



False Accounting?

Why the government's Higher Education reforms don't add up

By Dr Andrew McGettigan

Foreword

Liam Burns, President, NUS

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Foreword by Liam Burns, NUS President

The recent turn in England to student loans as the principal means of funding higher education is one of the murkiest moves yet made by the coalition government. In this astonishing report, Andrew McGettigan clears the fog and allows us to see what is really going on. By switching from spending to lending, ministers hoped to maintain the level of resources available for universities and contribute to deficit reduction, at the same time. This has been described by many as an ‘accounting trick’ and a ‘sleight of hand’ – but read on if you want to know exactly how the conjuring is done, using the obscure rules of public accounting, asset classes, RAB charges, dubious assumptions and more. The case for the prosecution against a policy settlement that looks at best rushed and too hopeful, and at worst negligent and reckless, is compelling.

Perhaps its most striking conclusions are about the problems being stored up for the future. In their haste to ‘get the thing done’ in December 2010, the government apparently made no assessment of the impact far higher tuition fees would have on inflation measures, to which the cost of many public expenses are linked. Because the welfare bill is so much larger than the fee pot, even small effects on inflation caused by the latter can have dramatic consequences, to the point where any savings from the higher education reform package are simply wiped out. The government seems set to pretend this just isn’t happening, but it is. The loan book is due to grow until at least 2030, and then stands for many decades as graduate repayments slowly erode it. But further, long term disruption in the European and world economies would surely mean paying far more in interest on the many extra billions owed, or else shifting them in a fire sale, at a gigantic loss. It raises the distinct prospect that the same people will pay twice: once by repaying their own debts, and again by paying off the public debt behind the whole enterprise in their tax bill.

It is beyond doubt that this is an intergenerational concern. The baby boomers got their higher education for free, but in a mass system in which half the population gets that opportunity and half don’t, I think it is right for those who directly benefit to make a contribution. But the scales have tipped too far and there are worrying signs for the future. If earnings growth is lower than projected, as now seems inevitable in the wake of a ‘lost generation’, excluded from work and opportunity, the cost of losses in the loan system could rise to 40 pence or more in the pound. Furthermore, government intends to extend the same loan scheme to cover fees for people aged 24 and over in further education – at an estimated loss of 60 pence in the pound. These are losses that seem designed to inspire public objection, and to soften us up for a more ‘fiscally continent’ system down the line, with higher loan repayments or the abandonment of cancellation after 30 years. This report shows us that the hawks are already circling. It would be intolerable if future (or even current) students were asked to pay even more still, because today’s government has cooked the books.



We should not forget that in addition to its money tricks, the government had another end in view when it forced through its HE funding reforms: it wanted the loaned voucher in the hands of students to force the development of stronger market forces in the sector. Student loans have long been a key part of the project to marketise higher education and have become a touchstone of capitalist educational economics. For students to invest in their education in a human capital system they need to have ready money to spend, and this is what student loans are really for. Hopelessly utilitarian, divisive, deathly for critical thinking: and all at huge cost. Cable and Willetts have spoken the rhetoric of 'student empowerment'. But the bare truth is that students now are in hoc to a loan shark who is himself in hoc to a gangster. There is no empowerment in that. So we will continue to campaign for the key recommendations of this report: government should come clean about its financial chicanery and open the books, secure the much-vaunted loan repayment terms in statute, and restore direct grant funding of universities for mainstream teaching activity. The battle for education is far from over, and these are its new fronts.



Executive Summary

The Intergenerational Foundation (IF.org.uk) is a politically independent charity that promotes the interests of younger and future generations in British policy-making. IF conducts robust research about intergenerational fairness in order to educate British society about the need to take the rights of younger and future generations into account.

IF commissioned Dr Andrew McGettigan to assess the liabilities that the higher education funding reforms and increasing student loans would deliver to future tax payers.

Britain's net debt passed the £1 trillion mark in March 2012. With debt now at 66% of GDP, limiting further borrowing is at the core of the Coalition's austerity measures. First among these is the effort to reduce the deficit and so slow the additional borrowing required each year to cover the shortfall between expenditure and income.

At the State Opening of Parliament on 9 May 2012, the Queen's Speech reiterated this aim: 'My ministers' first priority will be to reduce the deficit and restore economic stability.'

This motivation lay behind the earlier decision to slash annual direct funding to universities for undergraduate tuition by £3billion.

David Willetts, Minister for Universities and Science, said: 'Higher education cannot be entirely insulated from the savings necessary to reduce the deficit. So, in future, the key beneficiaries of higher education will pay more of the costs, but only where they can afford to do so and via a more progressive loan system.'¹ Universities were granted powers to set higher fees to compensate for the loss of central funding. Loans available for tuition fees were increased accordingly.

Unfortunately, the government has made a shambles of these financing reforms. The botch can be attributed to political compromises and mistaken assumptions regarding the levels of fees that would be set by universities. This led to delays in implementing the reforms – evidenced most recently by the decision not to proceed with a draft Higher Education Bill in the new parliamentary session.

The original financial models produced by the Treasury in the Autumn of 2010 no longer reflect the expected impact of the new loan scheme. Despite what has been promised, there is likely to be no saving to the public-sector finances from the reforms to higher education funding. As a result, the political narrative offered to the public and parliament in favour of the funding reforms is undermined. There is no rationale for subjecting the sector to enormous upheaval.

There is repeated confusion around the headline figures of the deficit and the debt. Most recently, Nick Clegg, the Deputy Prime Minister, conflated the two at a tractor factory in Basildon, referring to the debt when he meant the deficit.

¹ David Willetts, 'Universities minister defends higher education reforms', *The Guardian* (19 September 2011). <http://www.guardian.co.uk/education/2011/sep/19/david-willetts-higher-education-reforms>



‘We have a moral duty to the next generation to wipe the slate clean for them of debt. We have set out a plan – it lasts about six or seven years – to wipe the slate clean to rid people of the deadweight of debt that has been built up over time.’

With regard to student loans, avoiding this mistake and understanding the difference between the deficit and the debt is imperative.

Replacing direct grants to universities with higher fees backed by higher loans reduces the relevant government department’s contribution to the deficit. But the cost of government borrowing to create the loans adds significantly to the national debt in the short and medium term.

The new loan scheme rests on an accountancy convention which treats the loan portfolio created as a financial asset, treats the borrowing like capital expenditure, and so takes the majority of the outlay out of the deficit calculation.

The Office for Budget Responsibility (OBR) estimates that annual loan outlay will amount to over £12billion from 2015/16.

- This represents an increase of £5–6 billion per year, eclipsing the £3billion saving achieved through the cuts to the block grant.
- The increased borrowing needed to finance higher tuition fees and the expansion of loans will add an additional £50 to £100billion to the public sector net debt over the next twenty years.
- This debt will only be paid down when annual repayments match and exceed the annual outlay. According to the OBR, this will be sometime around 2032; according to the Department for Business, Innovation and Skills (BIS), this will be after 2040.

Despite the proclaimed deficit reduction strategy, the debt will increase in the short and medium term. Longer term, the projected debt reduction depends on graduate earnings estimated over the next thirty years. This is speculative at best and the government admits the volatility inherent in the scheme. Even here, the government estimates having to write off 32 per cent of the value of the initial borrowing and associated costs.

It will be left to future governments and taxpayers to resolve any shortfall between the estimates used and the actual repayments that materialise.

In addition:

- Tuition fees are within the basket of goods used to determine the Consumer Price Index (but not Retail Price Index). Higher tuition fees will therefore have an inflationary impact, increasing CPI by 0.2 percentage points in the final quarter of 2012/13. The following two years will see a similar impact leading to an overall increase of around 0.6 percentage points.
- State pensions, tax credits and some other benefits paid by the Department of Work and Pensions (DWP) are index-linked to CPI, which is used to calculate their annual increase. **The impact of higher tuition fees could add £2.2billion to the social security budget by 2016 at a time when the Chancellor has just announced that he wants to see cuts worth £10billion from it.**

- There would therefore be no *overall deficit saving* from the new HE funding regime. BIS may save approximately £1billion per year, but DWP loses £2billion, leading to an overall *increase* to expenditure of £1billion; and additional pressure on borrowing.

This 'CPI effect' is an intergenerational one as most of the higher spending is on the older generation through higher pensions. Around £90billion each year is spent on state and public service pensions. The annual increase in that spending resulting from higher tuition fees would be equivalent to roughly £0.5billion annually representing a large transfer from young to old.

With increasing public sector net debt the result, two further possibilities arise:

- Future governments could change the terms and conditions on the loans to extract higher repayments from graduates;
- The government may attempt to offload the loan liabilities through various forms of sale, although any purchaser may need to be enticed with a large discount or ongoing subsidy (or indeed the promise of higher repayments from former students).

This government is secretly investigating the possibility of such a sale and is keeping developments from public and parliamentary oversight – privileging 'commercial interests' over democratic accountability. Under the terms of the 2008 Sale of Student Loans Act, loans can be sold to third parties without consultation and without consent.

While future cohorts will face loans offered on much less generous terms, those who have already taken out loans have also been deprived of guarantees and statutory protection: the 2012/13 loan agreement contains the following clause:

'You must agree to repay your loan in line with the regulations that apply at the time the repayments are due *and as they are amended*. The regulations may be replaced by later regulations.' (p. 8)²

The income-contingent repayment loans offered to students are also future-policy-contingent, potentially creating an indentured class of graduates from whom higher repayments can be extracted.

In sum, the Coalition has concocted a higher education funding regime which fails on its own criteria. It introduces fiscal instability into the sector and offers the nation minimal savings in return. While the deficit may be slightly reduced, large borrowings are required over the next two decades before the scheme is expected to pay for itself. These expectations may be pricked if adequate graduate repayments fail to materialise – leaving future governments to rectify the situation.

²http://www.direct.gov.uk/prod_consum_dg/groups/dg_digitalassets/@dg/@en/@educ/documents/digitalasset/dg_200469.pdf

Recommendations

Recommendation 1

The single best measure to avoid many of these accruing problems and uncertainties for borrowers and institutions would be to reverse the strategy commenced upon in 2010 and restore to significant levels the block grant for undergraduate teaching. This would enable institutions to set lower fees, lowering the inflationary impact on CPI and lowering the required loan outlay, thus diminishing the volatility of the current scheme.

Recommendation 2

The government needs to ‘come clean’ about the claimed savings in the move from grants to loans. Given the impact on CPI of higher tuition loans, it appears as if there is no saving. A public statement is needed.

Recommendation 3

The loan scheme is volatile. The government’s current estimates of 30–32 per cent losses on the loans— look weak. It is irresponsible for the current government to leave it to future governments to address the issue. A more generous sum for losses on the loan scheme – an ‘impairment’ –needs to be recorded in departmental accounts. A 40 per cent impairment would appear to be sensible, given independent analysis and the likelihood of higher tuition fee loans.

Recommendation 4

No sale of the loan book should proceed without discussion in Parliament on the terms of any deals, especially as it is likely to require repeated annual subsidies. Too much power currently lies with the Secretary of State. Given the ‘economic innumeracy’ of such sales in the past, an independent review should be commissioned, not simply the current private advice from Rothschild. The BIS Select Committee may also be the appropriate body to conduct such a review.

Recommendation 5

Although contracts can be overridden by primary legislation, as things currently stand, the combination of weak statutory and contractual protection for borrowers makes it too easy for future governments to amend the repayment terms and conditions. This situation should be rectified through tougher contractual clauses fixing the terms of repayment at the time the loans are taken out, or revising statute, so as to make future amendments possible only through primary legislation.

Recommendation 6

Although it was not possible to cover it in this report, there appear to be shortcomings in the maintenance support provided. Loans do not appear sufficient to meet costs of living, especially in London. The dangers are that students will have to seek additional borrowing from commercial sources or that they are distracted from study by having to undertake excessive paid work in term time. Discussion of maintenance loans should be decoupled from tuition fee loans. This report recommends that an independent commission, such as, again, the BIS Select Committee, review student finances from this perspective.

Introduction

Higher Education Institutions (HEIs) in England are currently recruiting new students for the next academic year. September will see the introduction of a new funding regime, which will entail much higher fees and much larger borrowings for students and the government.³ The publicly backed student loan scheme, administered by the Student Loan Company is accessed by over 800,000 students each year.⁴

Students can borrow to finance the annual fees while also accessing loans to cover their accommodation and living costs, so-called maintenance loans.⁵ The latter range from just under £4,000 per annum to over £7,000 for those who are studying away from home at a London institution. Once loans for fees and maintenance are put together we can see that some graduates on three-year degrees may leave university with individual debts of nearly £50,000, with those on longer courses facing more.

The loans are of a relatively unfamiliar kind: unlike fixed-term loans, where borrowing and interest is paid off in instalments over a defined period, the monthly repayments on these loans are determined by the income of the borrower. That means that the period of repayment is potentially open-ended, but in this case, the loans come with a commitment to write-off the outstanding balance on individual accounts thirty years after leaving university.⁶

There is currently £35billion of outstanding balance on individual loan accounts for these ‘income-contingent repayment loans’.

With over 300,000 new starters at university each year, the government is expecting to issue over £10billion in loans annually from 2014/15.

While protests and criticism have focused on the debt facing individuals, for higher education policy and funding a different set of questions arise.

How much of the money loaned will return in future?

What are the financial implications for future governments and taxpayers?

³ Students in England will access loans on terms different to those offered to students in Wales, Northern Ireland and Scotland.

⁴ These statistics include English domiciled students studying at other higher education institutions in the UK and EU students studying in England.

⁵ The scheme will also be expanded to include part-time students. A separate loan scheme is being extended to Level 3 post-16 qualifications offered in further education and private colleges. It is beyond the scope of this report to consider the implications of the latter, though some points raised here will be relevant. In addition, this report cannot consider the question of postgraduate funding: such courses are currently excluded from the student loan scheme and must be financed independently.

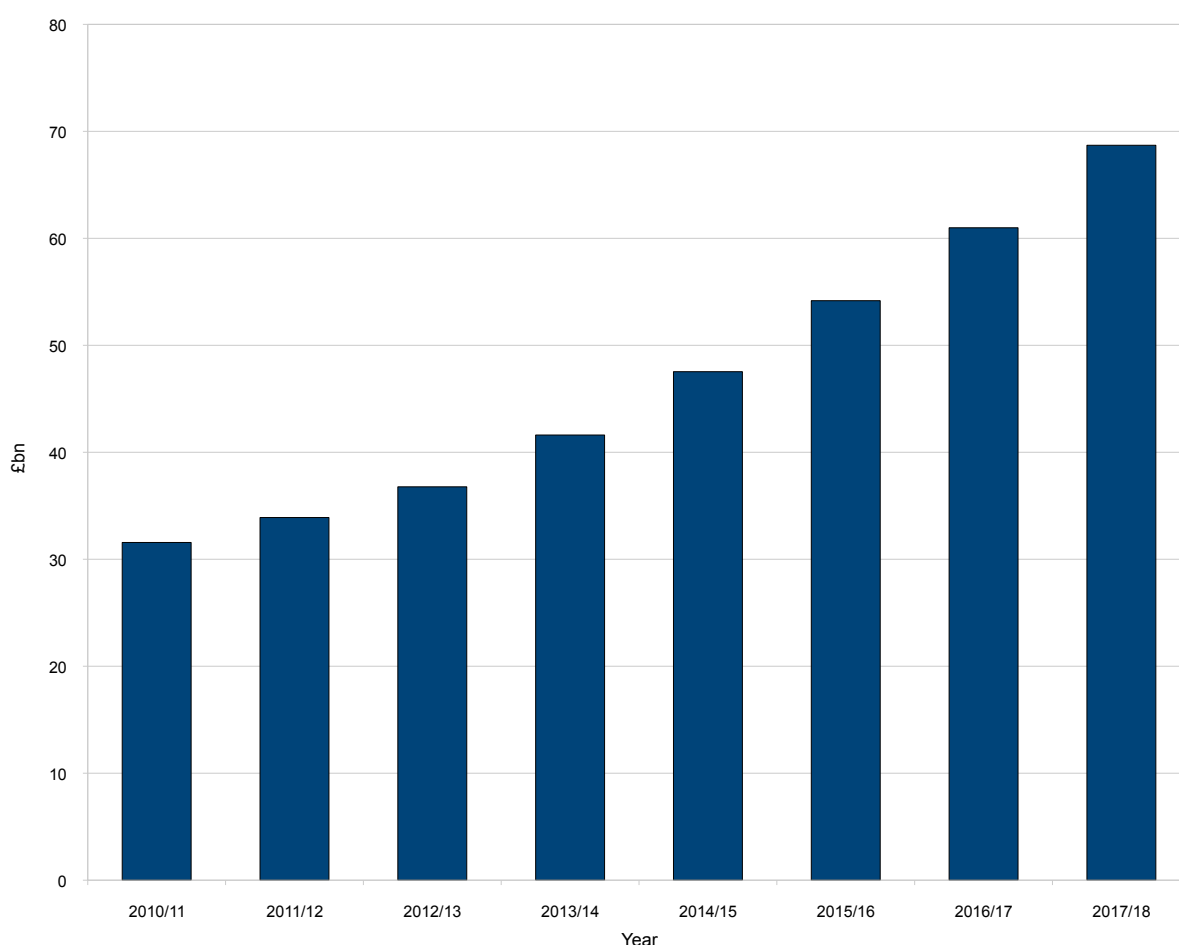
⁶ This report will primarily use the terms, ‘graduate’ and ‘graduation’, though I recognise that some students leave university without graduating. Those who do not complete their studies are required to repay any loans they have borrowed.

