Towards setting student numbers free

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1. One of the strengths of the Browne Review (Independent Review of Higher Education Funding and Student Finance, 2010) is that it offers a genuine strategy (Barr 2010*b*). An important element in the strategy is to set student numbers free by keeping the taxpayer cost of expansion low. The Review aims to do this by

- Abolishing taxpayer support (the T grant) for 'chalk and talk' subjects, notably arts and humanities, and social sciences;
- Imposing the cost of non-repayment of loans on universities, through a levy on fees above £6,000.

2. This note makes three sets of arguments:

- The aim of setting student numbers free is right.
- The method proposed for doing so in the Browne Review has deficiencies, which the government's response has aggravated. A

8. In principle, this suggests that the T grant should be retained. That, however, is not the whole story. The starting point is to observe that though the argument in the previous

different universities could constrain changes in the relative size of different institutions and degrees.

18. Thus policy design faces a tradeoff: in comparison with model 1, greater reliance on block grants reduces the taxpayer cost of an extra student but impedes changes in the relative size of different institutions and degrees. The only complete solution is that in the Browne Review – no T grant: thus the marginal taxpayer cost of expansion is zero and there is no constraint on changes in the relative size of institutions or degrees. As argued earlier, however, this approach is inefficient because it takes no account of social benefits listed in Box 1, and hence restricts size on the demand side. Thus policy has to optimise across the size and taper of the T grant and the way it is translated into block grant.[3]

19. Though the proposals in the previous paragraphs moderately raise measured public, two points are noteworthy. First, the spending is highly targeted to achieve efficiency gains. Second, the effect on public spending may be small. Suppose that 50 per cent of lending to students at Balls Pond Road University is not repaid. Then a targeted T grant would add £1,500 gross to public spending, but saves the £750 that would otherwise have been spent on fees loans that were not repaid. Even if a targeted T grant cannot wholly be accommodated within the parameters of the Comprehensive Spending Review, it is an important element for the future.

3 Strategic direction 2: Making the loan system less leaky

20. The Browne report recommends:

- A real interest rate of 2.2 per cent for graduates with sufficiently high earnings, with a zero real rate for graduates with lower earnings;
- An increase in the repayment threshold from £15,000 to £21,000, which is close to average earnings;
- Indexing the repayment threshold to earnings;
- Forgiving any loan that has not been repaid after 30 years (rather than 25).

21. The loan arrangements proposed by Browne are leaky (Barr 2010*b*, paras. 34-42), and subsequent modifications amplify the problem. Thompson and Bekhradnia (2010) point out that the government's estimates of the performance of the loan system are very sensitive to assumptions about the average level of fees (and hence the size of the average loan), and to the growth of real earnings (and hence repayment performance). There are good grounds for regarding the underlying assumptions as optimistic. In addition, the threshold at which repayment start is (a) high and (b) generously indexed.

22. To set student numbers free, three sets of changes are necessary to reduce the taxpayer cost of the loan system as much as possible:

- Reducing leaks by ensuring that higher-earning graduates repay in full;
- Shifting the costs of non-repayment by graduates with low lifetime earnings away from the taxpayer.

[3] This is a classic example of what economists call 'second-best' analysis, in that there is no perfect solution.

- Removing the perverse incentive to universities to charge the maximum fee, an incentive which arises because the cost of non-repayment of loans does not fall on the university or its graduates.[4] The resulting higher fees increase non-repayment and hence the cost of the loan system.

23. MAKING THE LOAN AS LEAK PROOF AS POSSIBLE by avoiding interest subsidies for graduates with low current earnings but high lifetime earnings (for fuller discussion, see Barr and Johnston 2010). Specifically:

- A real interest rate should apply from the moment the loan is taken out. Grace periods, whereby no real interest is charged during student days, are expensive and badly-targeted, since all graduates (except those with a substantial private income), even the highest earners, have low income while a student.
- The repayment threshold should be raised periodically in the light of the performance of the loan system or, failing that indexed, to prices. Indexing the threshold to earnings reduces the monthly repayment of all graduates including the highest-earners; again, this is badly-targeted and undermines the repayment performance of the loan scheme.

24. SHIFTING THE COST OF REMAINING LOSSES AWAY FROM THE TAXPAYER. In principle there are two ways of doing so: a national cohort risk premium, or an insurance premium paid by each university's cohort.

25. A national cohort risk premium:

- In this approach on a national basis, higher-earning graduates who have taken out a student loan pay the loss on the loans of low earning graduates.
- Thus on average there is a cross-subsidy from Oxbridge to Balls Pond Road University.
- This arrangement, however, gives all universities an incentive to charge £9,000, since they face no cost from doing so, nor do their low-earning graduates.

26. University insurance:

- In this approach each university pays an insurance premium calculated actuarially to match the predicted loss on the loans its students take out. This arrangement removes the cross-subsidy, and so the incentive for all universities to raise fees to £9,000 mainly to extract subsidies.
- One problem with this approach is that the insurance costs for Balls Pond Road

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Independent Review of Higher Education Funding and Student Finance (the Browne Review) (2010), *Securing a sustainable future for higher education: An independent review of higher education funding and student finance* (The Browne Review), http://hereview.independent.gov.uk/hereview/

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