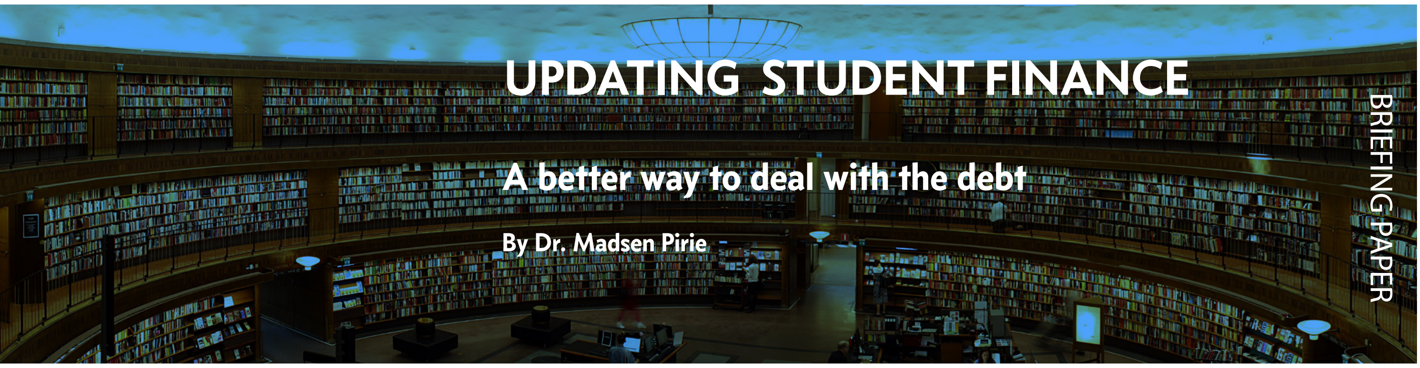

UPDATING STUDENT FINANCE

A better way to deal with the debt

By Dr. Madsen Pirie

BRIEFING PAPER

INTRODUCTION

The current system under which university education in England is financed via student loans has been accompanied by controversy since its inception. The 1998 Teaching and Higher Education Act was introduced by the recently elected Labour government under Tony Blair. It brought in tuition fees, with loans available for students to pay towards their fees, and also replaced maintenance grants by loans for most students.

Tuition fees were raised to £3000 per year in 2004, and in subsequent years to £9250. The increases were marked by student protest and street demonstrations, amid claims that this would discriminate in favour of middle class students and those from well-to-do backgrounds. The Labour manifesto pledge to scrap tuition fees altogether was reckoned by many analysts to have contributed to a large pro-Labour vote among young people.

Many claimed that tuition fees financed by student loans represented a shift from finance of university education by older taxpayers to finance of it by a cash-strapped younger generation which enjoyed few of the state benefits available to its older counterparts.

The replacement of maintenance grants by maintenance loans was seen by some as part of the same process, with these rising for the year 2016/17 to a maximum of £8,200 for students living away from home outside London, and more for those studying in the capital. For a typical 3-year course leading to a degree, this has meant that students upon graduating could face a debt burden in excess of £50,000 (according to the Sutton Trust, the average student debt at graduation was £44,000 in 2016). It causes disquiet among many students that they are starting their working life with such a huge overhang of debt.

The calculations of repayment liability and of interest charged are dauntingly complex and impenetrable, and the system has been charged several times with failure to process information rapidly, or to correct overpayment collected. The current basis for most is that interest will be charged at the Retail Price Index for salaries up to £21,000 and at RPI + 3% for salaries of £41,000 and over. Debts are written off after 30 years, no matter how much or little graduates pay back, and once you have paid off your debt you no longer make repayments. Graduates who go abroad for 3 months or more have to complete an Overseas Income Assessment Form so

