factors with much earlier roots) and credit constraints. For most students (though not all) a good system of loans addresses the latter.

Prior attainment

One message stands out starkly from the evidence – *it's school attainment, stupid.* As a researcher into early child development tragically put it, 'By the time they

Figure 2

Who goes to university? Entry into higher education by age 21: by socio-economic group (SEG) and highest qualification at age 18, 2002, England and Wales



Source: Office for National Statistics (2004: figure 2.15).

are eighteen, all the damage has been done'.[6] Data for 2002 (when students from poor backgrounds paid no fees) are illustrative. In that year, 81 per cent of children from professional backgrounds in England went to university; the comparable figure for children from manual backgrounds was 15 per cent.[7] Controlling for attainment, however, the result is very different. As figure 2 shows, over 95 per cent of people with the best A levels went to university, with virtually no socio-economic gradient. For people with slightly less good A levels, the comparable figure was 90 per cent. The major driver of participation is a person's prior attainment, with little effect of socio-economic background; and research based on more refined data Chowdry *et al.* (2010a), suggests that the effect on which university a person goes to, though real, is limited. More recent data, discussed below, support these results.

Credit constraints and debt aversion

Students generally cannot afford to pay fees upfront. Loans are designed to address the resulting credit constraint. Though they do so effectively for most students, debt aversion (i.e. a failure of loans to address credit constraints) requires discussion.

Though the UK has had income-contingent loans since 1998, public discussion continues to conflate credit-card debt, which is unforgiving, with student loans, which are a payroll deduction (table 1). The failure of government to make this clear is a glaring omission.

Table 1

Student loan repayments from 2012

Annual earnings	£21,000	£25,000	£30,000	£50,000
Income tax (monthly)	£225	£292	£375	£834
National insurance contributions (monthly)	£137	£177	£227	£365
Loan repayments new (monthly)	£0	£30	£87.50	£217.50

Note: Assumes that the 2011–12 income tax and national insurance contribution rates remain the same in 2012–13.

It is argued that people from poor backgrounds are unwilling to borrow, so that fees impede access, even if covered by an income-contingent loan. Some people are, indeed, reluctant to borrow to finance their degree. But it is mistaken to argue that this is caused by a blanket phenomenon 'debt aversion'. People from poor backgrounds often have mortgages and credit-cards, so are not debt averse *per se*. Studies are flawed if they take inadequate account of at least three reasons why someone might be reluctant to borrow.

Lack of prior attainment. The flawed argument is that people from poor backgrounds do not go to university because they are debt averse; thus money to widen participation should be spent on grants. The argument that the evidence supports is that resources to widen participation should be spent mainly on raising achievement in school and preventing drop out. The error, in short, is to attribute to the credit constraint behaviour that is determined mainly by the attainment constraint.

Lack of information and low aspirations. Some people, especially those from disadvantaged backgrounds, are badly informed about higher education. If such students under-estimate the benefits of higher education and/or over-estimate the costs, it is rational, *given what they know*, to be unwilling to take out a loan.[8] The primary response is to improve information. The case for grants arises where that approach is insufficient. There is also a case for full scholarships during a student's first year, on the basis that after doing a year, he or she is likely to be well-informed, and hence prepared to take out a loan.

Risk aversion. A student may be risk averse from fear of the unknown or because he is uncertain about how well he will do at university and about the benefits from a degree, including employment outcomes. To that extent, risk aversion is more an information problem than a debt-aversion problem. Again, the primary responses are better information and wider part-time options to provide a low-cost experiment and, where those fail, to pay grants.

The right policies to widen participation

Why might someone with the ability and aptitude not go to university?

Cannot afford it. As discussed, loans are the main instrument for addressing credit constraints.

Failure to get to the starting gate. The main policies seek to improve attainment in school. Access fails when someone leaves school at 16, usually for reasons that started much earlier. A second set of policies should raise aspirations and improve information, including better advice of subject choice for GCSE and A levels – advice both for pupils and for teachers. A major purpose is to demystify university, to give schoolchildren sources of information that are authoritative (university teachers) and with street cred (student mentors). A third element is financial support, particularly to encourage people to stay on at school.

The importance of such policies is widely agreed:

> Without a more level playing field earlier on in life, it will be extremely difficult for children from poorer backgrounds to access higher education. Too many young people currently leave school at sixteen, barely considering A levels, let alone higher education. This situation can be changed if we reduce inequality, support schools and further education colleges in disadvantaged areas and restore the Educational Maintenance Allowance. (McKay and Rowlingson 2011: 110–11)

Problems at the starting gate. Further problems arise when someone gets good A levels, but (a) does not apply to university or (b) applies to a local university without even considering an elite institution. The roots of these problems include lack of information and risk aversion. Relevant policies include better information, grants, and easily-accessible options for part-time study.[9]

Falling at an early fence. A final set of problems concern students who drop out early. Relevant policies include resources for additional academic and pastoral support, particularly during the first year.

