

# Higher Education Reforms: Progressive but Complicated with an Unwelcome Incentive

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## Higher education reforms: progressive but complicated with an unwelcome incentive

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### 1. Summary

Details of the proposed changes to higher education (HE) have been finalised ahead of tomorrow's vote in the House of Commons on the raising of the cap on tuition fees to £9,000. We find that:

- Lining up graduates according to their lifetime *earnings*, the Government's proposals appear more progressive than the current system or that proposed by Lord Browne. The highest earning graduates would pay more on average than both the current system and that proposed by Lord Browne, while lower earning graduates would pay back less.
- Lining up graduates according to their *parents' income*, graduates from the poorest 30% of households would pay back *less*, on average, than under Lord Browne's proposed system, *but more*, on average, than under the current system. While all graduates from families with incomes above this would pay more, graduates from the 6<sup>th</sup> and richest (10<sup>th</sup>) deciles of parental income would pay back the most under the proposed system.
- The Government announced today that it will up-rate the threshold above which graduates pay back their loan annually in line with earnings (as was proposed by Lord Browne) rather than at 5 year intervals, which makes the system more progressive than originally proposed.
- The National Scholarship fund – through which the taxpayer will cover the third year of fees for students from low income families who attend universities charging over £6,000 a year – will cost the government money in the short term. But we estimate that in the long term *the net impact* will be to slightly strengthen the public finances slightly (by around £11m a year) if universities charge £7,500 per year. This is mainly because universities will be required to cover the cost of fees for these students in their first year, thereby reducing the taxpayer subsidy.
- The new system is less transparent than the current system and that proposed by Lord Browne, with a more complex system of student support and interest rates. The new system also generates perverse incentives: the proposed National Scholarship fund, for example, provides a financial incentive for universities charging over £6,000 a year to turn away students from poorer backgrounds.

### 2. Introduction

Details of the proposed changes to higher education (HE) have been finalised ahead of tomorrow's vote in the House of Commons on the raising of the cap on tuition fees to £9,000. The proposals form the Government's response to the recommendations of the Browne Review.<sup>1</sup> While the Government accepts a substantial part of the review's recommendations, including an increase in fees and the repayment threshold, it has put

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<sup>1</sup> Source: <http://hereview.independent.gov.uk/hereview/report/>

forward alternative proposals for student support and interest rates that are more progressive with respect to lifetime graduate earnings, but also more complex, less transparent, more administratively burdensome and more likely to result in perverse incentives. This Briefing Note supersedes previous analysis by IFS researchers of the implications of the proposed reforms to student finance.

The key differences compared with Lord Browne's proposals are:

- Tighter means testing of grants, which saves the taxpayer money.
- A fee cap of £9,000 but with no levy on fees above £6,000. The levy was intended to recoup the cost to government of providing larger loans to cover these fees; without it, the cost to the taxpayer is higher than under Lord Browne's recommendations.
- Increasing the interest rate for higher earning graduates and reducing it for lower earning graduates, via the proposed interest rate taper (see Table 1 below). Graduates earning above £32,000 (in 2012 prices) will face a higher interest rate than under Lord Browne's recommendations, while graduates earning between £18,840 and £32,000 will face a lower interest rate.
- Making the maintenance loan system more complex without any significant savings to the taxpayer, compared to Lord Browne's proposals.
- The announcement of an £150 million National Scholarship to fund a free third year's tuition for an estimated 18,000 students from the most disadvantaged backgrounds. The same students will also be eligible for free tuition in the first year of their studies if they attend a university charging more than £6,000 a year: the cost of this subsidy will be met by the institution itself. We estimate that in the long run this feature of the scholarship could result in the Government actually saving money overall, by reducing the total amount of fee loans the Government must issue.

### **3. Comparing the key features of the current and proposed systems**

Before we analyse the impact of the government's proposals, it is important to outline how key parameters differ – in 2012 prices – under the current system, the system proposed by Lord Browne, and the system proposed by the Government.

