HE Finance: Lessons from the UK

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Summary of UK system

- High average loans for a typical degree
  - 2016 system average loan is around £57,500 (c. $80,000) so very large
- Students pay 9% of all earnings about £21,000 (c. $30,000 US)
  - Repayment rate of 9% one thing that has remained constant in UK
- Interest rate of 0-3% + inflation
- Debt written off after 30 years
  - Proportion of loan debt that will not be repaid depends on number of assumptions but likely to be around 30% but with high uncertainty though more likely to be lower rather than higher

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Lesson 1 from UK – Income Contingent Loans work

- ICLs have been running since 1998 and approximately 90% of all students in England take out loans
  - Application is easy (on-line), well advertised by all Universities when they offer place and very high take up rates
  - When apply give your National Insurance (social security) number to ensure subsequent collection/tracing of future graduates is easy
  - EU students get fee loans and have a slightly different but equally easy application process
- When student graduates and gets job, employers deduct student loan repayment each pay period
  - Student loan and social security repayments based Real Time Pay in period cf income tax which is reconciled retrospectively (at end of financial year)
  - CRUCIAL TO HAVE REAL TIME DEDUCTION

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Lesson 2 – You need some caps in place

- All the risk from ICL student loans is on government – very little on Universities
  - Same with current US system
- So need to cap loan amount
- When fees increased from £3,000 to £9,000 in 2012 – increased loans by same amount as increase in fees
  - government thought would be variation in fees
- But with ICL's – no risk to universities of charging higher fees
  - And this is what happened…

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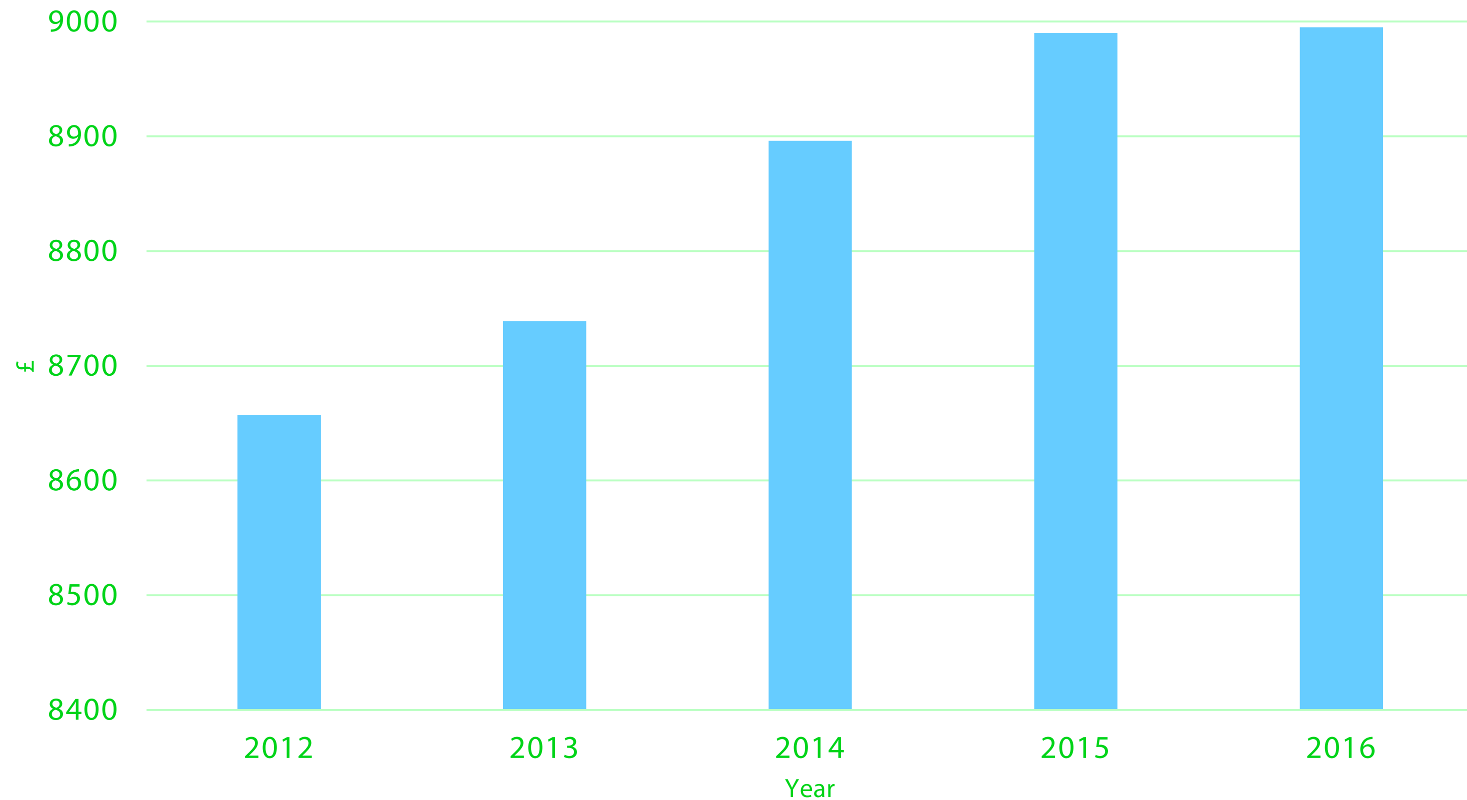
Average Fees Charged in England



