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**OECD IMHE-HEFCE International Comparative  
Higher Education Financial Management and  
Governance Project**

# Financial management and governance in HEIs: England

This report has been produced by HEFCE.  
It has been informed by research and fieldwork at a sample of universities and colleges  
carried out for HEFCE by RSM Robson Rhodes

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*January 2004*

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**CONTEXT: HIGHER EDUCATION IN ENGLAND**

1. According to the responsible government department the main purposes of higher education<sup>1</sup> are:
  - ◆ to enable people to develop their capabilities and fulfil their potential, both personally and at work;
  - ◆ to advance knowledge and understanding through scholarship and research;
  - ◆ to contribute to an economically and culturally diverse nation.

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***Universities and colleges of higher education***

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There are 131 higher education institutions (HEIs) in England, comprising 77 universities, 14 general higher education colleges and 40 specialist higher education institutions.

***Universities***

2. Universities are diverse, ranging in size, mission, subject mix and history. They are self-governing and independent.
3. The oldest universities were founded many centuries ago. Those founded in the nineteenth and in the early part of the twentieth century are generally incorporated by a Royal Charter, which defines their degree-awarding powers (but often does not define, for example, details of membership of the governing body). A few of these older institutions were created by Act of Parliament, rather than by Royal Charter.
4. Many other newer HEIs have achieved their status through a single Act of Parliament, the Education Reform Act 1988, which created higher education corporations out of the polytechnics and colleges of higher education that were then under local government control. Under the Further and Higher Education Act 1992, the Privy Council<sup>2</sup> was enabled to grant the title of “university” to these former polytechnics and colleges of higher education, provided they met certain eligibility criteria.
5. Universities have their own degree-awarding powers. Articles of Governance of HEIs are approved by the Privy Council. HEIs are also required to seek Privy Council approval for any changes to their Articles of Governance.
6. Although the origins of HEIs vary, an important factor they have in common is their legal independence. As independent entities, they have substantial freedoms. For example, they can:
  - ◆ own assets<sup>3</sup>;
  - ◆ enter into contracts;
  - ◆ borrow funds;
  - ◆ set terms and conditions for staff employment.

***Colleges***

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<sup>1</sup> DfES statement of the purposes of higher education.

<sup>2</sup> The Privy Council is the advisory body to the monarch as head of state.

<sup>3</sup> Also see paragraph 84 for impact of public capital grants.

7. Higher education colleges also vary in size, mission subject mix and history. Like universities, they are self-governing and independent. Some college were founded up to 150 years ago, and a significant number were established as church colleges. Some award their own degrees and other qualifications; in other colleges, qualifications are validated by a university.

8. Higher education colleges with degree-awarding powers can apply to the Privy Council for the right to use the title of “university college”.

9. Many colleges cover a wide range of subjects, while some specialise in one or two areas, such as art and design, dance and drama, or agriculture.

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### **Staff**

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10. Universities and colleges in the UK employ around 100,000 full-time and around 40,000 part-time academic staff. Total staff numbers are around 300,000. Academic staff in most universities and colleges carry out research as well as teaching. Most have doctorates and many have professional qualifications.

11. Pay scales are nationally negotiated for most university and college staff. There are currently separate pay scales for pre-1992 universities and post-1992 universities. In pre-1992 universities, conditions of employment (such as holidays) are negotiated locally. In the post-1992 universities, there is a national agreement covering conditions of employment.

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### **Tuition fees**

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12. It costs around £4,400 per year to provide an average undergraduate course. The Government meets most of this cost through allocations to HEIs from the Higher Education Funding Councils.

13. In England, undergraduate students from the UK and European Union (EU) on full-time higher education courses contribute up to £1,100 per year towards tuition fees (2003-04 rate).

14. To ensure students are not prevented from entering higher education for financial reasons, students and their parents are assessed to determine their ability to pay. In 2001-02, 43 per cent of all full-time students did not have to pay any fees, 16 per cent paid part of the fee, and 41 per cent made the maximum contribution<sup>4</sup>.

15. Universities and colleges are free to set the fee levels they charge to students from outside the EU.

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### **Students in the UK**

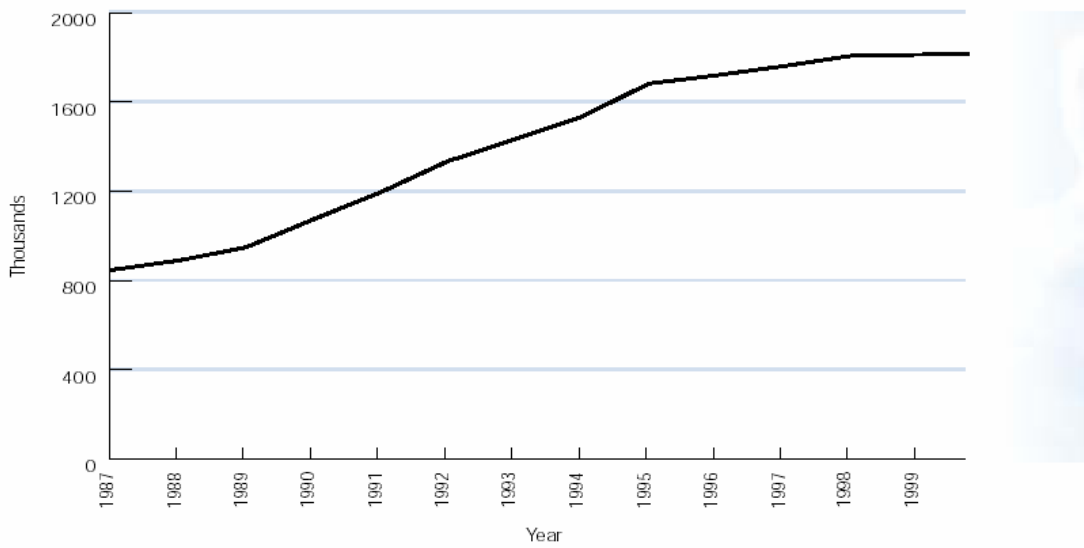
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16. The nature of higher education in the UK has changed significantly over the 40 past years. The number of students has increased dramatically: there are now over 1.8 million students at higher education institutions.

#### **Figure 1: Higher education students in UK higher education institutions**

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<sup>4</sup> DfES published Statistical First Release (SFR) data .



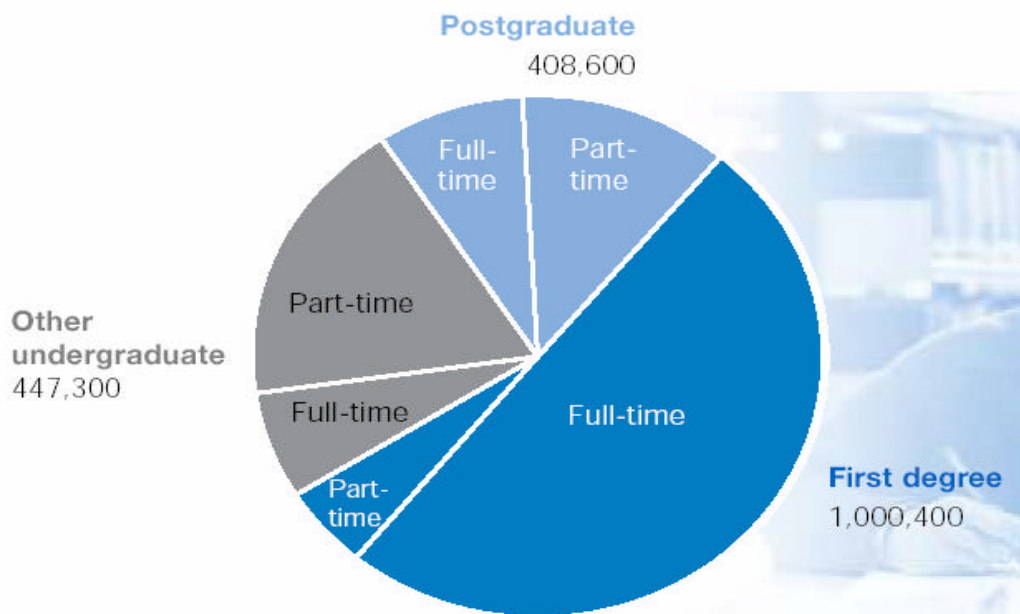
Source: DfES

HE students in UK higher education institutions

17. These are split by mode (full-time or part-time) and level of study (undergraduate or postgraduate) as shown in Figure 2.

Figure 2: HE students in UK HEIs, by level and mode of study 1999-2000

Total 1.85m



Source: HESA - '1999-2000 Student Record'

18. Women now make up around 55 per cent of the student population. In the UK about 20 per cent

of full-time first degree students are 21 or over when they start their course.

19. In addition there are over 112,000 students on further education courses at UK universities and higher education colleges<sup>5</sup>.

20. The level of participation in higher education by school leavers increased rapidly in the 1980s and early 1990s. Currently around 43 per cent of those aged 18 to 30 have some experience of higher education. The Government's target is to increase this towards 50 per cent by 2010.

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### ***International students***

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21. There are some 243,000 students from overseas studying in the UK. They come from over 200 countries and represent almost 12 per cent of the student population. Thirty-seven per cent of these students (90,000) come from EU countries<sup>6</sup>.

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<sup>5</sup> HESA Red Book 2001-02.

<sup>6</sup> HESA Red Book 2001-02.

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## THE CONSTITUTIONAL AND FUNDING POSITION

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### *Introduction*

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22. As previously stated, higher education in England is provided in some 131 higher education institutions; and additionally in around 200 colleges of further education<sup>7</sup>. Only universities or university colleges have powers to award taught degrees<sup>8</sup>. Where higher education is provided by institutions other than universities or university colleges, the taught degrees awarded are validated by, and bear the name of, a responsible university. Other than in specific instances only universities have powers to award research degrees.

24. The higher education sector in England is mostly publicly funded, although there is one private university with a charter (the University of Buckinghamshire), and there are also campuses of international or foreign national institutions describing themselves as universities. These institutions receive no UK public funding and are outside the scope of this study.

25. In this report, the universities, colleges, schools and institutes of higher education described above are referred to generically as "higher education institutions" (HEIs). Their roles are discussed more fully in this Section of the report.

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### *Legal status of HEIs*

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26. HEIs are independent bodies. They are not, therefore, structurally part of Government or regarded as part of the public sector. For example, borrowing by HEIs is not part of government borrowing. Even so, government policy objectives, and the fact that HEIs receive either the majority or a substantial part of their income from public funds mean that, in practice, Government exerts a significant influence over the behaviour and expectations of the higher education sector as a whole. Public expenditure on higher education can be viewed as investment for the public good, to produce both an economic and a social return. For example, the internal rate of return for individuals in the UK in 1999-2000 was 17.3 per cent for men and 15.2 per cent for women, well ahead of the OECD country mean of 11.8 per cent and 11.3 per cent respectively<sup>9</sup>. Similarly, the social rate of return in the UK in 1999-2000 was 15.2 per cent for men and 13.6 per cent for women, again ahead of other leading OECD countries<sup>10</sup>.

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### *Relationship between Government and HEIs*

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27. The Government department responsible for higher education is the Department for Education and Skills (DfES). The Secretary of State for Education and Skills leads the development of policy on higher education in the context of the DfES's policies on education, and overall government policies and priorities.

28. The development of higher education policy takes account of advice from the Higher Education

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<sup>7</sup> Although only around 8 per cent of teaching provision is through these further education colleges.

<sup>8</sup> Powers to award degrees come from the Privy Council, the advisory body to the head of state.

<sup>9</sup> OECD Education at a Glance 2003.

<sup>10</sup> OECD Education at a Glance 2003.

Funding Council for England (HEFCE - see below) and others. The DfES is then responsible for the delivery of policy objectives, but in practice devolves much of the implementation of policy to Agencies, Councils and other bodies.

29. The DfES does not have a direct relationship with HEIs. Instead, it sets policy objectives for, and provides funds to, an intermediary body – HEFCE. A number of such buffer bodies<sup>11</sup> have operated in this role since 1918. Similar bodies currently in operation are the Learning and Skills Council which funds further education<sup>12</sup>, and the Teacher Training Agency which funds the training of school teachers.

30. The existence of an intermediary or buffer body helps to ensure that academic freedom is safeguarded and that HEIs are not subject to direct political influence. The freedom of the Secretary of State is also constrained by legislation. For example, under the Higher Education Reform Act 1988 and the Further and Higher Education Act 1992, the Secretary of State cannot control the level of funding provided to individual HEIs.

31. In addition HEIs have control over the courses they offer, the contents of the curriculum and over admissions policies. They are, however, encouraged to recruit students from a wide range of backgrounds.

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### **HEFCE's role**

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32. HEFCE was established in June 1992 under the terms of the Further and Higher Education Act 1992 as a legally separate, non-departmental public body operating within a policy and funding context set by the Government. HEFCE assumed responsibility for funding higher education in England on 1 April 1993, taking over from other funding bodies that had existing in various forms since 1918..