All analysis assumes that the £15,000 repayment threshold currently in place will be indexed to inflation from September 2012. In this note we also show the implications of continuing to freeze this threshold in nominal terms, as has been the case since 2006. In all our analysis, we compare the Government's proposals to the current system both with and without inflation indexation of the threshold, in order to make clear the implications of the Government's announcement today to up-rate the £15,000 threshold with inflation from 2012.

**Table 1. Details of the current system and proposals (figures in 2012 prices)\***

	<b>Current (2010 system)</b>	<b>Browne Review</b>	<b>Government</b>
<b>TUITION FEES</b>	£3,470 per year <sup>1</sup>	Uncapped	Up to £9,000 pa
<b>SUPPORT</b>			
<b>MAINTENANCE GRANT</b>	£2,990 per year if parental income less than £25,000 pa; tapered to zero if parental income less than £50,000 pa	£3,340 per year if parental income less than £25,000 pa; tapered to zero if parental income less than £62,500 pa	£3,340 per year if parental income less than £25,000 pa; tapered to zero if parental income less than £42,500 pa
<b>MAINTENANCE LOAN</b>	£3,590 per year if parental income less than £25,000 pa; increasing to a maximum of £5,060 per year if parental income equal to £50,000 pa; decreasing to £3,750 per year if parental income equal to £60,000; £3,750 per year for parental incomes equal to and above £60,000 pa	£3,850 per year	£3,980 per year if parental income less than £25,000 pa; increasing to a maximum of £5,620 per year if parental income equal to £42,500 pa; decreasing to £3,670 per year if parental income equal to £62,500; £3,670 per year for parental incomes equal to and above £62,500 pa
<b>BURSARY</b>	University pays a minimum of £350 per year if student receives full maintenance grant		
<b>SCHOLARSHIP</b>	University pays full first year fee if fees exceed £6,000 pa and student from FSM <sup>2</sup> background Government pays full third year fee if fees exceed £6,000 pa and student is from FSM background		
<b>FEE AND MAINTENANCE LOAN REPAYMENT</b>			
<b>REAL INTEREST RATE</b>			
during study	0%	2.2%	3%
after graduation	0%	0% if graduate is earning less than repayment threshold. Between 0 and 2.2% if graduate does not earn enough to cover full interest payment. 2.2% at earnings above this	0% if graduate is earning less than repayment threshold. Tapered between 0% at threshold and 3% if graduate is earning £36,780. 3% if earning above £36,780
<b>REPAYMENT RATE</b>	9%	9%	9%
<b>REPAYMENT THRESHOLD</b>	£15,000	£18,840	£18,840
<b>UPRATING OF THRESHOLD</b>	Annually with inflation from 2012	Annually with earnings from 2016	Annually with earnings from 2016
<b>REPAYMENT PERIOD</b>	25 years	30 years	30 years

\*under the current system, all figures for grants and loans are assumed to be frozen to 2011 and then inflated by 1 year to 2012(RPI). Fees are up-rated by 2 years RPI <sup>1</sup>Average fee charged is £3,290 <sup>2</sup>Receives free school meals

We now draw out some of the implications derived from Table 1.

## **Fees**

The largest single announcement was a cap on annual tuition fees of £9,000 per year (which was not recommended by Lord Browne). In return for preventing universities from charging more than this, the Government will not impose a levy on fees above £6,000 per year. Instead, universities wishing to charge more than this will be required to intensify their efforts to widen participation in collaboration with the Office for Fair Access. Universities would be free to charge less than £6,000 a year, but are unlikely to do so as on average, they would need to charge £7,000 a year just to replace the lost income from teaching grants.