Given the long lifetime of these loans, what legacy is being left for future policymakers to inherit?

The amount ultimately repaid is difficult to predict. There is a substantial risk involved in the new funding regime, but this government will not be around to deal with commitments it has taken on.

The 2011 White Paper, *Students at the Heart of the System*, shows the outstanding balance on income-contingent repayment loans doubling within six years to £70billion.

Figure 1 Outstanding balances on Income-Contingent Repayment Loans (£bn)



Source: BIS, *Students at the Heart of the System* (2011)

Unpublished figures released by the Department of Business, Innovation and Skills (BIS) to the Higher Education Policy Institute (HEPI) last summer project the scheme forward into the middle of the century and predict a peak total of *£191billion* around 2045/6 (See Figure 7, page 52). At that point the policy write-offs begin to erode the balance of outstanding loans and total annual repayments begin to match and exceed new annual loan outlay.

With this to mind, does the new regime displace the problem of funding higher education into the future, leaving future governments to deal with the reconciliation of estimated and actual repayments?



This report addresses this issue by outlining the main considerations underlying such an assessment.

It concentrates on loans and their relation to the headline public sector finance statistics: the deficit and debt. In particular it will explain how loans are recorded in national and departmental accounts.

Above all, it will argue that there is likely to be no overall saving to government from the new regime, though there is a saving to the higher education budget and BIS departmental expenditure.

In addition, the debt-financed expansion of loans introduces a fundamental volatility into the system – for which future governments and taxpayers will be liable. Does the viability of the fees and loan regime depend on altering the terms of repayment so that more of the money loaned comes back?

That is, it will set out the general problems surrounding the loan ‘book’ and why the government, like its predecessor, is seeking to sell, or ‘monetise’, the book and why that sale is unlikely to represent value for money to the taxpayer.

BIS is refusing to release a report it commissioned on a potential sale and alternative ‘routes to market’ for reasons of ‘commercial interests’. Any sale may simply be announced to the public once it has been negotiated and agreed.

The intentions are clear but have not been openly discussed. As things stand, the Secretary of State need not run any proposed sale by parliament (this can be done without consultation and without consent of borrowers).⁷ This is deeply concerning given the political stakes and the potential structuring of such sales, which may involve a substantial discount or ongoing subsidy to the purchaser.

At the time of writing (May 2012), the government appears to have postponed plans to pursue the Higher Education Bill originally planned for this year: no such Bill was announced in the Queen’s Speech. Any such postponement would provide an opportunity to revise the problems now apparent in the current scheme.

The report is divided into four parts.

The first part examines the political narrative of austerity used as the primary rationale in support of the new regime – it does so by analysing how loans figure within the national and departmental accounts and appear in calculations of the deficit and the public sector net debt.

The second part looks at the general problem of modelling graduate repayments over the next thirty-five years, dependent as they are on predicting a representative sample of graduate careers and earnings.

⁷ Although this report will concentrate on the new regime proposed by the Coalition, much of the groundwork that enabled the plans to be effected so quickly was put in place by the New Labour administration. New Labour introduced top-up fees of £1,000 pa in 1998/99; New Labour sold off the earlier mortgage-style loans in 1998 and 1999; New Labour introduced the legislation around differential fees that the Coalition used to call the snap vote on raising the maximum tuition fee to £9,000pa; the 2008 Sale of Student Loans Act was also their handiwork, as was the commissioning of the Browne review and the tender that was issued for financial advice on the sale of the loan book. The Coalition awarded that tender to Rothschild on coming to power in May 2010.



The third part looks at the possible sale of the loans issued, in particular, the original intention to 'securitise' loan repayments.

The final part takes the student or graduate perspective, asking what statutory and contractual protection exists against a future government changing the operation of the scheme so as to generate higher repayments. The report concludes with a set of recommendations.

Part One

Is there any saving in the move to the new funding regime?

Political narrative: the debt & the deficit

The Coalition formed around a clear economic narrative. Austerity measures were needed to reduce the deficit – the difference between annual revenues (taxation) and annual public expenditure – so as to slow down the increase of the public sector net debt.

That debt is hovering around £1trillion which is equivalent to 66 per cent of the GDP, excluding the effects of financial interventions.⁸

In the context of ‘austerity’, all government departments are expected to do their bit and higher education is no different. In an interview with *The Guardian*, David Willetts, Minister for Universities and Science, said: ‘Higher education cannot be entirely insulated from the savings necessary to reduce the deficit. So, in future, the key beneficiaries of higher education will pay more of the costs, but only where they can afford to do so and via a more progressive loan system.’⁹

Hence, the cuts announced in 2010 to the budget of the department responsible for higher education: Business, Innovation and Skills (BIS).

First, the Comprehensive Spending Review of that year announced an 80 per cent cut to the budget that financed block grants to English universities for undergraduate teaching. All such central funding was cut from arts, humanities and social science subjects, with savings expected to amount to £3billion per year by 2015/16.

Second, in order to meet this shortfall in income, a vote in December 2010 allowed universities to set a new maximum tuition fee of £9,000 per year, more than doubling the current cap of around £3 400. Students would be able to access higher loans from the publicly-backed Student Loans Company to meet those new fee levels.

The new policy was the focus of large-scale public protests and put enormous pressure on the Coalition, whose junior partners, the Liberal Democrats, still pledge to abolish tuition fees should they ever win outright power. Those demonstrations tended to focus on the higher costs individuals would face to finance study, the larger loans they would need to access and the subsequent debt that would follow them after graduation. In response, the Coalition emphasised how the new loan scheme would be more ‘progressive’, or at least demand lower mandatory monthly repayments.

⁸ ONS Public Sector Finances Statistics (March 2012). Including the effects of the measures taken in the midst of the financial crisis to take control over the failing banks (e.g. Northern Rock and RBS), has net debt at 140 per cent of GDP in 2011/12 (down from over 150 per cent in 2010/11).

⁹ <http://www.guardian.co.uk/education/2011/sep/19/david-willetts-higher-education-reforms>

The main justification offered by the Coalition for the new loan scheme is that it will save money over the current arrangements: although borrowing to create new loans will entail accessing larger sums of money from purchasers of government debt, most of that borrowing is expected to be repaid by graduates. The Office for Budgetary Responsibility estimates that annual loan outlay will increase by around £5-6billion to over £12billion by 2015/16.

My focus here is on these loans and the borrowing used to create them. Loans do not figure straightforwardly in the national and departmental accounts. With lifetimes now of over thirty years, loans have a complex impact on the headline Public Sector Finance Statistics, in particular, the Public Sector Net Cash Requirement (PSNCR) – the official term for the ‘deficit’ – and Public Sector Net Debt (PSND).

PSND, the debt, is a measure of national liabilities set against assets. Most liabilities are in the form of government borrowing through Treasury bonds (gilts).¹⁰ Liquid assets are ‘netted’ against liabilities to give a balance. Gordon Brown’s ‘Golden Rule’ was meant to limit the debt to 40 per cent of GDP over the business cycle, but with the problems of the last three years, the debt is now expected to peak at 76 per cent in 2015.

PSNCR, the ‘deficit’, is a measure of the difference between expenditure and income. The deficit represents a shortfall between those two, indicating a need for additional borrowing. This borrowing adds to the debt. Reducing the deficit is directed at slowing the growth of public sector net debt. For 2011/12, the deficit was around £125billion. Through cuts to government spending, the government plans to reduce the deficit substantially by 2016/17.

Returning to loans, how does the claimed saving to the deficit arise?

To compensate for the cuts to block grants universities set higher tuition fees – currently projected to average over £8,000 per year after fee waivers. Students will therefore need to borrow more to pay these fees and this will lead to much higher loans.

In February 2011, David Willetts provided a projected breakdown of costings for 2014/15 adjusted for inflation.¹¹

Table 1 The Claimed Saving to Expenditure

Block grant paid to direct universities	£2billion
Loans for tuition fees	£6.5billion
Maintenance loans	£3.5billion
Maintenance Grants and scholarships	£2billion
	£14billion

Source: David Willetts, 2011

¹⁰ Austerity measures are also directed at protecting the government’s score with credit rating agencies so as to maintain its ability to borrow at historically low interest rates.

¹¹ Speech to Universities UK annual conference (25 February 2011).

In 2010/11, total loans issued to cover fees and maintenance amounted to £6.6billion.

On the figures quoted before for 2014/15, the total loans come to £10billion. This increase, roughly £3.5billion, exceeds the claimed savings from cuts to grant (£3billion).

So what is going on? With loan outlay appearing to accelerate past any savings from cuts to grants, how does the new regime achieve any reduction to the deficit and the debt?

Simple calculations might indicate that the government is 'spending' more on higher education, since the additional annual loan outlay exceeds the cut to grants.

Willetts himself has repeatedly claimed that universities overall would be better off by around 10 per cent (should student numbers hold up): 'Funding for university teaching is expected to grow by 10 per cent over this Parliament. Although the central HEFCE [Higher Education Funding Council for England] grant is falling, more money will reach institutions as resources follow the decisions made by students.'¹²

First, we should note that these 2014/15 figures need to be revised upwards following the 2012 fee announcements by English universities. In its November 2011 *Economic and Fiscal Outlook*, The Office for Budgetary Responsibility (OBR) estimated that by 2016/17 new loans issues would amount to £12.7billion. (In Table 1, new issues of loans are set alongside repayments received and the interest being paid on the net borrowings used for student loans).

Table 2 Student loans: impact on finances (£billion)

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
New Issues	6.6	7.7	9.6	11.1	12.2	12.7
Repayments	-1.7	-2.0	-2.3	-2.6	-3.0	-3.5
Interest	0.7	0.8	1.2	2.0	3.1	4.3
Net Impact	5.6	6.5	8.5	10.5	12.2	13.5

Source: OBR *Economic and Fiscal Outlook* (November 2011).¹³

In its most recent report, released on 21 March 2012 to coincide with the 2012 Budget Statement, the OBR revised annual loan outlay again to reach **£12.9billion by 2016/17**, with estimated repayments held at the same level.¹⁴

Adjusted for inflation, this amount comes to a little over £11billion in today's costs and therefore represents an increase of about £4.5billion per year on 2010/11 loan outlay.¹⁵

¹² BIS press release 28 March 2012

<http://nds.coi.gov.uk/content/Detail.aspx?ReleaseID=423924&NewsAreaID=2>

¹³ OBR Supplement, 'Student loans and the financial transactions forecast' (November 2011).

<http://budgetresponsibility.independent.gov.uk/wordpress/docs/Supplementary-info-on-student-loans-20111205.pdf>

¹⁴ Footnote 2 to Table 4.25: Reconciliation of PSNB and PSNCR, OBR *Economic and Fiscal Outlook* (March 2012).

Compared to the claimed saving of £3billion from grants to universities, this would seem to imply an increase in total outlay of £1.5billion per year.

But when viewed from the perspective of government accounts, from where the two key measures of public sector finances are drawn, the debt and the deficit, student loans occupy an unusual position.

Funding made to universities in the form of grants counts as annual expenditure, spending, and appears in the calculation of the 'deficit'.

Loans however do not count against government expenditure in any straightforward way. This is because the Treasury expects to get back most of the money it lends. Loans are therefore treated differently in the accounts.

Student loans are classed as 'policy lending to the private sector'. The money used to issue the loans creates a financial asset, the loan 'book' or portfolio, which generates annual income in the form of graduate repayments. As a result, the borrowing used to create loans is not classed as spending and only appears in the calculation of PSNCR (the deficit) in adapted form.

Any borrowing to create the loan book, an investment, *does* however increase the debt (PSND).

Accounting for loans

It is government policy to continue to support undergraduate study through the publicly-backed Student Loans Company, which provides loans to cover both tuition fees and maintenance support.¹⁶

Whilst the government is keen to present undergraduate study as an personal investment that should produce a return in the form of future higher earnings, the new loans have been designed so that only those earning over £21,000 per annum have to begin paying back what they have borrowed. In addition, the government underwrites the loans in two ways – the loans are discharged upon death or incapacity, or thirty years after repayments become due. Outstanding balances in those circumstances are written off.¹⁷

This means that the government does not expect to receive back all that it lends. In effect, this is understood as a continuing form of public subsidy for higher education. The government underwrites the loans for those who do not see a significant return on their investment.

¹⁵ Using OBR's estimates for CPR (Table 1.1, EFO November 2011).

¹⁶ 'The loan book for English-domiciled students and EU students studying in England is owned by BIS. Loans are paid through SLC, a nonprofit making organisation, which maintains loan accounts. The SLC is a Company limited by shares; it was designated a non-departmental public body on 1 April 1996.'

¹⁷ With the new loans the interest charged will be a 'real' rate on a 'taper' (RPI +0–3% depending on earnings), which is above the government's own current cost of borrowing. However, in the accounts and long-term estimates used for student loans, the government's cost of borrowing is assumed to be RPI + 2.2%. A subsidy for interest may therefore need to be incorporated into the accounts depending on how the interest accumulates on the individual student accounts.

Loans therefore appear as expenditure only insofar as what is lent out fails to return. Non-repayment must be recorded. Where and when it does so is complex as the principles governing departmental budgets are run on a different basis to those that form the National Accounts.

Importantly, the new loan regime deals with loans which have lifetimes of thirty years and so what needs to be ascertained is what is paid for and when. Steve Smith, ex-President of Universities UK, the group of university vice-chancellors, wrote recently:

‘As I have said, the reality is that the government will spend much more on HE in 2014 than it does in 2011. The explanation for this seeming paradox lies in the arcane rules of government accounting. Cash advanced to the Student Loans Company (SLC) to pay to universities on behalf of students does not count as public expenditure: the only part that counts is the estimated amount that will not be repaid – the RAB charge – which is currently estimated at 31 per cent.’¹⁸

So, the government estimates that around 30 per cent of what is loaned out will fail to return; this loss, or non-repayment rate, is known as the ‘RAB charge’ – referring to the Resource Accounting and Budgeting convention used for departmental accounts.

The RAB charge

What follows is a simplified version of how RAB deals with long-term loans (a more detailed treatment can be found in the Appendix to this report). The manner in which the accounts are presented supports the government’s aim of deficit reduction, but obscures the borrowing behind the loans. That is, the impact on the public sector net debt is obscured. Additional costs may have to be met by future taxpayers or graduates whose contractual terms and conditions can be varied to allow for any unbudgeted costs to be clawed back.

Government estimates from 2010 and 2011 suggested that between 30 and 32 per cent of each year’s total loan outlay will not be repaid. With annual outlay rising to over £10billion per year from 2014/15, official models estimate that over £3billion of that outlay will be written off in the future. That is, for every £1 lent, the government only expects repayments over thirty years to have a ‘net present value’ of 70p. Part Two of this report considers the methodologies and assumptions used to generate such repayment estimates.

When the loans are issued the estimated non-repayment on that issue is recorded in the BIS departmental budget as expenditure for that year (this transaction is known as an ‘impairment’). **Loans are therefore recorded in the calculations of the deficit, only by the value of the *estimated* loss on the lending in the year the loans are issued.**

If all that is lent is expected to return in repayments, then loans would not figure in the deficit calculation at all (the impact on expenditure would be nil).

¹⁸ Steve Smith, Afterword to *The Manifesto for the Public University*, ed. John Holmwood (Bloomsbury, 2011), p. 136.

With respect to the net debt, the financing that creates loans must be raised by the government through borrowing. Three points follow:

1. That borrowing counts as a liability to the government, while the loan book counts as an asset. The borrowing contributes to the net debt as does all borrowing.
2. Income received from graduate repayments is set against the original borrowing, which is therefore paid down. These repayments *do not* count as income received in the calculation of PSNCR (the deficit), in contrast to, for example, tax receipts.
3. Any revision to the estimated repayments must be recorded as an additional transaction in expenditure. That is, should repayments prove to be lower than estimated, a future government will need to make additional allowance in expenditure, a further 'impairment'.

Having set out how loans appear in the departmental accounts, it is clear that we are dealing with three sets of considerations for working out the fiscal impact:

- The impact in the present on expenditure and therefore the deficit,
- the increasing net debt,
- the impact in the future as the estimates are reconciled with actual repayments.

We will broach each in turn beginning now by returning to the question of claimed savings and the impact in the present on expenditure and then looking at the impact on debt. Part Two will focus on estimating repayments.

Claimed savings

Roughly £1billion will be saved from departmental annual expenditure by moving to the new funding regime. This is because most of the money loaned is expected to be repaid and this is reflected in the accounting.

For an illustration of how the claimed savings are located, Prof Smith, in the same article quoted above, provided a worked example based on the figures that Willetts cited in February 2011.

'[W]hile funding to HEFCE reduces by about £3billion by 2014, public spending on fees and maintenance loans is expected to increase by about £4.3billion – and spending on student [maintenance] grants is also likely to increase by about £0.6billion. This equates to an increase of about £2billion in public spending on HE by 2014. ... [However] The savings to government ... come from the fact that the reduction in HEFCE funding of about £3billion is only offset during the year by the increased [maintenance] grant expenditure (of £600million) and *by the [additional] RAB charge of about £1.33billion*. Government thus spends about £2billion more each year, but the national accounts record this as a net reduction of about **£1.07billion**.¹⁹ [my additions and emphasis]

¹⁹ Steve Smith, Afterword to *The Manifesto for the Public University*, p. 136.

If we present those figures in an alternative form:

Table 3 Steve Smith's saving to expenditure (£billion)

Increase in loans for fees and maintenance	+4.3
Cuts to HEFCE's budget for funding undergraduate teaching	-3
Increase to maintenance grants to students	+0.6
Increased Outlay	+2

But

Increase in loans generates an increase in RAB of	+1.33
Cuts to HEFCE's budget for funding undergraduate teaching	-3
Increase to maintenance grants to students	+0.6
Decreased Expenditure	-1.07

Source: Steve Smith, 2011

To offer an alternative worked estimate using the more recent OBR figures, a similar saving can be identified.