33. HEFCE's statutory role is to:

- ◆ administer the funds provided by the Secretary of State and others for education and the undertaking of research;
- ◆ provide advice to the Secretary of State on the financial needs of higher education in England;
- ◆ ensure that provision is made for assessing the quality of education in HEIs and further education colleges that receive HEFCE funding<sup>13</sup>.

34. However, HEFCE does not limit its activities to these statutory roles, but seeks to add value to the public investment in higher education. This is described in its mission:

*“Working in partnership, we promote and fund high-quality, cost-effective teaching and research, meeting the diverse needs of students, the economy and society.”*

35. The current aims to deliver this mission are set out in HEFCE's 2003-08 strategic plan and are detailed at Annex A. HEFCE has revised its strategic plan to be more responsive to the needs of its key stakeholders over the next decade, and to take account of the policy aims of the Government's

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<sup>11</sup> The University Grants Committee operated from 1918 to 1989 (for the whole of Great Britain), initially as a committee in HM Treasury; the Universities Funding Council (for Great Britain) and the Polytechnics and Colleges Funding Council from 1989 to 1992 (England only); and since 1992, the higher education funding councils for England, Scotland and Wales.

<sup>12</sup> This includes tertiary education that is below degree level.

<sup>13</sup> Further and Higher Education Act 1992, section 65.



higher education White Paper “The future of higher education”, published in January 2003.

36. In addition HEFCE monitors the financial health of the sector and of individual HEIs. It is not, however, responsible for the financial management or governance of individual HEIs. That responsibility rests with the individual governing bodies.

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### ***Relationship between the DfES and HEFCE***

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37. While the HEFCE is a public body it has a role that is legally separate from Government. The powers of Secretary of State for Education and Skills are limited by legislation in terms of the directions that can be given to the HEFCE. This degree of independence from Government is intended to avoid direct political influence in universities and colleges. The Chief Executive of HEFCE is accountable to Parliament for the use of the funds provided to HEFCE.

38. HEFCE’s relationship with the DfES is described in a formal document (Financial Memorandum) setting out how the DfES expects HEFCE to operate, and the conditions that the DfES attaches to the funding it provides for HEFCE to distribute. This includes HEFCE’s own financial management arrangements and the process for paying grants. The memorandum also sets out a number of requirements in relation to HEFCE’s relations with HEIs.

39. In addition, HEFCE receives an annual guidance letter from the Secretary of State setting out the Government’s priorities for higher education and the funding being provided for the following three financial years<sup>14</sup>. This letter of guidance indicates if any of the funds provided by Government are for specific purposes, and any other conditions that are attached to the funds provided.

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### ***Relationship between HEFCE and HEIs***

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40. HEFCE defines its relationship with HEIs, under which it provides them with public funding, within a Financial Memorandum with each institution. (See Section Three). The Financial Memorandum lays down a series of responsibilities for both parties. Over and above imposing these responsibilities, HEFCE does not intervene directly in the management or governance of an HEI. However, it can attach conditions to its grant, and ultimately, it can withhold grant from an HEI<sup>15</sup>.

41. Inevitably, there is a tension between the independence of HEIs and the level of influence (or accountability) which HEFCE can bring to bear upon them through the Financial Memorandum. Similarly there is a growing debate about what is proper level of accountability to protect the public investment in higher education, the burden that this can impose on universities and colleges and the whether cuts across the freedom of autonomous institutions to operate in free markets. These tensions are discussed in Section Five of this report.

42. Following from the annual letter of guidance from the Secretary of State, HEFCE announces its funding allocations annually for the forthcoming academic year<sup>16</sup>. This will include any specific conditions attached to grants, in addition to the general conditions set out in the Financial Memorandum.

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<sup>14</sup> The funding year runs from April to March. Recent practice has been that only the funding for the first year is firm, with funding for the second and third years being subject to confirmation.

<sup>15</sup> See HEFCE 2003/54 for the model Financial Memorandum with universities and colleges. This sets out the standard conditions of grant that apply to all universities and colleges.

<sup>16</sup> From August to July.

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**Relationship between HEFCE and other stakeholders**

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43. HEFCE is no longer the sole – or in some cases even the major – funder of HEIs (see Chart 1). Not only are HEIs generating increasing levels of income from non-public sources, but there is also an increasing range of public sources of funding for both teaching and research (see section below on how higher education is funded).

44. This requires HEFCE to work collaboratively with other funders where there are common objectives to be achieved. There is also a distinction between public bodies as funders of activities and public bodies as purchasers of services. In aggregate, 60 per cent of HEIs' income comes from public sources; within this around 45 per cent is funding, with the remaining 15 per cent from contractual activities.

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**Monitoring higher education quality**

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45. HEFCE has a statutory duty to ensure that the quality of the teaching it funds is assessed. This is carried out for HEFCE under contract by the Quality Assurance Agency for Higher Education (QAA). Outcomes of QAA assessments are published. Over the past eight years, a comprehensive programme of reviews at subject level has been conducted, covering all main subject areas in all HEIs in England. The programme was completed in December 2001 and showed that, in general, the quality of higher education courses is very high. Having completed this initial programme, the QAA has developed a more selective, "lighter touch" approach to its work, relying more than previously on external reviews of HEIs' own quality control procedures. The principle underlying the new approach, which operates from 2003 onwards, is "intervention in inverse proportion to success".

46. The aims of the new approach still embody the need to meet the public interest in knowing that English universities and colleges are:

- ♦ providing higher education, awards and qualifications of both an acceptable quality and an appropriate academic standard; and (where relevant);
- ♦ exercising their legal powers to award degrees in a proper manner; and
- ♦ providing public information to inform student choice.

47. The three UK Higher Education Funding Councils (for England, Scotland and Wales) and the Department of Employment and Learning Northern Ireland jointly carry out a periodic Research Assessment Exercise (RAE) that assesses the quality of *research* by departments and groups within HEIs. The RAE is an accountability mechanism through which universities and colleges demonstrate how funds have been used. Outcomes of the RAE inform future funding decisions. The most recent exercise was conducted in 2001, based on peer review of research outputs. Each HEI reviewed is awarded a rating (between 1 and 5\* – five star) for the quality of its research in each subject area for which it makes a submission.

48. There has been a dramatic improvement in RAE scores over recent years. In 1992, 23 per cent of the researchers submitted<sup>17</sup> were in a department rated 5 or 5\*, rising to 31 per cent in 1996. In 2001, this had increased to 55 per cent. Nearly two-thirds of HEIs now have at least one 5 or 5\* rated

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<sup>17</sup> Percentage of staff submitted as being research active was around 60 per cent in both 1996 and 2001.

department. However, 75 per cent of research funding is allocated to 25 per cent of HEIs. The results of the assessment have a significant impact on the future level of research funding provided by HEFCE (see below).

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### ***How higher education is funded***

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49. The Government determines how much public funding it wishes to provide for higher education (see paragraph 39 above). These funds are then passed to HEFCE to determine how they should be distributed to universities and colleges. For 2003-04, HEFCE will allocate some £5,485 million to the higher education sector, as follows:

**Table 1: HEFCE funding 2003-04**

Teaching	£3,399M
Research	£1,042M
Special funding <sup>18</sup>	£815M
Rewarding and developing staff in higher education <sup>19</sup>	£178M
Teachers' Pension Scheme compensation	£47M
Flexibility and moderation	£4M
<b>Total</b>	<b>£5,485M</b>

*Source: "Recurrent grants for 2003-04" (HEFCE 2003/10)*

50. Teaching and research funds are allocated on the basis of formula funding described in HEFCE's publication "*Funding higher education in England: How HEFCE allocates its funds*"<sup>20</sup>. Further details are also in paragraphs 54 to 65 below.

51. A key principle of the funding arrangements is that core funding for teaching and research, which account for over 80 per cent of total funding, is provided as a block grant<sup>21</sup>. This allows HEIs discretion as to how these funds are used in delivering the outcomes required from the funding. Outcomes are measured by numbers of students who complete each year of study, and the quantity and quality of research outputs, as measured through the RAE.

52. If the block grant to an individual HEI is reduced, HEFCE moderates this reduction, so that institutions are protected against large year-on-year changes in their grant for a period of twelve months. This allows them time to adjust to the new level of core funding without adversely impacting on students.

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<sup>18</sup> Funding outside the core funding for teaching and research, where inclusion could distort the funding for individual HEIs. It includes targeted funds to provide incentives in specific areas, funding for national facilities, capital programmes and liabilities inherited from previous funding bodies, including College fees.

<sup>19</sup> Additional, earmarked funding to enable HEIs to address key issues around the recruitment and retention of staff. Funding is conditional on HEIs developing human resources strategies.

<sup>20</sup> This is updated annually following the announcement of funding each March. The current version is HEFCE 2003/29.

<sup>21</sup> In addition funding for Rewarding and Developing Staff and capital schemes - Science Research Investment Fund and Project Capital - are allocated formulaically by reference to teaching and research core funding. These increase the percentage to 89%.

53. In addition to this block grant and funding for rewarding and developing staff, some special funding is targeted where HEFCE is providing incentives to bring about change across the sector as a whole, such as the development of learning and teaching strategies or to enhance the quality of teaching. Currently this targeted funding accounts for less than 4 per cent of the total funds allocated by HEFCE.

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### ***Funds for teaching***

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54. As stated earlier, it is for HEIs to decide which courses they run and the curriculum content of those courses. That discretion may be constrained where the courses are recognised by professional bodies as leading to recognised qualifications, such as engineering.

55. HEFCE's method for funding teaching was developed in consultation with universities and colleges. It funds similar activities at similar rates for all institutions, and ensures that any variations are for explicit and justifiable reasons. In addition, it supports HEFCE's policy to increase opportunities for a wide range of people to enter higher education. It takes account of the extra costs of providing for certain types of student, such as part-timers and mature undergraduates, and supports diversity by recognising the extra costs of specialist colleges.

56. The other key principle of the teaching funding method is that institutions can bid for additional funded student places according to criteria that HEFCE determines each year.

57. In addition to the main teaching funding method, HEFCE has made separate allocations to recognise the additional costs of recruiting and supporting students from disadvantaged backgrounds, who are under-represented in higher education, and students with disabilities.

### ***Calculating the funds each year***

58. Some subjects are more expensive to teach than others. To allow for this, subjects are allocated to one of four price groups, according to historical cost data and by grouping cognate disciplines together. The four price groups have weights as follows:

Price group A	Clinical subjects	4.5
Price group B	Laboratory-based subjects	2.0
Price group C	Subjects with some studio or laboratory element	1.5
Price group D	All other subjects	1.0

59. The base price – for price group D – is set each year according to the funding available from the DfES. This then determines the prices for the other price groups, using the above weights. There are then a number of steps to calculate the amount of teaching funding for each institution.

60. First, the standard resource<sup>22</sup> for an HEI is determined by multiplying the number of full-time equivalent students in each price group by the price for that group. A number of additional amounts of grant may be added into the standard resource to take account of specific institutional<sup>23</sup> factors.

61. The final standard resource for the institution is compared with the previous year's actual resource (adjusted for inflation and changes in the base price). If this is within + or – 5 per cent of the assumed standard resource value (referred to as the tolerance band), the HEI will receive the same amount of teaching funds the following year.

62. HEIs can increase their teaching grant through bidding for additional student numbers each year. This method of incremental growth is under review. It is likely to be changed to move towards a more strategic and long-term approach, to meet the Government's target of 50 per cent of those aged 18 to 30 having some experience of higher education by 2010. Some of this growth will be targeted at foundation degrees (see paragraph 109).

63. Within the total funding for teaching, HEFCE allocates funds to contribute to the costs of providing for students from disadvantaged or non-traditional backgrounds, or who are at most risk of not completing their courses, and funds to support students with disabilities. For 2003-04 the HEFCE is allocating £265 million (within the total £3,399 million for teaching) for these purposes.

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### ***Funds for research***

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64. Public funding for research in HEIs comes from two main sources –HEFCE and the Research Councils. This is known as the "dual support system". Broadly speaking, dual support works as follows:

- ◆ HEFCE provides funding based on the outcomes of the RAE (known as quality related or QR funding) to support the research infrastructure in HEIs, that is, the cost of the salaries of permanent academic staff, premises, libraries, and IT costs. HEFCE funds also support "blue skies" and basic research in HEIs, and contribute to the cost of training new researchers. QR funding amounted to £1,042 million in 2003-04;
- ◆ Research Councils (funded by the Office of Science and Technology, part of the Department for Trade and Industry) provide funding for specific research projects. The six Research Councils invest a combined total of around £1.6 billion a year in research, of which some £600 million was awarded to HEIs in 2001/02<sup>24</sup>.

65. The key principle of the HEFCE research funding method is that funds are distributed selectively to HEIs that have demonstrated their strength by reference to national and international standards of excellence, as measured in the periodic RAE described above. Funds are allocated with reference to both the quality and volume of research activity. The relationship between RAE ratings and funding in 2003-04 is set out in the table below.

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<sup>22</sup> Resource includes HEFCE grant plus assumed tuition fees.