## **Upfront Support for Students**

The announcements included changes to the package of upfront support currently received by students. Students from the poorest families (with household income at or below £25,000) will be better off, in terms of upfront support, by around £750 per year compared with the current system. This is due to increases in the generosity of maintenance grants and loans. The government will save money by cutting maintenance grants back for those from higher income families – the maximum parental income at which a grant is payable has been reduced to £42,600 (currently £50,000 and proposed to be £60,000 by Browne). Overall, the total amount of upfront support is more generous than the Browne recommendations for student with household incomes below £37,500 and less generous for students with household incomes above this.

Contrary to Lord Browne's welcome recommendation of a universal maintenance loan, the current system of means-tested maintenance loans will continue, with a series of complicated tapers to determine the amount of support payable in the form of grants and loans.

Maintenance grants of £3,340 a year and maintenance loans of £3,980 a year will be payable to all students from households with annual income up to £25,000. Those with household incomes above this amount will then see the loan element of their support package increase and the grant element decrease with income, until household income reaches £42,600. Then as household incomes increase above £42,600, the total amount of support payable (purely in the form of loans) decreases until household income reaches £62,125. At and beyond this household income level a universal maintenance loan of £3,670 will apply. These changes will significantly increase the administrative burden of applying for and administering loans compared to Lord Browne's proposal. While there is a strong case for making upfront support for students relate to parental income, it is much harder to argue that graduate debt and therefore future graduate contributions should be related to parental income before studying rather than just the course taken and how well graduates do in the labour market. In particular it is difficult to justify why students from households earning £42,600 should face larger debts than all other students doing similarly-priced courses. Whilst the proposed system is more progressive than the current system and Lord Browne's proposals, the details of the proposed system are quite complex and less transparent than the system proposed by Lord Browne (a universal maintenance loan and means-tested grant). This was also progressive but less complex system, and therefore merits reconsideration.

## Bursaries and scholarships

As well as introducing changes to maintenance grants and loans, the announcements also include changes to upfront support in the form of bursaries and scholarships. Under the current system, universities must award a bursary of at least £350 per year to students from poor backgrounds (defined as those who receive a full maintenance grant). In practise, the bursary system is less than transparent, with many universities and colleges offering considerably more than the minimum and often to those with parental incomes higher than the minimum required for a full grant<sup>2</sup>. Both Lord Browne and the government agree that the bursary system should be scrapped. This move will simplify the application process for students, since they will no longer have to apply to both the university and the government to obtain their minimum level of support, though universities may still continue to operate their own bursary systems.

The Government has also proposed a new National Scholarship fund specifically aimed at poorer students. Under the scheme, universities that charge over £6,000 per year in tuition fees will be required to cover the full amount of the first year's fee for any student in receipt of free school meals (FSM). If the student stays in university until the third year, the government will cover the full value of his/her third year's fee, so those qualifying for the award will receive up to £18,000 depending on the fee set by the university they attend.

The aim of this scholarship is to ensure that higher tuition fees do not dissuade students from poor backgrounds from applying to universities that decide to charge fees over £6,000, and the scholarship may well have this effect. However there are a number of other implications resulting from this scheme. Most obviously, a student from a low-income background who studies at a university charging £6,000 (or below) will have to two years' fee loans, yet a similar student at a university charging £6,001 (or more) will only have to borrow one year's fee loan. This discrepancy could clearly distort the choices that students would otherwise make between different universities.

Universities that typically attract a high proportion of FSM students may be dissuaded from charging fees above £6,000 since they will have to meet the cost of a year's fee for each FSM student, or may turn away applicants from FSM backgrounds to avoid having to meet the cost of a year's funding, which would be an undesirable implication of the system.

Another issue is that the scholarship creates large incentives for households to manipulate their reported total income in order to qualify for it, because of the 'cliff-edge' in the eligibility rule. If the family income is just low enough to make the student eligible for FSM, then the student is also eligible for one (or two) year's free tuition. If the family income is marginally higher, the student will not be eligible. Parents with higher incomes will therefore have in incentive to reduce their reported level of gross income in some way.