Table 4 Worked example using OBR figures (£billion)

	2011/12	2014/15	Difference
Block grant (HEFCE)	5	2	-3
New loans to students	6.6	11.1	+4.5
Grants to students	1.4	2	+0.6
Subtotal	13	15.1	+2.1
Loans expected back (%)	74%	69%	
Estimated loss on lending recorded in expenditure	1.7	3.4	+1.7
Expenditure recorded (grants + loss)	8.1	7.4	-0.7

In sum, if we factor out the other costs, the saving to expenditure made by cutting the block grant to support undergraduate tuition is greater than the estimated *loss* on the new higher loans. Therefore, there is an estimated saving from moving to the new funding regime of roughly £1billion, while simultaneously increasing funding to the higher education sector.²⁰

²⁰ HEPI has independently estimated a saving of £1.3billion based on an estimated average net fee of £7,500. HEPI: John Thompson and Bahram Bekhradnia: *Higher Education: Students at the Heart of the System. An Analysis of the Higher Education White Paper* (August 2011). <http://www.hepi.ac.uk/466-1987/Higher-Education--Students-at-the-Heart-of-the-System.-An-Analysis-of-the-Higher-Education-White-Paper-.html>



Note, no official statement has been issued by government stating what savings are achieved through the new regime. The Intergenerational Foundation is calling for exactly such a statement (**Recommendation 2**).

Most of the higher loans are expected to come back, so moving from grants to higher loans saves money, even though it entails higher outlay.

We can see already that the crux of the issue will be the size of loans issued and the actual repayments that appear over the next thirty years and more. That is, whether there really is an actual saving depends on the accuracy of those estimates. **Using a low estimate, improves the presentation of the expenditure accounts and the headline deficit figure, but may not be responsible in the longer term.**

In sum, this is the impact of the policy on the BIS departmental accounts, but it does not consider broader economic implications of the new policy. It appears as if BIS's contribution to annual spending is reduced, therefore lowering its impact on the deficit. This it does, but student loans and more particularly higher *tuition fees* may have repercussions beyond BIS budgets.

First, is there any implication for future tax receipts? Higher education is estimated to give a boost to future earnings, the 'graduate premium',²¹ and therefore to future government revenues taken from income tax. If higher fees and larger individual debts dissuade people from studying, or if governments restrict access to higher education, owing to the expense of the loan book, will that have an impact on receipts?

The analysts London Economics have extrapolated from research that modelled the impact of higher tuition fees in 2006/07. Using models of demand provided by the Institute of Fiscal Studies (Deardon 2010), they estimate that Exchequer revenues could reduce by £3.72 billion per annum in present value terms – erasing the claimed savings. On their figures, the Exchequer would be *£2.39 billion worse off* as a result of the proposed changes to higher education funding.

HEPI has expressed reservations about these extrapolations, especially the attempt to quantify the impact in cash terms.²² Any such impact would not be seen for a few years and so the current and next government would not suffer from any consequent loss of revenue.

Second, and more concretely, undergraduate tuition fees are in the internationally-agreed basket of goods used to calculate the Consumer Price Index (CPI), which is determined by international convention. Fees will increase from around £3,400 to an average of over £8,200 (after fee waivers).

²¹ For more on the graduate premium, see Part Two.

²² '§35. The problem with the IFS study is that the changes over the last decades, on which they have based their conclusions, are far from ideal as 'natural experiments'. So when the £1,000 fee was introduced, students from wealthy backgrounds were entitled to an extra £1,000 loan, ostensibly for maintenance, but that would be seen by most as a technicality. Students from poor backgrounds were also entitled to this loan, and they did not have to pay the fee, but the non-repayable grant that they had previously received was cut by £1,000. So disentangling the effects of changing grants, loans and fees is problematic. ... §38 'The reality is that we cannot safely extrapolate from the introduction of fees in 1998, and then their increase to current levels, to predict the effect of the new arrangements. It seems quite plausible that some potential students will be deterred from entering higher education, but we do not know how many.' HEPI 2011.

Last year, investment analysts Henderson Global Investors (HGI) calculated that the higher fees that arrive from September 2012 will add 0.2 percentage points to CPI each year until 2014/15 (an additional 60 basis points).

This assessment was confirmed in the OBR's *Economic and Fiscal Outlook* (Autumn 2011).

'3.106 We have incorporated the effect of increases in higher education tuition fees in England in 2012 into our CPI forecast. We expect the effects on inflation to be felt over a few years as new cohorts of students paying higher fees replace existing cohorts. We judge that the average increase in tuition fees in 2012 could add around 0.2 percentage points to CPI inflation in the fourth quarter of 2012. There are a number of uncertainties around this estimate, including the average level of fees charged, changes to postgraduate and part-time course fees, and the effect of differences in regional policies. We do not judge these effects will be significant in the medium term.'

The OBR may not see this inflationary pressure as nationally significant. But CPI is used to up-rate tax credits, inflation-indexed benefit payments and national pensions.²³ By 2015–16, Simon Ward, who made the analysis for HGI, estimates that those additional credits, benefits and pensions will add £2.2billion per year to expenditure.²⁴ What this means is that the 'CPI-effect' would wipe out any claimed overall savings from moving to the new student funding regime. BIS's budget will see a saving but not the government's overall.

Further, given the concerns of intergenerational equity, William Cullerne Bown's question is pertinent. 'Why ... are we prioritising public sector pensions and welfare benefits at the expense of students?'²⁵

From an intergenerational perspective, around £90billion each year is spent on state and public service pensions.²⁶ The increase in that spending resulting from the inflationary effect of higher tuition fees would be equivalent to roughly £0.5billion – representing a transfer of resources from students, who pay the higher fees, to pensioners who benefit from higher fees.²⁷

A proviso should be recorded here. The September CPI figure is used to up-rate benefits in the following April. In this case, the inflationary impact of tuition fees would be seen in the final quarter of 2012/13 but would only have any impact on social security spending in the following April, 2014. This decision is confirmed around November or December through the Social Security Benefits Up-rating Order.²⁸ The government offers a 'triple guarantee' with respect to the basic state pension – increasing the pension by the highest figure from amongst growth in prices, wage inflation and 2.5%. But as with other index-linked benefits, the Secretary of State has 'discretion over how to measure changes in the general level of prices'.

²³ The government only recently moved these indices from RPI to CPI.

²⁴ <http://www.moneymovesmarkets.com/journal/2011/4/12/tuition-fee-rise-to-boost-cpi-and-cpi-linked-spending-reduci.html>

²⁵ 'The OBR's amazing CPI call', William Cullerne Bown, *Research Fortnight*, 15 February 2012.

²⁶ http://www.hm-treasury.gov.uk/budget2012_documents.htm Budget 2012 HM Treasury, p. 107.

²⁷ In total, pensioners receive roughly two-thirds of welfare spending.

²⁸ <http://www.legislation.gov.uk/ukdsi/2012/9780111519486/contents>



It is not clear whether the government would proceed with CPI in these circumstances or seek to exclude the impact of tuition fees from the calculation of this up-rating.

The Office for National Statistics (ONS) has not been asked to consider the implications. In February 2012, the ONS responded to a Freedom of Information request from the Intergenerational Foundation.

‘No attempt has been made to calculate the effect of the increased university tuition fees on the Consumer Prices Index (CPI) and there has been no correspondence to date with the Department of Science and Higher Education, the Treasury nor the Department for Business, Innovation and Skills about the effect.’

With George Osborne committing in his most recent budget to a further £10billion cuts from the welfare budget, we have to ask whether the government is really on top of what is going on.²⁹ Can the government exclude this ‘CPI effect’ from having any such impact? The government should issue a public statement on the matter outlining how the claimed savings are meant to materialise and confirming its approach to the inflationary impact of higher tuition fees (**Recommendation 2**).

To conclude this section of the report: there appears to be a saving to BIS departmental expenditure of around £1billion in the short term. This saving does not include the inflationary effect of higher fees which would impact on the departmental budget of Work and Pensions. In which case, the deficit (PSNCR) would not be reduced significantly, if at all.

Before turning to the second issue outlined above, the impact of loans on the public sector net debt, it is important to bear in mind that the government’s deficit reduction strategy *is aimed at slowing the growth of the debt*. Reducing expenditure reduces the need for additional borrowing to meet any shortfall between annual income and expenditure. Loans have a lower impact on the deficit than grants – but they affect the debt separately to their contribution to the deficit. This is a very important matter and one that has been systematically obscured from the debate around higher education reform.

The Debt – PSND

Although reducing the deficit slows down the increase to the debt, student loans increase the debt in a separate fashion. That is, it is not just their impact on expenditure that matters here.

The borrowing used to finance the annual loan outlay counts against the debt. This borrowing is only eroded by graduate repayments. In 2016/17, a shortfall of £8billion will be recorded between new lending and income from repayments.

Repayments are not estimated to match outlay until sometime between 2030 and 2040.

²⁹ ‘1.39 At Autumn Statement 2011, the Government set out plans for public spending growth in 2015–16 and 2016–17 to continue at the same rate as in the Spending Review 2010 period, with a baseline excluding the one-off investments in infrastructure announced at Autumn Statement 2011. Annex A sets out the implications for implied Departmental Expenditure Limits (DEL) and AME. For illustrative purposes, the annex shows that AME savings of £10.5 billion ...’ And in that Annex, ‘A.8 The biggest component of AME is welfare spending (social security and tax credit expenditure).’ Budget 2012

The higher loans for fees will therefore add between £50 and £100 billion to the public sector net debt (PSND) over the next twenty years, before annual graduate repayments are projected to match annual outlay.

With much higher loan outlay, borrowing to finance the loans is increased. This borrowing does count in the calculations of the net debt (PSND), which is a balance sheet measure assessing assets against liabilities.

Antony Szary, of the ONS, told *Research Fortnight* last summer.

‘The government finances loans to students by issuing debt instruments (gilts) that are scored as government liabilities, which increase Public Sector Net Debt accordingly. Insofar as government will need to increase its liabilities by issuing more debt instruments, this will push up national debt.’³⁰

Note that the overall logic of deficit reduction was about slowing down the accumulating annual increase to the net debt. But this borrowing for loans adds to the debt over and above the accounting impact in expenditure.³¹

A further quirk of the accounting conventions in play means that the asset created, the portfolio of loans issued, *does not net against the borrowing used to create it in the calculation of the debt*.

Although the public sector net debt is a measure of liabilities netted against assets, the loan book is excluded because it is classed as an *illiquid asset* and therefore cannot be easily realised as cash without loss.³²

Szary confirms: ‘Public Sector Net Debt is calculated as government liabilities less liquid assets. Student loans are not a liquid asset, so they do not feature in the calculation of PSND [the debt].’³³

Here lies a paradox in the accounts:

- the loan book is an asset so the borrowing used to create it counts as investment: it is therefore not classed as expenditure;
- but it is an *illiquid asset* therefore it does not appear in the calculations of net debt: its value is not set against the borrowing used to create it.

The loan book is then ‘off-balance sheet’, but the borrowing used to create it is not.

The borrowing for student loans is then only eroded by the receipt of graduate repayments.

³⁰ Andrew McGettigan, ‘Into the Shadows’, Supplement to *Research Fortnight* 381 (14 December 2011).

³¹ The borrowing, government bonds (gilts), is costed at the ‘nominal’ value (price at maturity), not at their price on the current market.

³² OBR, FSR (July 2011) 2.5 The level of PSND changes each year by the amount of public sector net borrowing (PSNB – the gap between spending and receipts) plus changes in public sector financial transactions (which includes student loans and other government lending), less changes in liquid assets.

³³ Andrew McGettigan, ‘Into the Shadows’, Supplement to *Research Fortnight* 381 (14 December 2011).

Further implications are illustrated by Table 2 (page 15). By 2016/17, the OBR estimates that repayments will amount to £3.5 billion, far below the increased annual outlay of £12.9 billion and the interest on the total borrowings to date. The debt will therefore climb over the coming decades until repayments increase accordingly and begin to match and exceed outlay. In its March 2012 *Economic and Fiscal Outlook*, the OBR expects 'the difference between new loans and repayments to peak around 2030 and then fall away' (4.158).³⁴

This document utilises the earlier OBR publication *Fiscal Sustainability Report* (July 2011), which modelled the impact of new arrangements:

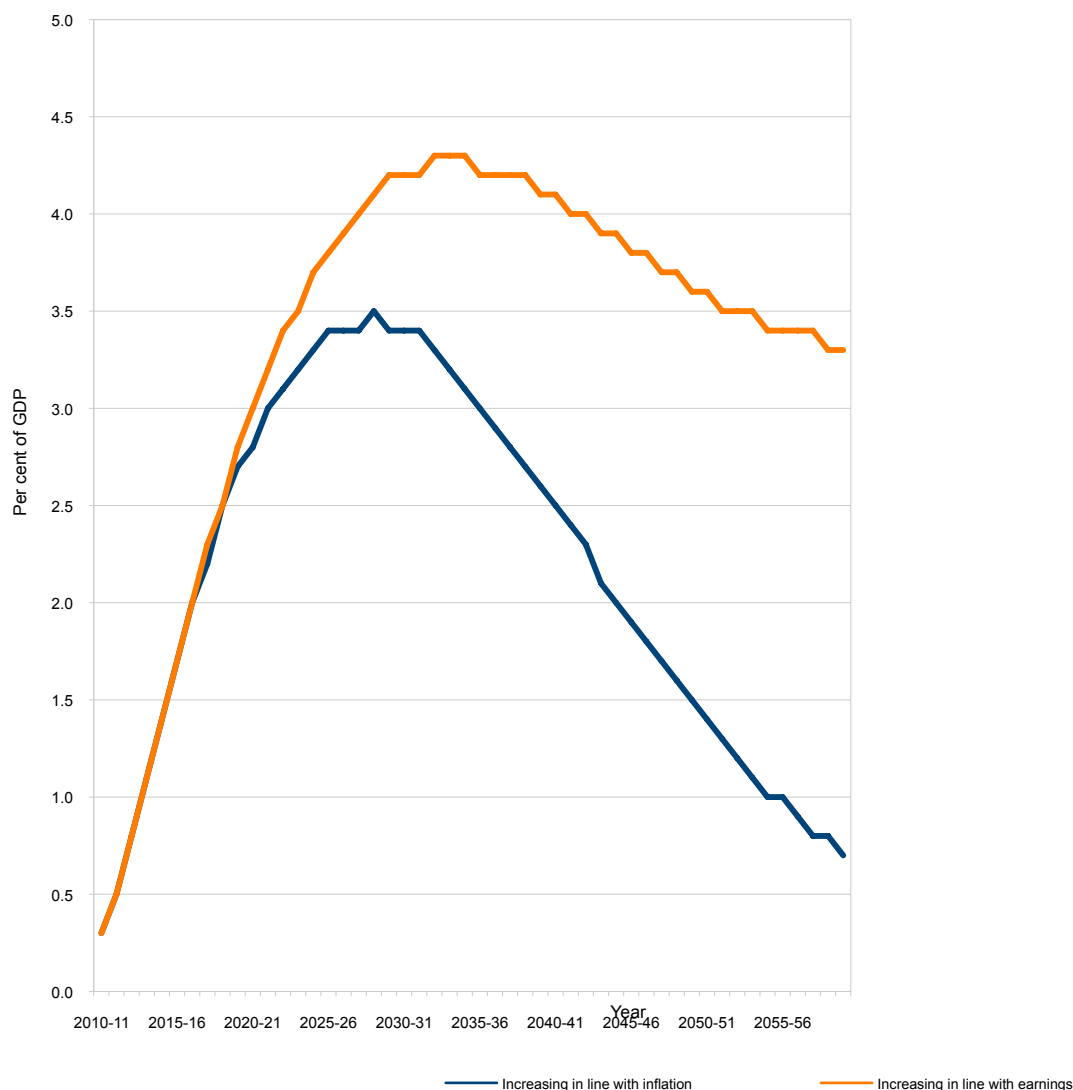
'37. Student loans are projected to increase net debt by a maximum of 4.3 percent of GDP (£63 billion in today's terms) around the early 2030s, falling to 3.3 percent of GDP (£49 billion) by 2060–61 as the value of loan repayments rises relative to the value of new loans made.'³⁵

We take the graph overleaf from the *Fiscal Sustainability Report*.

³⁴ <http://cdn.budgetresponsibility.independent.gov.uk/March-2012-EFO.pdf>

³⁵ OBR further notes that if average fee loans are £8,000 per year, then an additional 0.2 per cent of GDP (or £3 billion in today's terms) is added to the debt.

Figure 2 Addition to public sector net debt due to student loans



Source: OBR, FSR (July 2011)

We will look at the assumptions underlying such models and the different projections produced in Part Two. What is important to see here in official figures is that loans are adding to the debt (PSND) until around 2030: 20 years hence.

In fact, the OBR has made some revisions to its estimates. The graph above, drawn from the earlier report (July 2011), shows two alternative paths for the impact on net debt:

1. one path where tuition fees and maintenance loans increase by inflation: here the impact on net debt peaks at 3.5 per cent of GDP around 2030;
2. the other where tuition fees and maintenance loans increase in line with annual earnings. It is generally assumed that earnings will increase faster than inflation over the next twenty years, meaning that the second option would see higher loans and a greater impact on net debt. In the latter case, the impact on net debt peaks at over 4.0 per cent around 2035.

