HIGHER TUITION FEES AND REAL INTEREST TO HIT MIDDLE EARNERS

SUMMARY

- Raising the student fee cap to £7,000 per year would cost the government up to **£1.3bn** per year under current arrangements.
- This is unaffordable at a time when the Department for Business Innovation and Skills is looking to cut at least 25% from its budget. Reforming the student loan subsidy is therefore inevitable, and the imposition of a real interest rate is the most straightforward reform option.
- A real interest rate of 3% would leave middle earning graduates paying up to **£15,000 more** over their lifetimes for the same education as their better-off peers.
- One solution to this, as the SMF has previously suggested, is to introduce income-contingent interest rates so that higher-earning graduates face a commercial rate of interest.

THE STUDENT FINANCE SUBSIDY

The present student loan system offers students finance to cover tuition fees at zero real interest. Loans are only repaid at 9% of gross income above a £15,000 per year threshold. Any outstanding loans are written off after 25 years. These elements to the student finance system make it a broadly progressive system, protecting low current and lifetime earners.

But the subsidies available cost the Treasury in the region of 23p for every £1 it lends out to students. That amounts to a subsidy to each graduate worth about £4,800 under the current loan system with student fees at £3,290.[1]

In 2009/10, the Student Loans Company reported that 791,000 students took out tuition fee loans at an average rate of £3,030, and 748,900 students took out maintenance loans at an average rate of £3,610[2]. The subsidy cost to the taxpayer for last year was therefore approximately £1.2 billion.

[1] See http://www.ifs.org.uk/comms/comm115.pdfm for costing of the student loan subsidy
[2] http://www.slc.co.uk/pdf/slcsfr062009.pdf

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RAISING THE FEE CAP

Rt Hon David Willetts MP, speaking at the Universities UK annual conference last Thursday, said that graduates ought to expect to pay a larger contribution towards the cost of an undergraduate degree[3]. It has been suggested that Lord Browne's review of higher education funding will propose an increase in the student fee cap from the current level of £3,290 to £7,000 per year. Loan facilities would have to be provided to students to allow them to finance their education at this higher cost.

But increasing tuition fee loans to £7,000 will disproportionately raise the cost of the subsidy for four reasons:

- The total value of loans distributed to each student will increase to cover the higher fees;
- The proportion of graduates taking a loan out will likely rise from the current 4 in 5;
- The rising stock of debt for each graduate increases the cost to government of the 25-year debt write-off, since a greater proportion of students' loans are written off; and
- Each graduate's higher stock of debt means that the interest rate subsidy applies for longer.

IFS analysis suggests that the effective subsidy per graduate for a £7,000 annual fee cap would rise from a total of £4,800 to almost £10,000.[4] With some 791,000 students each year taking up a loan, the SMF estimates that the total subsidy cost per year could rise by **£1.3bn per year** – more than twice the current subsidy level.

Raising tuition fees to £7,000 under the current student finance arrangements would therefore mean the government finding an extra £1.3 billion per year at a time when departments are looking to cut at least 25% from its budget. This is clearly not going to be possible, so reform of student finance is inevitable.

To fund the expansion in tuition fee loans without slashing direct research and tuition funding –currently £7.1 billion per year - by even more than planned, the government is likely to have to dramatically reduce the loan subsidy available to graduates. This could be done by either by raising interest rates on loans to a commercial rate, or by ending debt forgiveness after 25 years. Both of these measures may be necessary to cover the costs of tuition fees rising. But this would leave graduates, for the first time, with a growing debt burden on graduation and an open-ended commitment to pay it off. Such a reform could seriously undermine recent progress on increasing undergraduate participation rates among the lowest socio-economic backgrounds.

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[3] "What would not make sense would be to fail to increase the contribution from graduates", http://nds.coi.gov.uk/content/Detail.aspx?ReleaseID=415386&NewsAreaID=2
[4] http://www.ifs.org.uk/comms/comm115.pdfm

IMPACT OF REAL INTEREST ON DIFFERENT GRADUATES

As well as increasing the cost of borrowing to students, charging a real interest rate on loans would have important distributional effects within each cohort of graduates. This is driven by the fact that lower earners will take longer to pay off their loans and will therefore ultimately end up paying more money for their education than do high earners. Even if the government were to retain the 25 year debt write-off in order to protect the lowest earners, the distributional implications of a real interest rate are significant.

The SMF has used Labour Force Survey data on graduate earnings to simulate how much graduates at different points in the income distribution would end up paying for the same education, with student loans charging a 3% real interest rate.[5] Based on current average levels of student debt of £20,900,[6] it is reasonable to assume that with a new £7,000 fee cap – a fee increase of £3,710 per year – the average debt on graduation for students attending the top-priced courses will rise to around £32,030.