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<sup>2</sup> In 2008/09 the typical bursary for a student receiving the full Maintenance Grant on a course charging full tuition fees was £890 ([www.direct.gov.uk](http://www.direct.gov.uk)).

Finally, it is likely that the scholarship system will provide an additional administrative burden to the government, universities and students themselves, who will presumably have to apply directly to the university to receive their scholarship.

### **Graduate Repayments**

There are important changes elsewhere. The Government proposes a higher maximum interest rate and a different way of tapering it than that proposed by Lord Browne. Instead of a capped real interest rate for lower-earning graduates to ensure that their debt does not increase in real terms, there would be a real interest rate applied linearly over the salary scale, from 0% at £18,840 a year (in 2012 prices) to a maximum of 3% at £36,780 (in 2012 prices).

While the maximum interest rate is higher than under Lord Browne's proposals, this taper is more progressive: new graduates earning between £18,840 and roughly £32,000 a year would face a lower rate of interest.

The prospect of a real interest rate has led to concerns about whether graduates from wealthy families may repay their loans more rapidly in order to reduce their total interest payment. In response to this, the Government has proposed an early repayment levy to discourage individuals (particularly high-earners) from making extra payments. While higher interest rates will increase the incentive to make larger repayments, the terms of the loan remain more generous than alternative commercially available sources of finance. This means that graduates are actually likely to be worse off anyway if they attempt to repay their loan faster. Nevertheless, for those facing a 3% real interest rate, the Government benefits more if these graduates take longer to pay their debt back, hence it also has a fiscal incentive to discourage early repayments from these graduates.

#### **4. Who are the winners and losers from the Government's proposals?**

Compared to the system proposed by Lord Browne, universities are the main winners: the absence of a levy enables them to keep 100% of any additional fee income above the basic £6,000 level (from students not receiving free school meals). This more than outweighs the likely costs to universities of having to provide a year's free tuition to students from the poorest backgrounds. The main loser of the Government's proposed system – relative to the one proposed by Lord Browne – is itself: the reduction in maintenance grants is more than outweighed by the cost of not imposing a levy. Rather than being compensated by universities for any losses from unpaid loans, the Government will have to meet the cost itself.

Table 2 summarises the balance of contributions to the cost of higher education under the current system, the Browne Review recommendations and the Government's proposals. The figures presented are total amounts *per graduate* over the course of their degree.

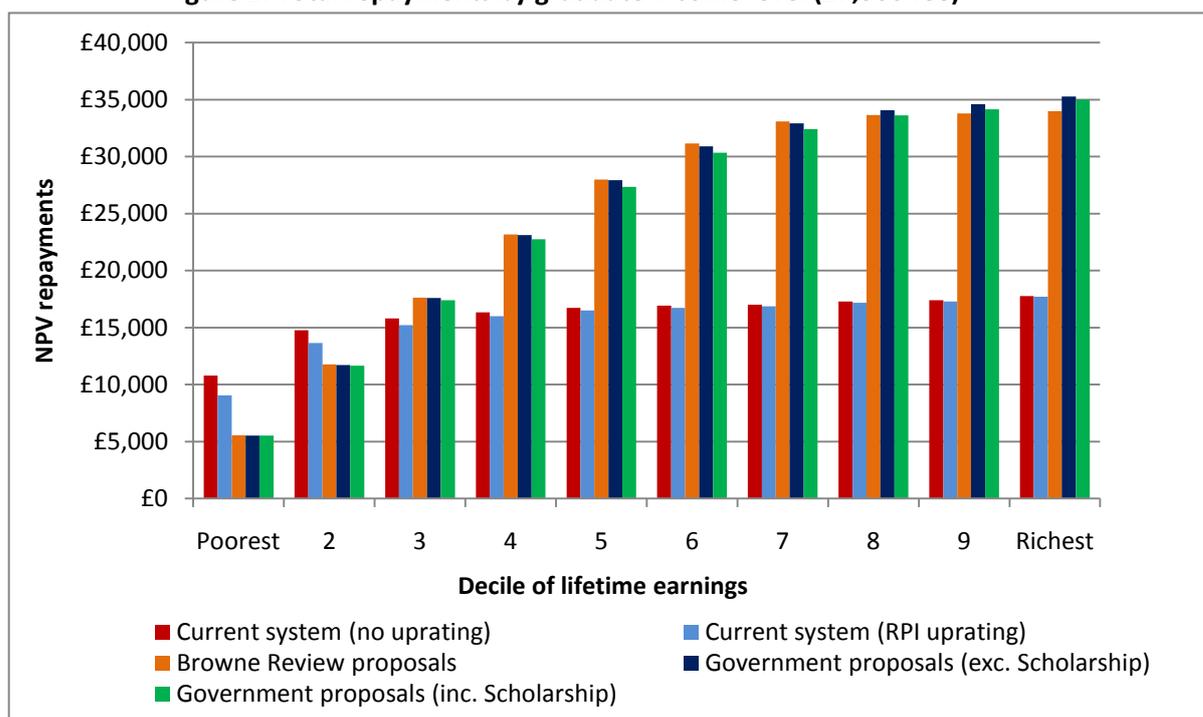
**Table 2. Balance of contributions to higher education under current, Browne Review, and Government scenarios**