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Lesson 3: Need a centralised, simple and transparent ICL system where everybody who needs a loan opts in

- English system successful - virtually every body opts in (90%)
- Why?
  - Loan terms are very competitive (below almost all alternative forms of finance), require no collateral and ensure students do not have prohibitive repayment schedules
  - Ensure that future career decisions /family formation decisions are not influenced by student debt worries as if in low paid job or taking career break, your student loan repayments are very low or non-existent
  - Easy to apply for –
- BUT NOT PERFECT
  - Abolition of student grants wrong, saves virtually no money, and is where means testing should apply (NOT LOAN SYSTEM)

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Lesson 4: If want to impose real interest rate need to write off loans to ensure progressivity

- Since 2012 England has imposed a real interest rate on student debt
  - 3% real whilst they study
  - 0% if left Uni and earn less than £21,000, 0-3% if earn between £21,000 and £42,000, 3% above £42,000
- Interest rate should be higher than government cost of borrowing but lower than alternative market options to ensure everybody opts into scheme
  - This ensures high earning graduates actually pay loan in full quickly
  - Always more progressive to have higher interest rate than higher repayment rates to protect low earners but need to minimise risk of early repayment by higher earners (trade-off)
- Forgiveness/Term of loan – the shorter the term the higher the progressivity of ICL system but less revenue
- Exact design depends on parameters but can design a cost neutral system with social insurance very easily

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Lesson 5 – HE finance scheme should be simple, transparent, and stable and future proof

- UK system has seen continual change over the last 18 years
- Too many changes too often……
- Make a system to last – decide parameters which are relatively future proof and which could cope with likely future changes without significant cost implications
  - Have loan length, interest rate, repayment rate(s) so make sure these are future proof
    - Think of clever and flexible ways to specify parameters e.g. interest rate is base rate +x % points; income threshold is y% of median earnings
  - UK system currently suffers as threshold for repayment too high and repayment rate fixed and too low on average for the large loans that are now available

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Illustration – UK Style loan in U.S.

- $25,000 loan
  - 10 year mortgage style loan – Interest Rate 4.3%
  - ICL with repayment rate of 10% and Interest rate of 3.8% (lower)

EXAMPLE:

- Low earning female BA Grads in the 20th centile of the earnings distribution (relatively well off)
  - Based on current US earnings (no real growth)
  - Standard economic assumptions