Note that grants are only a small part of the wide range of desirable policy interventions.

The Resulting Strategy

The analysis in the previous sections leads to a strategy with three parts:

- *element 1*: quality and size: universities should be financed from a mix of taxation (economic theory proposition 1) and tuition fees (propositions 1 and 3). Fees give institutions more resources and, through competition supported by quality assurance (proposition 4), help to improve the efficiency with which those resources are used. However, students generally cannot afford to pay fees or living costs, hence element 2;
- *element 2*: loans to address credit constraints: loans with income-contingent repayments should be large enough to make higher education free at the point of use (proposition 2). Such loans fix problems of participation for well-informed students with good school attainment. If the world comprised only such students, the strategy would end there;

- *element 3*: policies to address constraints with earlier roots, notably lack of attainment, imperfect information and low aspirations.

To achieve multiple objectives, policy needs multiple instruments. The specific argument is that tuition fees *combined with* policies to address credit constraints and earlier constraints on participation address all three of quality, access and size.[10] The error that pub economics makes is to consider tuition fees on their own without controlling for other relevant variables such as the availability of loans, prior attainment, etc.

Tuition fees alone (element 1) will reduce demand and harm participation; and tuition fees plus financial support (elements 1 and 2) address only some of the impediments to participation. A considerable literature (e.g. Dynarski 2002, 2003; Long with Riley 2007; Long 2010; Dearden *et al.* 2011) considers fees and financial support, and is sometimes wrongly interpreted as showing the ill-effects of fees. Its real importance is that it shows the effect of credit constraints, either because there is too little financial support and/or because complexity reduces its effectiveness. To the extent that lack of prior attainment, imperfect information and low aspirations are additional major constraints, it should not be surprising that evidence on the influence on participation of college aid *per se* is equivocal.

A more complete treatment needs to consider the full range of constraints. A major such project is currently in progress under a grant from the Nuffield Foundation.

Paradoxically, it is not only tuition fees that harm participation but also their absence. McKay and Rowlingson (2011: 110) cite Tilly's (1998) argument 'that groups with power try to retain the best opportunities for themselves in what he calls "opportunity hoarding" '. Tuition fees on their own do that, but so does tax finance beyond that commensurate with external benefits and addressing risk aversion rooted in imperfect information. There are at least three arguments. First, though tax finance on a sufficient scale can address credit constraints, it does nothing to address the other constraints. Tax-financed higher education, the system in Britain for over 40 years, produced the shameful participation figures already mentioned.

Second, over the past 25 years, higher education in almost all countries of the Organisation for Economic Co-operation and Development (OECD) has increasingly lost in the political competition for public resources. The resulting shortage of resources constrains size, and hence access, if student numbers are capped, and harms quality if they are not.

Third, tax finance has powerful redistributive effects. There is, of course, no such thing as 'free' higher education. Free is just another word for 'someone else pays', so the right question to ask is: Who pays? Part of the case for public finance of health care or compulsory school education is that everyone uses them. Higher education is different: participation is a matter of choice – and it is mainly people from better-off backgrounds who participate. Thus the taxes of poorer people, many of whom never even consider A levels,[11] pay for the degrees of people mainly from better-off backgrounds (for a cogent statement, see Wilby 2010).[12] Thus taxation (a) finances an activity consumed mainly by the better off, which (b) helps to maintain their position among the

better off, while (c) simultaneously harming access through a shortage of places and by crowding out activities that genuinely widen participation. A clearer example of opportunity hoarding would be hard to find.

The 2006 Reforms: A Platform on which to Build

The strategy

The 2006 reforms introduced by the Blair government were based explicitly on the three-part strategy outlined above.[13]

Fees. The previous tuition charge of £1,000 was replaced by one where universities could choose what fee to charge up to £3,000 per year, rising in line with price inflation.

Loans. The previous system provided a maintenance loan to cover living costs and, importantly, those loans had income-contingent repayments of 9 per cent of income above £10,000. However, there was no loan to cover fees, and the maintenance loan was too small. The 2006 reforms introduced a loan to cover fees, increased the maintenance loan, and raised the threshold at which repayments start to £15,000 per year. The loan charged an interest rate equal to the rate of inflation. Thus the system incorporated an interest subsidy for all graduates.[14] Any loan that remains unpaid after 25 years is forgiven.