	Current System (no up-rating)	Current System (up-rating by RPI)	Govt. (£7,500 fee)	Change from Current (up-rating by RPI)	Change from Browne	Govt. (£9,000 fee)	Change from Current (up-rating by RPI)	Change from Browne
<b>Source of funding (per graduate)</b>								
<b>Taxpayers:</b>	<b>£21,820</b>	<b>£22,290</b>	<b>£16,750</b>	<b>-£5,540</b>	<b>£1,820</b>	<b>£18,950</b>	<b>-£3,340</b>	<b>£3,810</b>
HEFCE	£12,320	£12,320	£2,430	£-9,900	£0	£2,430	£-9,900	£0
Grant	£4,270	£4,270	£4,520	£250	£-1,030	£4,520	£250	£-1,030
RAB	£5,220	£5,690	£9,800	£4,120	£2,840	£12,000	£6,320	£4,830
RAB %	24.5	26.7	28.1			30.6		
<b>Graduates:</b>	<b>£16,080</b>	<b>£15,620</b>	<b>£25,020</b>	<b>£9,400</b>	<b>-£150</b>	<b>£27,200</b>	<b>£11,580</b>	<b>-£70</b>
Fee loans	£6,670	£6,350	£14,240	£7,890	£-360	£16,420	£10,070	£-280
Maintenance loans	£9,420	£9,270	£10,780	£1,510	£210	£10,780	£1,510	£210
<b>Destination of funding (per graduate)</b>								
<b>Universities:</b>	<b>£21,780</b>	<b>£21,780</b>	<b>£24,340</b>	<b>£2,570</b>	<b>£1,480</b>	<b>£28,720</b>	<b>£6,950</b>	<b>£3,560</b>
HEFCE	£12,320	£12,320	£2,430	£-9,900	£0	£2,430	£-9,900	£0
Fees	£9,770	£9,770	£21,920	£12,150	£1,490	£26,300	£16,530	£3,560
Bursary	£-320	£-320	£0	£320	£0	£0	£320	£0
<b>Students:</b>	<b>£16,130</b>	<b>£16,130</b>	<b>£17,420</b>	<b>£1,290</b>	<b>£170</b>	<b>£17,420</b>	<b>£1,290</b>	<b>£170</b>
Grants	£4,270	£4,270	£4,520	£250	£-1,030	£4,520	£250	£-1,030
Maintenance loans	£11,540	£11,540	£12,910	£1,370	£1,210	£12,910	£1,370	£1,210
Bursary	£320	£320	£0	£-320	£0	£0	£-320	£0

### What are the implications for graduates?

The Government's proposed system has the feature that potential debt upon graduation will depend upon a student's family income, both because of the National Scholarship but also because of the maintenance loan schedule. This question is therefore best addressed by examining graduate repayments both by graduate earnings and by parental income. Clearly who is better or worse off relative to the current system depends on whether the repayment threshold would have been up-rated with inflation or not. The graphs below enable both comparisons to be made.

