

Labour's higher education funding plans

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Executive summary

- On 27 February 2015, Labour announced its much-anticipated policy to reduce the undergraduate tuition fee cap to £6,000 per year for students in England. Alongside this change, it announced an increase in the interest rate charged on loans after graduation amongst high-income graduates, as well as a rise in average maintenance grants. University funding would be held constant under its proposal, with additional teaching grants distributed to universities to offset the lower fee income that they would receive.
- Mid- to high-income graduates are the primary beneficiaries of this reform, with the very highest earners benefiting the most, despite the rise in interest rates that they would face. This is because high-earning graduates are the most likely to repay their loan in full under the current system; hence, they experience the largest reduction in repayments as a result of the lower fee cap (which the higher interest rate does not offset). Most lower-earning graduates will be unaffected.
- The introduction of the £9,000 per year tuition fee cap in 2012 appears to have had little or no effect on applications to, or participation in, higher education (HE) amongst full-time students. For this group, it is therefore unlikely that a reduction in the cap to £6,000 will boost enrolment. On the other hand, there have been large reductions in part-time enrolment. It is possible that the cut in the cap could help those numbers recover.
- Taken in isolation, this policy would slightly weaken the public finances. Debt will be permanently higher in the long run as a result of replacing fee loans with teaching grants, since some of the loans would have been repaid while grants are not.
- Based on current estimates of future graduate loan repayments, we estimate that the changes made to the HE finance system would result in an increase in the long-run taxpayer contribution to higher education of around £1,000 per student per year (£3,000 per student per degree) in today's money. For a cohort of 350,000 students, this is an increase in taxpayer support for higher education (resulting in an increase in public debt in the long run) of around £1 billion in today's money. The

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long-run cost of this policy relative to the current system, however, depends crucially on future graduate loan repayments, which are highly uncertain.

- In the absence of any other policy changes, Labour would have to find around £3.2 billion from net tax rises or spending cuts to pay for the full difference between current fees and the new £6,000 per year cap (which we assume all universities would charge) if borrowing is to be left unchanged in the short run.
- The Labour party proposes to avoid these effects by implementing a permanent tax increase through restricting tax relief available on pension contributions. This would more than offset the long-term increase in government debt created by the HE policy changes.

1. Introduction

In 2012–13, the coalition government made significant changes to the way in which higher education (HE) is funded in England. It substantially reduced the money paid directly to universities in the form of teaching grants and instead allowed universities to charge higher tuition fees, of up to £9,000 per year.

While students do not have to pay these higher tuition fees up front – they can take out a government-backed loan, which they do not have to repay until after graduation – the substantial rise was highly controversial and fuelled speculation that participation rates – particularly amongst disadvantaged students – would fall as a result. These fears do not appear to have been realised amongst full-time students, but there have been large reductions in part-time enrolment.²

On 27 February 2015, Labour announced its much-anticipated policy to reduce the cap on undergraduate tuition fees from £9,000 to £6,000 per year. Alongside this reform, it announced an increase in the maximum interest rate incurred on student debt and a rise in average maintenance grants. The features of the current ('2012') system and the proposed new Labour system are summarised in Table 1.1.³

Table 1.1. Summary of HE funding systems

	2012 system	Labour proposal
Fee cap per year	£9,000 per year	£6,000 per year
Repayment threshold	£21,000	£21,000
Repayment rate	9%	9%
Interest rate on debt while studying (+RPI)	3%	3%
Interest rate on debt once graduated (+ RPI)	0% if income < £21k. 0–3% if £21k < income < £41k. 3% if income > £41k.	0% if income < £21k. 0–4% if £21k < income < £47.7k. 4% if income > £47.7k.
Debt written off	30 years	30 years

Note: All figures are in 2016 prices to align with the first year the thresholds are set to affect the cohort of students who started university in 2012, the first year of the current system.

² See, for example, the latest UCAS and HESA statistics: <https://www.ucas.com/corporate/data-and-analysis/end-cycle-data-resources> and <https://www.hesa.ac.uk/stats>.

³ This analysis uses the system as it was introduced in 2012 and does not account for changes in net fees, bursaries or grants that have been made since then. These differences are small and while they will affect the overall figures shown in Table 1.1, they should not significantly affect the difference between the two systems.