<sup>23</sup> To recognise the higher operating costs for small or specialist institutions, or institutions operating in London.

<sup>24</sup> The Research Councils operate UK wide and also fund activity through their own institutes.

**Relationship between RAE rating and funding 2003-04**

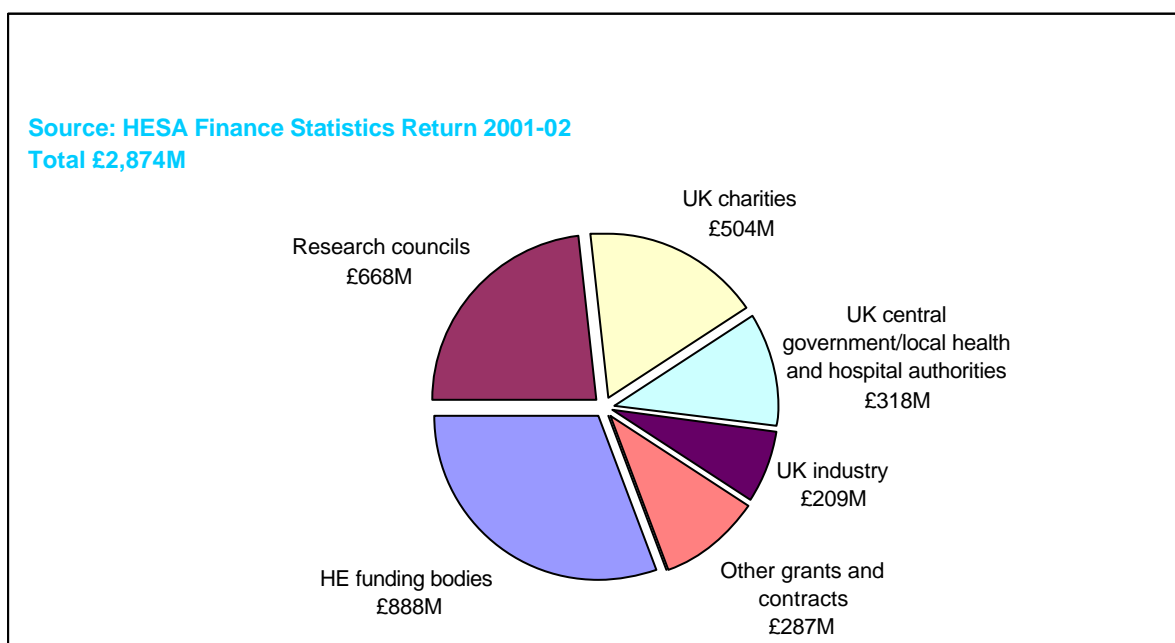
RAE rating	Funding weight
5*	3.357
5	2.793
4	1
3b	0
3a	0
2	0
1	0

Source: "Recurrent grants for 2003-04" (HEFCE 2003/10)

### Research funding and dual support

66. Since the late 1980s there have been differential growth rates of the different funding streams for HEI research. At the end of the 1980s, HEFCE grants were broadly in balance with all other sources of research funding (the Research Councils, research charities, industry and so on). By 1999-2000 however, the HEFCE grant was under one-third of the total research funding received by HEIs, as shown in Figure 3 below, with the latest year's data.

**Figure 3: Sources of research income for HEIs 2001-02**



67. This reflects the growth in other research funding streams, most notably from charities. A consequence has been that HEIs have not generally recovered the full costs of the increased activity from those commissioning the research. This is because most of these other funders currently pay only direct costs, plus a contribution to indirect costs, which is less than the full economic costs.

68. In addition, the balance between HEFCE research funding and research funding through the Research Councils (the two halves of the dual support system) has become unbalanced, as project funding through the Research Councils has grown more rapidly than HEFCE's research funding. As a result of this imbalance, HEFCE resources for research infrastructure have been spread across a greater volume of project activity. The Government has recognised this imbalance and its inherent unsustainability, and has announced additional funding to be phased in by 2005-06<sup>25</sup>. In addition, HEFCE is encouraging HEIs to improve their costing and pricing methodologies so that the full economic cost of their contribution to research projects is more transparent, and is reflected in the prices charged to public and non-public contract customers.

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### ***Student tuition fees***

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69. Under the current financial regime, home and European Union (EU) students in English HEIs make a contribution to their tuition costs. The full-time undergraduate tuition fee for 2003-04 is £1,125. This is set by Government and it is a condition of grant that HEIs do not charge higher or lower fees for these full-time students. This represents approximately 25 per cent of the average costs of a course (across all subjects).

70. HEIs are free to set their own fees for part-time courses or where the fee covers the full cost of tuition. Students from outside the EU are charged fees intended to meet the full costs of their courses. Income from overseas tuition fees was £649 million in 2000-01, close to 6 per cent of total income.

71. There has been much debate in the UK about the funding of higher education and the level of tuition fees. Some HEIs wish to charge higher fees to UK and EU full-time undergraduate students (sometimes called "top-up fees") to generate increased income. The Government's White Paper "The future of higher education", published in January 2003, sets out its intention to give HEIs the power from 2006-07 to increase tuition fees up to a limit of £3,000 per year.

72. Institutions which do this will be required to have Access Agreements in place, and to satisfy a new Office for Fair Access that they are taking appropriate action to safeguard and promote access for students, irrespective of their background. Students can take out government loans while they are studying, and will repay their fees through a deferred repayment scheme collected through the tax system once their post-graduation income reaches a threshold level. These proposals are subject to legislation.

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### ***Other public funding***

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73. Total public funding for HEIs was £7,135 million in 2001-02 (see Figure 4 below). Significant amounts of this are provided from sources other than the HEFCE and the Research Councils. The most important are:

- ♦ the Department of Health, through the National Health Service (NHS). The NHS currently spends around £1 billion per year in the higher education sector, providing training courses for nurses, physiotherapists and other healthcare professionals. (There are also complex arrangements for funding clinical academics commonly known as "knock for knock", which try to ensure that teaching and research costs in medical schools are appropriately

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<sup>25</sup> £244 million through HEFCE and a further £120 million through the OST, for same level of research volume.

allocated between HEIs and their associated teaching hospitals);

- ◆ the Teacher Training Agency. The Agency currently allocates some £200 million per year to train teachers;
- ◆ the Learning and Skills Council. This provides funding of some £70 million per year in respect of further education courses<sup>26</sup> delivered by HEIs.

74. In addition, HEIs generate around £700 million in income by providing services to government departments, such as research contracts and consultancy.

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### ***Non-public funding***

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75. Most HEIs have always had some sources of private income. These include research and consultancy carried out for industry, donations and sponsorship, income earned from trading activities, and fees charged to students who are not funded by the Government (overseas students and many part-time students). For most institutions, these private sources of income have increased as a proportion of the total in recent years. This is chiefly due to the financial pressures on government funding to institutions and the positive encouragement they have been given to generate additional income.

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### ***Summary of income to HEIs***

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76. The sources of total income in 2001-02 are shown in Figure 4. Income from public bodies totals £7,135 million (60.3 per cent), with income from non-public bodies of £4,699 million (39.7 per cent).

77. Figure 5 shows the proportion of non-public income<sup>27</sup> for HEIs for 2000-01.

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<sup>26</sup> This is post-secondary education but below that recognised as higher education.

<sup>27</sup> See Figure 4 for definition of public and non-public income. Those in the top half of the figure from public sources; those in the lower half of the figure are from non-public sources.



Figure 4: Sources of finance for English universities and colleges, 2001-02

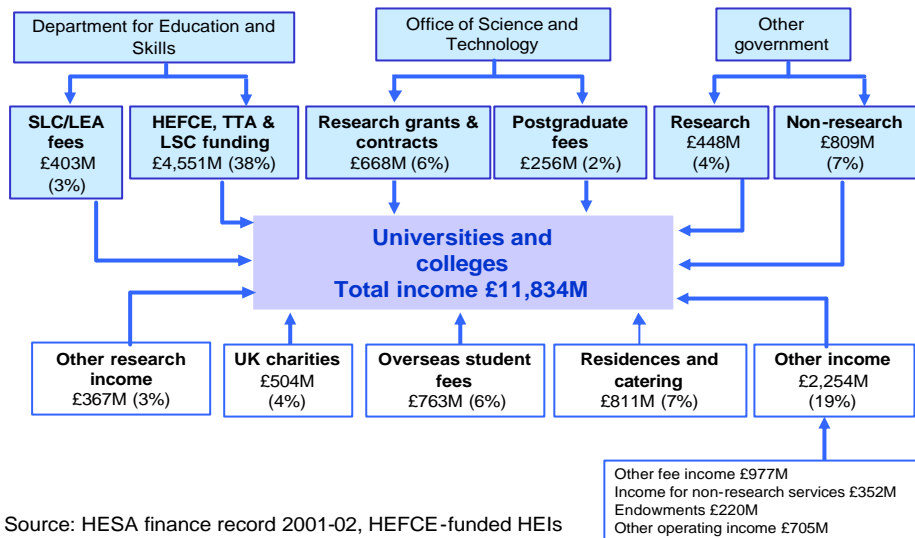
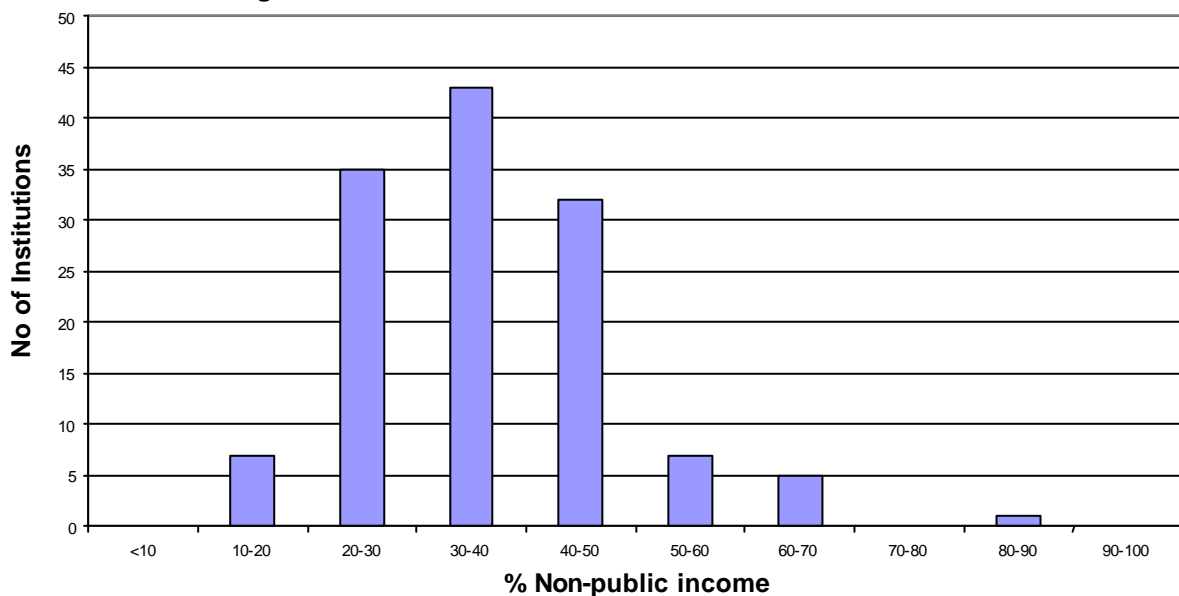


Figure 5 Non-public income as a % of total income 2000-01

HEFCE average = 39.6%



78. The chart clearly demonstrates the wide range in the amount of non-public income received by individual HEIs.

79. The relative proportion of each type of income also varies significantly between HEIs. For most institutions, HEFCE provides the single largest source of income. Even so, this frequently amounts to less than half of the HEI's total income. For some HEIs the proportion of income from HEFCE may be quite small.

80. This is illustrated by the following analysis of the financial statements for 2000-01 for six HEIs.

**Table 2: Sources of income for six HEIs – 2000-01**

HEI	Funding Council grants %	Tuition fees and education contracts %	Research grants and contracts %	Other income %	Public: non-public income proportions <sup>28</sup>
Exeter University	38	21	13	28	54:46
Hull University	39	26	10	25	60:40
Imperial College, London	30	11	39	20	49:51
Lancaster University	35	17	15	33	52:48
Liverpool John Moores University	54	26	3	17	76:24
Rose Bruford College	66	29	0	5	78:22

Source: RSM Robson Rhodes analysis of HEIs' statements of accounts 2000-01.

81. The table shows that for some HEIs the HEFCE grant amounts to under 40 per cent of total income. This is a reflection of the HEIs' success in generating income from other sources. HEFCE is prevented by statute from taking account of income from these other sources when making decisions about funding allocations<sup>29</sup>.

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### **Governance and management**

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82. Governance arrangements for HEIs are defined to a greater or lesser extent within their document of incorporation. Although there is no single form defined by statute, in practice the governance arrangements of HEIs are broadly similar.