**Figure 1. Total repayments by graduate income level (£7,500 fee)**

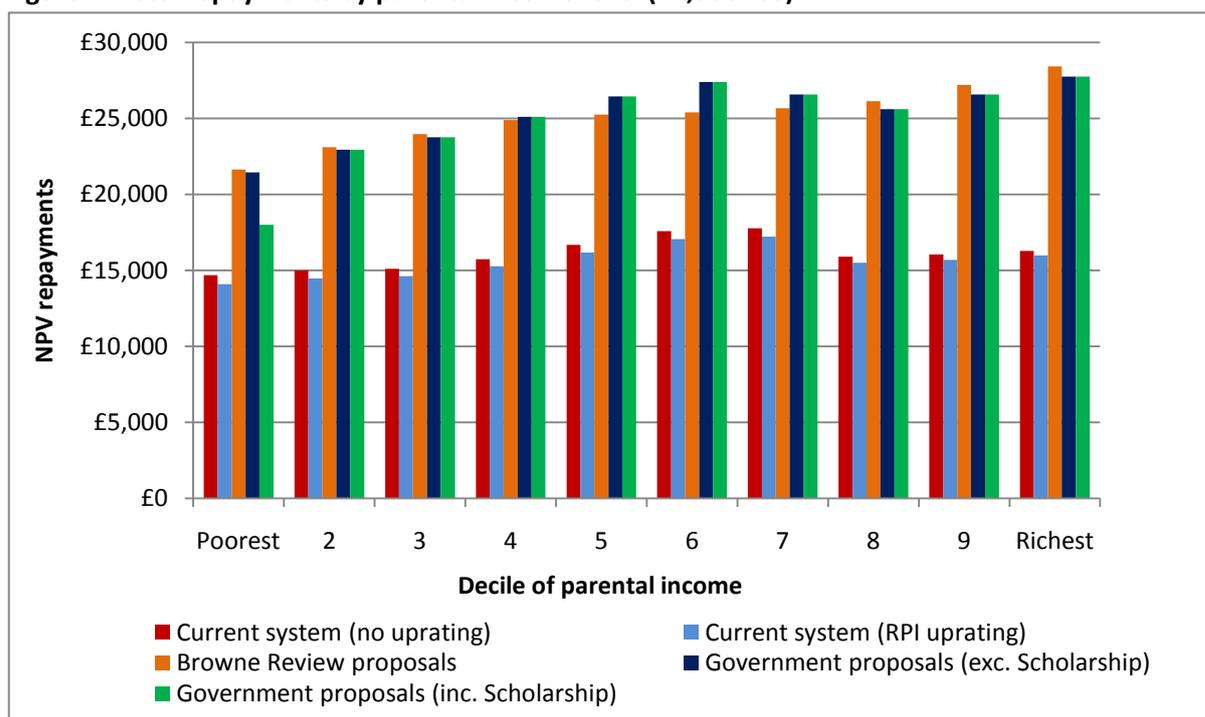


We see from Figure 1 that graduates in the bottom two deciles (on average) are better off than under the current system regardless of how the current repayment threshold is indexed. Across all graduates, we calculate that 24.3% of graduates would be better off compared to the current system assuming no up-rating of the current £15,000 threshold; while 22.9% would be better off if the current threshold was linked to inflation (see Table 3). This is because fixing the current threshold in cash terms makes it less generous to graduates, and therefore makes other policy options seem relatively more generous in comparison. Nevertheless, the Government’s proposed system is more progressive among graduates than both the current system and the one recommended by the Browne Review. The highest earning graduates (those in the top two deciles) would pay more on average than under the proposals made by Lord Browne, while graduates in the other income groups would pay back less.