In the summary quoted above, from July 2011, we can see that the OBR believed that loans would increase by earnings. Subsequently, it has revised this preference in favour of the alternative: inflation only. That is, the OBR has revised its model to opt for the projection which most minimises the impact on net debt.

In the March 2012 *Economic and Fiscal Outlook*, the OBR presented the lower of the curves as representing the current government's intentions: 'In line with recent announcements, we assume the maximum amounts will be frozen in 2013–14, and then rise with *RPIX inflation* thereafter (4.159).'

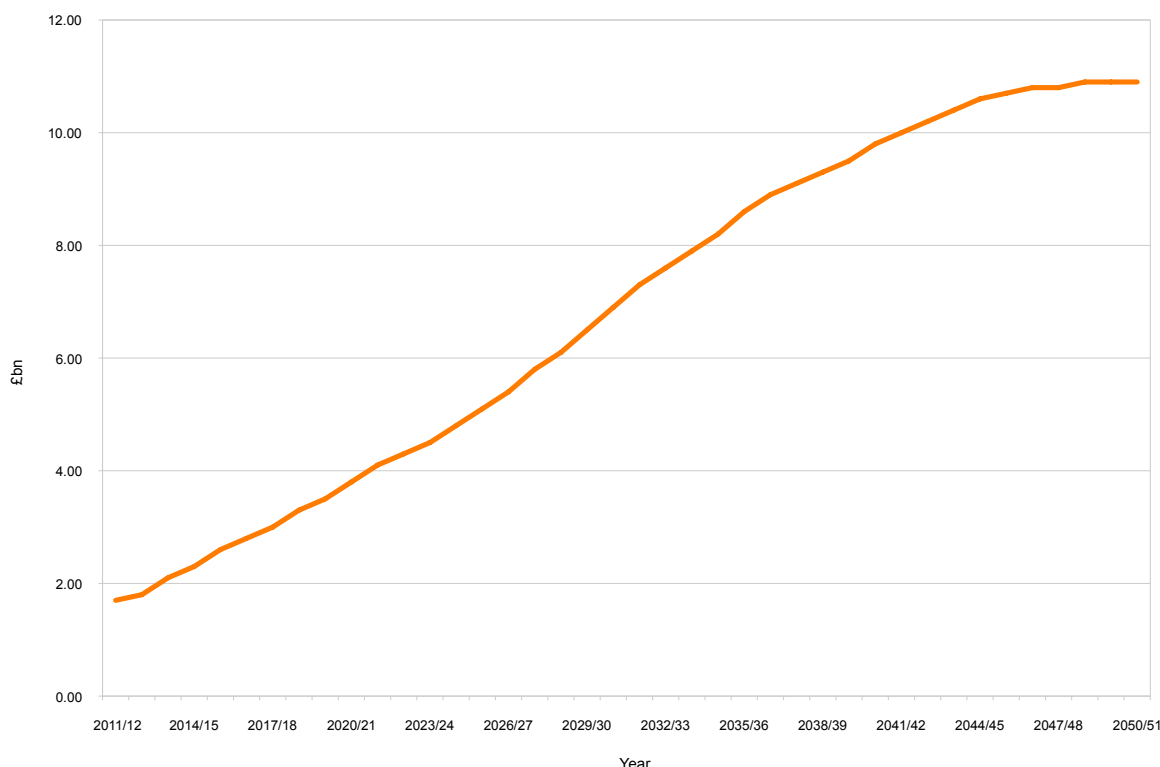
The OBR is then projecting that the impact on debt will peak around 2030 when just under 3.5 per cent of GDP is added (about £50billion in today's terms).

Since, as stated, most models assume earnings rise faster than inflation, and given that universities are labour-intensive operations with around 55–60 per cent of expenditure being staffing costs, only increasing by inflation would potentially erode the real resources available to universities.

The OBR did not provide any workings in illustrate how it had reached its conclusions about the impact on the debt attributable to student loans. However, last summer, BIS released a different set of figures, which included projections for the repayments on student loans until 2050/51.

The impact on net debt of student loans will be reduced when annual repayments match and exceed annual outlay on new loans. According to BIS, this is only likely to happen after 2040, when repayments are projected to pass the £10–11billion mark in today's prices.

Figure 3 Annual repayments from student loans (£billion)



Source: BIS (inflation adjusted)

One question arises when comparing these two sets of figures. If the BIS figures show annual repayments only passing £10billion around 2040, why do the OBR figures show the impact on net debt peaking nearly a decade earlier?

This can be attributed to two reasons:

1. The OBR debt figures have presumably allowed for the claimed saving to BIS we discussed earlier (roughly £1billion per year);
2. The OBR appears to be using very low estimates regarding the take-up of loans by students.

The second point bears further attention. When the OBR drew this graph in July 2011, it was assuming that the average loan to cover tuition fees in 2012/13 would be £6,750. This is lower than BIS's assumed fee loan level of £7,500 and may account for a sizeable amount of the discrepancy between the two sets of data. With around one million full-time undergraduate students in the English system a difference of £750 per student is sizeable.³⁶

³⁶ Note that the difference between the average tuition fee after waivers and the average loan for tuition fees is based on the idea that not all students will take out the maximum loan to which they are entitled. Currently around 800,000 eligible students take out loans. BIS Economics Paper #14 *Supporting Analysis for the White Paper* (June 2011)



The logic of these assumptions will be discussed in more detail in Part Two. It is also worth noting that the OBR assumes that the average loan taken out to cover maintenance would be £3,300 pa in 2012/13.

This appears to be a more reasonable estimate, though London Economics has estimated an average maintenance loan of £4,172.³⁷

Considering these two variables in the context of the OBR projections, one could envisage a scenario where an additional £1,500 is loaned per student, potentially adding £1.5billion to the annual loan outlay from 2012/13 onwards.

Should the 'CPI effect' discussed earlier also need to be considered in these projections, then the savings associated with point 1 above would be discounted.

For these reasons, the OBR estimates of the impact of student loans on public sector net debt are at the lowest end of possible outcomes. It is therefore reasonable to indicate that the likely impact on net debt could peak at between £50billion and £100billion before repayments begin to catch up with the additional outlay. And consequently, that it takes longer for repayments reach the required level.

Owing to this impact on debt, the government will most likely ignore the recent call from Tim Leunig and Neil Shephard.³⁸ They note that the government's current cost of borrowing is so low that simply adjusting that single variable in the Treasury models of loans generates a new estimate of *nil* write-offs overall. That is, no expenditure is needed since the difference between the cost of borrowing and the real rates of interest charged on individual accounts would pay for the policy write-offs: there would be no loss.

'With a 0% real cost of capital to government, the 0–3% real interest rate paid by affluent graduates means that successful graduates (deciles 5–10) overpay by enough to offset the losses from low earning students whose debts are forgiven. The government therefore makes a profit on the average loan.'

They therefore call for the government to massively expand higher education places.

'We have people who want to go to university, and a system that means they will pay the entire cost of doing so. Allowing them to do so will cut unemployment in the short run, deliver a more competitive university sector, and increase skills, social mobility and growth in the medium run. Why would government stand in the way of this happening?'

³⁷ 'We have estimated that the average maintenance loan for students living away from home outside of London will stand at £3,965 per annum (2010/11 prices), while the average maintenance loan for students living away from home in London will be £5,524 per annum (2010/11 prices). We have estimated that the average maintenance loan across all students will be approximately £4,172 per annum.' London Economics: 'The Returns to Higher Education Qualifications' (BIS – Research Paper 45 June 2011).

³⁸ 'The cost of expanding higher education is – zero.'
<http://www.oxford-man.ox.ac.uk/~nshephard/Thecost.pdf>

The government may have good reason no longer to trust its models, or rather the assumptions underlying its original estimates. But, more likely in this case, is that the additional borrowing for 100,000 new places would show up too clearly as increased net debt: roughly £1billion additional annual outlay using the low estimates of loan uptake favoured by the OBR.

SUMMARY of the impact on net debt

1. Borrowing for loans adds to the debt.

2. That borrowing creates a financial asset, an investment, so the borrowing does not appear directly in annual expenditure (only the estimated losses on the loans do).

3 Loans are *illiquid financial assets* as classified by the ONS. This means that the value of the financial asset created *does not net against the borrowing used to create it*. That is, the debt is increased by the borrowing but the value of the financial asset is not registered in the accounting as a counterbalancing asset.

4 Only *actual repayments received* reduce the borrowing.

5 With little or no saving to expenditure, the net debt is increased by the additional borrowing. BIS's contribution to the PSNCR (the deficit) is reduced, but it still contributes to a greater net debt (PSND).

6. The debt grows until annual repayments increase to match and exceed annual outlay: this is not projected to happen until beyond 2030 (OBR) or 2040 (BIS).

Repeated delays to policy announcements from BIS are related to an ongoing worry from the Treasury about the cost of the scheme in terms of borrowing.

Such considerations may underlie the decision to refrain from imposing penalties on early repayments. Although the government may lose out on higher interest charges to high earners in the long run, the early generation of additional repayment income reduces borrowing.

It is rational for governments to borrow to fund higher education. The OECD advises the following: 'public investments in education, particularly at the tertiary level, are rational even in the face of running a deficit in public finances. Issuing government bonds to finance these investments will yield significant returns and improve public finances in the longer term' (OECD 2010).

Here, where the government is running an increased *debt*, the questions are rather whether the government is representing the true costs of the scheme, whether it has a poorly designed scheme that displaces the problems generated to future governments (in 2030), and whether it is setting aside sufficient funds to meet the future policy write-offs. The last two points are addressed in the next section, which looks at how the scheme is modeled, and turns to the third of our key fiscal questions: what happens if the actual repayments do not resemble the estimates?

Part Two

Estimating the loss on loans – volatility in the models

‘[The third challenge for financial sustainability is] that the government has got its calculations right on the repayment profile for the student loan book. This has got to turn out to be robust to make this whole thing work into the longer term.’

Alan Langlands, head of Higher Education Funding Council for England ³⁹

Higher borrowings to finance higher student loans will add billions to the debt over the next couple of decades. Much of the money loaned is meant to come back, supposedly leading to a long-run saving when compared to the current system.

The crucial issue for income-contingent repayment loans lasting over thirty years lies in estimating the income of former students so as to accurately model the repayments they will make. We are used in the debate about loans to looking at the problem from the perspective of the indebted individual. However, repayments look likely to be lower than estimated by the OBR, Treasury or BIS. That official figures are low may indicate political pressures to underplay the costs of the scheme.

The unpredictability and volatility of income-contingent repayment loans combines with poor design so that no one can say with certainty how much student debt will have to be written off in 2046. A system that only reaches operational maturity after almost thirty years is not reasonable. Future governments will have to deal with any further shortfall in estimated repayments – over such long periods and with such high additional net debt, the scheme appears fundamentally irresponsible.

The new loan scheme is complex and uses unusual loans which have lifetimes of over thirty years. Long range projections about repayments are fraught with difficulties. It does not seem sensible to place too much trust in these estimates.

The big question is what happens if the financial engineers have underestimated the borrowing required and the repayments that come back? The estimated loss on the loans issued each year is recorded in that year’s expenditure. This is, in accounting terms, known as the ‘impairment’ on the loans. Actual repayments will be received over the thirty-year lifetime of the loans.

³⁹ John Morgan, *Times Higher Education*, 10 April 2012, ‘Government’s sums must be right... or else, says Hefce head’ <http://www.timeshighereducation.co.uk/story.asp?sectioncode=26&storycode=419572>

If the actual repayments turn out to be lower than expected then an adjustment must be made to the impairment in expenditure.⁴⁰

Future accounts pick up any newly discovered liability. It will therefore be future governments that have to rectify the problem of actual repayments falling short of the original estimates made on loans issued by earlier governments.

With earlier governments issuing higher loans, a sensible and responsible accounting approach would be to set aside a bigger impairment than estimated. This would be one reason for insisting on the government issuing loans to set aside a more generous (i.e. pessimistic) impairment (**Recommendation 3**).

Loans: the basics

‘Income-contingent repayment loans’ are loans where monthly repayments deducted from payroll are determined by income not by the total amount borrowed. In the case of loans taken out from 2012/13 onwards, the repayment threshold will start at earnings of £21,000 pa gross in 2016⁴¹ – one year after those taking three-year degrees graduate. All earnings over that threshold will be subject to a 9 per cent levy towards repaying the loans taken out.⁴² The threshold will rise in line with average earnings annually. Should earnings fall below the threshold, repayments are suspended. Repayments cease when the debt balance is repaid.⁴³

Unlike most loans and mortgages, the period of repayment is therefore not determined in advance but is open-ended; the period to is determined by the ability of the monthly repayments to meet the initial amount borrowed (subject to interest rates).⁴⁴

⁴⁰ Taking the Government’s RAB value as a given, HEPI estimates that for each extra £100 in the average fees less fee waivers, the RAB charge would increase by about 0.2 per cent, with an increase in cost to Government of about £50 million. HEPI: John Thompson and Bahram Bekhradnia *Higher Education: Students at the Heart of the System. An Analysis of the Higher Education White Paper* (August 2011) Table 2.

⁴¹ ‘The student loan repayment will be based on all your gross income over the applicable threshold, including all your unearned income (for example, dividend income from shares) if it is more than £21,000 a year.’ Student Loans: Term and Conditions 2012/13.

⁴² Those earning over £21,000 will effectively be paying a marginal tax rate of 41% of earnings above that level (9% loan repayment, 20% income tax, 12% National Insurance).

⁴³ Comparisons with student loan debts in the USA are difficult to make since they use mortgage-style loans where monthly repayments are determined by the amount borrowed and there is no repayment threshold. As UK tuition fees in the public sector are capped at £9,000 pa, this also limits the amount of debt with which students graduate. The problem for many US graduates is that the monthly repayments are unsustainable without a well-paid job – default in this case is failure to meet repayments. This problem will not arise with English graduates though the outgoings will obviously affect disposable income.

⁴⁴ This focus on the monthly repayments in government briefings means it may be understood as a tax, but one which incorporates a mechanism to limit the total contribution and which is better able to recoup money from EU students, who must be treated equitably when it comes to fees, and those heading abroad after graduation. EU students have accessed loans for fees – though not maintenance – since 2006/07, with outstanding balances now amounting to £45million. The government’s White Paper proposed increasing the annual operating budget of the Student Loans Company by £10million so that the company is better positioned to chase the debts of those leaving the UK after graduation.

There is however a tweak in the system which introduces a limit. The loans are not dischargeable in bankruptcy, but are nullified in the event of death or disability, whilst any outstanding balance is written off thirty years after graduating.⁴⁵ Advocates of the scheme in government have repeatedly emphasised the generous and progressive nature of the loan scheme, which will see lower average monthly repayments than that operating currently.

We have had a decade of experience with income-contingent repayment student loans. The cohort who left university in 2000, had average debts of just over £4,000. The repayment patterns on such small amounts are not reliable for predicting what will happen with the new higher levels of debt. Around 40 per cent of the 2000 had fully repaid by March 2011. The average borrower who left university in 2010 with over £17,000 of debt; the cohort leaving in 2015 is estimated by BIS to have £30,000 on their balances.⁴⁶

With a threshold of £21,000, many low-earning graduates will avoid repayment; many graduates will fail to repay their loans and have large amounts written off after thirty years. Official figures estimate that over 70 per cent of graduates will fail to repay their balances; the analysts London Economics estimate that 70–80 per cent of women will have their balances written off (currently 20–30 per cent), while 30–40 per cent of men will be in that situation (currently fewer than 10 per cent are expected to benefit from 25-year write-offs).⁴⁷

The scheme will see substantial numbers of students graduate with debts of over £40,000, since students will be eligible to access loans for tuition of £9,000 pa and for maintenance (of over to £7,000 pa for those studying away from home in London). Further, some degrees involve more than three years of registered study.⁴⁸

Given such amounts, the complexities of the scheme and the long lifetimes of the loans, predicting patterns and levels of repayment is extremely difficult. The scheme is volatile. A BIS spokesman told HEPI when releasing the official figures we will discuss below: ‘Forecasting student loan expenditure and repayments several decades into the future is inherently difficult and relies upon a great number of assumptions about future events, economic growth and student behaviour, and cannot anticipate decisions that may be taken by future Governments.’⁴⁹

⁴⁵ Students aged 60 or under are eligible for loans. Students aged over 50 are no longer required to demonstrate that they intend to return to work after full-time study. The first iteration of income-contingent repayment loans cancelled outstanding balances once the graduate reached the age of 65; this has now been changed to a defined period after graduation.

⁴⁶ Student Loans Company: *Income Contingent Repayments By Repayment Cohort And Tax Year 2000/01 To 2009/10 Inclusive (Provisional)* (16 June 2011)

⁴⁷ London Economics, written submission to the BIS Higher Education Select Committee report, *The Future of Universities*, 2011.

⁴⁸ We will see in Part Three that other factors mean it is not like a tax: chiefly sale to third parties and the status of the ‘debt’ balance.

⁴⁹ HEPI: John Thompson and Bahram Bekhradnia *Higher Education: Students at the Heart of the System. An Analysis of the Higher Education White Paper* (August 2011); §24. <http://www.hepi.ac.uk/466-1987/Higher-Education--Students-at-the-Heart-of-the-System.-An-Analysis-of-the-Higher-Education-White-Paper-.html>

BIS has gradually increased its estimated loss on loans – with an impact assessment that was published to support the policies in the White Paper using 32 per cent, up from 30 per cent in 2010. These slight variations in percentage points translate into large sums when the annual loan outlay is over £10billion. The million+ lobby group and the analysts London Economics, who have collaborated in this area, are citing estimated losses of around 37 or 38 per cent.⁵⁰

The remainder of this section surveys the different issues at play, mainly to illustrate the number of assumptions involved in making these estimates and underscoring the complexity and volatility of the whole exercise.