83. Governance arrangements typically include the following elements (the titles may vary between institutions but the functions are the same):

- ◆ a **governing and executive body**, often called the council or board of governors. This body has ultimate responsibility for the strategic direction and long-term sustainability of the institution;
- ◆ a **body which oversees academic affairs** of the HEI, often known as the senate or the academic board;
- ◆ a **series of committees** of the governing body, which typically include a finance committee, an audit committee, a nominations committee, a remuneration committee, a health and safety committee and committees focused on particular issues – such as student residences, sports, specific building projects and so on;

<sup>28</sup> See Figure 4 for definition of public and non-public income.

<sup>29</sup> Further and Higher Education Act 1992 (section 66(2)).

- ◆ an **officer as head of the HEI**. The title of this officer varies between HEIs depending on their histories and traditions. Titles include principal, director, vice-chancellor, master, provost, rector or simply chief executive. Under the terms of the Financial Memorandum with HEFCE, each HEI must designate an officer who signs and takes responsibility on behalf of the governing body for compliance with the Financial Memorandum, and this is invariably the head of the HEI;
- ◆ an **executive management group**, typically comprising the head of the institution and senior managers responsible for academic and administrative functions. There are significant differences in the role and status of some of these senior managers between different types of institution. In the universities created in 1992, these are typically permanent management posts with managerial titles (such as director or assistant principal) even where they have responsibility for staff, students and the curriculum. By contrast, in the older universities, there is normally a permanent post of Head of Administration, with the title of Registrar or Director of Corporate Services and a fixed term post, often called Pro-Vice-Chancellors, held by senior academics. At the end of their term of office, the latter return to their academic work;
- ◆ a **director of finance**. In both types of institution, there is normally a director of finance but the status and reporting arrangements of this post vary. In the new universities the director of finance is nearly always a senior manager reporting directly to the head of the HEI, and a full member of the executive management group. In many of the old universities, the director of finance formally reports to the Head of Administration or, less commonly, to a senior academic officer (Deputy or Pro-Vice-Chancellor), rather than directly to the head of the institution. He or she may not always be a member of the most senior management team.

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### **Assets and staff**

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84. As independent legal entities, HEIs own their own assets. The total (insured) value of buildings, land and equipment in the English higher education system is approximately £26 billion<sup>30</sup>. The asset value of large universities is typically in the range £100 million to £500 million; and for smaller colleges it may be much less. Certain assets may have been funded by specific capital grants, which then creates a public (Exchequer) interest. Those funds remain with the HEI as long as they are invested in the original assets, or other assets used for higher education or research. If an asset with an Exchequer interest is sold, the proceeds should be reinvested for eligible purposes within three years. The asset purchased or created by the reinvested funds is then also subject to an Exchequer interest.

85. Subject to these rules, HEIs are free to invest in their assets, to use them as security for borrowing, and to dispose of them.

86. HEIs employ their own staff and have power to hire and dismiss them, subject only to employment law and the provisions of career long tenure for certain academics. All HEIs are, however, expected by HEFCE to have human resources (HR) strategies with policies and procedures for such matters as recruitment and retention, equal opportunities, staff development and performance management.

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<sup>30</sup> Excluding student residences.

87. Academic staff tend not to see themselves in the same relationship with their employing HEI as is the case in the private sector. Their contracts give them a good deal of freedom to pursue their research and academic interests, as well as delivering teaching and other services required by the HEI. It is often said that an academic's first loyalty is to his or her discipline and to academic colleagues in that discipline, rather than to their employing institution.

88. It is generally accepted that academic salaries in England have fallen behind those of comparable professions, but the relative freedom that academic staff have over their own working lives is quoted as a compensating factor. However, the recruitment and retention of staff is of increasing concern, as universities and colleges are increasingly operating in globally competitive markets.

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## THE CURRENT POLICY CONTEXT

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### *Introduction*

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89. Since taking office in 1997, the present Government has repeatedly stated its commitment to education at all levels – from pre-school groups through to lifelong learning programmes.

90. The Government's view is that higher education can make a significant contribution to a number of policy objectives, including:

- ◆ economic development;
- ◆ social inclusion;
- ◆ “good citizenship”.

91. A summary of government policy and aspirations for higher education was set out in “*Modernising higher education – facing the global challenge*” by the then Secretary of State in February 2000. This was updated in January 2003 by the publication of the White Paper “*The future of higher education*” which amounts to a major re-statement of the Government's aims and priorities. Much publicity has been given to the changes in funding of higher education contained in the White Paper, which include the possibility for HEIs to charge a higher level of tuition fees to home and EU students (see funding of higher education in Section One).

92. A major thrust of the White Paper is to encourage institutions to be more strategic and selective in identifying the activities and markets where they can excel, and to focus on these. There is also a strong message about institutions further developing their governance and management capabilities. The Government proposes to focus an increased level of public funding of research into a smaller number of institutions and departments. This even more selective approach is seen by the Government as necessary to ensure that UK research retains its world reputation. Proposals to change HEFCE's funding method for research (described in Section One) are currently the subject of consultation.

93. As well as maximising the economic benefits of research, the Government aims to develop an inclusive, world-class higher education sector which provides students with the skills they need, and helps to underpin a productive economy and cohesive society. “In order to achieve that we need a higher education system that is more relevant and more accessible to a greater number of young people from a broader range of backgrounds.”<sup>31</sup>

94. The Government has therefore made it a priority to further improve access and quality in higher education. This has four key goals:

- ◆ increased participation and fair access;
- ◆ excellent teaching and better completion rates;
- ◆ strengthening research excellence;
- ◆ world-class technology transfer and links to business and regional economies.

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<sup>31</sup> DfES statement of the purposes of higher education.

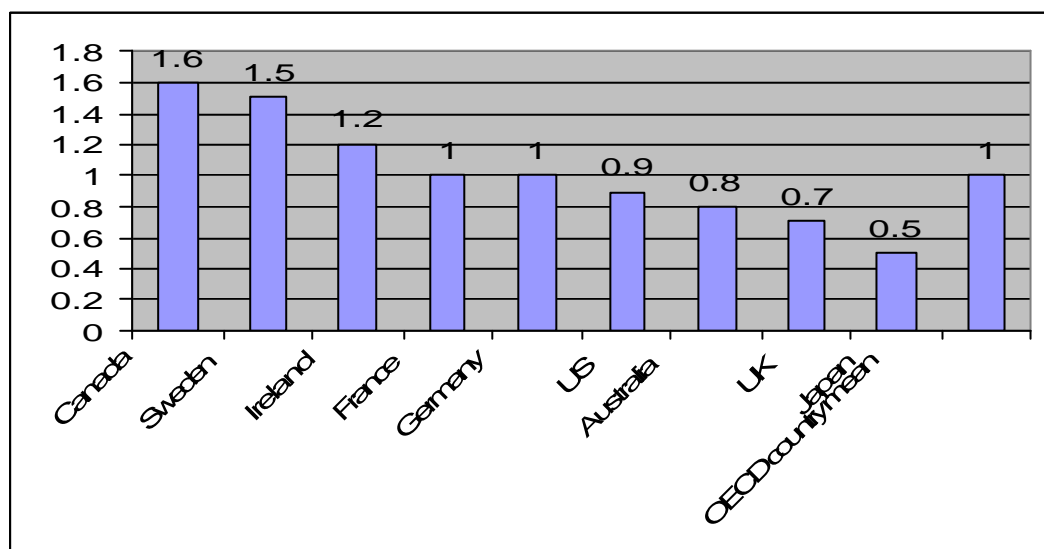
### Economic development

95. The importance of higher education as a driver of economic prosperity is a critical element of the Government's policy. Key elements of this argument include the following:

- ◆ to be competitive in the modern, knowledge-based global economy, countries require a skilled and knowledgeable workforce. It is important that as many of the workforce as are able to do so secure appropriate skills through higher education;
- ◆ the UK lags behind some other developed countries in terms of the proportion of people attending higher education and acquiring appropriate skills;
- ◆ one of the keys to future success is innovation, achieved through research programmes. HEIs are seen by the Government as key drivers of this research and innovation. (This analysis is set out in full in "*Investing in innovation – a strategy for science, engineering and technology*", published jointly by the DfES, the Department of Trade & Industry and HM Treasury in July 2002);
- ◆ specifically, it is forecast that the UK economy will generate an extra 1.7 million jobs by 2010. It is predicted that 80 per cent of these jobs will require skills secured by attending higher education courses of one type or another.

96. Public expenditure on higher education in the UK as a percentage of GDP is below that of other leading OECD countries<sup>32</sup>. UK public expenditure on higher education is 0.7 per cent of GDP compared with 1.6 per cent by Canada, 1.5 per cent by Sweden, 1.2 per cent by Ireland, 1 per cent by France and Germany and 0.9 per cent by the US. The average of OECD countries is also higher, at 1.0 per cent.

**Figure 6: Public expenditure on higher education as a percentage of GDP (2000)**



Source: OECD "Education at a glance" 2003

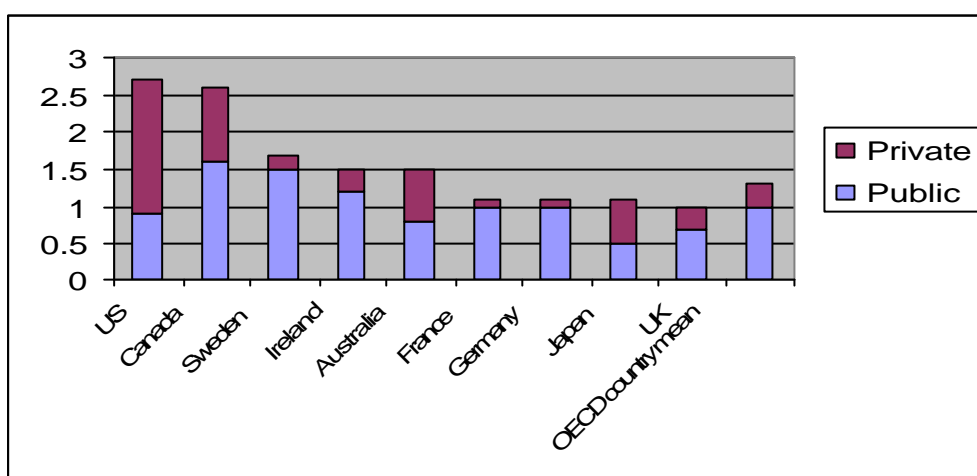
97. Like many of its competitors, the UK spent more on tertiary education during the 1990s. However, the relativities between public and private expenditure on higher education vary between OECD countries.

<sup>32</sup> OECD "Education at a glance" 2003.

98. While public investment represented 70 per cent of total investment in higher education in the UK in 2000, the proportion in Japan (45 per cent), the United States (33 per cent), Australia (53 per cent) and Canada (62 per cent) was lower<sup>33</sup>. This is shown in Figure 7 below. The total expenditure in higher education therefore varies as a percentage of GDP. The UK total was 1.0 per cent in 2000, compared with 1.5 per cent in Ireland and Australia, 1.7 per cent in Sweden, 2.6 per cent in Canada and 2.7 per cent in the US.

99. The public share of expenditure on higher education in the UK is greater than for some other OECD countries. The scope for universities and colleges in the UK to attract substantially increased private investment is, however, constrained by government policy that sets the level of the full-time tuition fee, and by the expectation that education in HEIs is still a public service to serve the public good.

**Figure 7: Public and private expenditure on higher education as a percentage of GDP (2000)**



Source: OECD "Education at a glance" 2003

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### **Research and knowledge transfer**

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100. The White Paper proposes to allocate public funds for research even more selectively. And HEIs are being encouraged to collaborate more on research, so that consortia and clusters of institutions are able to generate a greater critical mass of research activity. Institutions are also being required to take a more careful account of the full economic cost of research, and to manage their research more effectively to ensure that it is a sustainable activity in financial terms. The present arrangements for funding research projects through the Research Councils (as part of the dual support system) are also being reviewed to ensure that they are not unintentionally undermining the financial viability of institutions.

101. There has been an increase in policy attention and public funding directed to a related stream of activity which is often called knowledge transfer. The Government and HEFCE see this as a third academic activity alongside teaching and research, and it is often referred to as third stream or third leg. It relates to all the interactions between HEIs and the local and regional businesses and communities which they serve. These interactions are not the same as academic research, although

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<sup>33</sup> OECD "Education at a glance" 2003.

they are sometimes connected with it.

102. Knowledge transfer includes activities such as contract research, consultancy, training and professional development which is not for higher education awards, and a broader range of interactions between universities and their staff and the community. These activities are sometimes sources of commercial income for HEIs, which can introduce new issues of business planning and management, financing and risk management.

103. The rapid growth of research in HEIs in science, technology and medicine has had a significant impact on the culture of the institutions. Modern research in these fields has many of the features of a business (such as work in teams, international collaboration and competition, use of high technology, and multiple sources of finance). Some argue that this has helped many senior academics in these fields to qualify themselves for senior management positions in their institutions.