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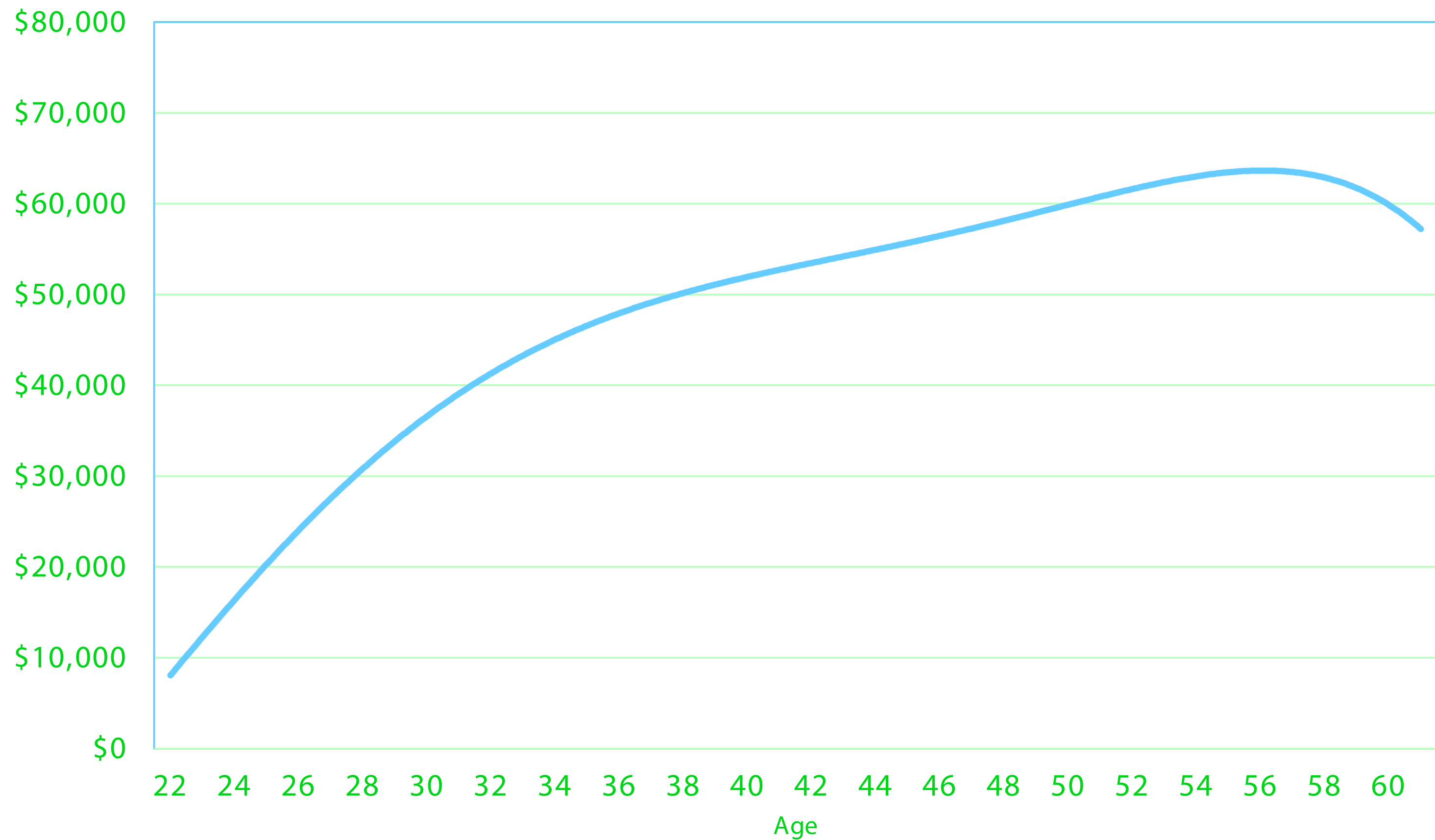