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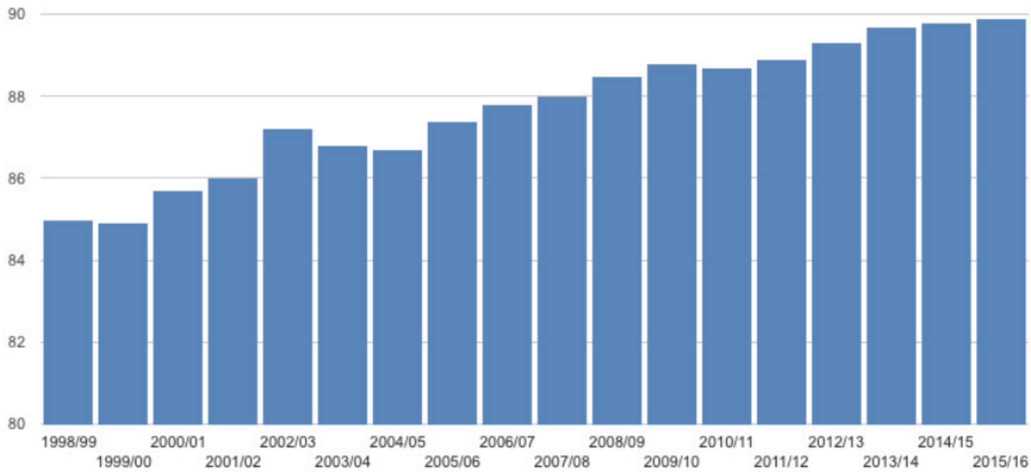
that repayments can continue to be made, although there are obvious difficulties in some cases of enforcing collection.

ADVANTAGES AND DRAWBACKS

The current scheme has both plus and minus points about it. It was originally claimed that the prospect of taking out loans to pay tuition fees and maintenance costs would deter potential students from disadvantaged backgrounds. In fact, by practically every measure of socio-economic status the numbers from under-privileged backgrounds going to university have increased. Whether the measure is of household income, eligibility for free school meals or coming from deprived areas, the numbers from poorer backgrounds have risen rather instead of falling as some had predicted.

Chart 1 - Percentage of UK domiciled young full-time first degree entrants from state schools by academic year



The complexity of the system is a major drawback, with many students unable to fathom what their liabilities will be, and when they will be incurred, following graduation. This impenetrability makes it more difficult for students to make rational career choices.

Repayment has proved difficult to collect in practice, with the default rate estimated to be 45%. The Institute for Fiscal Studies has recently calculated in a report that three-quarters of UK university leavers will never pay off the entirety of their student loans, even if they are still contributing in their 50s. The same report estimates that the average student accrues £5,800 of interest even before they graduate. Elsewhere it is reckoned that high earning graduates could pay an additional £40,000 in interest added to the amount borrowed by the time their loan is paid off.

It has also emerged that the current loans system contains incentives that tilt towards university courses that do not, on average, lead to high salaries, and which therefore postpone repayment. Institutions that offer low-cost arts and humanities courses now attract 47 percent more income per student than they did in 2011, whereas the highest-cost courses only attracted 6 percent more income. Thus the government's desire to boost take-up of places in science, technology, engineering and mathematics is being undermined by a system that directs students to cheaper courses that will involve less repayment.

If poorer students were more inclined to take lower cost courses, the ones that lead to lower salary jobs on average, the effect would be to reduce social mobility with poorer students becoming lower-earning employees. Although some commentators claimed this would be a result, there is no evidence that this has happened in practice. Indeed, there is a case for suggesting the reverse might happen, with poorer students seeking degrees that lead to high-earning careers in order to be more able to repay their student loans.

ARE LOANS IN FACT A GRADUATE TAX?

The loans taken out to cover tuition fees and maintenance are by no means like conventional loans, in that repayment does not take place until the borrower is earning, depends on the salary of the borrower, and does not have to be made by a set date. The loans system is in reality a form of graduate tax, although it does not tax graduates equally, and the tax ceases once the debt has been discharged, or after a set time.

It seems to have the disadvantages of both. The sums are called loans, and students feel that they are going into debt. Psychologically this makes them feel they are committing themselves to paying for their own education at a time when their earning power is at its weakest. The fact is that it is only as adult earners will they pay for that education they received when younger. Adult taxpaying graduates are paying for the education they underwent as students.

This is not substantially different from having university education given free to students and having it funded by graduate taxpayers, which is the essence of a graduate tax. A key difference is that under the so-called loans system university education is not perceived of as free, and not all graduates end up paying the tax that funds it. It is also inconsistent: students with pre-existing wealth can pay off early, low earners pay little or nothing, but mid-to-high earners may pay almost as much in interest as they do in principal. It is also true that many students worry about the debt they have incurred, as they do about their ability to repay it in the future, with some feeling it as a millstone around their adult lives.