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### ***Social inclusion***

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104. The Government's view is that, in a knowledge-based economy, higher education is a powerful instrument of social justice because it both drives wealth creation and creates opportunities. As access to higher education is expanded, so the higher education system will increasingly underpin social justice within the community, as part of a framework of lifelong learning.

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### ***Good citizenship***

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105. The Government also believes that higher education produces citizens who are able and willing to engage in debate about public issues, and who are more likely to take an active role in society and the community.

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### ***Widening and increasing participation and fair access***

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106. In order to secure these economic and social policy objectives, the Government is seeking to widen and increase participation in higher education. It has set a target that by 2010, towards 50 per cent of those aged 18 to 30 should have had an experience of higher education. The current participation rate is around 43 per cent. The Government also requires that significant progress be made year on year towards fair access and social inclusion, and that completion rates, currently in excess of 80 per cent, do not reduce.

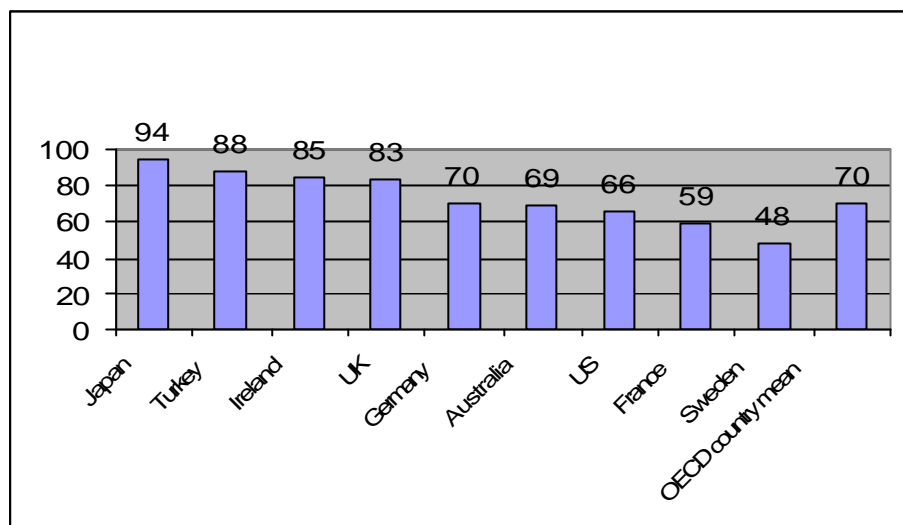
107. UK higher education has a lower non-completion rate than other leading OECD countries, except Japan, Turkey and Ireland, as shown in Figure 8.<sup>34</sup>

### **Figure 8: Completion rates of HE students**

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<sup>34</sup> OECD 'Education at a glance' 2003.





Source: OECD "Education at a glance" 2003

108. Addressing the participation target requires action on both demand and supply, which are currently roughly in equilibrium at the sector level. On the demand side, the Government launched the Excellence Challenge initiative to encourage entry to higher education. The Government recognises that the key issues are raising the proportion of students that stay in education at 16, and raising the aspirations of those who have no family history of going on to higher education. HEFCE – with the Learning and Skills Council, the funding body for further education – also launched Partnerships for Progression, to encourage more pupils to stay on at 16 and to improve progression routes from further education to higher education. These two programmes (Excellence Challenge and Partnerships for Progression) are being brought together under the Aimhigher banner.

109. Alongside this it will be necessary to increase supply to match increasing demand. It is estimated that, to meet the Government's targets, some 300,000 to 350,000 new higher education places will be required by 2010. It is likely that many of these new places will be delivered in new ways, in order to make them more attractive. So, for example, there will be more courses linked directly to work skills (such as the new foundation degrees), more part-time provision, and more off-site and distance learning.

110. HEFCE's plans to secure these extra places are currently under development.

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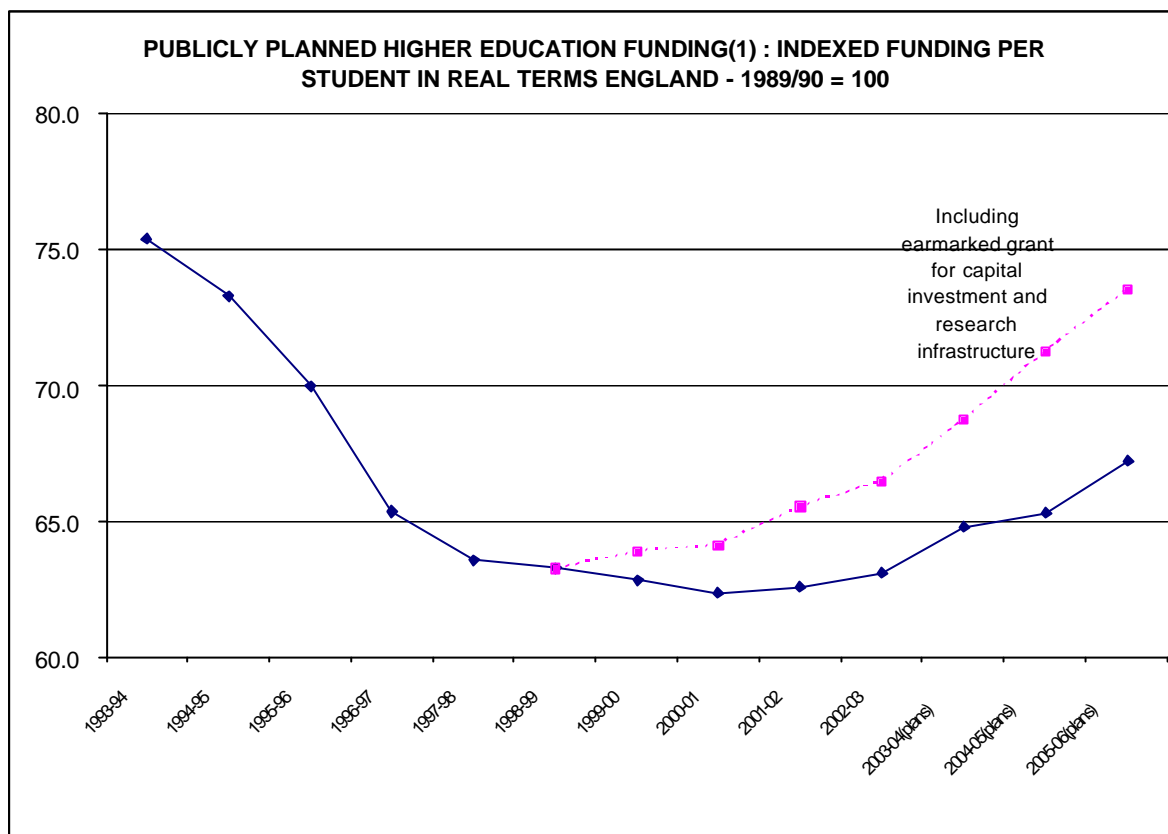
### ***The current funding position***

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111. HEFCE advises the DfES on the needs of higher education and the implications of various levels of funding. The level of funding provided is determined by the Government within its own objectives and priorities. Between 1989 and 1997, higher education funding for teaching was reduced by 36 per cent in real terms, after taking account of volume changes.

112. This downward trend in funding began to be reversed by the current Government from 1999-2000, although planned funding for 2003-04 is still 33 per cent below the 1987 level in real terms. This is shown in Figure 9.

**Figure 9: Public higher education funding for England 1989-2004**



Source: DfES

### ***The financial position of HEIs***

113. Income and expenditure of HEIs in England was some £12 billion in 2001-02, representing a breakeven position. When the full economic costs of activities are taken in to account, however, the picture is one of the sector operating in substantial deficit. This deficit position is being addressed through HEIs being encouraged to identify and recover the full economic costs of their activities.

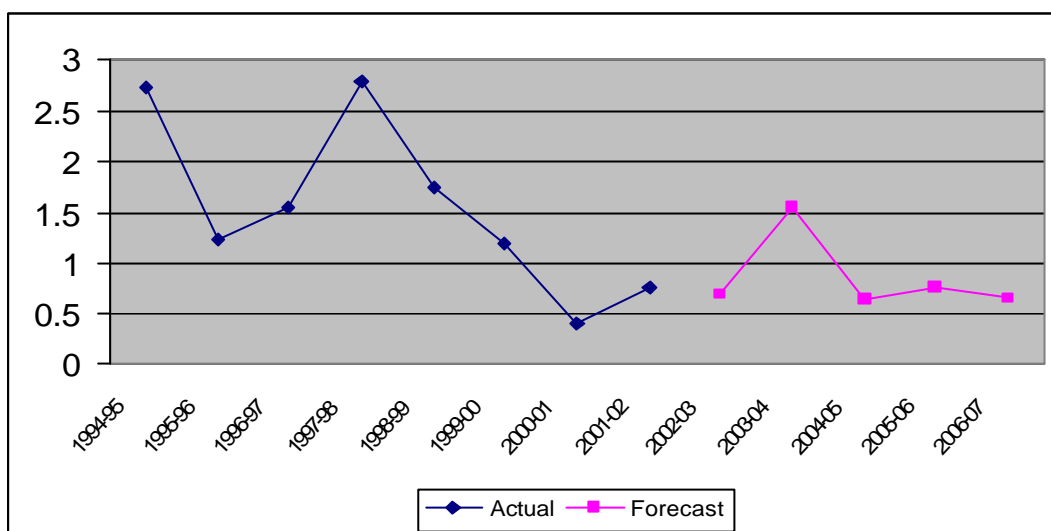
114. Actions have included:

- ◆ rationalising the academic portfolio;
- ◆ internal restructuring;
- ◆ increasing student:staff ratios through staff reductions or non-replacement of posts, or delaying replacement of vacant posts;
- ◆ deferring expenditure on maintenance and on re-investment.

115. These are essentially short-term actions to allow time to address the fact that levels of operating surplus are insufficient to provide the necessary level of funding for reinvestment. Two national studies in 2002 of the investment required in the higher education physical infrastructure showed that the impact of deferring investment and maintenance of assets had created a backlog of remedial investment required of around £8 billion (UK), that is, some 30% of total asset value and 60% of the total turnover of the sector.

116. Figure 10 below shows the national trend in operating surplus of the HE sector. This shows that operating surpluses as a percentage of total income have been in decline over the past decade<sup>35</sup>.

**Figure 10: Higher education sector operating surpluses and deficits**



Source: HEFCE analysis

117. The above are sector total figures; there is a wide variation between individual HEIs. For example, around a third of all HEIs have been operating in deficit in recent years.

**Table 3: Numbers of HEIs reporting operating deficits**

Year	Number of HEIs reporting operating deficits
1996-97	43
1997-98	30
1998-99	30
1999-2000	54
2000-01	48
2001-02	46

118. Alongside this decline in public funding and in operating surpluses, HEIs are seeking to expand their income across all their activities. This will include income from both public and non-public customers. This has led to a widening of the customer and activity base for most HEIs, as illustrated in Section One. The success of HEIs in seeking non-public sources of income is demonstrated in the table below.

<sup>35</sup> HEFCE analysis of actual results and forecasts for the sector in aggregate.

**Table 4: Public sector income as proportion of total income – 1994-95 to 2001-02**

Year	Percentage
1994-95	67.9
1995-96	66.9
1996-97	65.2
1997-98	64.3
1998-99	63.0
1999-2000	61.4
2000-01	60.4
2001-02	60.3

*Source: HEFCE analysis of HEI financial statements 1994-95 to 2000-02*

119. The table clearly shows the decreasing proportion of public sector income. This trend involves an important paradox for HEFCE and HEIs to manage. On the one hand, by diversifying and reducing their reliance on a particular source of funding, HEIs can be said to be reducing their risks. On the other hand, it can be argued that the diversification also carries risks that need to be managed – for example institutions need to develop more market focused approaches and systems. As stated in paragraph 74, the public income includes a growing proportion that relates to the provision of services on a contractual basis, as opposed to funding for core activities.

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### **Assets and infrastructure**

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120. Although HEIs are not part of the public sector, they receive the major part of their funding from the Government. Like public bodies, this has been on an annual budget basis, and accounted for as cash. So while HEIs have balance sheets and are clearly responsible for the management of their assets, they have tended to look to the Government to fund their capital needs.

121. At present approximately half of HEIs' capital expenditure is met from capital grants. Like other parts of the public sector, there has been a tendency to neglect investment in and maintenance of buildings when other financial pressures have increased.

122. At the time of the creation of the new universities in 1992, a national survey was conducted of the condition of university estates. This showed that there was a significant backlog of maintenance which needed to be undertaken to bring all university buildings and facilities up to a satisfactory condition.

123. Since this survey, there have been a number of public funding schemes to support HEIs in replacing and refurbishing different types of assets (poor estates, libraries, laboratories etc). More recently, there have been two large schemes to support investment in buildings for science research (the Joint Infrastructure Fund and the Science Research Investment Fund). Over the years 1999 to 2006 these two schemes together will have provided approximately £3 billion. Despite these schemes, HEIs have repeatedly argued that their infrastructure is in poor condition and is inhibiting their ability to undertake world-class teaching and research.