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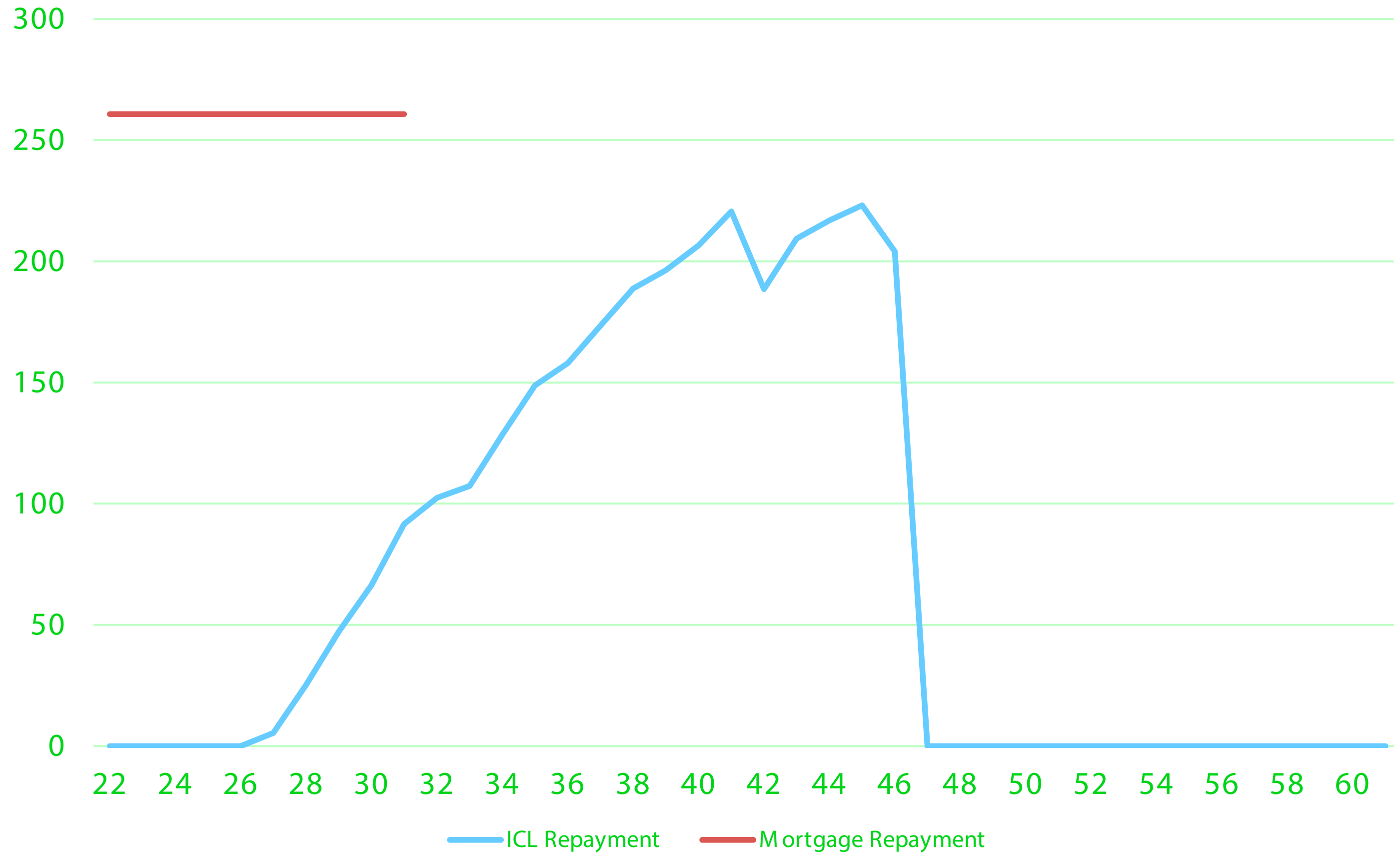