THE AUSTRALIAN SYSTEM

The way higher education is financed in Australia is quite similar in fact to the system used in England, but tweaks it is perceived somewhat differently. Just like England, students need not stump up funds at the time of consumption. But a lack of interest, cheaper fees, higher wages, cheaper living costs, and a faster repayment schedule mean it doesn't feel that way. For example, anti-fees protests are typically marginal, attracting mere hundreds, compared to the hundreds of thousands in Britain that completely close down major cities.

It is a remarkably simple system, in that students have to tick a box accepting a liability to pay a graduate tax when they are earning enough to be able to do so. They do not have to start paying this tax until they are earning AU$50,000 (roughly £30,000 at current exchange rates), but at that point a tax of 4 percent of their total annual earnings is deducted from their salary. This rises to a maximum of 8 percent of salary when they are earning AU$100,000 (roughly £60,000) per year.

The tax lasts as long as it takes for you to repay the cost of your education; if you pay it off before you die, it stops. That cost is more like a credit entry than an actual loan. What's more, the Australian government offers the money interest free, though it is indexed annually in line with inflation so its buying power is maintained. It is, of course, a form of loan, in that the cost of their education is not carried by the general Australian taxpayer, but by the graduates themselves when they are earning.

Australian students do not need to worry that they might end up in low paid jobs carrying a loan they are unable to pay off. They are more aware than the British student that no tax payment will be required of them until they are earning close to an average salary. In fact, the median starting salary for Australian bachelor degree graduates aged under 25 is somewhat higher than AU$50,000 per year—around AU$10,000 more than the equivalent for English graduates, so more than half will be immediately liable for the 4 percent payroll deduction.

There are other differences between the two systems. In Australia the cost of university courses varies with the subject, with the arts and humanities less costly than subjects such as engineering or medicine that require more costly equipment and more intensive training. Australian fees are therefore lower than those in England, ranging from about two fifths to two thirds of the English equivalent, and there is a subsidy toward them from general taxation. That subsidy for humanities subjects is about £3,000 per year. They also have an extensive maintenance grant system alongside their maintenance loan system, and in addition, it is far less common for students to move out to go to university—something that is nearly universal in the UK.

The system is simple and widely accepted, and has a low 'default' rate compared to either the UK or the US. Owing to the subsidised fees, the longer term of repayment, the quicker rate of repayment, and the fact many Australian students live at home, thus needing far less in maintenance loans, only 17% of Australian loan funds are not repaid, compared with the 45% 'uncollected' in England.

There are two weaknesses to the Australian approach. The first is that it contains the same perverse incentives as the English system, in the students might be tempted into low cost courses that lead to lower average salaries, knowing that they will not have to start paying the tax until they are earning the minimum level at which repayment starts.

The second drawback of the Australian system is that it conceals to some extent the actual cost of university courses. Since students do not see themselves as paying fees up front or borrow money to do so, many of them might not be aware of the cost of the courses on offer, or perhaps have only a vague awareness of it. This in turn provides less incentive for the institutions to pursue efficiencies that could keep their costs down.

It should be noted that there is no fee cap as there is in England, and nor is there a cap on student numbers. Institutions can charge fees and admit numbers on the basis of the demand for places in the courses they offer, and the numbers they think they can take in without serious threat to the quality of those courses. The result has been that over the operation of the scheme as presently configured there has been a 20 percent increase in the numbers choosing to undergo higher education. Obviously there will be limits imposed by the need to avoid excessive class sizes, and to be able to provide an acceptable number of contact hours between teachers and students, and in some scientific and technical subjects there will be the need to avoid putting too much pressure on a limited supply of equipment.

That said, however, it seems as if the Australian system is more flexible and more responsive to student needs than can be achieved by the more top-down approach used in England.

CHANGING TO A MORE OVERT GRADUATE TAX MODEL

There is a strong case for England to learn the lessons of the Australian system, to study its successes and the reasons for them, and to adapt higher education finance in England to correspond more with an Australian-style system. That is, the UK government should remove the remaining trappings of the fees system, in order that the system is perceived to more closely resemble a graduate tax, as in Australia.