124. National studies carried out in 2002 (see paragraph 116) confirmed that there was a significant investment backlog, of around £8 billion, to bring all the higher education infrastructure up to a good

condition that is fit for purpose. The Government has accepted this conclusion and has begun to provide additional funding for infrastructure. A condition of the continuation of this funding could be that institutions provide infrastructure strategies, and take explicit responsibility for the maintenance of their infrastructure.

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### ***Accountability and costing***

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125. In 1999 the Government launched a major initiative, called the Transparency Review, to require HEIs to develop more advanced information on the costs of their activities, and to report annually on these as a part of their accountability for public funds. Compliance with this was a requirement of the 1998 Comprehensive Spending Review for all universities and colleges of HE. A standard approach to costing was developed for use in HEIs, based on the concepts of activity-based costing. The methodology was developed collaboratively between the UK funding councils and HEIs and includes a requirement for institutions to account for the use of academic staff time, which is a major element of universities' total costs, but is also a difficult and sensitive element to measure.

126. The Transparency Review has now been fully implemented in all HEIs. It has provided a new source of management information which will enable managers and governors of HEIs to understand the financial performance of their different activities (teaching, research, other academic activity, and support activities) and should make a significant contribution towards better financial management.

127. The approach adopted for the Transparency Review is now being applied to costing and pricing in a number of areas where HEIs provide services to public customers (such as the NHS and research contracts).

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### ***Other policy developments***

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128. A number of other developments in policy in higher education are relevant to this report, although less central than those described above.

#### **Growth of research and investment in the arts and humanities**

129. There has been significant growth in the importance of the creative and cultural industries in England, both as a cultural and social contributor, but also as a generator of economic activity and employment. In the past, research and scholarship in the arts and humanities, which underpin these industries, has tended to be seen as a "poor relation" to the sciences. However, a number of recent reports have emphasised the importance of these disciplines for the economy, and the creation of a new Arts & Humanities Research Council by 2005 was announced in the January White Paper.

#### ***New methods and technologies in teaching and learning***

130. This is a time of change and development in the technologies available to support teaching and learning, and in the methods used to support student learning. More students in England are now studying "off-campus" (for example through distance learning, e-learning, and work-based learning); and more of the students who are "on-campus" are also in paid employment, or study part-time, or are mature students with families and other commitments. The impact of these changes is still not entirely clear, but they are likely to affect the investment needs of HEIs, and the profile of staff they employ.

131. The future increase in student contributions to the cost of their tuition is also expected to create

new consumer awareness and demands, in addition to other market pressures on HEIs.

#### ***Competition and collaboration***

132. There has been a long term trend throughout the British economy to increase market awareness, fair competition, and consumerism. This has affected higher education and other public services, although the precise balance between competition and collaboration (or state planning) has varied with changes in government. The present funding regime provides no real incentives to encourage stronger universities and colleges to collaborate with weaker institutions. This will need to be addressed if collaboration is to develop as one route through which universities and colleges can continue to deliver a range of activities, while focussing on their areas of strength.

133. During the 1990s there was increasing emphasis by HEIs on competition, marketing, and business approaches. More recently there has been a greater emphasis on collaboration. One particular stand on this has been a policy to encourage small or weaker institutions to seek collaborative partners, and stronger institutions to form consortia, which can be more effective in a regional and global market. At present a number of English institutions are discussing or considering mergers and strategic alliances, and it seems likely that this will be an increasing feature of the policy context for the foreseeable future.

#### ***Leadership, governance and management***

134. There is an increasing focus on leadership within higher education, so that universities and colleges are equipped for the challenges that they will face in the coming years. This includes the creation of a Leadership Foundation to assist with developing these skills, drawing on world-class practice.

#### ***Quality and students as consumers***

135. As students are now contributing to the costs of their teaching, they are more concerned to ensure they receive value for money. The marketability of their degree and the brand name of the HEI it comes from have increased in importance.

136. For students to make the right choice of HEI and course they need information. The developing agendas for both quality assessment and quality enhancement are requiring HEIs to publish information to inform students, including outcomes of quality assessment and summaries of external examiners' reports.

137. In addition, Universities UK, the Standing Conference of Principals and HEFCE have been developing new arrangements to bring together their various activities to promote quality enhancement. A major focus is on enhancing the teaching skills of academics.

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**DESCRIPTION OF POLICY INSTRUMENTS**

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***Introduction***

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138. Universities and colleges are autonomous bodies responsible for managing their own academic and financial affairs. Consequently they have the primary responsibility for good financial governance and management.

139. There are a number of other instruments that seek to secure the good financial governance and management of the higher education sector. The principal instruments discussed in this report relate to the position and role of HEFCE as a buffer body with specific responsibilities in financial management and accountability for the HE sector:

- ◆ the duties placed on HEIs by HEFCE;
- ◆ the funding methods adopted by HEFCE;
- ◆ the monitoring of institutional health by HEFCE;
- ◆ the development of good practice, particularly in governance and management by HEFCE in collaboration with the sector.

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***HEIs' own management arrangements***

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140. HEIs are responsible for defining and implementing their own strategies, and their own corporate governance and management arrangements (within the terms of their articles of governance), and for identifying and managing their own risks. HEIs are responsible for appointing their own external auditors, and for ensuring that internal check and control procedures are in place, and that the efficacy of these is audited internally.

141. In order to discharge their responsibilities, HEIs employ staff from a variety of disciplines and specialisms, who have professional and personal interests in making a proper contribution to the effective management of their employing organisations. For example, our site visits provided evidence that the professional accountants employed by HEIs would develop medium term financial forecasts, even if HEFCE did not require it of them. (Even so, it is likely that HEFCE's influence has accelerated the development and dissemination of such good practices).

142. As a result, HEIs regularly adopt best professional practice in conducting their affairs. During the site visits a number of examples of good quality financial management were identified in:

- ◆ the budget development process;
- ◆ budgetary control and budget management;
- ◆ management accounting, support to budget holders and board level reporting;
- ◆ cash flow forecasting and management;
- ◆ risk management techniques;
- ◆ financial planning and forecasting, including scenario and "what if" analysis.

143. In addition HEIs need regularly to review the context within which they operate and to meet the expectations of their stakeholders and customers. Their own management arrangements, therefore, need to continue to evolve, to provide the levels of assurance that are now necessary.

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***HEFCE as a buffer body and the duties it places on HEIs***

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144. HEFCE sits between Government and HEIs. This provides opportunities to influence in both directions. While part of HEFCE's role is to implement government policy on higher education and to influence the development of the sector, it can also shape that policy through its knowledge of the sector and its advisory role to the Secretary of State. It is important in this position that HEFCE is able to retain the confidence of the Government and of the HEIs.

145. There is evidence that, generally speaking, HEFCE has been successful in achieving this through its policy of being open and consultative with the sector; of respecting institutional autonomy; and of offering advice and guidance – developed in partnership with the HE sector – rather than attempting to tell institutions what to do.

146. These policies can become strained when institutions are in financial difficulty, or when Ministers want to see action or outcomes which the sector is not inclined to deliver. Fortunately such cases have been rare.

147. It is a natural consequence of the relatively autonomous English system that such tensions will occur. When they do, it is a challenge for HEFCE to retain the confidence of both government and HEIs while showing that it is independent and willing to speak out when it believes this is necessary.

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***Duties placed on HEIs by HEFCE to demonstrate accountability***

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148. HEFCE has established a Financial Memorandum with each HEI it funds. Each HEI must ensure that:

- ◆ a principal officer is designated, with responsibility, on behalf of the governing body, for ensuring the memorandum is complied with;
- ◆ the funds provided by the HEFCE are used in accordance with the purposes set out in the Further and Higher Education Act 1992, the memorandum, and any conditions imposed by HEFCE;
- ◆ there is proper stewardship of the funds;
- ◆ it has a sound system of internal management and control;
- ◆ sound risk management arrangements are in place;
- ◆ its financial and academic affairs are planned and conducted to ensure that it remains solvent and that, taking one accounting period with another, its total expenditure is not greater than its total income;
- ◆ value for money is delivered from the use of public funds;
- ◆ information required by HEFCE is provided to it;
- ◆ conditions imposed by HEFCE are satisfied before any long-term financial commitments are undertaken;



- ◆ adequate costing and pricing methodologies are employed;
- ◆ proper accounting records are maintained;
- ◆ an Audit Committee is appointed, and internal and external audit provided in accordance with HEFCE's Audit Code of Practice;
- ◆ HEFCE's Audit Service is provided with the information it needs to evaluate the HEI's internal control and governance arrangements.

149. HEIs' response to these requirements has been positive, and non-compliance with the Financial Memorandum is rare. Naturally, some requirements are easier to satisfy than others. For example, HEIs do not always know the full costs of their activities or seek to recover those full costs in the pricing of those activities. Although most are now gaining much better information as a result of the Transparency Review, it will take time for this costing information to feed through into management decision-making and into pricing behaviour.

150. HEFCE's Audit Service evaluates the internal control and governance arrangements of HEIs. The Audit Service has produced, and periodically updates, a Code of Practice covering the internal and external audit of HEIs. Compliance with the code by HEIs is compulsory under the Financial Memorandum.

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#### ***Funding methods adopted by HEFCE***

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151. The way in which HEFCE allocates funds to the sector is an important lever in the behaviour of the sector. HEFCE has two basic approaches to funding:

- ◆ a block grant, where HEIs are allocated a specific sum to deliver broad outcomes – such as teaching or undertaking research – but with discretion as to how those funds are used;
- ◆ funding targeted as specific programmes and initiatives. This requires HEIs to deliver specific outputs or outcomes in exchange for the funding.

152. It is a matter for HEFCE as to which of these approaches is applied to a particular situation. One factor will be whether HEFCE has confidence that HEIs will deliver the required outcomes through adding funding to the block grant, or whether a more targeted approach is necessary. Currently over 90 per cent of funding is distributed via the block grant, with around 5 per cent being targeted at specific programmes or initiatives<sup>36</sup>. The alternative approaches are described further below.

#### ***Block grant***

153. The block grant for teaching and research was described in detail in Section One of this report. HEIs have discretion to use these funds as they wish in delivering the teaching and research outcomes for which the funding is provided. Accountability is therefore in output and outcome terms – student numbers and research activity – rather than how the funds are used. Within this, quality is paramount. HEIs that receive poor assessments of teaching or research quality (through the work of the QAA or through the RAE) will lose funding, either directly by having it withdrawn by HEFCE or through customers (students and funders) deciding to go elsewhere.

#### ***Targeted funding***

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<sup>36</sup> The remaining sums cover funding for national facilities and a number activities or liabilities inherited from previous funding bodies.

154. HEFCE also targets funding to achieve specific changes within the sector. These include funding for developing learning and teaching strategies, rewarding and developing staff, and developing closer links with business and the community. HEIs are required to submit proposals for this funding and demonstrate that their use of the funds will help to deliver the policy objective in question. They are also required to disseminate good practice.

155. HEFCE applies a limited amount of funding to developing good practice in governance and management. In some cases, the aim of allocating these funds is to allow specific HEIs to develop good practice, which can then be disseminated to the rest of the sector; in others, good practice is developed collaboratively with the sector, with adoption being promoted jointly.

156. HEFCE has used targeted funding to improve collaboration between institutions, to bring about structural change or to address strategic issues, that it considers are beneficial to the sector.

157. Capital funding is provided, but is targeted at particular outcomes – such as addressing past under-investment in infrastructure, or improving facilities for disabled students. In these cases all HEIs receive an allocation, conditional upon the funds being used for the intended purpose, but leaving it to the HEIs to decide how those outcomes are achieved.

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### ***Approach to institutional health***

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158. HEFCE has a two-pronged approach to its role in terms of institutional health. There is an implicit assumption that other factors – such as the quantum of funding – are not within the scope of this process. The two prongs are complementary:

- ◆ the first is to monitor HEIs and to identify any areas of concern at an early stage. Action can then be sought from HEIs to resolve their particular situations. This is the reactive part of the process;
- ◆ the second is to address the causes of such institutional health problems. The development and promotion of good practice in governance and management is intended to help HEIs avoid problems in the first place. This is the proactive part of the process.

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### ***Monitoring of institutional health***

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159. HEFCE has established a regime under which it monitors and encourages good financial governance and management in HEIs.

160. The monitoring arrangements have been extended over recent years beyond just financial monitoring, to cover the institution as a whole. Institutional health monitoring considers the factors that could lead to financial health difficulties, such as under-recruitment, poor results in quality assessments, loss of key contracts, loss of key staff, and weaknesses in governance and in management arrangements and systems.

161. This is an early warning system to identify and deal with problems, many of which can be viewed as weaknesses, in some form or other, in governance and/or management. This needs to be seen alongside the development of good practice in governance and management, which seeks to help HEIs to address the causes of problems and to prevent other occurrences.