Modelling – thirty years into the future

The models used to map the impact on national debt and individual loan accounts over the next decades involve a number of variables owing to the complexity of income-contingent repayment loans. Projections must make assumptions about the behaviour of those variables. For one, the models assume that future policy will not change. In Part Four, I will suggest that this is unlikely. We can further count several other variables:

- Rises in average earnings (which determines the repayment threshold of £21,000);
- RPI – the main determinant of the interest rate paid on the accounts;
- The numbers and amount of tuition fees and the loans accessed to pay for them;
- The numbers and amount of maintenance loans accessed;
- The number of students within the system;
- The government's cost of borrowing.⁵¹
- And graduate earnings (the income in income contingency);

The first two are difficult to predict over the next 35 years. For example, the assumption that the next thirty years of RPI and average earnings will resemble the previous thirty, while reasonable, already indicates the general problems with the whole business of predicting future repayments against the loan outlay over such long periods. It would be interesting to survey economists to see how many think the next thirty years will resemble the last thirty years.

⁵⁰ The estimated losses on loans made to part-time students are 65 per cent, but these loans will represent a very small amount of the loans issued.

⁵¹ Assumed to be 2.2% over inflation by government. As noted above, the current cost of government borrowing is below RPI.

Inflation

Many published models generate very high numbers owing to the compound effects of assuming fixed, *but different* levels of RPI and average earnings. The BBC produced a report and spreadsheet last year in collaboration with ‘leading accountants’ which had the increase in average earnings at 4 per cent but RPI at 2 per cent for the next thirty years. Such parameters may or may not be unlikely but skew public perception of the expense of the scheme as the model generates high figures across the board – with, for example, average earnings coming in at £78,000 pa by 2045.⁵² The government’s itself assumes a level of 2.75 per cent for RPI and general the rise in average earnings (both BIS and OBR).

An example of these problems can be seen in an exchange with the website editor for moneysavingexpert.com. I alerted the website to a couple of misplaced assumptions and interpretations of the loan scheme in their ‘calculator’. In response, ‘MSE Dan’, who made the corrections I suggested, wrote:

‘What’s struck me during the process is *how marked the changes caused by a tweaked assumption have been*. It will be really interesting to eventually find out the levels set by government, and how they affect repayment amounts and timescales.’

The manner in which ‘tweaks’ to the assumptions about future RPI and average earnings cause large-scale changes to total repayments made is a mark of the volatility of the scheme.⁵³ To examine assumptions further, let’s compare the different figures cited earlier produced by the OBR and BIS last summer.

BIS’s assumptions on a model that runs until 2050/51:

1. Student numbers are to remain constant.
2. No assumptions are made about changes to maintenance loans – they move in line with inflation.
3. The average loans made for fees are assumed to be just over £7,500 in 2012/13. (NB, this is different to the average fee level as the model is assuming that not all students will access the level of tuition fee loans to which they are entitled: BIS assumes a 90 per cent uptake).
4. The average fee loan is assumed to increase with inflation.
5. Only 80 per cent of maximum possible maintenance loans are accessed each year, roughly £3,280 per full-time student.
6. That the balance of men and women in the student population remains constant.⁵⁴

⁵² www.bbc.co.uk/news/education-12767850

⁵³ Although there are still problems with the calculator, chiefly the failure to up-rate its indicative salary figures by inflation to give a better representation of earnings, it is a very useful tool to familiarise oneself with the workings of the scheme. MSE Student Loan Calculator 2012 <http://www.moneysavingexpert.com/students/student-finance-calculator>

⁵⁴ HEPI pointed out that the BIS ‘Ready Reckoner’ model developed in support of the Browne Review assumed 50 per cent women, and questioned this assumption given the current predominance of women in higher education. BIS reassured HEPI that their model used to calculate the RAB takes the proportion of women into account. This is important for, as noted before, the gendered RAB charge makes for difficult reading: over 50% for women according to HEPI (with men still under 10% on average).

OBR assumptions

When explaining their approach to student loans, in the July 2011 *Fiscal Sustainability Report*, the OBR write that their figures are: ‘based on [BIS] projections for loans and repayments out to 2060, based on a number of *stylised assumptions* and the OBR’s long-term economic assumptions.’⁵⁵

OBR stress the uncertainty and underline four key assumptions:

1. Student numbers are assumed to remain constant. Although higher fees may discourage students, and there is a demographic decline in traditional student age groups, the OBR assumes that universities would adjust fees to maintain demand.⁵⁶
2. Maintenance loans are assumed to be £3,300 pa and move in line with inflation.
3. The *average tuition fee* is assumed to be £7,500 in 2012–13.
4. The loan take-up rate will be 90 per cent slightly up from the current take-up: ‘Higher fee rates would suggest that more students will need a loan, but the introduction of a real interest rate on the loan could discourage take-up.’

Average Tuition Fee Loans

On the OBR’s assumptions (from July 2011), the average tuition fee loan would be £6,750 (90% of £7,500). This is lower than BIS’s assumed fee loan level of £7,500 and may account for a sizeable amount of the discrepancy discussed earlier. With around one million students in the system a difference of £750 per student is sizeable.

In Autumn 2011, the OBR’s *Economic and Fiscal Outlook* contained the following paragraph outlining some revisions:

‘4.147 We have also raised our forecast of the payments that the Government will make under the new fee arrangements. In July, the Office for Fair Access (OFFA) released figures for the average tuition fee for the 2012–13 academic year, which after deductions is £8,161. This number is likely to fall slightly as a number of institutions are seeking to revise down their agreements with OFFA, so at this stage we have assumed the average fee will be £8,100. We then need to make an assumption on the average loan per student, given that some students will choose not to take a loan and some will take out less than the full amount. *For this forecast, we have assumed the initial average loan per student for tuition fees will be £7,000....* This implies that students will on average request loans to cover around 86 per cent of total fees. There continues to be significant uncertainty over the eventual average loan per student.’⁵⁷

⁵⁵ Box 3.2 ‘Student Loans’, OBR, *Fiscal Sustainability Report* (July 2011).

⁵⁶ This is questionable as it does not allow for the possibility that resources available to universities outside of an ‘English Ivy League’ can be maintained at £7,500 pa.

⁵⁷ OBR, *Economic and Fiscal Outlook* (Autumn 2011).

In this regard, the OBR has made two alterations to its assumptions: the average fee is assumed to be £8,100, an increase of £600 pa, but the take-up has then been revised down to 86 per cent from the earlier 90 per cent. The justification for this is unclear. Had the take-up assumption remained at 90 per cent the average tuition fee loan would be £7,290.⁵⁸ The revision from £6,750 to £7,000 does not appear to have yet produced a revised graph of the impact on net debt.

The average fee loan level determines the level of borrowing the government must take out in the first place to finance the loans. The OBR is pitching its assumptions on the low side. With higher fees, more students would seem likely to access the publicly-backed loan scheme. Similarly, the OBR's estimates of maintenance loan take-up are also low. London Economics estimates that the average maintenance loan will increase to £4,172 pa: £800 per student per year above the OBR figure.⁵⁹

In 2013 we will learn what these actuals are for the first cohort of students on the new loan scheme. At that point, the models will have a more substantial basis.

We can see that, in large part, BIS and the OBR share a number of assumptions, but the two key ones for assessing the health of the system are the levels of loans and the level of future graduate earnings. We will stick with the first for a while because of an important point that may not be apparent.

If average loans increase, then an increasing percentage of the higher loans will be lost. That is for each additional £100 of borrowing a higher proportion of that additional fee is not repaid.⁶⁰ The 'marginal RAB charge' is very high. With a RAB of 30 per cent at £7,500, moving to £8,000pa fees does not simply add a liability of £150 per student. The marginal cost to the taxpayer of that £500 may be much higher.

London Economics and HEPI have both provided illustrative tables of the 'marginal' RAB cost. London Economics produce a table which also shows the 'marginal RAB' – the amount of additional fee which is not repaid.⁶¹

⁵⁸ The March 2012 *Economic & Fiscal Outlook* maintains these figures: '4.159 For the English scheme, we assume that the initial average loan per student for tuition fees will be £7,000, with the average maintenance loan of another £3,300.'

⁵⁹ London Economics 'The Returns to Higher Education Qualifications' (BIS – Research Paper 45 June 2011).

⁶⁰ The reverse is also true and should be borne in mind by prospective borrowers. HEPI 2010: §26 'Not only does the higher debt from the higher fees not generate higher payments, but for these low income former students, on average going to a £9,000 fee university for three years only costs £289 more than a £6,000 fee university. For low earners, the higher threshold levels mean that their total contributions are determined more by their income than the fee level or interest rate.' Those in lowest quintile for earnings will even pay less under the new scheme despite higher borrowings.

⁶¹ For comparison, HEPI estimates of the higher RAB charges for fees above £7,500 can be found at HEPI: John Thompson and Bahram Bekhradnia *Higher Education: Students at the Heart of the System. An Analysis of the Higher Education White Paper* (August 2011) §18. <http://www.hepi.ac.uk/466-1987/Higher-Education--Students-at-the-Heart-of-the-System.-An-Analysis-of-the-Higher-Education-White-Paper-.html>

Table 5 Estimates of losses on loans issued

	Aggregate Loss on loans issued	Marginal loss on incremental £500	Total Additional cost to Exchequer
2010/11 system (£3,290 fee)	26.1%		
2012/13 system (£7,500 fee)	37.0%		
2012/13 system (£8,000 fee)	37.8%	66.1%	£181.2m
2012/13 system (£8,500 fee)	38.6%	69.1%	£362.0m
2012/13 system (£9,000 fee)	39.4%	72.3%	£542.0m

Source: London Economics, 2011

This table and the considerations that preceded it demonstrate the importance to the government of driving down fees. To this end, it has encouraged universities and Offa to promote fee waivers over maintenance bursaries, reduced the total number of students studying higher education by 15,000 and introduced restrictive and artificial recruitment control mechanisms to encourage higher education institutions to set fees below the target of £7,500 pa.

Graduate earnings: Growth in the economy

The other key determinant of repayment and non-repayment in the models for the new student loan scheme is obviously graduate earnings. Modelling forms the basis for generating estimates of the loss on the scheme. How reliable are such projections?

Graduate earnings are affected by the general economic situation. HEPI have noted that the new loan scheme is *more volatile* than the current scheme in this regard: ‘the sensitivity of the RAB [losses on the loans] to changes in the income growth is much higher than for the current system. So the income growth estimation has to be more accurate, even though it has to be made far into the future.’⁶²

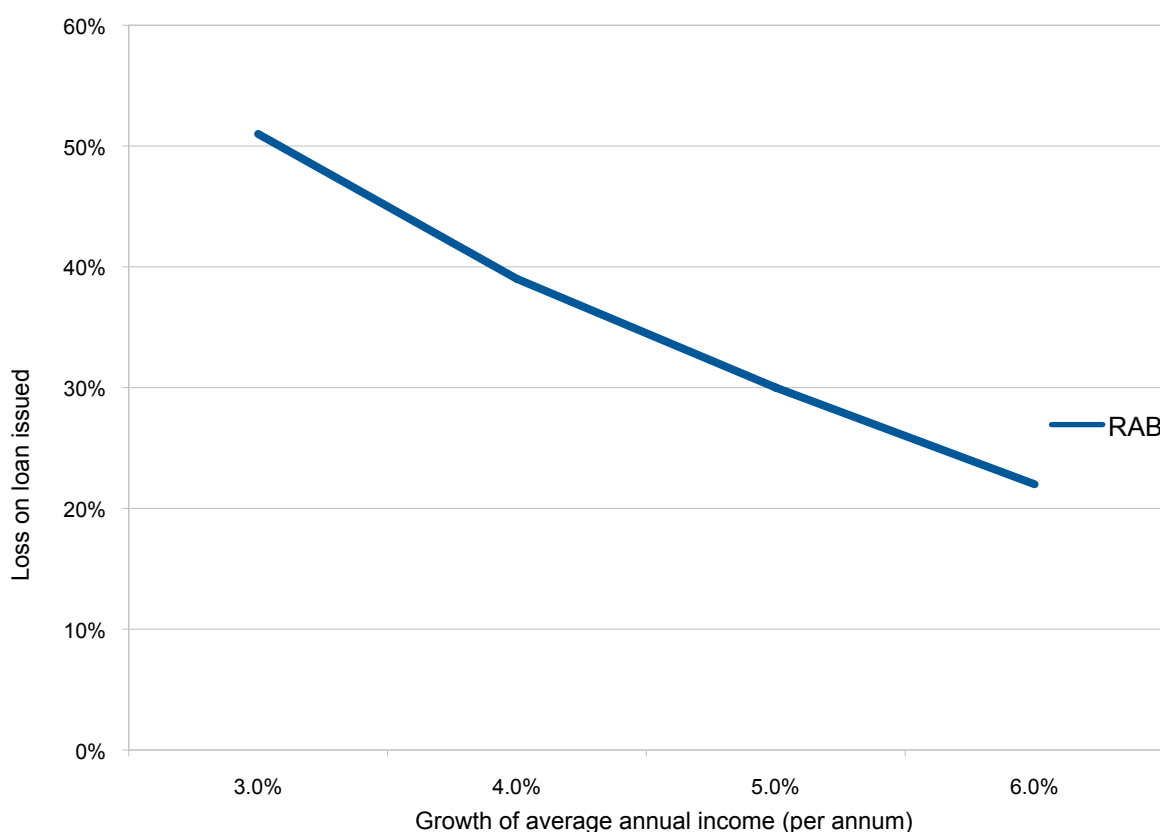
⁶² HEPI: John Thompson and Bahram Bekhradnia, *Higher Education: Students at the Heart of the System. An Analysis of the Higher Education White Paper* (August 2011) §44. <http://www.hepi.ac.uk/466-1987/Higher-Education--Students-at-the-Heart-of-the-System.-An-Analysis-of-the-Higher-Education-White-Paper-.html>

To see the problem we only need to refer to the OBR's *Economic and Fiscal Outlook* from November 2011.

'We include estimates of the net cash requirement as a consequence of the Government's announcements on higher education funding, and the legacy effects from previously agreed student loans. Student loan repayments are expected to be lower than we forecast in March [2011], due to our forecast of lower average earnings in the economy.'⁶³

In a stagnating economy with wages frozen for the public sector and barely keeping up with inflation more generally, the worries around the design of the loan scheme and its ability to generate repayments come to the fore. HEPI provide the following diagram plotting the actual losses on the scheme against general growth in income and conclude that the government estimates on repayments look optimistic on this basis. With the ONS now indicating a second quarter of slight decline in output, technically a recession, these figures are worrying for the viability of the loan scheme. Should the loss on the scheme go above 45 per cent then any supposed saving would disappear regardless of the 'CPI effect'.

Figure 4 Change in loss on loans issued with change in real income growth



Source: HEPI, 2011⁶⁴

⁶³ OBR, *Economic and Fiscal Outlook* (Autumn 2011), §4.146.

⁶⁴ HEPI: John Thompson and Bahram Bekhradnia, *The government's proposals for higher education funding and student finance – an analysis* (November 2010). Annex A. <http://www.hepi.ac.uk/466->

Graduate Earnings: the 'premium'

The fundamental reasoning behind a move to higher fees and loans is that graduates enjoy a return from higher education in the form of higher wages; this is the 'graduate premium'. That is, their wages are meant to be better after graduation than they would have been had they not pursued further study to gain a degree. With a higher repayment threshold, set around average earnings, this question assumes central importance: what will the future graduate premium amount to?

Estimates of graduate earnings for the next 35 years are largely based on the previous 30 years, when the student population, and therefore the graduate 'premium', might be assumed to be very different.

However, despite the recent expansion in higher education in England, the graduate premium has been maintained.

HEPI indicate an important change: the spread or distribution of graduate earnings has widened. 'This is important because a high proportion of low earners will lead to a high RAB, whatever the average earnings, and very high earners will not provide the same subsidy as the middling high earners.'⁶⁵ Here RAB is the shorthand for the estimated loss per pound lent. A wider spread would see more individuals falling under the repayment threshold and therefore not repaying. While the benefits accruing to a small class of professional graduate careers may increase.

The most recent ONS labour force survey, *Graduates in the Labour Market*, released on 6 March 2012, provides further food for thought, particularly in relation to the changes seen in the last decade. It indicates that 35.9 per cent of those graduating within the last six years are filling low or unskilled jobs that could be done by school-leavers, whereas the equivalent figure from 2001 was 26.7 per cent. Although graduates enjoyed better chances of being in work (86 per cent) than non-graduates (72 per cent) at October 2011, for our purposes we are more interested in what they are earning.