The maximum interest rate incurred on student debt would increase from RPI+3% under the 2012 system to RPI+4% under the proposed Labour system. Individuals with income below £41,000 per year would face the same interest rate under both systems. Those with income between £41,000 and £47,667 would pay an interest rate between RPI+3% and RPI+4% (on a linear taper), and those earning above £47,667 would pay RPI+4%.

Finally, for individuals with parental income below £25,000, maintenance grants would increase by £400 per student per year from £3,400 per student per year. Individuals with parental income between £25,000 and £42,000 would receive smaller increases to their grants.

2. Policy implications

Labour has announced that up-front university funding would be unchanged from the current system, meaning that the shortfall from reduced fees would be counterbalanced by increased teaching grants. Taking into account the facts that not all universities charge the full £9,000 per year, that some students receive fee waivers from their institutions, and that some courses last longer than three years – and assuming that all institutions charge the full £6,000 per year under the new system – we estimate that teaching grants would rise from around £675 to around £3,450 per student per year on average.

Initial government spending would also be held constant as loans have simply been converted to teaching grants. The major change in terms of long-run finances, therefore, would be a shift in the burden of costs from graduates to the taxpayer. This arises because under the current system some graduates would be making repayments on the final £3,000 of loans per year, while under Labour's proposed system the taxpayer would automatically contribute the full amount up front. Graduate repayments are therefore lower – and the government contribution to higher education higher – by the average expected value of any repayments made on that last £3,000 per year of loans.

Based on a set of assumptions about future graduate earnings growth and the government's cost of borrowing and assuming there are no changes to the parameters of the loan system over the repayment period, we estimate that, under the current system, around half of graduates (the lower-income half) will end up not making any repayments on that last £3,000 a year of loans. This means that the proposed change in policy would make no difference to the government contribution to the education of these graduates. It would for higher-income graduates, however.

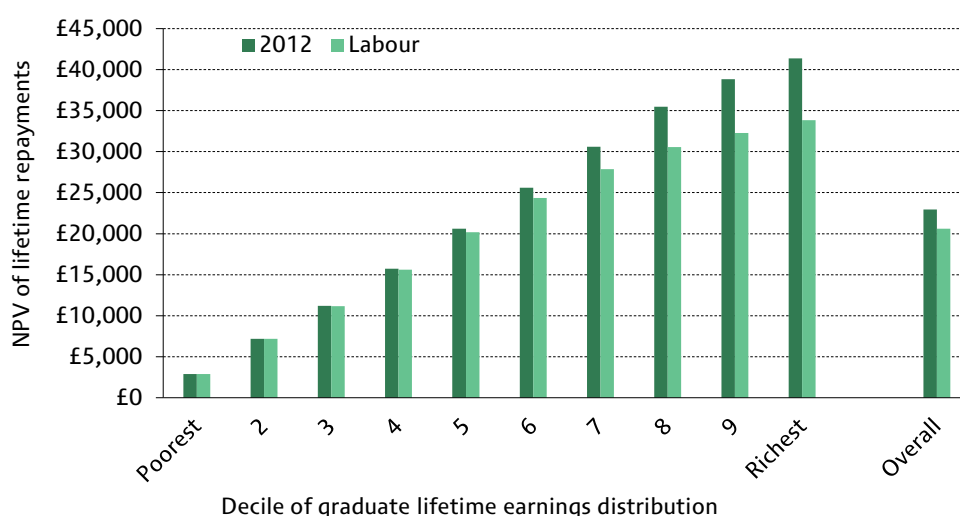
Based on current estimates of expected future graduate repayments, we estimate that graduate repayments would decline by around £2,400, on average, in today's money under the new policy. (That is, under a particular set of assumptions about future earnings and, importantly, discount rates, the current value of the reduction in future loan repayments will be about £2,400 per graduate on average.) The current value of the taxpayer contribution would therefore rise by an equivalent amount, plus the increase in maintenance grants, taking us to £3,000 per graduate per degree. Per cohort (either of new university entrants, or of a single year of current entrants, assuming student numbers remain constant), this figure amounts to approximately £1 billion in today's money.⁴

⁴ This assumes a cohort size of approximately 350,000. Tables 2a and 7a from <https://www.hesa.ac.uk/sfr210#tables> give a total of 331,150 first-year undergraduate students from England

Of course, because of the huge uncertainty surrounding expected future graduate loan repayments, the expected increase in taxpayer contribution is also hugely uncertain. If graduates were to repay a substantially larger proportion of that final £3,000 per year of loans, then the taxpayer contribution would rise equivalently. If all loans were to be repaid, then the total taxpayer contribution of Labour's policy would rise by the full value of the increase in teaching grants, of around £2,800 per student per year on average.