The crucial difference is that this would mean the end the psychological burden that student loans impose. In their place would come the box-ticked acceptance of that subsequent obligation to have repayments deducted from earnings once they are above a set threshold. In order to do so, the government must shoulder the interest burden that would otherwise be chargeable on the book value of this obligation. Instead it should be indexed every year for inflation so its buying power remains constant. Students would no longer have that average of £5,800 added in interest charges before they graduate, and nor would high earners face adding £40,000 in interest charges added to their loan before it was paid off. This may amount to a greater subsidy from general taxation.

There are significant differences in starting salaries achieved by graduates, depending on the courses they have chosen. Those who graduate in art and design or media studies, for example, can expect an average starting salary below £20,000. By contrast, those who graduate in subjects such as mathematics, engineering or medicine will start on average at over £25,000.

The level at which graduates start to pay the graduate tax they have signed into will be the subject of much calculation and discussion, but initial considerations suggest the starting threshold might be £22,500 per year, at which point the graduate would start to have 5 percent deducted from their salary as repayment towards the cost of the qualification they gained. This deduction would be on their whole salary, not just the amount above a threshold, meaning much more rapid repayment. In Australia, the average repayment term is eight years. The disincentive effects of such a system would be balanced out by the fact that the faster you pay, the less you must pay later. The 5 percent per annum deduction would rise to 8 percent per year when the graduate's earnings passed perhaps £30,000 per year.

ENCOURAGING EXCELLENCE

Some courses are recognized to have greater potential than others to contribute to the economic well-being of the nation. For example it is reckoned that courses that include engineering, mathematics, medicine and the hard sciences have greater potential than some others to put the UK into the front rank of technological expertise and help its economy to advance.

A group of university vice-chancellors should be asked to draw up a list of these 'core' subjects so that special measures can be taken to promote them. This is not to denigrate other courses, but simply to point out that they have lower potential to add economic value to the nation's future than these 'core' subjects, without passing any judgement on their intellectual or academic merits.

Consultation with university vice-chancellors should be held to establish a list of 25 universities deemed to be of the highest quality. Obviously, the Russell Group of 24 universities already does some of this, as do some of the reputable international rankings, and the simplest way might be to add a few more quality institutions, such as the University of St Andrews, to most of the Russell Group list.

A powerful incentive to encourage students to apply for 'core' subjects at quality universities would be given if those students awarded first class honours degrees had their obligation to refund their education discharged. If a student graduated with a first class honours degree in one or more of the 'core' subjects at a high-quality university, their education would be regarded as paid, with no liability to the subsequent graduate tax.

An independent academic body would be needed to oversee and monitor such a system, principally to ensure that no university tried to game the system by awarding first class degrees too readily in order to attract students. Any deemed to be doing so would risk being demoted from the approved high-quality list.

This would help balance out any perverse tendencies within the system that steered people toward less costly and less demanding courses. It would attract students toward the 'core' subjects that the government is anxious to promote, and would encourage them, once accepted into a high-quality institution, to work hard to excel, and to strive for the first class honours degree that could remit their liability to refund the costs of their education through a graduate tax surcharge.

There will undoubtedly be much discussion and controversy if such an incentive scheme is introduced, in that there will be disagreement concerning which subjects should make it into the category of 'core' subjects, and which institutions should be admitted into the “high-quality” category. The decisions concerning such matters would be best made by an independent body with a strong academic make-up, so that people actually involved in university education were making the judgements, rather than politicians or civil servants, even if the decisions had ultimately to gain the final approval of government.

CONCLUSION

The proposals contained herein still contain the basic element that those who profit most from a university education should ultimately be the ones to fund it. It seems wrong that those less academically or intellectually endowed, and who will on average earn lower salaries than their graduate counterparts, should pay higher taxes fund the education of those who will be equipped to earn more than they will.

The new principle, however, is that students will have the education without paying for it at the point of receiving it, and will only pay later, via a graduate tax surcharge, when they are earning enough to be able to do so. Students will not pay fees when they enrol, and will not have to take out loans to do so. They will incur an obligation, one to be discharged later on, and one that will be fully acquitted once they have paid the actual costs of their university education.

These proposals will give students more security, universities a greater degree of independence, and will help give the nation the flow of highly qualified graduates it will need in the future.