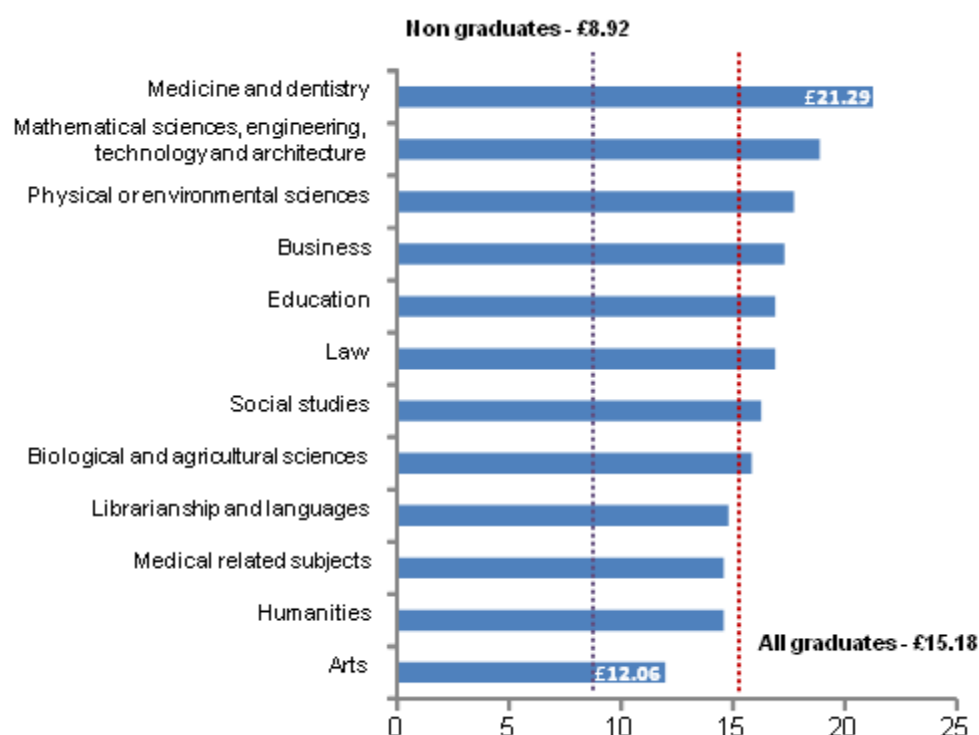
The average graduate wage is £15.18 per hour, though this includes the high-earning careers of medicine and dentistry (which still receive large government support through central grants to institutions). Art graduates earn £12.06 per hour. For comparison, the hourly wage for £21,000 pa is £11.54, assuming a 35-hour week.

Whilst earnings are higher for graduates than for non-graduates, fewer graduates seem to be earning over the important £21,000 threshold.

[1875/The-government's-proposals-for-higher-education-funding-and-student-finance-%e2%80%93-an-analysis.html](http://www.if.org.uk/1875/The-government's-proposals-for-higher-education-funding-and-student-finance-%e2%80%93-an-analysis.html)

⁶⁵ HEPI 2011 §25.

Figure 5 Average hourly graduate earnings by degree subject



Source: ONS, Labour Force Survey 2012⁶⁶

The large-scale move from grants to higher loans brings uncertainty into the heart of higher education as the viability of the loan scheme depends on making predictions about the general shape of the economy and graduates within it for the next three to four decades. Current indications about the graduate premium suggest it will be eroded further except in a small group of professions.

Income-contingent repayment loans with such large debts, thirty-year life times and such low repayments fashion a system that is too 'leaky' or 'incontinent' according to Prof Nick Barr of London School of Economics (see below). Too much money flows out, not enough may come back, even after thirty years.

From the perspective of the current economic situation, the transformation of the last decade and the pressures on young people, the assumptions underlying the modeling of repayments looks over-optimistic. It still benefits young people to go to university and do well, but, for a significant number, their opportunities and earnings may be eroded in the short to medium term and as such the Exchequer cannot rely on future graduate earnings to enable the loans to be repaid.

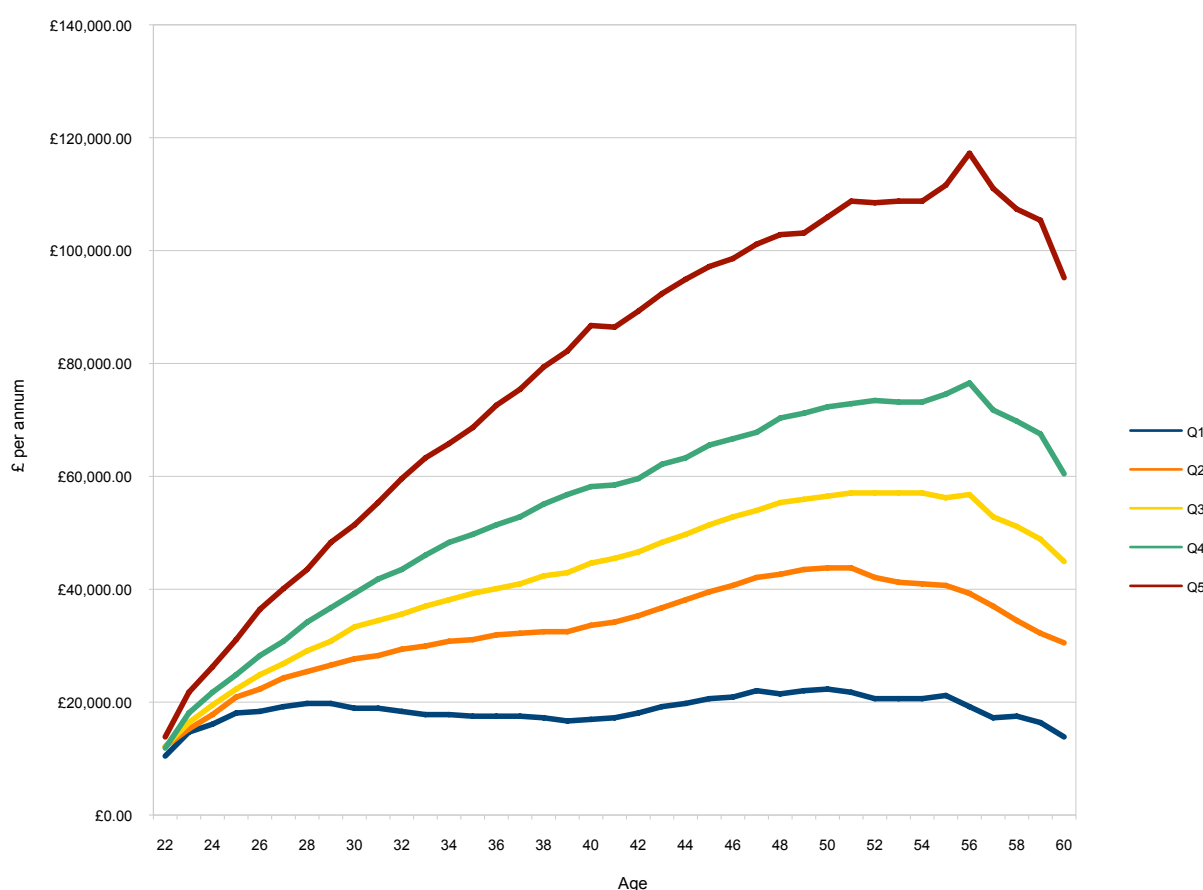
⁶⁶ ONS, *Graduates in the Labour Market* (March 2012).

As London Economics state:

‘[U]nless there is a fundamental shift up in either the earnings or employment outcomes of graduates in the future, it is probably the case that this financial asset will start to be significantly eroded at some point in the future. However, it may require several years to assess whether new borrowers do in fact require higher subsidies/write offs than the current cohorts of student loan recipients.’

The end of that fragment touches upon a further point. Income-contingent loans have their repayments determined by future graduate earnings. But the design of the proposed scheme, which keeps repayments low until salaries rise, catapults the majority of repayments twenty years into the future. Nick Barr and Alison Johnson have used data from the Institute of Fiscal Studies to illustrate the ‘bulge’ in salary paths, especially marked amongst professionals in the top-earning quintile.⁶⁷

Figure 6 Average graduate (real wage) salary path by quintile



Source: Barr and Johnson, 2010 (using IFS data)

⁶⁷ ‘Interest subsidies on student loans: A better class of drain’ Nick Barr and Alison Johnson, Discussion paper 114, London School of Economics: Centre for the Economics of Education, March 2010, <http://cee.lse.ac.uk/cee%20dps/ceedp114.pdf>

If we recall that repayments only commence at £21,000 we can see that actual repayment patterns for the new scheme may only become apparent in perhaps twenty years' time.

The government's estimates therefore depend largely on forecasting earnings two decades hence. This means that any variation between actual and estimated may not become clear until 2035. The virtues of income-contingent repayment loans are undermined in the particular design of the current scheme, the result of many compromises.

Conclusions regarding the new loan regime

Grant expenditure is made and accounted for in the present. Loans are made in the present but repayments return over the years.

The actual losses on loans made in 2012 may generate much larger actual impairments than those initially recorded in the departmental accounts. Faced with the difficulty of predicting repayments, the failure to account for this potential variation is one of the biggest weaknesses of the loan scheme: the current government is setting aside what may prove to be far too little. And as emphasized in Part One, there appears to be little or no saving from the changes even in the short term.

What the uncertainty about repayments indicates is that the borrowing used to finance student loans increases the public sector net debt, without the guarantee that it will be paid down as per the OBR graph.

A more conservative impairment would be better for fiscal purposes, but not for political purposes. We call upon the government to commit to putting aside an impairment of at least 40 per cent in the accounts so as to mitigate the problems future governments may face (**Recommendation 2**).

Uncertainty could be reduced by restoring the teaching block grant and therefore supporting universities directly for their activities without displacing costs onto graduates whose earning profiles are unpredictable (**Recommendation 1**). Since reinstating some block grant would also enable universities to lower fees, restoring the teaching grant would reduce CPI in the same way that the current policy increases it.

There is no immediate saving and a troubling volatility is introduced into higher education funding, such that no one can safely say what the gain or loss is over the next thirty years. With such a fiscal impact, what needs to be re-assessed is the overall rationale for the new scheme.

Although these were not always overtly expressed by government, it is clear that two additional aims lay behind the change to the new regime:

1. To introduce differential fees into the sector and 'make the money follow the student'.⁶⁸

⁶⁸ I have elsewhere analysed the manner in which loans generate information and therefore enable new kinds of performance metrics. See Andrew McGettigan, *The Great University Gamble* (forthcoming, Pluto Press).



2. To remove block grant as far as possible to create a 'level playing field' for private providers, who do not qualify for such funding, but who can charge fees to their student who, increasingly, can access the publicly-backed loans.

That is, the 'austerity' narrative is a convenient story which appears to cover a different agenda in higher education – the creation of a new kind of marketplace with fewer restrictions on market entry and the rejection in practice of any notion of the public benefit of higher education.⁶⁹ The NUS have launched a campaign around higher education funding with the slogan, 'Come Clean'; here, in the face of government spin, it is very apposite.

The importance of such a slogan becomes more apparent in the next section, when we turn to the potential sale of the student loan book.

Given these concerns, the proposed extension of the model to further education and post-16 vocational study in 2013/14 appears ill-conceived (Level 3 and Level 4 post-24 loans). The government is currently consulting on the name for this scheme – a somewhat insulting approach to the public who surely want more oversight of these decisions.⁷⁰

These loans will have the same repayment threshold and interest taper, but the government estimates a RAB charge (non-repayment rate), here of 60 per cent: the budget for 2013/14 is £129m and £389m in 2014/15 – much lower than the billions required for higher education.⁷¹

Further, the recent Budget announced a scheme to 'pilot a programme of enterprise loans' with start-up capital of £10million.⁷² Richard Branson has advocated offering income-contingent repayment loans to young entrepreneurs who choose not to go on to higher education.⁷³ BIS has put out a tender for providers.⁷⁴

⁶⁹ For a more detailed account of this agenda, please refer to Andrew McGettigan, "New Providers': The Creation of a Market in Higher Education'; *Radical Philosophy* 167 (March/April); pp. 2–8.

⁷⁰ <http://www.surveymonkey.com/s/FELoansproductname>

⁷¹ There are no maintenance support loans for Further Education.

⁷² '1.241 The Government also recognises that the best route out of unemployment for some young people will be starting up in business, but that it can be difficult to obtain the skills and capital required. Building on the support already available, including the New Enterprise Allowance, later this year the Government will pilot the best way to introduce a programme of enterprise loans to help young people set up and grow their own business.' Budget 2012

⁷³ <http://www.guardian.co.uk/business/2012/mar/21/budget-young-entrepreneurs-loans>

⁷⁴ <https://www.bis.gov.uk/news/topstories/2012/Apr/providers-sought-to-help-deliver-start-up-loans-for-young-people>

Part Three

The Sale of Student Loans to Third Parties

Given the growing debt associated with loans and the possibility that repayments do not meet estimates, it is unsurprising that the government has been investigating ways to dispose of the student loan book.

This may involve an outright sale. The pre-1998 ‘mortgage-style’ loans were sold in two separate sales amounting to £2billion in value in the late nineties (for the latter, the government continues to pay a subsidy to the purchaser today).

The Coalition’s attitude to sale appears consistent with that developed in the final years of the last Labour administration. The 2008 Sale of Student Loans Act enabled the sale of the current type of loan, in ‘tranches’ if necessary. This came into force in July of that year with the decision to sell lying with the Secretary of State heading up BIS.⁷⁵ Sales or transfers can occur without the consent of borrowers, or indeed notice, and onwards-transfers of ownership are also permitted unless the Secretary of State intervenes (now, nominally, Vince Cable).

In 2009, the ‘Vision’ statement for the planned programme of sales gave as its main aim:

‘To create and deliver a business model that will provide Government with the sustainable capability to sell BIS-owned Income-Contingent Repayment student loans at a good value for the Government and at a time of its choosing, dependent on operational readiness and market conditions’.⁷⁶

A programme of sales was meant to commence later that year and ‘continue indefinitely’ with projected proceeds from sale giving indicative figures of £6billion per year in 2008/09 and 2010/11. There has as yet been no buyer and the programme was suspended in 2009.

The original intention was not an ‘outright sale’, as had happened earlier, but a ‘securitised’ solution. This would have involved selling investors a type of bond where the return included the right to a share of future graduate repayments.⁷⁷ However the market conditions were not considered appropriate.

It was therefore decided in the interim to commission financial advice on alternative ‘routes to market’. Alongside the Browne Review into the funding of higher education, a tender was published seeking a report on other ways to ‘monetise’ the loan book besides outright sale and securitisation.

⁷⁵ New legislation was required, as when the new income-contingent repayment loans were introduced in 1999 the legislation allowing the earlier sales was repealed.

http://www.legislation.gov.uk/ukpga/2008/10/pdfs/ukpga_20080010_en.pdf

⁷⁶ *Operational Efficiency Programme Asset Portfolio 2009*.

<http://webarchive.nationalarchives.gov.uk/20110218143459/http://www.hmg.gov.uk/media/52715/oe-assetportfolio.pdf>

⁷⁷ *Operational Efficiency Programme Asset Portfolio 2009*, p. 66.

The Coalition has continued this approach. Rothschild, who had advised on the earlier outright sales, were appointed to prepare the advice in May 2010 immediately after the general election result. The White Paper from last summer indicated that Rothschild's advice was 'imminent' but as yet no formal response from BIS has appeared.

In April, in a reply to an FOI request from journalists at False Economy, BIS confirmed that the Rothschild review had been received and that BIS was currently examining the feasibility, implementation, and market for sale, but it refused to release the report or provide additional details as that 'would prejudice commercial interests'. 'A disclosure of the information requested at this stage may also adversely affect BIS's bargaining position during contractual negotiations should a sale proceed which would result in a less effective use of public money.'

Perhaps something will appear along with the delayed responses to the various White Paper consultations (now more than three months overdue). References to 'monetisation' (§1.42) there – and Willetts's repeated use of the term – indicate that an alternative to an outright sale is still the preferred option.

'1.41 We want to find a solution that will manage all current and future ICR [Income-Contingent Repayment] loans on an ongoing basis (unlike the one-off sales of the late 1990s). It is fundamental to us that under any solution borrowers would be placed in no worse a position as a result of a transfer of their loans. If the portfolio is sold, further conditions must be met. In particular any sale would need to reduce significantly government's risk exposure to the loan book and represent value for money for the tax payer.'⁷⁸

The government thereby commits to ensuring that there should be no material difference between the conditions on the sold loans and those that still remain on BIS's books and managed through the SLC. But, as we will see, this does not mean that repayment terms and conditions will not be changed. If terms need to be changed to facilitate a sale, we may see all loan terms changed accordingly. Part Four of this report considers this issue in more detail.

The main aim of any sale is to remove the debt from the government's books and to remove the risk of repayments coming up short. The original BIS objectives were to:

- 'significantly reduce the risk to the Government associated with holding a growing portfolio of Income-Contingent Repayment student loans on the Government's balance sheet';
- 'ensure that any transaction is structured in such a way that *sufficient risk and control will be transferred from the Government's balance sheet* at the point of sale'.⁷⁹

One problem with securitisation is that it might not sufficiently remove the risk and balance from the government's books. Selling investors *the right to a share of income, rather than the loans outright*, is likely to mean that the loan book remains 'on-book' in terms of national accounts classification, especially if the 'special purpose vehicle' that concocts the debt products is arms-length rather than fully independent of government.⁸⁰

⁷⁸ *Students at the Heart of the System*, www.bis.gov.uk/hereform

⁷⁹ *Operational Efficiency Programme Asset Portfolio* 2009, p. 68; my emphasis.

⁸⁰ See the *Government Manual on Debt and Deficit* (4th release, March 2012) for further information, especially Part V Chapter 5 on securitisation and classification.

The 2009 assessment indicated: 'The Government would like to achieve a full risk transfer and therefore believes that an outright sale of the assets will be required.'⁸¹

I have elsewhere indicated what alternatives might be possible.⁸² But it is telling that Willetts met with Santander, the bank, to discuss the possibility of *independent* student loan finance. The 2009 assessment again indicated: 'Third party origination of new loans would present a *permanent de-risking* of the Government's balance sheet' [my emphasis].