Figure 2.1 splits graduates into 10 equally-sized groups (deciles) on the basis of lifetime earnings and shows how expected future repayments vary across the distribution.⁵ It shows that this average expected reduction in loan repayments of £2,400 per graduate in today's money varies substantially across the graduate lifetime earnings distribution.

Figure 2.1. Distributional comparison of the current (2012) system and the proposed Labour system



Note: 'NPV of lifetime repayments' is the value of expected future graduate repayments in today's money (i.e. in 2014 prices, discounted using a discount rate equal to the government's assumed cost of borrowing (RPI+2.2%)). Assumes graduates repay following their repayment schedule and have no unearned income. Source: Authors' calculations using IFS's graduate repayments model.

As described above, for graduates in the bottom 50% of graduate lifetime earnings – those earning less than £30,700 on average per year – there is essentially no effect on their repayments. They do not come close to paying off their debt given the repayment rules under either system, so their future loan repayments are unchanged, meaning that they do not benefit from the lower fees. They also do not earn enough to be affected by the new higher interest rate that would be introduced for higher-income graduates under the new system. The government contribution towards their education is thus essentially unchanged.

For graduates in the top half of the graduate lifetime earnings distribution, total repayments would be lower, since they take out smaller loans and have less to repay on

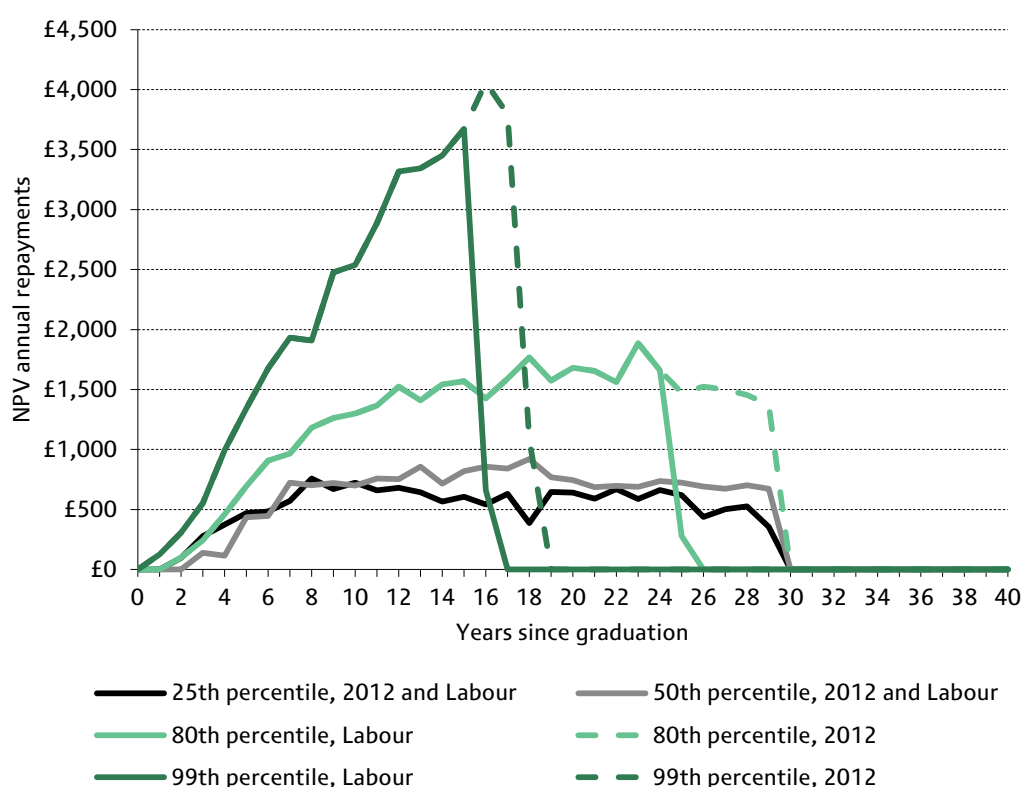
and 18,170 first-year EU students all studying full-time in an English higher education institution (the latter figure is just those studying for first degrees) in 2013–14. Our estimates of the increase in government funding required do not allow for any increase in the student population with the removal of the cap on student numbers but do account for the fact that non-English students are not eligible for maintenance loans.

