

Saving student loans¹

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1. This note estimates the cost of different policy packages compared with the current student loan system. The policy implications are summarised in Table 1 and paras 10-14. The central message is that for the time being the threshold of £21,000 at which loan repayments start should remain constant in nominal terms. The reason is simple: because otherwise – as before the reforms – the loan system will be fiscally expensive. The result is a tight constraint on student numbers, which is (a) inequitable (it is students from disadvantaged backgrounds who are most likely to be crowded out), (b) inefficient, because of underinvestment in skills, and (c) politically nasty.

Assumptions

2. The benchmark is the current system: fee loans are £3,290 per year and maintenance loans £5,500, so that the total loan per student over three years is about £26,000; the threshold at which graduates start to repay is £15,000 per year; and there is a zero real interest rate. Our starting point (updated from Barr and Johnston, 2010) is an estimate that averaged across all borrowers non-repayment is 25.8% of borrowing in present value terms, i.e. about £6,800 per student.

3. The proposed system has an assumed average fee loan of £8,000 and maintenance loan of £5,500, so that the total loan is just over £40,000, about £14,000 larger than the present loan; the proposed repayment threshold is £21,000 indexed to earnings; and the real interest rate varies between zero and 3%.

4. We make the following assumptions.

- The government's borrowing rate is 2.2% in real terms.
- All the options include modified New Zealand-type protection, where real debt is allowed to rise during university years, but low earners are then protected so that real debt does not rise further thereafter.

The costs of different policy options

5. In assessing the proposed changes it is helpful to distinguish several effects. First, the size of the loan will increase, which will increase losses. Secondly, the terms of the loan have been changed: the higher interest rate will reduce losses; the higher repayment threshold will increase losses. In the analysis that follows, we hold the size of the loan constant at the new, higher level of about £40,000 and discuss options for different interest rates and different loan thresholds.

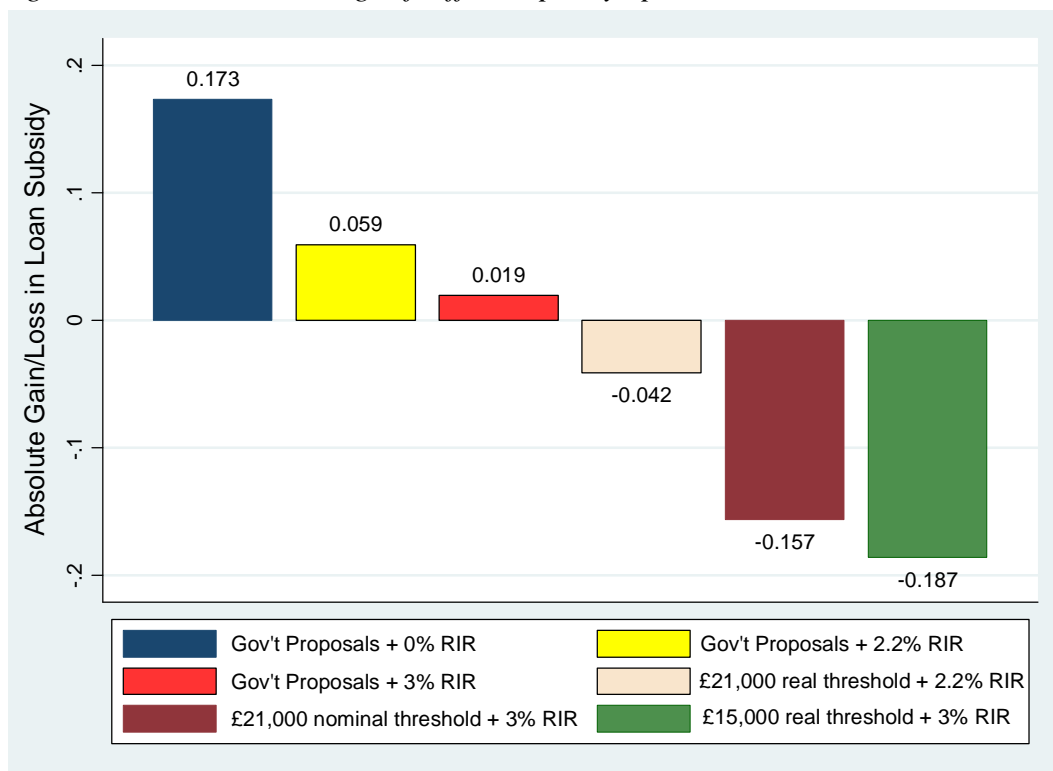
¹ We are grateful to Neil Shephard for comments on an earlier draft. The views expr

6. The first three bars in Figure 1a show the cost of the proposed system with different interest rates.

- The first (blue) bar shows the gross cost of higher fees and higher repayment threshold indexed to earnings, holding other things constant, including the interest rate. This system adds 17.3% to the cost of loans, i.e. increases non-repayment (and hence the RAB charge) by £173 for every £1,000 lent. Thus, as Table 1 shows, the increase in a typical loan of £14,000 means that loans add £2,444 per student to the cost of the present system of £6,800.
- The second (yellow) bar shows the cost of the proposed system with a real interest rate of 2.2% and modified New Zealand-type protection. This option costs 5.9% more than the present system, i.e. an extra £834.
- The third (red) bar shows the cost of the proposed system with a real interest rate of 3%. This option costs 1.9% more than the present system, i.e. an extra £268.

7. The cost of the government’s proposals, with a sliding interest rate from 2.2% to 3% lies somewhere between the second and third bars. Thus the government’s proposals are more expensive than the present system. Put another way, the gains from charging a higher interest rate are largely lost by raising the repayment threshold and indexing it to earnings.

Figure 1a: Costs and savings of different policy options



8. The next three bars show potential savings.

- The fourth (pink) bar shows the savings from indexing the repayment threshold to prices with a 2.2% real interest rate, assuming an inflation rate across the life of the loan of the Bank of England’s central target of 2% CPI. Compared with the cost of the present system, this arrangement would save 4.2% of lending to students, i.e. just below £600 per student.

- The fifth (brown) bar shows that if the repayment threshold remains at £21,000 in nominal terms with a 3% real interest rate, the savings for the 2012 cohort would be 15.7% of lending, or £2,218 per student, and larger if fees on average are higher than our assumption of £8 in