Here the SLC would continue to act as factor collecting repayments through payroll, possibly for a fee, but the bank, or other third party, would be issuing new loans. Talks probably broke down because the bank would have been seeking a guarantee from the government to underwrite the scheme (i.e. keeping the risk on the national books).

This leads to the difficulty of a sale. Why would a purchaser want to buy what the government so clearly wants to sell? Martin Wolf, the Chief Economist at the Financial Times, has described such sales as economically illiterate: 'The white paper contains many other ideas, some good and some bad. A bad one is selling off the loan book. This is surely economic illiteracy. The loan book is sure to be most valuable to the state, which has much the lowest cost of funding.'⁸³

But sales occur for other reasons, not least the management of the headline public sector finance statistics and the political narrative that can be spun around those.

In the late 1990s, the government offered subsidies to the loan purchasers in both deals. The value of the annual subsidy on the first sale was estimated to be £350m, *£50m over the costs* associated with not selling the loans; similar calculations for the second sale reveal an estimated total subsidy of around £400m, £90m above the 'on-book' costs. That is, in order to shift £2billion of debt off the books, the government was willing to *lose* around £140m in total.⁸⁴

For the sake of improving the headline public sector finance statistics, in this case, net debt (PSND), the government was prepared to lose money over the lifetime of the loans. This should be seen in the context of Gordon Brown's 'Golden Rule' and the general expansion of Private Finance Initiatives (PFIs) under New Labour. The annual subsidy paid to the third party purchaser is analogous to the annual fees given under PFI to those who raise the private capital.

This, we should remember, was a sale of 'mortgage style' loans used only for living costs. The balances on graduation were low (under £5,000 in almost all cases) with zero *real* rates of interest and a fixed repayment period of five years to clear the debt borrowed, once the repayment threshold was crossed.

http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/methodology/ESA_95

⁸¹ Ibid. p. 69.

⁸² Andrew McGettigan, 'Into the Shadows', Supplement to *Research Fortnight* 381 (December 14, 2011).

⁸³ 'How to Free our Universities to Compete', 30 June 2011, *Financial Times*.
<http://www.ft.com/cms/s/0/a044cb4e-a35d-11e0-8990-00144feabdc0.html>

⁸⁴ Sue Hubble and Paul Bolton, House of Commons Research paper 07/78, November 2007, 'Sale of Student Loans Bill'. <http://www.parliament.uk/briefing-papers/RP07-78>

The last was set at a very generous 85 per cent of average annual earnings, so it took years for many to begin paying. Even so, these loans had more predictable patterns of repayment than income-contingent repayment loans.

Under the terms of the 2008 Sale of Student Loans Act, similar subsidies could be offered to purchasers of the new-style loans: 'The Secretary of State will be permitted to include provisions in any sale to compensate a loan purchaser in specified circumstances.' They will be necessary since the unpredictable graduate repayment patterns, already outlined, are as unattractive to buyers as they are to the government. Without proper data to go on, potential buyers cannot assess the risk of non-repayment, and therefore cannot price a fair deal. A larger discount may have to be offered to buyers to trigger an initial purchase.⁸⁵ Given that £140m was required as a subsidy to sell off old loans amounting to £2billion, what would be needed to monetise a loan book based on issuing over £10billion every year?

The government is committed to ensuring taxpayer value for money and any large subsidy would undermine this objective. That said, we should consider that *tranches* of the loan portfolio could be sold in order to assess and cultivate market appetite and produce data for future pricing purposes. The OBR has reiterated that the government is committed to selling *part of the student loan book*.⁸⁶

Although there were earlier commitments to prevent third party purchaser 'cherry-picking' loans, 'particular classes of loans' may be offered – for example, loans made to students at Oxford and Cambridge who are more likely to have high levels of graduate repayments.⁸⁷

What the desire to sell the loan book indicates is an awareness of the risks associated with increasing net debt. The real issue is how much of a discount or subsidy would have to be offered to attract purchasers; Martin Wolf's comments about economic illiteracy have particular weight given the current low cost of government borrowing. A corollary, which we will address subsequently, is whether the facilitation of such a sale would also depend on making the *terms of repayment less generous* so that higher levels of repayment come back.

The politics of the sale of the loan book are murky. No sale should proceed without discussion in Parliament on the terms of the deal, especially as it will require repeated annual subsidies (**Recommendation 4**). An independent review into the process of selling the loan book should be convened. It should be public as opposed to the private advice provided by Rothschild. The BIS Select Committee could undertake such an investigation. Is it really true that borrowers pay no mind to whether their loans are government-owned or providing returns to private investors?

⁸⁵ Hungary funded higher education through private investors buying bonds securitised against graduate repayments. That scheme however is much smaller and far less generous than the one we have in England. There is no repayment threshold, interest on the loans is around 10% and 6% of all income is repaid on graduation. Importantly, the design means the RAB charge is zero – there is no endogenous loss to the scheme. However, the current travails of the forint may unsettle the scheme. See Berlinger and Gönczi 'An efficient student loan system: case study of Hungary' <http://www.tandfonline.com/doi/abs/10.1080/03797720902867542>

⁸⁶ OBR, *Economic and Fiscal Outlook* (March 2011), §§4.151-4.152

⁸⁷ *Operational Efficiency Programme Asset Portfolio 2009*, p.68. <http://webarchive.nationalarchives.gov.uk/20110218143459/http://www.hmg.gov.uk/media/52715/oe-assetportfolio.pdf>

Comparison with PFI

At this point it is worth considering how the student loan scheme compares to Private Finance Initiatives (PFIs).

As discussed above, the student loan scheme does appear to manipulate one of the headline public sector finance statistics. Moving from predominantly grants to loans reduces the deficit (PSNCR), even though PSND is increased by the additional borrowing required for loans. It is an ‘off-deficit’ accounting trick. In contrast, PFI was and is off balance sheet, removing the cost of borrowing from the public sector and moving it to the private sector. Were the loan book to be sold, a similar shift to *fully* ‘off balance sheet’ could be achieved.

In both cases, the presentation of the accounts provides an incentive to pursue the option.

PFI structures long-term arrangements with fixed fees and complex contracts. The problem with student loans is more the practicality of estimating how high the level of repayments will be. A strange inverse of PFI, but with similar problems in relation to the future: should the loan repayments not materialise what looked to be an asset, the loan portfolio, fails to offset the original liability.

Table 6 Comparison between PFI and Student Loans

	PFI	Unsold Student loans	Sold Student Loans
Off balance sheet?	Yes	No (but ‘off-deficit’)	Yes
Future Costs committed?	Yes: Committal to fixed fees to private capital for up to 30 years	No: Committal of present borrowing and cost of borrowing in the hope of future repayments over 30 years	Yes: Annual Subsidy to purchaser that may exceed cost of keeping loans on book
Risk	What is paid out in fees over the lifetime of the contract wipes out any saving had from using private, rather than public, capital sector	That repayments are much lower than estimated and so policy write-offs exceed the 30% estimate (RAB charge)	That what is paid out in subsidies over the lifetime of the loans wipes out any saving to be had from shifting the loans off book to third parties

Without a sale, the design of the scheme – income-contingent repayment loans – makes repayment patterns volatile and leaves the nation with mounting debt. The last two governments have sought to sell the student loan book because it offers a potential solution to the problem of financing undergraduate education. Using an originate-to-distribute model would cost the government an annual subsidy but keep the funding of higher education off-book – in terms of reducing both the deficit and the national debt. The implications for future students are manifest in the following considerations (Table 6). So the question arises: can the terms on the loans be reset so as to facilitate such a sale?⁸⁸

⁸⁸ Moreover, one might stress that no infrastructure is purchased through student loans – only an illiquid book of financial assets. While there is ‘human capital’ investment there is no resale value to the educated individual.

Part Four

Changing the repayment terms on student loans

According to unpublished figures released by the Department for Business, Innovation and Skills to HEPI, the total outstanding balances on loan accounts is estimated to peak at £191 billion around 2050.

Future cohorts could face loans offered on much less generous terms than those on which the new scheme was sold to Parliament, without the need for primary legislation.

*Meanwhile, those who have already taken out loans have no protection against future governments also changing their terms and conditions. They have systematically been deprived of the protections one would associate with commercial loans and sign up to a loan agreement that includes the following clause: **'You must agree to repay your loan in line with the regulations that apply at the time the repayments are due and as they are amended. The regulations may be replaced by later regulations.'** (p. 8)⁸⁹*

As well as being income-contingent, the loans are future-policy-contingent. This leaves borrowers in an unenviable position.

What would a well-designed loan scheme look like? For some, this is the wrong question and we should be discussing the funding of higher education through a graduate tax, additional corporate tax or general taxation.

However, assessing the design of the loan scheme depends on understanding what the intentions behind it are. Nick Barr, who is the most astute writer on student loans, sees the point of income-contingent loans as removing a burden from public sector expenditure so as to lift the current rationing on higher education places and achieve three ends:

- improving access to university;
- improving the quality of the education provided there; and
- boosting the size of the sector so as to meet the unmet demand currently registered by the number of applicants who fail to achieve places each year.

Barr's most recent submission to the BIS Select Committee on universities castigated the Coalition government for concocting a new regime marred by political compromises and a mess of intentions.⁹⁰

⁸⁹http://www.direct.gov.uk/prod_consum_dg/groups/dg_digitalassets/@dg/@en/@educ/documents/digitalasset/dg_200469.pdf

⁹⁰ Nick Barr, 'Assessing the White Paper on higher education' (July 2011). Supplementary Submission to the Business, Innovation and Skills Committee.
<http://www.publications.parliament.uk/pa/cm201011/cmselect/cmbis/writev/885/m61.htm>

Firstly, he believes removing all block grant for some subjects fails to recognise the general public good provided by university-level education. He would restore the teaching grant for this reason and as such enable universities to set lower tuition fees.

His second main point is that a loan scheme that still represents a fiscal burden is no better than what we had before; student places are still costly if there is a 30 per cent loss on loans; the Treasury still has to ration places. He rightly notes that the government's artificial recruitment restrictions – the AAB+ initiative and the core / margin model for allocating places – are mainly designed to drive down the overall cost of higher education.⁹¹

In that case, universities are faced with a zero sum game in which little expansion is possible overall. (Since the government is no longer committed to acting as the backer of last resort, many universities face great uncertainty in the short to medium term, as it may be more difficult for them to maintain their student numbers under these conditions.)

We have the worst of both worlds: students are still costly if they do not repay a sufficient amount of what is borrowed.

The reforms will not:

- improve the quality on offer ('It is not clear how a structure designed to reduce price will lead to improved student experience.');
- widen access (Barr is particularly critical of the decisions to abolish AimHigher and the Educational Maintenance Allowance);
- or, enable more students to attend. A central tenet of mainstream economics is that free market competition cannot drive down price while there is unmet demand in the system – the artificial mechanisms of the white paper are designed to generate pressures on price through alternative means.

Barr sees one major botch resulting from political compromises:

'[I]n an attempt to make the resulting larger loans politically more palatable, the reforms raise the threshold at which graduates start to repay from £15,000 to £21,000 and index that threshold to changes in earnings.'

Moving the threshold up to £21,000 in 2016 for the new cohorts of graduates takes low earners out of repayments *but also lowers the monthly contributions* of all others as the threshold is used to set the margin above which 9 per cent of earnings are taxed.

Barr argues that the single best measure available to improve the stability of the student loan scheme would be to freeze that threshold.

⁹¹ 'We will free around 85,000 student numbers from current controls in 2012/13 by allowing unrestrained recruitment of the roughly 65,000 high-achieving students, scoring the equivalent of AAB or above at A-Level and creating a flexible margin of 20,000 places to reward universities and colleges who combine good quality with value for money and whose average charge (including waivers) is at or below £7,500.' BIS, *Students at the Heart of the System* (June 2011)

But up-rating this threshold in line with average earnings was the last-minute concession awarded to the Liberal Democrats before the December 2010 vote on raising the maximum tuition fee. While setting the repayment threshold at £21,000 was an essential part of the political pitch to the public. Monthly repayments will be lower although debts will be higher.

The earlier intention was to *review* the threshold every five years. This change did not improve the overall viability of the loan scheme.

The Liberal Democrats may not be around in 2016, so this may open up scope for a return to a review of the repayment threshold.

I commenced with this summary of Barr's position because too little attention has been focused on the fiscal problem: it appears as if too little of what is loaned will come back. In which case, the most coherent philosophy in favour of loans is wrecked by what is implemented.

On the moneysavingexperts.com website, Fact 17 on student loans declares, 'Many people will never pay it all back.'⁹² But if too many people fall into this category, the government of the day will probably have to consider changing the terms of the loan scheme.

We have already seen measures taken by the government to limit exposure on the loan book. Firstly, the government is attempting to maintain strict control of overall student numbers. Secondly, as mentioned, it has introduced stringent and complicated restrictions on undergraduate recruitment, the so-called 'core and margin' model.

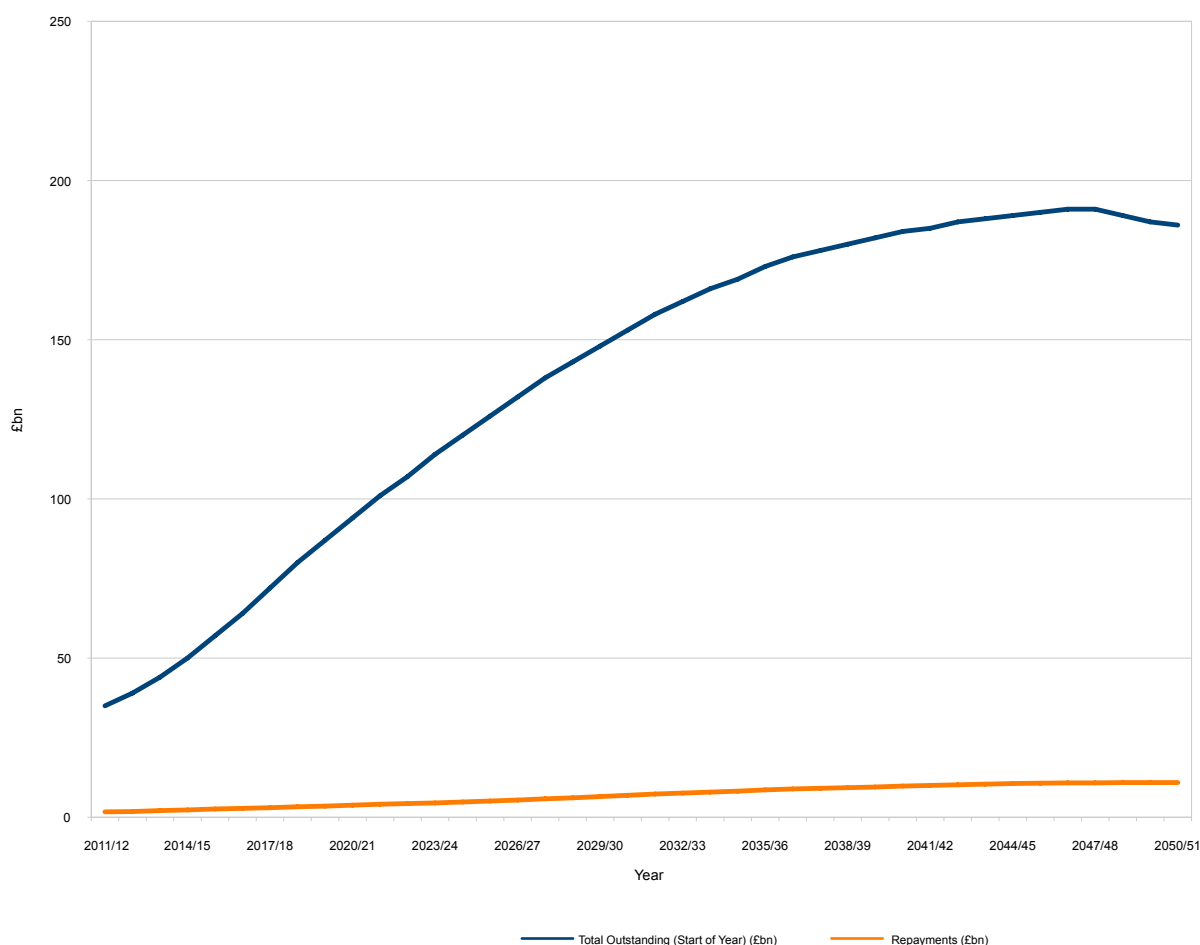
In order to understand further potential changes, and in particular changes to the terms of repayment, we need to look again at the figures we cited from the OBR and BIS. BIS did not merely provide estimates of repayments (Figure 3), BIS also estimated the outstanding balances on student loan accounts until 2050/51.

BIS estimates that outstanding student debt will climb from £35billion in 2012 to £191billion by 2046. At this point, the outstanding amounts drop as the thirty-year write-offs on individual loans kick in.⁹³ But before then, roughly an additional £150billion has appeared.

⁹² <http://www.moneysavingexpert.com/students/student-loans-tuition-fees-changes>

⁹³ 'The table shows projections each year from 2011–12 to 2050–51. The figures are all adjusted for inflation and presented in 2011 prices. They are equivalent to those published in the White Paper, which were calculated before the Department's accounts were published on 18 July and therefore started in 2010–11 and were presented in 2010 prices. The projections are based on the new student support system and repayment regulations due to be introduced for students entering study from 2012/13 onwards. They are for full time English students at UK Higher Education Institutions (HEIs) and for full time EU students at English HEIs. EU students are eligible for fee loans only.' BIS email to HEPI.

Figure 7 Outstanding balances on Income-Contingent Repayment Loans (£bn)



Source: BIS, 2011

The difference between OBR and BIS figures

How do these figures provided by BIS compare to the earlier graph from the OBR?