⁵ In principle, graduates must make repayments out of unearned income exceeding £2,000 per year. In practice, however, only those who submit self-assessment tax returns make repayments on the basis of unearned income. Given that the number of individuals to whom this applies is relatively small, together with the challenges of estimating unearned income, we focus on repayments made out of earnings only.

average. This would outweigh the effect of the higher interest rate (which would increase the size of the outstanding debt more rapidly for those earning above £41,000 per year). We estimate that the biggest net winners from this reform are those in the top deciles of the graduate earnings distribution, who repay less in total than under the current system, despite the higher interest rate.

Figure 2.2 provides further insight into these distributional implications, showing expected average annual repayments for example individuals at different parts of the distribution of graduate lifetime earnings: specifically, for individuals earning at the median of graduate lifetime earnings, as well as at the 25th, 80th and 99th percentiles.

Figure 2.2. Expected annual repayments for example graduates with different lifetime earnings under the current (2012) system and the proposed Labour system



Note: NPV repayments are the value of expected future graduate repayments in today's money (i.e. in 2014 prices, discounted using a discount rate equal to the government's assumed cost of borrowing (RPI+2.2%)). Assumes graduates repay following their repayment schedule and have no unearned income. Source: Authors' calculations using IFS's graduate repayments model.

The total savings for graduates are equal to the area between the dotted and solid lines. The graph shows that there would be no difference in expected repayments under the current and proposed new systems for those earning at the 25th and 50th percentiles of graduate lifetime earnings. But there would be a clear benefit for those earning at the 80th and 99th percentiles, arising from the fact that the increase in the interest rate they face does not outweigh the smaller loans they take out, meaning that they are subsequently able to clear their debt more quickly. We estimate that those earning at the 80th percentile of graduate lifetime earnings would repay £7,000 less in total in today's money than under the current system, while those earning at the 99th percentile of graduate lifetime earnings would repay £8,300 less in today's money.

Again, it is worth highlighting that these figures are all based on assumptions about future graduate earnings growth, about the government's cost of borrowing and that there will be no changes to the parameters of the loan system over the repayment period; in fact, all three are subject to change. These estimates should thus be regarded as indicative of the likely long-run cost to graduates and the taxpayer only.

3. Design

The main change to the parameters of the loan system is the new higher interest rate charged on the outstanding debt of high-income graduates. The introduction of a higher interest rate (of RPI+4%) while keeping the taper rate constant means increasing the upper income threshold from £41,000 under the 2012 system to around £48,000 under the proposed system. Existing plans are for these thresholds to be uprated in line with earnings (although this has not been confirmed either by Labour in its announced plans or by the current coalition government). Previous IFS analysis⁶ illustrated the implications of a less generous uprating system and future IFS analysis will further examine the implications of freezing these thresholds for a limited period.

Although high-income graduates are better off under the proposed Labour policy – their expected future loan repayments are lower in total – the new higher interest rate they face increases their incentive to repay the loan early or to not take out a loan in the first place. Early repayment would increase the cost to the taxpayer because it reduces the period of time high-income graduates would face a rate of interest on their debt that exceeds the government cost of borrowing. Non-take-up of loans by the highest-income graduates would also increase the cost to the taxpayer because we estimate that these individuals will repay more than the value of their loans under the proposed system. Further, the lower fees make the latter option more affordable.

The fact that the policy will be introduced for all students from September 2016 means that there may be some tricky transitional issues to consider. First, while those who are already at university may be pleasantly surprised to find that they will be able to borrow less than anticipated in the final years of their course, they would be borrowing this smaller amount under different loan terms from those of their previous debt: in particular, if they went on to earn more than £41,000 per year, they would face a higher real interest rate on their new loan. This would presumably require the Student Loans Company to keep track of multiple loans per student issued under different terms. More importantly, it is unclear which debt would be repaid first: graduates would presumably prefer to repay the higher-interest debt first, while the government would presumably prefer the opposite (in order to maximise repayments).