162. HEFCE collects from HEIs certain key information to help it form a view as to their institutional health:

- ◆ strategic plan;
- ◆ annual operating statement;
- ◆ audited accounts;
- ◆ five-year financial forecast;
- ◆ mid-year financial return;
- ◆ management letters from external auditors;
- ◆ audit committee annual report;
- ◆ student recruitment data;
- ◆ quality assessment data.

163. This information is analysed and monitored by specialist teams at HEFCE.

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#### ***Development of good governance and management practice***

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164. HEFCE and others regularly produce good practice guidance for HEIs on a variety of management and financial issues. For example a guide for governors has been produced by the Committee of University Chairmen and published jointly with HEFCE<sup>37</sup>.

165. Guidance is developed in consultation with HEIs and is often publicised and supported by regional seminars.

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#### ***Summary of the application of policy instruments to HEIs***

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166. In summary, the various responsibilities to secure sound financial governance and management of the higher education sector are as follows:

- ◆ HEFCE advises DfES on the financial needs of the sector;
- ◆ the Government decides how much public money it wishes to provide for higher education;
- ◆ the DfES delegates to HEFCE the detailed work of monitoring, regulating and passing funding to the sector;
- ◆ HEFCE develops funding policies and methods to deliver its aims and objectives and secure certain outcomes;
- ◆ HEFCE sets a financial and accountability framework within which HEIs have discretion as to how they operate, through the Financial Memorandum and the Audit Code of Practice;
- ◆ HEFCE monitors the overall institutional and financial health of the sector and of individual HEIs; and develops and promotes the adoption of good practice.

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<sup>37</sup> HEFCE 01/20 April 2000.

167. Table 5 summarises the various elements of the policy framework which, collectively, seek to ensure that the higher education sector is properly financially managed and remains financially viable.

**Table 5: Summary of financial governance and management framework**

<b>Area</b>	<b>Responsibility</b>	<b>Extent of external involvement</b>
Financial health of individual HEIs	HEIs responsible for their own financial positions.	Monitored by HEFCE. Certain requirements imposed by HEFCE through the Financial Memorandum. HEFCE monitors the delivery and quality of the financial returns which HEIs are required to submit to it.
Financial governance and management arrangements	HEIs establish their own arrangements.	Good practice drawn from across the sector developed by HEFCE in collaboration with the sector.
Financial regime	HEIs establish their own arrangements, within thresholds and requirements set by the Financial Memorandum.	Some regulation by HEFCE, concerning deficits and borrowing.
Audit arrangements	HEIs appoint their own internal and external auditors, in accordance with the HEFCE Audit Code of Practice.	Audit regime specified by HEFCE in Code of Practice.
Financial systems and information	HEIs have complete freedom.	None, subject to auditor satisfaction.
Financial planning	HEIs establish their own arrangements, within thresholds and requirements set by the Financial Memorandum.	HEFCE requires submission of corporate plan periodically, and requires annual operating statements and five-year financial forecasts each year.
Risk management and risk-based internal controls	HEIs have significant freedoms.	Audit Committee is required to confirm that risk management and internal control arrangements are satisfactory. Good practice guidance issued by HEFCE.
Quality of teaching	HEIs' responsibility to maintain standards and deliver high quality teaching.	Regular assessments by the QAA and monitoring and approval of courses by professional and statutory bodies  Also the good practice guidance for franchising and overseas collaboration issued by the QAA.
Quality of research	HEIs' responsibility to deliver high quality research.	Outputs are assessed by the RAE. Peer review of applications for Research Council grants and other external research contracts.

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## THE REGIME IN PRACTICE

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### *Introduction*

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168. This section of the report examines how the instruments for ensuring sound financial governance, management and financial viability operate in practice. It sets out:

- ◆ HEFCE as a buffer body;
- ◆ how the funding regime operates in practice;
- ◆ how the HEFCE monitoring regime operates in practice;
- ◆ the impact of good practice guidance.

169. The analysis includes, where relevant, the views of a small sample of HEIs. During the course of our work six HEIs were visited to seek their views on the effectiveness of their own financial governance and management, and the effectiveness of the HEFCE monitoring and support regime.

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### *HEFCE as a buffer body*

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170. One of the most important instruments which impacts on the viability of the higher education sector is the confidential advice which HEFCE provides to the Secretary of State, about the level of funding required in the sector and many other matters. HEFCE has a direct route to influence government policy and spending plans.

### *The monitoring regime*

171. HEFCE's monitoring regime has been described as "light touch", because wherever possible it seeks to rely on institutions' own financial monitoring processes, and on information that they collect for their own purposes. This is part of HEFCE's approach to minimising the accountability burden on HEIs. The regime recognises that financial management is simply one part of institutional management, and so the information the HEFCE collects from HEIs (financial and non-financial) is intended to enable it to form a view about the health of the whole institution.

172. The relationship between HEFCE and an HEI is important, and it is in the interests of both parties for it to operate successfully. So, for example, HEFCE seeks to avoid operating in heavy-handed ways by attaching conditions to funding or withholding funds, unless other methods have proved to be unsuccessful. In practice, processes of persuasion and support are well established and appear to operate well. These processes enable HEFCE to work with HEIs to address their problems efficiently, while respecting their autonomy. HEFCE favours the continuation of this approach.

### *The layers of the relationship*

173. In practical terms, the relationship between HEFCE and HEIs operates at a number of levels.:

- ◆ senior or "Board" level;
- ◆ management level;
- ◆ audit level.

*Senior or Board level*

174. At the highest level, there is a formal relationship between the HEFCE Board and the governing body of each HEI. There will also be visits by the HEFCE Chief Executive or directors to the head of the HEI to discuss strategic issues, maintain contact and to ensure that, at this level, the general policies and principles of the relationship are understood.

*Management level*

175. There are also regular visits by HEFCE's officers (Regional Consultants and their teams) to HEIs to discuss current funding issues, institutional health, progress against plans, and relevant operational issues such as recruitment, academic restructuring, or capital developments.

*Audit level*

176. The HEFCE Audit Service has a programme of visits to HEIs. Based on the information which HEIs provide to HEFCE (see below), the Audit Service undertakes a risk-based audit, examining particularly:

- ◆ corporate governance arrangements;
- ◆ the high-level finance strategy;
- ◆ the institutional risk strategy;
- ◆ the latest review of the internal audit service carried out independently by separate auditors.

177. The HEFCE Audit Service approach is to place reliance for routine matters on the work of other auditors, that is, HEIs' own internal and external auditors. This approach frees the HEFCE Audit Service to concentrate on the more significant issues identified by its risk analysis. It can then make recommendations for HEIs to address any weaknesses it has identified. HEFCE does not have the legal authority to insist that these recommendations be implemented, but in practice HEIs generally seek to co-operate and implement recommendations.

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***HEFCE risk assessment and its results***

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178. HEFCE uses three cyclical processes to identify whether or not an HEI may be at risk. In sequence they are:

- ◆ the financial forecasts (submitted in July of each year);
- ◆ the financial statements, containing the audited accounts (by December);
- ◆ the mid-year financial review (March), which reports on progress within the year.

179. This cycle allows HEFCE to identify any deterioration in financial health. The financial forecasts will have identified the intended surplus/deficit positions for the planning period of five years, and also various other indicators such as student numbers and staff costs, and the extent and financing of the capital programme. From these forecasts, HEFCE identifies how the HEI views its own progress, and the forecasts are constructed to allow inconsistencies in the underlying figures to be identified.

180. The audited financial statements and the mid-year financial review are then used to confirm (or otherwise) progress and trends in implementing the programmes represented by the financial forecasts.

Any significant changes identified at this stage can lead to a re-assessment of the HEI's institutional health classification.

181. Other key factors that may lead to financial difficulties are also monitored on a regular basis. These include recruitment of undergraduate students against planned targets. This can lead to a funding shortfall that may turn planned surpluses into deficits, or increase deficits already expected. This may lead to a revision of institutional health status, especially if the contingency planning and risk assessment that form part of the financial forecasts have been poor. Other events affecting institutional health outside the cyclical process tend to be singular and related to the specific circumstances of the HEI concerned.

182. Based on the assessment of the information available to it, HEFCE places each HEI into one of four risk categories.

183. This categorisation attempts to distinguish between institutions that are at immediate risk (for example through poor recruitment), those that may be at risk within a year or so, and those that over the period of the strategic plan or forecasts may have issues that need to be addressed. When the risks are immediate, HEFCE will require an HEI to prepare an action or recovery plan and will monitor progress against the milestones in such a plan. Only when HEFCE is satisfied that the causes of the difficulties have been addressed will monitoring be scaled back to normal levels.

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### ***The funding regime in practice***

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184. It is clear from analyses by HEIs themselves, sector representative bodies and HEFCE that there is insufficient public funding to enable all HEIs to operate to international standards of excellence in all activities simultaneously. HEIs therefore need to focus on their strengths. As part of this focusing on strengths, HEFCE concentrates on:

- ◆ trying to ensure that effective financial governance and management arrangements are in place, so that HEIs make the best use they can of the available funding;
- ◆ using funding incentives to influence the behaviour of HEIs;
- ◆ encouraging HEIs to focus on what they do best, on the basis that not all HEIs can provide the necessary level of excellence in all activities.

### ***The effect of funding on HEIs' behaviour***

185. The level of funding provided by HEFCE and the conditions attached to that funding influence institutional behaviour. Generally speaking, it will be natural for HEIs to seek to maximise their share of any available funding and pursue the resources available to the sector.

186. The teaching funding method provides limited opportunities for growth. HEIs can bid for additional student numbers to secure funded growth. They can, at the same time, position themselves where they wish within the "tolerance band" of differences between actual resource and standard resource (see paragraph 62). A position close to +5 per cent means recruiting fewer students, having less fee income but keeping the grant: this may be beneficial if it allows teaching costs to be reduced. A position close to -5 per cent means recruiting more students, increasing fee income but not the grant: this may be beneficial if it allows teaching costs to be held down or grow only marginally.

187. On the other hand, HEIs have perceived that there are greater opportunities to secure increased levels of funding for research. Some HEIs have therefore invested in developing their research with the expectation that this will lead to success in the next RAE and more funding for research.

188. Similarly HEIs may bid for targeted funding – to seek additional income – even where the particular scheme does not fit with the direction in which the HEI is heading.

189. Such behaviours may not be in an HEI's best interests as they could take the HEI in a direction that is contrary to its core mission. They could also lead institutions to take short-term decisions, with a view to securing income, which may limit their ability to move in a more appropriate direction. These behaviours are understandable when HEIs are having to focus on what they see as short-term survival rather than long-term viability and sustainability.

190. Providing funding for specific purposes impacts on institutional behaviour in other ways. For example, students have benefited from HEIs' development of their learning and teaching strategies, which has been met from specific funding. Similarly, HEIs are in the process of improving their human resource management practices with the help of funds for developing and rewarding staff. Consultations and reviews also have an impact and can help inform developments and improvements.

191. The focus is to support universities and colleges in developing their own strategies for managing their activities.

192. Most capital funding is now provided to HEIs as a conditional allocation. All HEIs receive an allocation but the use of the funds must be linked to broad policy objectives, such as addressing past under-investment in infrastructure, or providing facilities for disabled students. It is questionable whether the policy objectives would be met if the funds were part of the block grant. It is also a condition of such funding that HEIs follow good practice in procurement and decision making.

193. The Financial Memorandum requires that HEIs are aware of the full economic costs of their activities. Since 1997, HEFCE has been working to help HEIs improve their cost information and for this information to be become embedded in decision-making processes. The subsequent Transparency Review and the implementation of the Transparent Approach to Costing has led to increased knowledge about the costs of activities, and increased awareness for pricing and funding. Since 1999-2000 HEIs have been required to provide summarised information about the costs of activities.<sup>38</sup>

194. HEFCE's view is that, while this has led to an increase in accountability, it is also having a profound beneficial impact on management decision-making in many HEIs. Increased awareness of the real costs of activities is leading to an increased focus of whether some activities should continue or how costs could be reduced. In parallel there is increasing understanding of the need to reflect the value received by the customer in the prices charged. Much of the context for this is the recognition that HEIs need to generate more funds themselves, to provide the cash flow to invest for a sustainable future.

195. The Government's 2002 spending review highlighted the need for HEIs to take responsibility for the long-term sustainability of their infrastructure and to recover the full costs of their activities. The additional funding that will flow from 2004-05 will aim to address these issues, although universities and

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<sup>38</sup> HEIs are required to provide information on the costs of: publicly funded teaching; non-publicly funded teaching; publicly funded research; non-publicly funded research; and other activities.



colleges will be expected to deliver additional activities with the increased funding.

### ***HEIs' views on the monitoring regime***

196. Fieldwork was undertaken at a sample of six HEIs, listed in Appendix B. These indicated that HEFCE is regarded by HEIs as being a valuable buffer between the sector and the Government. Relationships between the HEIs and HEFCE are generally good. Some HEIs described the relationship as a "partnership", although others are less certain about HEFCE's role and questioned what it is – funder, planner, policeman or adviser? Generally, the relationship with HEFCE is more valued, and viewed more positively, by newer and smaller institutions, than by the larger and longer established HEIs. This is a reflection of the diversity of the HE sector.