If we instead examine the implications of the proposed reforms by students’ *parental income*, we see that the proposed system including the scholarship enables graduates from the poorest 30% of households to pay less, on average, than under Lord Browne’s system, but still significantly more, on average, than under the current system. This is because while overall debt for students with a scholarship will be slightly lower than under the current system, repayments will be still be higher because of the increase in interest rates. Interestingly, graduates coming from the 6<sup>th</sup> decile of family income pay back the most, on average, because they receive the highest maintenance loans and are not eligible for any support from the National Scholarship. Under Lord Browne’s proposal, graduate repayments increase slightly by decile of parental income, which contrasts with the peaks at the 6<sup>th</sup> and 10<sup>th</sup> deciles under the Government’s proposals. This somewhat perverse distributional effect could have been avoided if the Government had adopted the Browne Review’s simpler and

more transparent recommendations: a universal maintenance loan of the same value to all students, with a means-tested grant providing the progressively-targeted student support.

**Figure 2. Total repayments by parental income level (£7,500 fee)**



Both the Government's and Lord Browne's proposals ensure that graduates in the bottom 20% to 25% of graduate lifetime earnings are actually better off than under the current system (see Table 3). All other graduates are worse off than under the current system. For around half of graduates, the proposed system is effectively a 30-year graduate tax (as shown in Table 4): these individuals will simply pay 9% of their earnings above the repayment threshold for 30 years and then have the rest of their loan written off. One key difference compared with the recommendations made by Lord Browne is that under the Government's proposals, around 10% of graduates would pay back more than they borrowed (see Table 5). This is due to the proposed 3% maximum interest rate, which exceeds the Government's discount rate of 2.2%.

**Table 3. Proportion of graduates who pay back less than under current system (under a £7,500 fee)**

	Current with no up-rating of threshold	Current with RPI up-rating of threshold
Browne proposals	24.5%	23.1%
Government proposals	24.4%	23.2%

**Table 4. Proportion of graduates who have some debt written off**

	£7,500 fee	£9,000 fee
Browne proposals	51.5%	57.1%
Government proposals	48.7%	54.8%

**Table 5. Proportion of graduates who pay back more than they borrowed**

	<b>£7,500 fee</b>	<b>£9,000 fee</b>
Browne proposals	0.6%	0.5%
Government proposals	9.2%	10.7%

## 5. Comments

The proposed government system is progressive compared to both the current system and that proposed by Lord Browne when looking at repayments across the distribution of *graduate lifetime earnings*. When looking at repayments across the distribution of *parental income*, the system is more progressive than the current system and that proposed by Lord Browne for the bottom 6 deciles. Graduates from the bottom decile of parental income distribution benefit significantly more than graduates in higher deciles because of the operation of the scholarship. However, because of the complicated maintenance loan system described earlier, the proposed system is not progressive throughout the top 4 deciles of *parental income*. This is also the case with the current system. Lord Browne avoided this by having a universal maintenance loan with all the progressivity of the student support system achieved through the grant. The complexity added by the Government saves it around £360 per student. This small saving could equally have been achieved via a small reduction in the universal maintenance loan proposed or some tweaking of the grant system; this would also have provided the additional benefit of greater transparency and a lower administrative burden. The Government's decision to implement a different system of maintenance loans is therefore a lost opportunity.

The aim of the scholarship is to ensure that higher tuition fees do not dissuade students from poor backgrounds from applying to universities that charge above £6,000; it also offers poorer students some additional protection if universities charge high fees. The scholarship may well achieve these ends and have a positive impact on participation compared to a system without a scholarship, if students are repelled by their perception of the higher fees. It allows students from the poorest backgrounds to have a 'taster' year of university without having to take out a fee loan.