Policies to widen participation. The 2006 reforms restored maintenance grants, required universities that charged £3,000 to provide students from poor backgrounds with a bursary of at least £300 and established an Office for Fair Access.

Crucially, reforms also 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 and pre-school places were increased;
- increased emphasis on basic skills included a Literacy Hour and Numeracy Hour;
- Education Maintenance Allowances (EMAs) targeted financial support on students from poor families from age 16 to encourage them to stay at school. Important symbolically, receipt of an EMA gave the student an automatic entitlement to a grant if he or she continued into higher education;
- AimHigher sought to improve the information of schoolchildren and to raise aspirations.

Outcomes

Despite widespread misgivings, outcomes were mainly beneficial. Tuition fees brought in significant additional resources and, as table 2 shows, applications continued to trend 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 per cent 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 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 £3,000. Universities competing with the best US institutions continued to find themselves financially outgunned; and since almost all universities charged the maximum, there was little price competition, so that there is room for improvement on the quality objective.

On loans, one piece of unfinished business was inadequate explanation of how the system worked. Another was the costly and regressive interest subsidy. Though not fully evident in 2006, the major resulting distortion was the cap on student numbers which arose when the fiscal cost of loans collided with the economic crisis. Table 2 shows that between 2009 and 2010, applications rose by 57,000 but places only by 5,000. As a result, 210,000 students

Table 2

Applicants and acceptances, 2005–10 (000)

	2005	2006	2007	2008	2009	2010
Applicants	522	506	534	589	640	697
Accepted applicants	405	391	413	457	482	487
Rejections	117	115	121	132	158	210
Year on year growth in applicants		−16	28	54	51	57
Year on year growth in places		−14	23	43	25	5

Source: UCAS (2011).

– 30 per cent of total applicants – were unable to find a place. As noted, excess demand has adverse effects not only on size, but also on access and quality.

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 and also, given its timetable, to get higher education finance off the agenda of the 2010 election.

The 2012 Reforms: The Good, the Bad and the Unspeakable

The Browne Review

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 . . .'.

In an early assessment (Barr 2010d), I argued that the Browne Review's recommendations had two great strengths: they were a genuine strategy, and they went a long way to eliminating the shortage of university places. I also warned against cherry picking.

The components. The Browne strategy can be thought of as having eight components:

- *component 1*: loans, as close as possible to fiscally neutral. The cost of finance was to be covered by a real interest rate, with targeted subsidies for low earners. The loss on graduates with low lifetime earnings was to be covered by a levy on fees above £6,000, the rate of levy rising with the size of the fee;
- *component 2*: a system of maintenance grants;
- *component 3*: self-financing teaching in most subjects by withdrawing taxpayer support for teaching (for brevity henceforth referred to by its popular name of T grant) in the arts and humanities and the social sciences, except for subjects which the government regards as a priority;
- *component 4*: relaxation of the constraints on student numbers in most subjects;
- *component 5*: a level playing field in terms of access to student loans for new institutions, including private providers;
- *component 6*: flexible prices. The proposal had no explicit fees cap. As well as covering the loss on loans, the levy on fees was intended also to create incentives to contain any excesses, i.e. a 'soft' cap;
- *component 7*: quality assurance, based largely on mandatory provision by universities of information relevant to prospective students, including on teaching quality and the destinations of each university's graduates;
- *component 8*: stronger action to widen participation earlier in the system, including improved advice at school on choice of subject and university.

The strategy. This is best evaluated against the objectives set out at the start of the article:

- *Size*: excess demand is eliminated by lifting numbers controls for most subjects, with new institutions facing the same terms as current ones (components 4 and 5). Critically, the fiscal cost of increased student numbers was to be kept low by making (a) loans and (b) most teaching self-financing (components 1 and 3).
- *Quality*: incentives to quality arise through eliminating excess demand, a level playing field for new entrants, and flexible prices (components 4, 5 and 6), and through robust quality assurance (component 7).
- *Access*: this is promoted through loans and grants (components 1 and 2) to address credit constraints, through action earlier in the system (component 8) to address constraints with earlier roots, and through better information about student loans (component 1).

Looking at the wider panorama of government policy, a strategy that finances a larger share of the costs of higher education from the earnings of graduates and transfers resources to spending at younger ages has the potential to be profoundly progressive.

Weaknesses. The strategy addressed the stress points of the 2006 reforms by abolishing the fees cap and by correcting the interest subsidy problem and, as a result, addressing the constraint on student numbers.