Two loan regimes are shown in the chart below for graduates starting out with a £32,030 debt and facing a real interest rate of 3%:

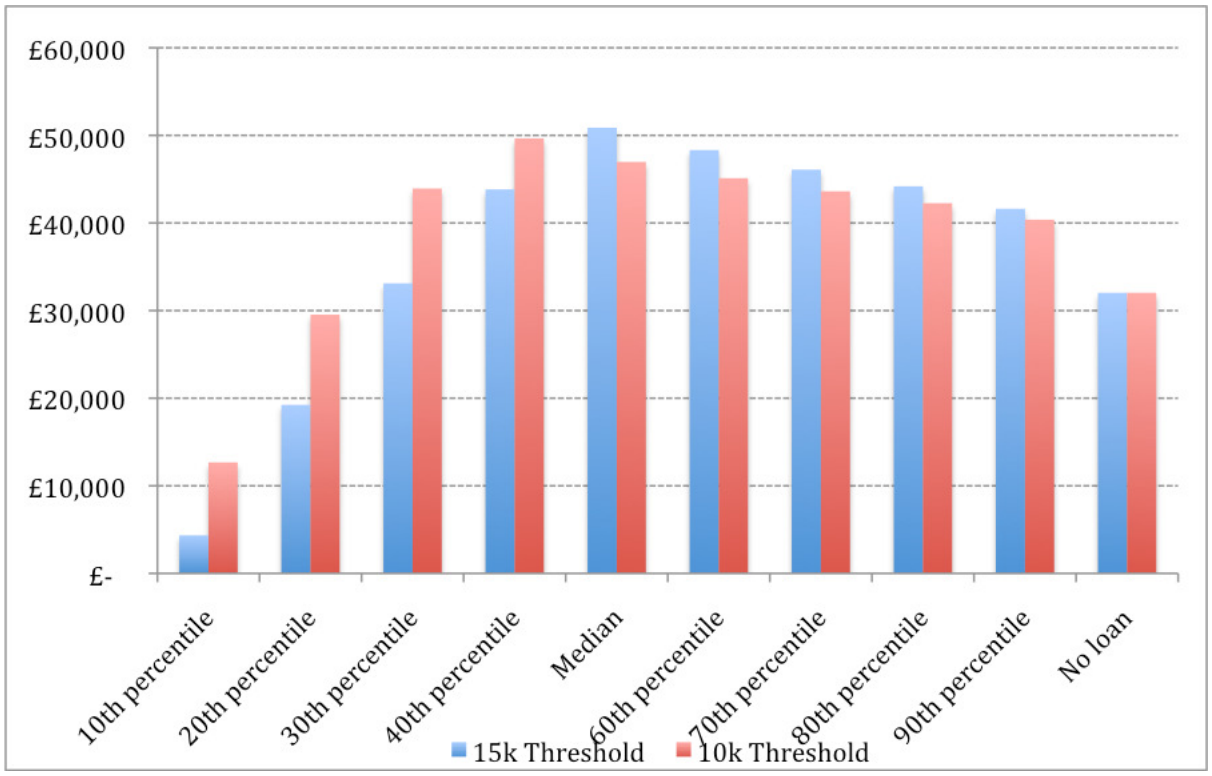
1. Graduates are required to repay 9% of their gross income over £15,000 p.a.
2. Graduates are required to repay 9% of their gross income over £10,000 p.a.[7]

Scenario 1 represents the current loan system with real interest rates applied. Scenario 2 represents a system in which the income threshold is reduced to £10,000p.a. to further reduce the cost of the subsidy through restricting the number of graduates benefiting from the 25-year write-off. In both cases the debt forgiveness after 25 years remains in force.

The simulation shows that this arrangement leaves graduates who start out with the same debt, potentially from the same university course, paying very different amounts for their education. While low-earners are somewhat protected by the 25 year debt write-off, middle earners are hit hardest by the new system. In either repayment framework, middle earners end up paying around £10,000 more over their lifetimes for their education than do high earners in the 90th percentile. Compared to people who are sufficiently well-off not to need a loan, middle-earning graduates will pay around £15,000 more for their education.

[5] Labour Force Survey quarterly data. Assumes 2% real wage growth.
[6] SLC http://www.slc.co.uk/pdf/slcsfr062009.pdf
[7] In both cases the income threshold is assumed to rise in line with prices.

Figure 1: Distributional consequences of real interest on student loans: lifetime payments by graduate income position



CONSEQUENCES AND SOLUTIONS

A simple solution to the burgeoning costs of the student finance system would therefore be very regressive. It would leave middle-income families labouring under the weight of growing graduate debt in their 30s, while the best-paid graduates are free of the burden. Many feared that the higher fees introduced in 2006 might damage participation by students from low-income families. These fears have proven unfounded, largely thanks to the generous subsidies currently on offer to students. But the imposition of real interest rates on higher levels of student debt could change this unless reforms are more carefully designed. Clearly therefore, if higher fees are to be fiscally viable *and* fair to graduates, the loans system muct target subsidies much better than would the current system with real interest rates.

As the SMF has previously suggested, one approach to resolving this problem would be to implement graduated interest rates.[8] Under such a scheme, graduates earning more than, say, £25,000 per year would face

[8] Ian Mulheirn and David Furness, *Axing & Taxing: A plan to cut the deficit* (London: Social Market Foundation).

a commercial rate of interest, while lower-earning graduates would continue to benefit from zero real interest rates. Additional income bands could be introduced to increase the progressivity of the system.

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