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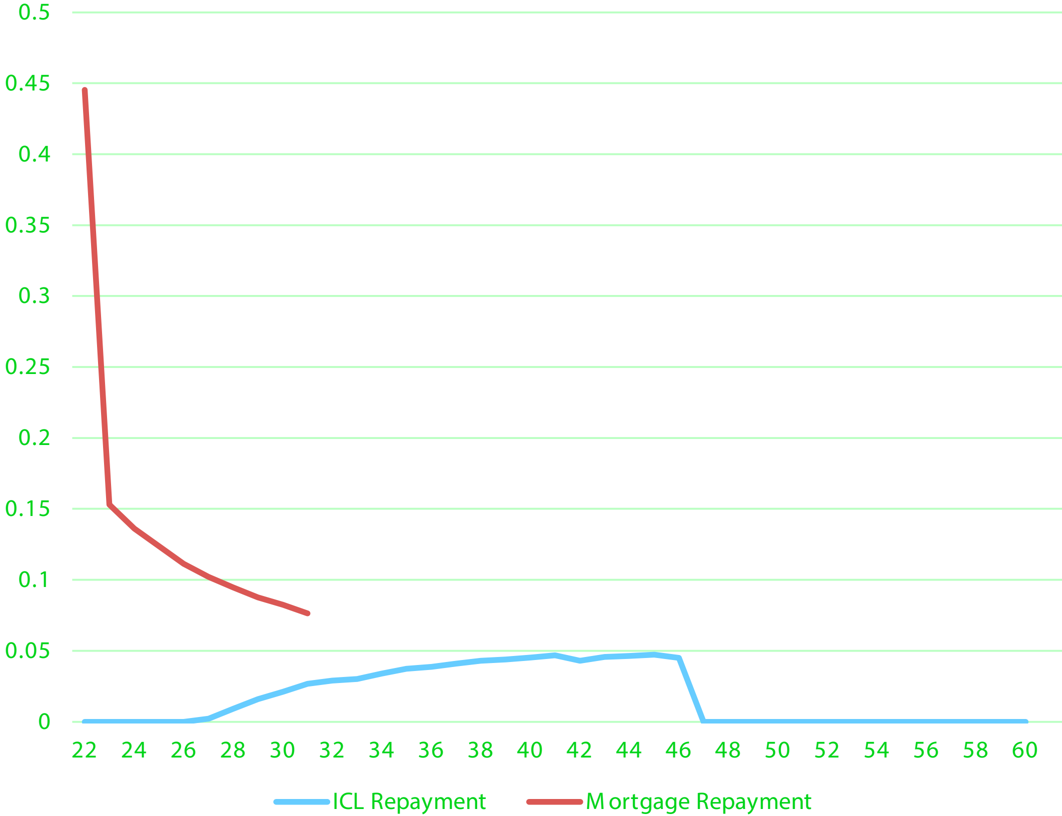

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How much of loan repaid?

- Mortgage style loan
  - Even with a default rate of 7% or lower – loans fully repaid in today's money
  - But average burden of loan over first 10 years of labour market have very perverse labour market and family formation effects
- What about for ICL loan?
- How much repaid? Guess?
  a) 80%
  b) 90%
  c) 98%

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Conclusions

- Income contingent loans work, and have widespread international application
- A well designed system can be:
  - Fully self funding (reduce government outlays)
    - Higher earners pay more than their loan and offset low income students who pay less than their loan (but pay less than under current system as pay back more quickly)
  - Reduce perverse labour market and family formation incentives of mortgage style loans for low earning graduates
  - Better design for ALL graduates (losers banks currently doing loans)
    - All better off in terms of labour market incentives and/or total cost of borrowing in today's money
  - Simple to administer and have very low default rates due to the fact that the average burden can never exceed repayment rate

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English HE finance system – History (not used)

- Had system of ICL since 1998 when up front fees first introduced in 1998
- Originally ICLs just for maintenance but from 2006 available for fees and maintenance
  - Currently available for fees up to £9,000 pa plus maintenance (min £5,200 pa)
- Grants (student aid) abolished in 1998, re-introduced in 2005 and will be abolished again from 2016
- Up until 2012 outstanding debt just uprated with inflation but since 2012 uprated by inflation + interest rate 3% (max rate)
- Debt is written off after fixed time which has ranged from 25 to 30 years (important for progressivity of system particularly with real interest rates)
  - Current proposal to increase to 35 years
- Repayment is at 9% above an earnings threshold which has ranged from £10,000 to £21,000 with no/inflation/earnings uprating
  - Currently £21,000 (likely to be frozen in nominal terms for 5 years)

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