Two components, however, were badly designed. In component 1 (loans as close as possible to fiscally neutral), the levy on fees above £6,000 had entirely the right intention – to contain the fiscal cost of loans. However, the size of the levy was independent of the repayment performance of each university's graduates so that all universities faced an incentive to charge higher fees. A second problem is the level of income at which loan repayments start. Under the 2006 arrangements, repayments are 9 per cent of a graduate's income above £15,000 per year. The Browne report recommended that this threshold should be (a) raised to £21,000 and (b) indexed to average earnings, greatly increasing the fiscal cost of loans. Both problems are discussed further below.

Component 3 (self-financing teaching), again, has entirely the right idea – that an increase in student numbers should not have substantial fiscal costs. Again, however, the component is not well designed. Abolishing taxpayer support for teaching is mistaken because it ignores the external benefits of higher education.

The concluding section sets out better ways of designing these two components. Were those to be adopted, the Browne proposals would fly.

The government's response

Though these arguments were put to government (Barr and Shephard 2010), what happened was very different – a selective implementation of Browne coupled with devices designed to improve political presentation – a case study in cherry picking. 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, 2011b).

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 increased to £9,000. As discussed below, loans continue to be far from fiscally neutral for two reasons, negating component 1: the income threshold at which repayments start is too high; and universities had an incentive to charge £9,000, since the costs of unrepaid loans falls not on the university but on taxpayers. Because of the cost of loans, constraints on student numbers remain, negating component 4, and the resulting excess demand undermines the beneficial effects of competition on quality, largely negating component 7. Finally, action to widen participation (component 8) is negative.

Because of the incentive, just mentioned, most universities announced the intention to charge £9,000. To counteract this effect, a major purpose of the White Paper was to introduce stronger competition within a student numbers constraint by liberalizing in two ways. First, in 2012 it allowed universities to recruit as many students as they liked with A level grades (or equivalent) of AAB or better. To protect the cap on total student numbers, student allocations were reduced by 65,000, the estimated number of AAB students. Second, of the remaining student numbers, 20,000 were made available for bidding by institutions charging average fees (net of fee waivers) below £7,500.

The rest of this section evaluates the resulting system. 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 repayment threshold, leading to the cap on student numbers; and the likely effects of increased competition which the White Paper seeks to introduce in the face of capped student numbers. The unspeakable elements concern retrograde steps in policies to widen participation.

The good

Raising the fees cap. From 2012 universities can charge up to £9,000 in real terms. Two questions arise: whether there should be a fees cap at all; and, if so, why it is right to increase it.

Though the case for variable fees is strong, there are good reasons for establishing a maximum. In the short run, the cap needs to be high enough to bring in extra resources and, by strengthening competition, to improve the incentives to use those resources efficiently, but low enough to maintain long-term political support for the strategy and to allow institutions less used to competition time to develop the necessary management capacity.

There is also a longer-term argument. 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 high fees at US Ivy League universities. The resulting additional income is ploughed back into facilities, a distortionary upward bias in spending which, it can be argued, leads to quality which is inefficiently high.[15]

Why, then, is it right to increase fees? The cap of £3,000 was too low: it brought in useful additional resources, but not enough, and there was no

variation in price, muting competitive incentives. Thus there is a good case for raising the cap. However, the increase is too large. First, abolishing taxpayer support for teaching in most subjects is mistaken; as argued below, a positive T grant could be accompanied by a lower fees cap. Second, change should avoid large shocks, allowing people time to adjust their expectations and plans. Such arguments are particularly important for long-term policies like student loans and pensions.

Raising the interest rate on student loans. From 2012, the interest rate on student loans will be built round a real interest rate of 2.2 per cent (i.e. 2.2 per cent above the rate of inflation), broadly the government's cost of borrowing over the long run, structured as follows:

- during student days: a real interest rate of 3 per cent;
- graduates with total income below £21,000 per year: a zero real interest rate;
- graduates with total income between £21,000 and £42,000 per year: 2.2 per cent rising gradually to 3 per cent;
- graduates with incomes above £42,000: 3 per cent.

The new structure has desirable characteristics. It directly addresses the problems of blanket interest subsidies; in particular, by reducing the fiscal cost of loans, it is an essential component in relaxing the constraint on student numbers. Second, it avoids the mistake of a grace period (i.e. no interest charge during student days). Though a grace period sounds intuitively like good policy, it means that *no* graduates, not even the highest earners, repay their loan in full and is very expensive (Shen and Ziderman 2009). Third, the new structure has a progressive element. Graduates with incomes above £42,000 per year 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.[16]

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. One way to assess quality is through inspection. Those who lived through the QAA arrangements of the late 1990s need no reminder of the ills of that approach.