However there are a number of counter-intuitive (or even perverse) implications resulting from this scheme. While it does benefit poor students, it does not benefit poor graduates. The lowest earners are not affected by it as most of their debt is written off regardless; the benefit is greatest in the middle of the distribution of lifetime earnings. Most obviously, a student from a low-income background who studies at a university charging £6,000 (or below) will have to borrow the full fee amount for two years (up to £12,000) – while a student at a university charging £6,001 (or more) will have his/her fees covered for two years and only needs to borrow a maximum of £9,000 for fees (for a three-year degree). Given the Government's emphasis on allowing student choice and fee variability to drive the higher education sector, it seems surprising to introduce a distortion into this quasi-market which would potentially make a degree at an oversubscribed, elite university cheaper than at a less prestigious one.

This leads to a further issue: requiring universities to fund the first year of free tuition from their own income could impose significant costs upon universities, while saving the Government money. The Government does not have to issue a fee loan for this additional year that is provided for free, which reduces the associated loan subsidy (reflecting the expected costs of writing off the debt). Under a £7,500 fee, for example, the cohort of graduates would, as a whole, make £126 million less in repayments over their lifetime. However, the burden of this does not fall on the Government. Universities lose the full amount of the annual fee, which totals £137 million across the entire cohort of graduates. The difference of £11 million is actually a saving to the Government: it loses less from providing a year's free tuition (because some of money, if loaned out, would not have been repaid anyway); moreover, this is outweighed by a larger saving that results from not having to issue fee loans for the additional year of free tuition. If all universities charge only £6,000 then this issue does not arise as their liability to match-fund additional free tuition is not triggered; at the other extreme, if they charged £9,000 then they would lose £164 million of fee income, while the Government would actually benefit to the tune of £26 million.

This re-introduces the undesirable feature of the bursary scheme (as outlined by Lord Browne): universities that attract a higher proportion of poorer students have to absorb additional costs compared to universities that attract a lower proportion (if they want to implement fees above £6,000). Given that the scholarship creates a large distortion in the higher education sector, as well as a financial incentive for high-status universities not to accept the poorest students, we think it would be better for the Government fund the additional year of free tuition itself. It could then claw back the money from the most expensive universities in ways that are not related to by the proportion of poor students they attract – for example, via a levy scheme similar to the one proposed by Lord Browne.

## Appendix: Supplementary tables

Table A.1 Implications of different fee levels for graduates

Average fee	Average NPV repayment	Average number of years to repay	Proportion with some debt written off	Proportion repaying more than they borrow	Proportion repaying less than under current system
£6,000	£22,770	24.2	43.0%	7.7%	23.2%
£7,000	£24,240	24.8	46.5%	8.7%	23.3%
£7,500	£25,020	25.1	48.7%	9.2%	23.2%
£8,000	£25,770	25.4	50.8%	9.8%	23.2%
£8,500	£26,500	25.7	52.8%	10.2%	23.2%
£9,000	£27,200	26.0	54.8%	10.7%	23.2%

Table A.2 Implications of different fee levels for public finances

Average fee	RAB charge (%)	RAB charge (£) per graduate	Total RAB charge across all graduates	Extra cost relative to £7,500 fee
£6,000	25.7%	£7,970	£2,906 million	-£669 million
£7,000	27.3%	£9,120	£3,327 million	-£248 million
£7,500	28.1%	£9,800	£3,575 million	£0
£8,000	29.0%	£10,510	£3,833 million	£258 million
£8,500	29.8%	£11,240	£4,101 million	£525 million
£9,000	30.6%	£12,000	£4,378 million	£802 million

Note: Final two columns show costs per cohort of graduates. This is in principle indicative of the annual cost when the system is in a steady state.