197. Those HEIs describing the relationship as a partnership stated that they regularly have informal (and helpful) discussions with HEFCE staff about emerging issues. Others, however, are more cautious and generally avoid having such discussions, preferring to keep HEFCE at arm's length. This group prefer to use their own networks with the sector to explore ideas and issues.

198. HEIs clearly perceive the tension between their status as independent bodies, and the influence exerted on them by HEFCE. Some consider this tension to be more of a difficulty than others.

199. Some of the HEIs we visited consider that HEFCE should be more proactive, helping to solve problems, rather than just identifying them. There is a view in the sector that once HEFCE has identified a financial problem at an HEI, it introduces a severe monitoring regime, but does not proactively help the HEI address its problems. Conversely, some HEIs would clearly be uncomfortable about greater proactivity on HEFCE's part, and consider themselves perfectly capable of managing their own affairs.

200. The HEIs visited stated that HEFCE's monitoring arrangements are not particularly onerous or time-consuming. This is pleasing given the concerns raised by the sector about the accountability burden that it faces, as evidenced in the report by PA Consulting for HEFCE in 2000<sup>39</sup> and the recent report by the Better Regulation Task Force on higher education.

201. The HEIs visited also stated that the effect of the HEFCE monitoring regime on their behaviour is, at most, marginal, in as much as:

- ◆ the monitoring arrangements do not have the effect of forcing HEIs to develop information or analyses that they otherwise would not. The material provided to HEFCE is either already produced (such as audit letters) or would be produced and acted on internally anyway;
- ◆ management decisions and action are not different from what they would have been, simply because of the monitoring regime.

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### ***Good practice guidance***

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202. Good practice guidance is intended to help HEIs to develop their governance and management arrangements. There is a balance to be struck here. Guidance is guidance and it is not mandatory to use it. However, it does represent good practice developed in consultation with the sector, so it is appropriate that HEFCE should ask questions of an HEI that is unwilling to apply good practice.

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<sup>39</sup> HEFCE publication Better accountability for higher education 00/36 August 2000

203. The guidance documents relating to financial governance and management cover:

*Strategic areas*

- ◆ strategic planning
- ◆ risk management
- ◆ effective financial management
- ◆ developing financial strategies

*Operational areas*

- ◆ estates management
- ◆ investment decision-making
- ◆ related companies
- ◆ costing and pricing
- ◆ procurement
- ◆ value for money studies.

***HEIs' views on the good practice guidance***

204. During the site visits, mixed opinions were received about the value of the good practice guidance developed by HEFCE.

205. The newer and smaller institutions find the guidance much more helpful than the older and larger ones. This appears to be because:

- ◆ the newer HEIs are still coming to terms with the requirements of the sector and its financial regime and are appreciative of the help and guidance provided by HEFCE;
- ◆ the smaller HEIs do not have the management resources to develop their thinking, policies and procedures around all the matters on which HEFCE has issued guidance. They are also, therefore, appreciative of HEFCE's support;
- ◆ the older and larger HEIs, however, whilst not dismissive of the value of the guidance, are alert to the tensions between their independence and comprehensive HEFCE guidance. Some see the guidance as being an intrusion into the way they manage their affairs. This perception is strengthened by the view that the HEFCE Audit Service occasionally expresses a view about the extent to which an HEI has implemented the guidance, even though it is not mandatory.

206. The guidance itself is generally (but not exclusively) seen as helpful, of good quality and the product of good levels of consultation. We did receive views, however, that the guidance reflects the lowest common denominator, because of the extensive consultation – that is, in order to reflect all the opinions received, the guidance becomes overly general and vague. We also received views that HEFCE should, on occasion, consult less, be more forceful and show some leadership – just tell the sector what needs to be done. This is another manifestation of the diverse nature of the sector.



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**STRENGTHS, WEAKNESSES, OPPORTUNITIES, RISKS**

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***Introduction***

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207. The previous sections have described the constitutional position of higher education in England, the policy context within which HEIs operate, along with the instruments used to deliver policies and how these work in practice.

208. This section considers how well these policy instruments work; what are particular strengths and where there are opportunities for the future, while recognising that there are inherent risks associated with such opportunities.

***Context***

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209. There is an inherent dichotomy in the role of HEIs and this, if anything, is increasing. HEIs are independent bodies that are encouraged to act independently and to take responsibility for their own affairs. This would support a relationship between Government and HEIs that is essentially a contractual one.

210. However, the primary relationship between Government and HEIs is a funding – not a contractual – one. While such an approach allows HEIs considerable discretion in how public funds are used, the HEIs are held to account for the use of those funds, as if they were public bodies. This is probably inevitable given the scale of public funding being provided for higher education.

211. While HEIs are responsible for their own academic and financial affairs, increasing proportions of their funding are linked to the delivery of specific government objectives. However, to put this in perspective, over 90% of HEFCE funding is still distributed to HEIs as a block grant that they can spend as they wish to support teaching, research and related activities. Accountability for this funding is achieved through output measures, and continuity of funding through performance against these measures.

212. Similarly, the Government has said it is not the banker of last resort. However, it remains to be tested whether Government, or HEFCE, would allow a major HEI to go out of business. Whilst there have been no insolvencies, several institutions in financial difficulty have merged with stronger institutions and as a result have lost their individual identity.

213. It is also true that, although institutions have remained solvent, in some cases this has only been achieved by adopting severe measures to restore financial health, including closing departments. HEFCE's present institutional health monitoring arrangements have proved to be an effective early warning system, with identified problems being addressed; but this is again an activity consistent with a funding, rather than a contractual, relationship. Such monitoring arrangements are unlikely to cease.

214. Allied to this is the confidence that financial institutions draw from the policies and practices that exist in this area. Some HEIs have been seeking and obtaining ratings from credit rating agencies, such as Standard and Poor's or Moody's. It is not clear how these ratings would be affected if HEIs received less of their income as public funding or if the role performed by HEFCE no longer existed.

215. Nor is it always clear that HEIs really wish to become totally private with no public funding. Having a secure and guaranteed level of income is something most businesses would find attractive. Whatever the strings attached to such funding, or the extent to which it increases year on year, it is predictable and likely to continue.

216. What is evident is that the role of higher education and its relationship with the state is evolving. The days of higher education being just about the pursuit of knowledge for its own sake have gone. However, it is equally true that HEIs are much more than bodies educating people for employment. The span of activity and interaction has widened and now needs to embrace a wide range of requirements.

217. It is also evident that, because of the dominance of public funding for higher education, the behaviour of HEIs can be strongly influenced by public funding arrangements – HEIs will, quite naturally, seek to maximise their income. Therefore, one of the challenges for the coming years is for there to be sufficient funding available, across the range of core activities, to act as incentives for HEIs to build on their areas of strength. In turn this will require HEIs to understand the context in which they operate, to ensure they know what their customers (including students) want and expect, and to have the capacity, capability and skills to meet those requirements.

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### **Strengths**

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218. Higher education in the UK is a success story and compares well with other countries across a range of measures.

219. Currently the UK carries out 4.7 per cent of the world's research, it produces 7.6 per cent of the world's scientific publications, and over 9 per cent of the citations of scientific papers. It ranks first in the world in terms of the number of publications and citations generated for each pound spent on research.<sup>40</sup>

220. The UK is the second largest host country for international students after the US, and had the second highest annual growth rate for such students (13.9 per cent) of any country between 1985 and 1995. In the three years to 1998, the UK increased its share of the international student market represented by the OECD countries from 12 per cent to 16 per cent.

221. The percentage of students who do not complete their courses is lower in the UK than in all other leading OECD countries, except Japan, Turkey and Ireland<sup>41</sup>. The UK has higher proportions of graduates in employment three years after graduation.

222. Within the UK, higher education has delivered a major shift from an elite system to one serving a much larger proportion of society. Participation among young people increased from around 5 per cent in the early 1960s to 43 per cent in 2000.

223. The evidence from the QAA is that quality standards have been enhanced. Similarly the periodic RAEs<sup>42</sup> have provided evidence of the continuing improvements in research quality.

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<sup>40</sup> Katz, 2000 - taken from OECD, Main Science and Technology Indicators, OECD Statistics, 1999 and ISI National Science Indicators.

<sup>41</sup> OECD 'Education at a glance' 2003.

<sup>42</sup> 1986, 1989, 1992, 1996, 2001

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**Weaknesses**

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224. This success has been achieved against a background of substantial real terms reductions in unit funding (adjusted for volume changes), over most of the past two decades (see Figure 9). While this undoubtedly encouraged increased efficiency, it has now reached a level where it represents under-investment in both the physical infrastructure and human capital. This is beginning to be addressed but will take sustained action over a number of years to remove a backlog of under-investment.

225. The constraint on funding has encouraged HEIs to secure income where it is available – or thought to be available. This has been one factor that has led HEIs to build research capacity. Other consequences have been for some HEIs to pursue initiatives which might not fit with their long-term strategy, in order to attract income; or to seek to maximise income from contractual activities, perhaps without assessing the costs of delivery. These actions are all essentially short-term, but can have longer-term consequences.

226. This situation, therefore, represents a risk to the sector's ability to sustain educational provision at the necessary levels of international excellence, and therefore to compete successfully in global markets. The Government and HEFCE believe that individual HEIs need to build on their strengths to make the most of their resources and remain competitive.

227. The continuing high proportion of funding that comes from public sources risks perpetuating a dependence culture. This is exacerbated where funding is targeted at specific activities, as this will inevitably distort institutions' behaviours. Decision making should be in the hands of universities and colleges, but Government needs to have confidence that universities and colleges will make proper use of such funds and deliver the outcomes it expects.

228. While the level of public investment in higher education remains high, it continues to decline. This questions the appropriate relationship and accountability requirements between government and universities and colleges. Is this still a funding relationship, or is it evolving to one of partnership or even a purchaser? The accountability requirements need to line up with these changes in relationship.

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**Opportunities**

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229. The competing priorities that face governments and the choices that they need to make are likely to mean continuing constraints on the availability of public funding for higher education. This means that HEIs will need to be even more strategic in determining the activities they wish to undertake, and will need to secure sufficient resources to ensure these cover their full economic costs.

230. The proposed introduction of variable tuition fees from 2006 will represent a further market element into higher education. It will alter the balance of public:private funding of higher education in the short to medium term as the additional funding will be met up front by the Government, with contributions being made by students after graduation. How this market will operate is at present unknown. There is a risk for universities and colleges if they misread the market and get their pricing strategy wrong.

231. A greater understanding of the complex context in which they operate will be necessary if universities and colleges are to build on their particular strengths and work with others who have complementary visions.

232. Within this universities and colleges will be able to reach a broader range of students and to do with new methods of teaching.

233. Systems for quality assurance and quality enhancement need to keep pace with the changing customer requirements.

234. The importance of strong leadership and effective governance and management arrangements is now more apparent if new challenges are to be met. Equally it is essential to be able to recruit, retain, reward and develop staff adequately. Management information needs to continue to evolve to inform decision-making, to secure the right relationship between value and cost.

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**Risks**

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235. These opportunities also represent potential risks to HEIs' ability to deliver high quality teaching and research on a long-term sustainable basis, which the sector will need to manage. For example:

- a. Universities and colleges may not respond to every Government priority.
- b. There is an inappropriate balance between what HEIs are expected to deliver, the funding provided to do so and the extent of accountability that is required by funders.
- c. Universities and colleges do not adapt to the increasing need to take account of market conditions and fail to respond to the changing requirements of students and other customers.
- d. If markets operate without check, this could lead to over-correction in response to changing patterns of demand.
- e. Universities and colleges are not successful in recovering the full economic costs of their activities, in aggregate, from public and private sources.
- f. Universities and colleges struggle to recruit and retain academic and other staff in increasingly competitive labour markets.

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## APPENDIX A

### HEFCE STRATEGIC AIMS 2003-08

HEFCE's strategic aims, as set out in its strategic plan for 2003-08, are to:

- ◆ Provide the opportunity of higher education to all those who can benefit from it.
- ◆ Ensure that all higher education students benefit from a high-quality learning experience fully meeting their needs and the needs of society.
- ◆ Develop and sustain a dynamic research sector that holds a strong position among the world leaders, and makes a major contribution to economic prosperity and national wellbeing and to the expansion and dissemination of knowledge.
- ◆ Support all institutions in making a significant and measurable contribution, through knowledge transfer and related activities, to economic development and the strength of communities.
- ◆ Ensure excellent provision across the full range of activity within HE, by supporting institutions to focus on achieving excellence in what they do best and to collaborate based on their strengths.
- ◆ Provide support, through a broad-based partnership, to enhance further the sector's leadership, governance and management.
- ◆ Ensure HEFCE can effectively deliver this strategic plan, working to the highest standards in all that we do.



**APPENDIX B**

**SITE VISITS CONDUCTED AS PART OF THE STUDY**

University of Exeter

University of Hull

Imperial College of Science, Technology and Medicine, University of London

Lancaster University

Liverpool John Moores University

Rose Bruford College