An alternative approach is through well-informed consumers. A bright 16-year-old will ask questions like 'Will it be interesting?', 'Will I be well taught?' and 'Will I get a good job'. These are good questions, and an important part of quality assurance is mandatory publication of information that addresses them, 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. That some of these variables are hard to measure is not an argument against the

approach. The various data should have common definitions,[17] and should be audited.

Alongside mandatory publication of relevant data, this approach also involves self-evaluation by institutions, using criteria agreed with the quality assurance agency, and concentrated assistance for institutions with significant quality problems.

Information is important also for matching students and courses. Because of technological advance, there is greater demand for skills, for more diverse skills, and for retraining, since knowledge goes out of date more quickly than previously. Separately, in times past long-term, full-time employment, often with the same employer, was the norm. Today labour market relations are more fluid, with portfolio careers embracing full-time work, part-time work, self-employment, etc. Given diversity of individual objectives, degree subjects, academic approach, modes of study, financial constraints and labour-market constraints, information has a key role in matching.

Improved support for part-time study. Callender (2011) rightly criticizes the 2006 arrangements. The 2012 reforms make fees loans available to students studying at least 25 per cent of full time. Wider options for part-time study are another element in improving matching. They also assist participation by offering a low-cost experiment. Someone who is uncertain about whether he or she could cope with university and/or would enjoy it, might not take the risk of full-time study. The easier it is to dip one's toe in the water the greater the assistance to participation, through evening study locally and/or online. Either option allows the student to stay in his or her home and job.

The bad

Abolishing taxpayer support for teaching. The reforms follow Browne in largely replacing T grant by a larger loan entitlement. This policy is mistaken because it ignores the external benefits of higher education.

When deciding whether or not to go to university people generally consider only their private benefit. Without a subsidy, price will be too high, hence demand below its efficient level, leading to either or both of two outcomes: if universities increase fees by the full amount of the withdrawn subsidy, the risk is that too few students will apply; if universities do not increase fees to cover the lost subsidy, the risk is an inefficient reduction in quality.[18]

Why was this policy adopted? A major reason is that replacing T grant by loans reduces the standard measure of the budget deficit, the Public Sector Borrowing Requirement (PSBR). To understand why, it is necessary (unfortunately) to understand how student loans enter the public accounts. Suppose that 30 per cent of lending to students will not be repaid. If total lending is £4 billion per year, the 70 per cent that will be repaid, i.e. £2.8 billion, is not included in the PSBR. Only the estimated non-repayment, £1.2 billion, is included – the Resource Accounting Budget (RAB) adjustment.

Illustrating with a simple example, replacing T grant of £4,000 per student by a loan has the following effect:

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

Thus in the simplest case, replacing T grant by an equal increase in loan entitlement reduces PSBR by £2.8 billion.

Bluntly, 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, with ill-effects, as discussed, on quality and/or size. Moreover, even in its own terms, the reduction in public spending is likely to be an over-estimate. Thompson and Bekhradnia (2011) (see also, Chowdry *et al.* 2010b) conclude that 'the full-time student loan RAB values are both uncertain and optimistic . . .' (Thompson and Bekhradnia 2011: 6). Thus the changes look like a dodgy Public Finance Initiative:[19] with optimistic assumptions, the numbers look good in the short run but are likely to have a high-long run cost.

Raising the threshold at which loan repayments start. The reforms propose that the threshold should be increased from £15,000 to £21,000 *and* indexed to earnings. Thus repayments are 9 per cent of income above £21,000. The reforms also propose that any loan that has not been repaid after 30 years (rather than 25 currently) should be forgiven.

The higher threshold has profound ill-effects. The change is expensive because it reduces monthly repayments by £540 per year (i.e. 9 per cent of £6,000). That is true for someone earning £21,000; it is also true for someone earning £121,000. And, with lower monthly repayments, more graduates will not repay fully within 30 years. Thus the higher threshold leads directly to the numbers cap.

Second, and adding further to costs, the higher threshold creates an upward bias in fees. Graduates of Balls Pond Road University tend to be at the lower end of the graduate earnings spectrum, those of Oxbridge at the higher end. The cost of non-repayment by Balls Pond Road University's graduates falls not on the university but on taxpayers generally. Thus all universities have an incentive to charge higher fees. The fact that the average fee is higher than the government expected was both predictable and predicted.[20]

Third, distributional effects are not as progressive as presented. Graduates earning below £21,000 (presumably the intended beneficiaries) benefit least; and anyone earning £15,000 or less does not benefit at all. In addition, the cost of the policy leads to the restriction in student numbers shown in table 2, particularly harming students from disadvantaged backgrounds. Thus the policy is badly-targeted: the focus of political discussion was on the cohort of graduates, ignoring the effects on those thereby excluded from higher education.