Second, the fact that the policy has been preannounced means that those applying to enter university this year may respond to the change in regime – for example, by deferring their secured place at university or by not applying through clearing if they fail to meet their existing offer. If such behavioural change were significant enough, then it might have implications for the overall numbers of students entering university in September 2015. Such behavioural response is not unprecedented: some students 'brought forward' their university participation in anticipation of the preannounced increases in the tuition fee cap in 2006–07 and 2012–13. One might expect the

⁶ C. Crawford, R. Crawford and W. Jin, *Estimating the Public Cost of Student Loans*, IFS Report R94, 2014, <http://www.ifs.org.uk/publications/7175>.

behavioural response to be larger here, because the removal of the cap on student numbers affords greater flexibility for students to respond to the regime change.

4. The impact on the government finances

When thinking about the impact of these reforms on the public finances, it is easiest to think about the impact on the profile of public debt over time. The higher education (HE) reform itself makes no difference to debt in the short run – spending on student loans is replaced by spending on teaching grants. In the longer run, it increases debt – none of the teaching grant gets paid back while some of the student loan spending would have been. In the long run, debt would be around £1 billion higher per cohort of students (based on an increase in the taxpayer contribution of £3,000 described above, and assuming 350,000 students).

At the same time as the reform to HE funding, Labour has proposed a package of changes to the taxation of pensions. It estimates that this would raise about £3 billion a year,⁷ reducing debt in both the short and long run. Taking the HE funding reform and pensions tax changes together, these would reduce government debt, but that is *despite* the change to HE funding (which actually slightly increases the debt) and just because an additional tax increase has been announced.

The impact of Labour's proposed HE reforms on government 'borrowing' are complicated by the different accounting treatment of loans and grants. The former do not count towards borrowing (as measured by public sector net borrowing) in the year they are issued (and repayments from graduates do not reduce government borrowing when they are received) since they are counted as 'financial transactions'. Only the debt interest accruing on the loans made, and any write-offs at the end of the repayment period, affect borrowing. In contrast, spending on grants counts towards government borrowing in the year they are made.

This means that the direct effect of replacing fee loans pound-for-pound with increased teaching grants would actually be an increase in government borrowing in the absence of any other policy action. If teaching grants are increased by £2,800 per student per year and maintenance grants are increased by £200 per student per year (across all students), this would result in a direct increase in borrowing of around £3.2 billion per year, assuming a fixed number of 350,000 students per cohort.⁸ However, a large proportion of this would be offset by lower borrowing in future, arising from the lower write-offs that smaller loans would entail.

The proposed reform increases the taxpayer contribution to HE (since none of the teaching grant or increased maintenance grant gets paid back, while some of the loans made would have been), and therefore weakens the public finances in the absence of any other policy action. The long-run cost of this policy relative to the current system depends crucially on future graduate loan repayments, which are highly uncertain. However, while the reforms weaken the public finances in expectation, they also reduce some of the uncertainty around the long-run public cost of funding the degrees of a given cohort of students, by replacing some of the uncertain cost of student loans with the certain cost of grants.

⁷ <http://press.labour.org.uk/post/112218577289/a-better-plan-for-a-better-future-fairer-for>.

⁸ Accounting for the fact that non-English students are not eligible for maintenance loans.

5. Conclusions

The reform to HE funding announced by Labour on 27 February would:

- leave university finances largely unaffected in the short run, but perhaps more susceptible to spending cuts in the longer run;
- benefit higher-income graduates;
- leave the half of graduates with lower lifetime income largely unaffected;
- increase the incentive for those who expect to have high income in future not to participate in the loan system at all;
- boost 'cash in pocket' for around half of students by up to a maximum of £400 per year.
- Previous evidence suggests this reform will have a limited impact on full-time participation in HE, but might have a positive effect on part-time participation.

The effects on the public finances of the HE reform by itself would be to:

- leave government debt largely unaffected in the short run, but higher in the long run;
- increase borrowing in the short term, by around £3.2 billion a year;
- reduce the uncertainty around the public cost of funding HE, by replacing some of the uncertain costs of loans with a certain cost of grants.

Accounting for the additional revenues Labour expects from the announced package of changes to the taxation of pensions, the overall effect on the public finances would be to:

- reduce government debt in both the short and long run;
- leave government borrowing largely unaffected in the short run and lower in the long run.