A fairer way to finance tertiary education

Nicholas Barr *dispels some of the commonly held myths around higher education funding and outlines the core elements of a financing system guided by principles of fairness and efficiency.*

Everyone knows that the welfare state exists to relieve poverty (the “Robin Hood” element). Less well-known is that it exists also to enable people to redistribute over their life cycle (the “piggy bank” element). Estimates show that somewhere between two-thirds and three-quarters of welfare state spending is of the latter sort – for example, pensions redistribute from a person’s younger to their older self. The NHS is similar, in that older people make considerably greater use of health and social care than younger people.

Student loans are a form of inverse pension – they redistribute from a person’s earning years to themselves in earlier years to invest in their skills. Many years ago, I argued for a loan repaid through a graduate addition to national insurance contributions, and I continue to think that that is the right frame for thinking about student loans within the wider finance of tertiary education.

Ground rules for fair and efficient finance

A well-functioning and fair system of finance has four starting points. First, cost-sharing is necessary because mass tertiary education loses out to other public services such as the NHS, and desirable because it is still mainly students from better-off backgrounds who go to university.

Second, risk-sharing. Tertiary education should be free to the student, with graduates contributing to the cost of their training. Since borrowing to finance a qualification is risky, the loan should protect the borrower from excessive risk.

Third, equitable participation. The argument that fees harm access is an example of what I call “pub economics” – something that everyone knows is true – but is not. Powerful evidence shows that resources from pre-natal through primary and secondary school are the major determinants of participation.

Fourth, a holistic approach to tertiary education. Policy should consider tertiary education as a whole, tearing down the wall between university education and further education.

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How we got into this mess

A loan to cover annual tuition fees of £9,250 for three years, plus living costs can total £58,000 for a student living away from home outside London. Graduates make repayments of 9 per cent of their income above £27,295; any balance outstanding after 40 years is forgiven.

It's natural to think of that figure in terms of credit card debt, which is seriously scary. But few people repay their loan in full. In the jargon, the RAB charge is a measure of how much will not be repaid, ie, of the leakiness of loans. In 2021-22 the RAB charge was 57 per cent, though reforms are in hand that are projected to reduce it to 37 per cent. Moreover – a central design feature – repayments are income-contingent – a payroll deduction alongside income tax and national insurance contributions, so that a low earner makes low or no repayments. Unlike conventional debt, failure to repay does not lead to bankruptcy.

Thus we have a system with a high sticker price and leaky loans – but the subsidy goes unnoticed, a self-inflicted and heavily criticised wound. The reason loans are so leaky are reforms by the coalition government in 2012, which abolished most taxpayer support for teaching, increased the rates of interest, and raised the level of income at which graduates start to repay. These changes dramatically increased the size of student loans and the extent of non-repayment. Why those changes? Largely to exploit a loophole in the way student loans enter the public accounts, a practice for which a leading supermarket was fined £235 million.

Why does leakiness matter? Large loan subsidies, though intuitively appealing, are a blunt instrument for achieving equity objectives. Making loans less leaky frees resources for policies that do more for access.

In sum, taxpayer support for teaching is too low, fees are too high, the interest rate too high and the repayment threshold too high – right system, wrong parameters.[1]

Why not simply abolish tuition fees?

The argument for "free" – ie, taxpayer financed – higher education is beguiling but mistaken. Over-reliance on public finance means that the taxes of lower earners benefit mainly students from better-off backgrounds and, in doing so, harm participation by crowding out pro-access policies earlier in the system that evidence overwhelmingly shows are the main drivers of improved participation. Aggravating matters, higher education regularly loses out to more politically salient pressures on public spending such as nurses' pay and social care in the face of population ageing: the result is falling funding per student (putting quality at risk) or numbers caps, further harming access.

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Where we should be: a lower sticker price and smaller, less leaky loans

A strategy for financing tertiary education that follows the ground rules above has three mutually-supporting elements: First, finance education institutions primarily through a mix of tuition fees and taxpayer finance (with some finance from employers an option). Second, finance students mainly through well-designed loans that protect low earners. And third, widen participation through policies that focus mainly on interventions earlier in the system.

That, broadly, was the strategy of the 2006 reforms, which resulted in increases in tuition fee income for universities, in grant and loan numbers, in student numbers and – largely because of policies earlier in the system started in earlier years, such as SureStart which boosted nursery education – a striking 53 per cent increase in applicants from the most disadvantaged backgrounds.

What would the resulting system look like?

If implemented, to finance institutions, such a system would rebalance finance between taxpayer and graduates by restoring some teaching grant (T grant) and reducing (or at

least not increasing) tuition fees. Restoring some T grant is part of cost sharing, and also gives government a policy lever that allows it to give extra funding to areas it wishes to encourage, e.g. particular subjects, particular types of students, or particular institutions.

Reforms to loans would reduce the interest rate from its current level (for most students of 3 per cent real, ie, 3 per cent above the rate of inflation); instead the interest rate should be at or close to the government's cost of borrowing, giving students access to the government's risk-free interest rate. A second reform should lower the threshold at which repayments start, but with a repayment rate starting at (say) 3 per cent, rising in steps to 9 per cent at higher incomes. The underlying idea is that loans should be designed so that graduates with a good earnings record should repay in full, non-repayment being limited to low-earning graduates.

To enhance access, reforms should restore or improve the resourcing of policies (some of them abolished in 2012), including nursery education (quantity, quality, price, availability), the literacy and numeracy hours, and successor policies to education maintenance allowances (which offered income-tested support between GCSEs and A level), and AimHigher (which sought to improve information and raise aspirations).

For how long should repayments continue?

In a pure loan, repayments continue until the borrower has repaid in full, or qualifies for forgiveness. In a system of equity finance, repayments last for life, or until retirement – generally referred to as a graduate tax. In this design high earners repay more – and some much more – than they have borrowed (I call this the Mick Jagger problem, given his time as an LSE student).

A third option is a hybrid, in which repayments stop when the borrower has repaid (say) 120 per cent of the loan. Thus higher earners cover some or all the loss on low earners. This is the purest manifestation of student loans as social insurance, in the same way as the national insurance contributions of an LSE professor contribute to the cost of unemployment benefit for workers with less job security. The extra 20 per cent can be thought of as analogous to the mortgage projection insurance that is generally required to cover a home loan.

Since loans protect low earners, they make a loss by design, so a second question is

where the resulting costs should fall. They could fall entirely on taxpayers (as currently); be shared between taxpayers and borrowers (the social insurance design), and/or be shared between taxpayers, borrowers and education institutions.

Finally, any of the options outlined above could be combined with stepped repayment rates starting from a lower threshold than currently and starting at a lower rate.

Beyond higher education

Though discussion of finance has mainly concerned higher education, the government is rightly moving towards a more integrated approach embracing both higher and further education. That policy direction, however, requires careful planning to provide a flexible system in which people can build skills in different ways, in different combinations, at different speeds. Doing so would involve granular delivery supported by granular finance, equitable across all tertiary education. Current debate tends to focus on distributional effects for students in higher education, ignoring the fact that the subsidies for the 50 per cent who go to university are much larger than those for the 50 per cent who don't. They should not be forgotten.

[1] Sound bite stolen from Anna Vignoles.

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