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 the 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.

The White Paper mechanism to increase competition. As noted, the White Paper aims to improve quality by promoting competition, initially by allowing free recruitment of students with AAB grades at A level, but with the total quota for all universities reduced by 65,000; in addition, a quota of 20,000 students is available for bids by universities charging an average net fee below £7,500. The impact on quality, though in principle beneficial, is compromised by the cap on student numbers. If student numbers are fixed:

- admissions are a zero-sum game: if some universities expand others must contract;
- if the number of institutions increases (e.g. because of new entrants), the average size of each must fall.

In assessing the potential effects, it is useful to distinguish three types of institution, which the *Financial Times* calls 'the new elite', 'the squeezed middle' and 'the insurgents'.[21]

The new elite (henceforth group A) universities accept mainly AAB students. For the group as a whole, expansion is by bidding AAB students away from the squeezed middle and/or by converting places for non-EU students into EU places.[22] The effects on quality should not be overstated. Any increase in domestic competition is dominated by the international competition those institutions have faced for many years. To imagine otherwise is to argue that those universities teach well enough to attract foreign students, but need domestic competition to encourage them to teach UK students well.

The squeezed middle (henceforth group B): for the group as a whole, student numbers are reduced by the size of the margin and, because they charge more than £7,500, those universities cannot bid for extra students. Quality is at risk for two reasons: universities in this group lose money because they lose quota; and they risk losing their best (AAB) students to group A. The worry is that over time, these effects will 'hollow out' institutions at the core of English higher education, putting at risk the export performance of the sector. Note that it is not the AAB mechanism *per se*, but the cap on student numbers that raises concerns about the squeezed middle.

The insurgents (henceforth group C), comprising new providers, further education colleges and access universities, have an average net fee of less than £7,500. The group as a whole can expand by bidding for students from the 20,000 margin on the basis of price and quality. However, within that higher numbers total, if new providers and further education expand, access universities face contractionary pressures.[23] Places are allocated by the Higher Education Funding Council for England (HEFCE).

There are at least three potential impacts on quality:

- the arrangements create inefficient segmentation. In the extreme, the system will move towards what has been called 'soft binarism';[24]
- competition with student numbers capped is more likely to reduce price than to raise quality;
- the need for HEFCE to allocate places on the basis of bids, far from releasing competitive incentives, is one of a shortage of places with inten-

sified central planning (a point which Thompson and Bekhradnia 2011 emphasize). Even a rudimentary knowledge of the communist experience suggests scepticism.

There are also potential effects on access. Universities face incentives to bring down their average net fee either directly or through fee waivers. To the extent that the main barriers to access occur earlier in the system, fee waivers do little to widen participation. The most powerful policies are earlier intervention and more university places, on which the White Paper does nothing.

There are also concerns about fair access (i.e. the ability of disadvantaged students to get to an elite university), because the AAB metric militates against the use of contextual data in assessing applications (e.g. the fraction of pupils at an applicant's school achieving five good GCSE passes).

Starting to relax the numbers constraint for some institutions puts the issue on the agenda of university managements and, to that extent, is helpful. But the main benefits of the mechanism require that it operates in an environment with less tight control of student numbers, a point taken up in the concluding section.

In the present context, though presented as creating incentives to quality, the White Paper mechanism is mainly a device to contain public spending by bearing down on fee levels. Once more, the faulty design of loans distorts policy.

The unspeakable

Politicians talk loudly about widening participation, but their actions are consistent with pub economics rather than the evidence. Two problem areas stand out.

Abolishing Education Maintenance Allowances and AimHigher and implementing cuts to SureStart – the policies which directly address problems of participation at their source – is the most egregious error. Whether or not there was a case for reforming these policies, abolition was a huge mistake. Doing so at about the same time as finding £100 million to reinstate weekly rubbish collection[25] calls into question the commitment to widening participation.

Excessive focus on grants and bursaries 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.

Conclusion: The Next White Paper

Where things stand now

Relative to the 2006 reforms, the 2012 changes take policy backwards. High fees expose the problems that arise if the loan system is leaky. Leaky loans lead

to rationing of places, which is bad for the economy and bears particularly on students from disadvantaged backgrounds.