The OBR graph represented the impact of student loans on the public sector net debt.

The BIS graph represents the total *outstanding balances on individual loan accounts*.

These two different figures represent the difference between the total amount graduates owe to the government (BIS figures), and the impact of the borrowing (and related costs) the government had to incur to provide the funding for loans less the repayments received (OBR figures).

How future governments manage these two figures will be an increasingly important aspect of higher education policy. A future government will not face the same political pressures as those who introduced the scheme, but it may be confronted with continuing stagnation in the economy and a loan book where there appears to be a lot of debt that is going unpaid. The obvious policy temptation is to use the outstanding balances to pay down the debt through increased repayments.

This involves changing the terms and conditions on loans. (These debt projections obviously assumed that the terms and conditions determining future repayments remain the same as that is the policy being modelled).

Generating more and higher repayments would make the scheme less of a risk for governments and would also make a sale more attractive to potential buyers.

Note that this is a policy recommendation already coming from established quarters, as well as from academics. Demos, the think tank previously associated with the New Labour project, has called for the terms of repayment to be made 'less generous' so as to generate more repayments and thereby to reduce the level of policy write-offs.⁹⁴

Matthew Grist, the author of the report, also suggests 'considering some combination of the following':

- a lowering of the threshold at which loans are repaid;
- scrapping the 30-year time limit on loans extending the lifetime so that it matches the *whole of a graduates working life* (we saw in Figure 2.4 that earnings are highest on average when people are in their fifties);
- increasing the real rate of interest on loans for higher earners;
- increasing the surcharge slightly for earnings above the repayment threshold (this is planned to be 9 per cent).

Grist plans to undertake the quantitative work on analysing possible combinations and their the distributional effects, seeking to maintain the 'progressive nature of the scheme'.

Who will face such changes?

Those advocating changes to repayment terms and conditions are probably advocating a change for future cohorts.

We already have income-contingent repayment loans with different terms in England for those who started before 2006 (write-offs at 65) and those who started between 2006 and 2011/12 (write-offs 25 years after graduation). Both those groups also see a repayment threshold of £15,000 pa. These borrowers are not affected by the new regime commencing in 2012.

On the face of it, it would seem to be easier to change the details for those taking out loans, say, in 2020.

Previously, the terms of loans have been altered to the benefit of borrowers: for example, at the beginning of the 2005/06 tax year, the repayment threshold was raised from £10,000 to £15,000. It would be unprecedented to return to those already graduated and revise their repayment conditions so as to extract a higher level of repayments.⁹⁴

⁹⁴

John Thompson has suggested to me that the manner in which the government changed the terms on public sector pensions would be such a precedent. The government moved the index used in annual up-rating from RPI to CPI.



However, this is now largely a matter of political will.

There is no legislative or contractual difference between setting different terms for new cohorts and revising the terms and conditions of those *who have already taken out income-contingent repayment loans*. It would be a relatively straightforward matter to freeze the repayment threshold, for example. But other options are available.

The statutory and contractual protections that pertained to the earlier mortgage-style loans no longer apply to income-contingent repayment loans.

The new loans are *not* covered by the Consumer Credit Act⁹⁵ and interest rates can be set at the discretion of the relevant Secretary of State using statutory instruments (administrative 'Regulations'), as can the other details of the scheme, such as the repayment threshold (and the percentage determining level of repayment).⁹⁶ Although the current government has stated its intention to set real rates of interest on the new loans (i.e. above inflation determined as RPI), it has given itself powers to set levels much higher than that.

The 2011 Education Act, which received Royal Assent last November, now allows governments to set up to *market rates* of interest on student loans using statutory instruments (rates must be 'lower than those prevailing on the market, or no higher than those prevailing on the market, where the other terms on which such loans are provided are more favourable to borrowers than those prevailing on the market.'). This paragraph overwrites previous statute which ensured the low-interest status of student loans.⁹⁷

Interest rates can approach and in certain circumstances match terms on commercial borrowing: the market rate is now the effective cap and – given the difference between the interest rates on, say, credit cards, and the levels on the interest rate taper – there is considerable scope for adjustment. With more leeway to shift around the level of interest rates, it makes it easier for governments to control the mechanics of the scheme without the need for primary or secondary legislation.⁹⁸

Having recognised this lack of statutory and legal protection, what do the terms and conditions of the student loan agreements say?

⁹⁵ One implication of this exemption is that the SLC is not required to meet the same standards regarding information provision as those providing commercial loans.

⁹⁶ Statutory instruments are a form of delegated legislation governed by the 1946 Statutory Instruments Act. In this context, the legislation governing interest rates must be laid before parliament before it comes into operation. Unless an MP 'moves a prayer to annul it', it becomes law by the prescribed date without debate or vote. The ability to contest is limited: the instrument may be removed but not amended. Opposing statutory instruments is difficult, as the time for debate is restricted and the government is able to repeatedly publish. Regulations governing new loan scheme were laid before parliament over the Summer of 2011, while Parliament was on its summer recess. The Joint Committee on Statutory Instruments has some additional powers, mainly to question due process.

⁹⁷ Previously legislation prevented interest rates from going over 'the specified rate for *low-interest loans*' (subsection 4 of Section 22 of the 1998 Teaching and Higher Education Act). Interest rates are currently administered by determining the '*lower of the Retail Price Index (RPI) in March 2010, or 1% above the highest base rate of a nominated group of banks*'.

⁹⁸ The government has not yet produced the new regulations governing loans from 2012/13. These regulations would set the interest rates, new repayment threshold and thirty-year write-off period.



The clause that currently appears in the 2012/13 'STUDENT LOANS – A GUIDE TO TERMS AND CONDITIONS' allows future administrations great leeway to change terms and conditions:

'You must agree to repay your loan in line with the regulations that apply at the time the repayments are due *and as they are amended*. The regulations may be replaced by later regulations.' (p. 8; my emphasis)⁹⁹

It is clear that the loans are not merely income-contingent, but are in principle *future-policy* contingent. This clause has appeared in previous loan agreements, but with much higher debts on graduation more likely (as stated earlier, up to £50,000 could be possible) this clause becomes more concerning.

Indeed, whether the outstanding balance on an individual's account is really debt or a nominal figure to produce an improved graduate tax (as claimed by the government) is determined by such a clause. It is debt because of the risk that a future government seeking to pay down the national debt will return to these graduates and exact higher repayments.¹⁰⁰

Currently it may be difficult for the current government, or the next, to alter the terms. Such a change would be unprecedented. But, as we have seen, the impact of the new, much higher loan scheme is itself unprecedented ... and volatile. I do not wish to make any claims as to the likelihood of this turn of events, but it is a possibility. Whatever the current government's intentions, future governments are not bound by them and the legislative framework is such as to make such changes easier.¹⁰¹

Who is to say whether the UK will not face a long decade of stagnation or a crisis around debt rollover refinancing? Who can say what the economy will look like in 15–20 years' time? Might we in future face problems similar to those of Italy and Greece?

If so, we should avoid having a class of citizens, graduates, from whom a technocratic administration can tap extra cash, having claimed that the existing scheme was too unaffordable and with large levels of outstanding debt on individual loan balances.

Providing additional protection is the right and proper approach to a generation who now face much higher fees and much higher loan debts.

Although contracts can be over-ridden by primary legislation, as things currently stand, the combination of weak statutory and contractual protection make it too easy for future governments to amend the repayment terms and conditions. This situation should be amended through tougher contractual clauses fixing the terms of repayment at the time the loans are taken out. **(Recommendation 5)**¹⁰²

⁹⁹http://www.direct.gov.uk/prod_consum_dg/groups/dg_digitalassets/@dg/@en/@educ/documents/digitalasset/dg_200469.pdf

¹⁰⁰ And also because it can be reclaimed from those who move abroad outside of the UK tax system.

¹⁰¹ Similar concerns might apply to a graduate tax, but such schemes would lack the psychological impact of the individual debt balance and the ability of a future government to point to objective losses in a comparable manner. The level of scrutiny of tax increases is potentially higher – see the current Labour attempts to overturn certain parts of the 2012 Budget by organising votes against the freezing of tax relief for pensioners. Statutory instruments would avoid this level of resistance.

¹⁰² A petition to this effect is available here: <http://epetitions.direct.gov.uk/petitions/30290>

Conclusions

From an intergenerational perspective, one aspect of the new funding regime for higher education was always apparent: the next cohort of students faces much higher tuition fees.

Another aspect, the focus of this report, has been occluded. Although the new funding regime appears to reduce expenditure, it does so by exploiting quirks of the accounting convention used in departmental accounts.

It is not clear whether many Coalition politicians understand the difference between the deficit and the debt. When it comes to loans perhaps some of them think that clever financial engineers have come up with a technocratic solution to the funding of higher education. They have not.

Annual expenditure is reduced because only estimates of losses on loans are recorded. Factors determining the level of repayments are so varied and unpredictable that no one can estimate them with confidence. The loans have thirty-year repayment lifetimes: whether actual repayments match the estimates is a problem for future governments, and taxpayers, to confront. The implication of the 'CPI-effect' from higher tuition fees is particularly troubling: potentially wasting any savings from the higher education budget on increased tax credits, pensions and index-linked benefits.

The true costs are picked up further down the line, while in the short to medium term, the borrowing to finance student loans ratchets up the public sector net debt by billions.

If each generation should pay its own way, then this is an irresponsible approach. The scheme does not reach operational maturity for at least another twenty years, when, finally, annual repayments are expected to match annual outlay. This government introduces the scheme but is not setting aside sufficient funds to meet the financial commitments it has generated.

In sum, the Coalition has concocted a botched higher education funding regime which fails on its own criteria. It introduces instability into the sector and offers the nation minimal savings in return. This upheaval, and the higher debts faced by former students, cannot be justified on 'fiscal' or 'austerity' grounds.

Such conclusions lead us to understand why both this government and its predecessor have made great preparations to sell off the new loans to private providers. Selling off the loans, or the rights to graduate repayments, will probably involve a loss to the Exchequer and therefore the taxpayer, via annual fees or subsidies. On the one hand, this exacerbates its 'economic illiteracy' but, on the other, it would have the advantage of reducing the public sector net debt. Again, the headline statistics would mask the real impact in a manner akin to PFI. That the government is conducting such negotiations in secret is troubling from the perspective of democratic accountability.

Whether to facilitate a sale or simply to fix the leaks in the loan scheme, future governments may have to change the terms for future cohorts or even return to those with large outstanding loan balances and exact higher repayments. There is little statutory or contractual protection here.

This is a dismal prospect. Those former students will also be future taxpayers: they face a double or even triple whammy.

Recommendations

Recommendation 1

The single best measure to avoid many of these accruing problems and uncertainties for borrowers and institutions would be to reverse the strategy commenced upon in 2010 and restore to significant levels the block grant for undergraduate teaching. This would enable institutions to set lower fees, lowering the inflationary impact on CPI and lowering the required loan outlay, thus diminishing the volatility of the current scheme.

Recommendation 2

The government needs to 'come clean' about the claimed savings in the move from grants to loans. Given the impact on CPI of higher tuition loans, it appears as if there is no saving. A public statement is needed.

Recommendation 3

The loan scheme is volatile. The government's current estimates of 30–32 per cent losses on the loans— look weak. It is irresponsible for the current government to leave it to future governments to address the issue. A more generous sum for losses on the loan scheme – an 'impairment' –needs to be recorded in departmental accounts. A 40 per cent impairment would appear to be sensible, given independent analysis and the likelihood of higher tuition fee loans.

Recommendation 4

No sale of the loan book should proceed without discussion in Parliament on the terms of any deals, especially as it is likely to require repeated annual subsidies. Too much power currently lies with the Secretary of State. Given the 'economic innumeracy' of such sales in the past, an independent review should be commissioned, not simply the current private advice from Rothschild. The BIS Select Committee may also be the appropriate body to conduct such a review.

Recommendation 5

Although contracts can be overridden by primary legislation, as things currently stand, the combination of weak statutory and contractual protection for borrowers makes it too easy for future governments to amend the repayment terms and conditions. This situation should be rectified through tougher contractual clauses fixing the terms of repayment at the time the loans are taken out, or revising statute, so as to make future amendments possible only through primary legislation.

Recommendation 6

Although it was not possible to cover it in this report, there appear to be shortcomings in the maintenance support provided. Loans do not appear sufficient to meet costs of living, especially in London. The dangers are that students will have to seek additional borrowing from commercial sources or that they are distracted from study by having to undertake excessive paid work in term time. Discussion of maintenance loans should be decoupled from tuition fee loans. This report recommends that an independent commission, such as, again, the BIS Select Committee, review student finances from this perspective.

Appendix

Loans in departmental accounts

There is more than one accounting framework at work. In the National Accounts, the policy write-offs associated with student loans will be recorded as capital transfers *at the time the loan is written off*.

However, Departmental Accounts follow an accruals convention which means that the costs are recorded *when the liability for that capital transfer is first incurred*. Thus there is a difference in timing in the two different modes of presentation.¹⁰³

Resource Accounting and Budgeting (RAB) has been used across government since 2001. Its complexity is notorious. Allyson Pollock, in her book *NHS plc*, notes that it was resource accounting which first helped to create the internal market there in the early 1990s. Its treatment of student loans has prompted critics to refer to it as a ‘mirage’, ‘smoke and mirrors’, a ‘sleight of hand’ or an ‘accounting trick’, but its mechanics will have a profound impact on higher education over the coming years.

In fact, the departmental accounts have recorded student loans in three different ways since their introduction over twenty years ago.

Initially, the entire cost of the loans issued was recorded as expenditure, then, from the introduction of RAB, a provision was built up over time to meet non-repayment. Since 2010/11, following the implementation of the Alignment (Clear Line of Sight) Project, things have been different.¹⁰⁴

Departmental budgets are split between ‘resource’ and ‘capital’ budgets with the former used for spending and the latter for investment. There is a further split within those budgets between Departmental Expenditure Limits (DEL) and Annually Managed Expenditure (AME). This means there are four separate components to the departmental budget: Resource DEL, Resource AME, Capital DEL, Capital AME. The administrative costs of running the department are part of Resource DEL.

Departmental Expenditure Limits are set by spending reviews and work towards four-year plans. Annually Managed Expenditure budgets are set centrally by the Treasury and are used for ‘demand-led’ and volatile items or where ‘programmes are so large that they could be expected to absorb effect within DEL’. The value of the student loans issued is placed within Capital AME for those reasons.

¹⁰³ ‘8.12 Where these debts are deemed to be policy write offs, they will be recorded as capital transfers in the National Accounts at the time the loan is formally written-off; there is however no transaction in Departmental Accounts or budgets.’

http://www.hm-treasury.gov.uk/d/consolidated_budgeting_guidance_201213.pdf

¹⁰⁴ For a discussion of the change to resource accounting, see the Dearing report’s (1997) section on ‘The Treatment of Student Loans for Public Expenditure Purposes’.

<http://www.publications.parliament.uk/pa/cm199798/cmselect/cmduemp/241-i/ee0305.htm>

When the loans are issued, an ‘impairment’ is recorded in the Resource DEL accounts. This impairment reflects an estimate of the subsidy on lending and the write-offs. This is where the estimated loss of 30p per pound lent is recorded: it is referred to as the ‘RAB charge’.¹⁰⁵ It represents:

- (i) the difference between the government’s own cost of borrowing (estimated at 2.2 per cent real interest though it is currently much lower) and the debt interest accruing on student loan accounts (0–3 per cent real interest rates depending on earnings) is a cost;¹⁰⁶
- (ii) the ‘policy write-offs’ of outstanding balances after thirty years (and in the event of death or disability).

This spending for the impairment is ring-fenced within the Resource DEL.¹⁰⁷ This means that the estimated costs of the write-offs are recorded when they are incurred in entirety.¹⁰⁸ This is a more responsible convention than that used prior to 2009/10 given much higher loans with longer lives. (This is a simplified account which does not explain how interest receivable on the loan accounts is capitalised nor how the subsidy on borrowing is recorded.)

At the same time, the full value of the borrowing used to create the loans is recorded in the Capital AME budget. (The net value of the loan book is this borrowing minus the impairment in the Resource DEL account.)

Income received from graduate repayments is recorded in Capital AME against the original borrowing, which is therefore paid down. These repayments *do not* count as income received in the calculation of PSNCR (the deficit), unlike, for example, tax receipts.

Finally, any revaluation of the impairments (needed because the forecast estimates were incorrect) is charged to the Resource DEL exactly as was the original estimate of impairment. That is, should repayments prove to be lower than estimated, a future government will need to make additional allowance in the BIS Resource DEL budget.

¹⁰⁵ David Willetts: ‘This Exchequer subsidy for loans is known as the Resource Accounting and Budgeting (RAB) charge – a forecast of the amount of money that will not be repaid – and it is going to be at the core of university financing for many years.’ <http://www.timeshighereducation.co.uk/story.asp?storycode=416257>

¹⁰⁶ ‘8.11 Subsidy impairment – Student loans are offered at a loan rate lower than government’s cost of capital, as such over the lifetime of the loans there is an effective subsidy. The main student loans impairment is to account for this subsidy and will be valued as the difference between the expected income from the loans and the costs of delivering them at government’s cost of capital (agreed as 2.2% for loans).’

¹⁰⁷ The net present value of the loan book is achieved by setting this ringfenced spending commitment against the total value of loans in the Capital AME budget.

¹⁰⁸ For more detail see, Chapter 8 ‘Financial Transactions’ §§8.10-8.21 of Consolidated Budgeting Guidance 2012/13.

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