The root problem: the cost of loans

Barr and Johnston (2012) estimate that the higher interest rate and higher repayment threshold together increase the loss for the average graduate slightly from 25.8 to 27.7 per cent of total lending. However, the absolute loss per graduate rises from about £6,800 under the current system to over £11,000 (Barr and Johnston 2012). That increase has two mutually reinforcing causes. First, the size of loans has increased to reflect the increase in the fees cap; part of the latter increase would (and should) have happened anyway, but the increase is larger because of the abolition of taxpayer support for teaching. Second, losses rise disproportionately with the size of the average loan, i.e. the loss is larger if loans rise from £35,000 to £40,000 than from £25,000 to £30,000.[26] The cost of loans distorts policy in the following ways.

Size. This is constrained directly by the need to contain costs. The constraint is bad in itself, and causes collateral damage both to access and quality.

Access. The cap on student numbers is most likely to harm students from disadvantaged backgrounds. In addition, some expensive policies are largely political window dressing: grants are targeted on those who make the starting gate, many of whom would have gone to university anyway (i.e. deadweight costs); fee waivers do little for participation, and, if awarded once a student has started university are almost wholly a deadweight cost. Third, saving money by abolishing EMAs and AimHigher is deeply retrograde. Finally, there are virtually no loans for postgraduate students or students in sub-degree tertiary education.

Quality. This is affected adversely in at least two ways. The abolition of T grant is a net reduction in resources going to universities. That assertion would be false only if all universities were able to charge fees that entirely offset the decline in T grant. That would be true only if fees had no bearing on the demand for places at any university, i.e. if the demand curve facing each university is vertical. That view, however, is (a) implausible and (b) logically incompatible with the emphasis on fee waivers and grants.

Second, the cap on student numbers mutes the effects of competition on quality. The White Paper's attempt to introduce competition within the numbers cap affects quality through 'soft binarism', through downward pressure on price and through more interventionist central planning.

What should be done now?

At a minimum, the repayment threshold for loan repayments should remain constant in nominal terms for the time being. Beyond that, the current position is not sustainable. Another White Paper will be necessary in a few years. Its elements are outlined below.

Taxpayer support for teaching

Restoring some T grant should be a priority. The simple way to do so is at a level between zero and the current level but awarded as a block grant[27] to each university so as to control public spending.

A more sophisticated approach (Barr and Shephard 2010: paras 6–19) proposes a tapered T grant, awarded as block grant, such that universities charging a low fee receive the maximum T grant and universities charging high fees receive little or no grant, with a taper for intermediate fee levels. In addition, there should be a premium for each disadvantaged student, independent of university. In the resulting system, Oxbridge, charging £9,000, gets no T grant, but receives a premium for each disadvantaged student (the minority of students at Oxbridge). Balls Pond Road University, charging a low fee, receives the maximum T grant plus a premium for each of its many disadvantaged students.

Relaxing the constraints on student numbers

Barr and Shephard (2010: paras 20–29) outline two ways of improving the loan system.

First, reduce losses by reducing the repayment threshold. Most graduates should repay their loan, but with protection for graduates with low lifetime earnings.

Second, shift the remaining losses away from the taxpayer, sharing the cost between:

- the national cohort of graduates, by charging an interest rate, say, 1 per cent above the government's cost of borrowing, thus extending the duration of repayments (see Barr 2010c). This cohort risk premium would be designed to cover the loss on fees of up to (say) £7,500;
- the university: thus, for example, if Oxbridge charges fees of £9,000, the Student Loans Company would pay Oxbridge a fee £(9,000 – X), where £X is an insurance premium based on an estimate of non-repayment by Oxbridge graduates on their loans to cover fees above £7,500.

Pulling the elements together, abolishing T grant reduces demand. It also leads to a restriction of supply since the size of loans and their design makes the marginal cost of expansion high, leading to the cap on student numbers. Thus the case the government has to answer is that the 2012 reforms restrict both demand and supply. In contrast, T grant as block grant (a) increases demand at the margin *and* (b) reduces the marginal taxpayer cost of expansion, since the fees cap could be lower, hence loans smaller.

By reducing the taxpayer cost of expansion, the combined effect of T grant as block grant and improved loan design makes it possible to ease the numbers constraint. The resulting benefits are threefold: the size of the sector can increase; such expansion assists access; and the quality gains from competition are enhanced. In addition, if the fiscal costs of loans are lower, it becomes both possible and desirable to extend loans to postgraduate students and students in sub-degree tertiary education.

Policies to widen participation

The determinants of participation are increasingly well-understood. Action should include policies to foster early child development, to raise attainment in school, to increase information and raise aspirations, and to target resources accurately. Thus SureStart, action on literacy and numeracy, Aim-Higher and Education Maintenance Allowances or successor policies should be restored and strengthened.

In sum

The interest subsidy in the 2006 system makes loans fiscally expensive. The 2012 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. Numbers are capped at a level such that there is substantial excess demand for places. Thus, 'universities are not competing for students . . . Instead, students are competing for places'.[28]

The resources currently spent on a fiscally incontinent loan system should be diverted to (a) restoring some T grant as block grant, (b) adjusting loan design in order to relax the constraint on student numbers, and (c) strengthening policies to widen participation. The resulting policies combine to address the core objectives. The 2012 reforms do not.

Notes

1. This article draws on my 15-year partnership with the late Iain Crawford and to many conversations with Howard Glennerster. More recently, I am grateful to Alison Johnston and Neil Shephard for wide-ranging discussions when writing together, and to Andrew McGettigan, Robin Naylor, Neil Shephard, the editor and two anonymous referees for helpful comments on an earlier version. None is implicated in the views expressed or remaining errors.
2. See Collini (2012) for wide-ranging discussion and a critique of current policies.
3. Clearly the quality of the investment matters – see Wolf (2004).
4. The core difference between borrowing to finance a degree and borrowing to buy a house is that in the former case there is no physical collateral. For fuller discussion, see Barr 2012: ch. 12. The original argument was set out by Friedman 1955. On why loans rather than a graduate tax, see Barr 2010b.
5. Though only indicative evidence, most of the top 100 universities in world rankings are in competitive systems.
6. Leon Feinstein at a conference. See also Feinstein (2003).
7. Education and Skills Select Committee (2002: 19).
8. See Usher (2006) for a Canadian study.
9. See Stange 2012 on the value to students of being able to make decisions step by step in response to new information.
10. In terms of economic theory these elements are very familiar: higher fees move people back up their demand curve; the pro-access policies shift the demand curve of people from disadvantaged backgrounds outwards.
11. Sixty-eight per cent of 19-year olds applying to university in 2011 had parents with a degree, compared with 28 per cent for those with parents educated below A Level (Department for Education, 2011: chart 2.1.2).

12. In economic terms, higher education is a superior good. Beyond subsidies commensurate with external benefits, when did it make sense to subsidize a superior good?
13. For fuller discussion, see Barr (2004). For a comprehensive OECD study which reaches the same conclusion, see Santiago *et al.* 2008.
14. It was accepted in late 2003 that it would be reasonable to charge an interest rate related to the government's cost of borrowing. However, the Treasury did not press this point and so it was decided at a late stage that the government should reap the political benefits of charging a zero real rate (Charles Clarke, *pers. comm.*) Given the Second Reading majority of five in January 2004, this reading was accurate.
15. The problem is recognized. As the President of an Ivy League university put it, 'It's time to call an end to the amenities arms race'.
16. For fuller discussion of combining student loans with social insurance, see Barr (2010c).
17. Analogously, credit card companies must use a common definition of the interest rate. For a voluntary US example of data on universities based on a common template to assist comparability, see http://www.ucan-network.org/ (accessed 17 April 2012).
18. Applications were above trend in the year before the 2006 fee increase, and below trend in 2006 as people accelerated university entrance (e.g. by cancelling gap years). Thereafter, applications resumed a rising trend (table 2). There was a similar 'blip' in applications for 2012, though the main decline was among older applicants, who may have been reluctant to take the risk of giving up their job during a recession. Time will tell whether this is a blip or a trend.
19. For broader discussion of problems with such arrangements, see Treasury Committee (2011).
20. Barr and Shephard 2010: para. 22; Smith and Smith (2010) illustrate the point by considering a degree with £9,000 fees targeted at old-age pensioners.
21. 1 July 2011, http://www.ft.com/cms/s/0/cc088644-a416-11e0-8b4f-00144feabdco.html (accessed 17 April 2012).
22. With a higher fees cap, the differential between EU and non-EU fees (which latter are not subject to a fees cap) is smaller, hence the substitution is plausible.
23. 'The number of undergraduate places at English universities will be cut by 10,000 in 2012–13, with the slots allocated instead to 155 further education colleges', *Financial Times*, 8 March 2012, http://www.ft.com/cms/s/0/5676a964-685c-11e1-a8cc-00144feabdco.html#axzz10VxQyDFX (accessed 17 April 2012).
24. I am grateful to Graeme Wise for this term.
25. http://www.guardian.co.uk/environment/2011/may/30/local-rubbish-collection-council-incentive?INTCMP=SRCH (accessed 17 April 2012).
26. If the average loan is very small (say £100) most graduates will repay in full; if the average loan is enormous (say £250,000) virtually nobody will repay in full.
27. E.g. a university would receive T grant for (say) 2,000 students, but no extra if it recruited 2,100.
28. *Economist*, 4 February 2012, http://www.economist.com/node/21546003/print (accessed 17 April 2012).

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