

# Response to the government's consultation on freezing the repayment threshold

IFS Briefing Note BN177

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## Introduction

In the Summer Budget on 8 July 2015, the Chancellor announced plans for several important changes to higher education funding and student support. These reforms are analysed in detail in Britton, Crawford and Dearden (2015).<sup>2</sup>

One of the proposed reforms was a plan to freeze the income threshold above which student loan repayments are made in nominal terms at its current level (£21,000 per year in 2016 prices) for 5 years.<sup>3</sup> The Department for Business, Innovation and Skills launched a public consultation regarding the proposal on 22 July 2015.<sup>4</sup>

This short note extends the work of Britton, Crawford and Dearden (2015), analysing the likely implications of the proposed changes for students entering university in 2016-17.

## Methodology

Our analysis is conducted using IFS's graduate earnings model. The model is described in more detail in Britton, Crawford and Dearden (2015) and Crawford, Crawford and Jin (2014),<sup>5</sup> but in essence we take the cohort of students expected to start university in 2016-17 and match them to a series of simulated 30-year graduate earnings profiles.<sup>6</sup>

Information on students enables us to calculate the amount of financial support to which they are entitled, including the maximum amount of loans they could take out. We assume that all students take out the maximum fee and maintenance loans to which they are entitled.

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<sup>1</sup> The authors gratefully acknowledge support from the Economic and Social Research Council (ESRC) through the Centre for the Microeconomic Analysis of Public Policy at IFS (grant reference ES/H021221/1).

<sup>2</sup> J. Britton, C. Crawford and L. Dearden, *Analysis of the Summer Budget Reforms Announced in Summer Budget 2015*, IFS Briefing Note BN174, 2015, <http://www.ifs.org.uk/uploads/publications/bns/BN174.pdf>.

<sup>3</sup> Students can borrow money from the government to cover their fees and contribute towards their living costs. These loans are repaid after graduation, and only once income rises above the income threshold.

<sup>4</sup> See [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/447565/BIS-15-445-student-loan-repayment-threshold-consultation.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/447565/BIS-15-445-student-loan-repayment-threshold-consultation.pdf).

<sup>5</sup> C. Crawford, R. Crawford and W. Jin, *Estimating the Public Cost of Student Loans*, IFS Report R94, 2014, <http://www.ifs.org.uk/comms/r94.pdf>.

<sup>6</sup> In principle, graduates have to make student loan repayments out of unearned income if it exceeds £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 earned income only, which is why we estimate graduate *earnings* profiles rather than graduate *income* profiles.

The earnings profiles enable us to calculate annual and total loan repayments throughout the 30-year repayment period (assuming no early repayment and no repayment avoidance), and hence statistics such as the proportion of graduates who are likely to repay their loans in full, the average number of years taken to repay, and the resource accounting and budgeting (RAB) charge, which can be thought of as the long-run cost to the government of issuing student loans.<sup>7</sup>

## Implications of freezing the repayment threshold

The government's consultation document sets out further details of the announcement made in the Summer Budget. The proposal is for the income threshold – the threshold above which graduates are liable to start making student loan repayments – to be frozen in nominal terms for five years from 2016-17, i.e. to stay at £21,000 per year until 2021-22, after which there would be a further consultation on what should happen.

As well as the income threshold, there is another threshold built into the student loan system: the level of income above which students are charged the highest interest rate (of RPI+3%) on their loans. This threshold is currently set at £41,000 per year. The consultation document makes no mention of what will happen to this threshold.

In the analysis that follows, we model a number of scenarios:

- The default scenario is the funding system we assume will be in place for new students entering higher education in 2016-17. This includes the change from maintenance grants to loans set out in the Summer Budget. It assumes that, in the absence of any reforms arising from the consultation, both the income and interest thresholds would rise in line with average earnings (as forecast by the Office for Budget Responsibility) from 2016-17 onwards.<sup>8</sup>
- We model the implications of freezing the income and interest thresholds in nominal terms for five years, with both rising in line with average earnings thereafter.
- We model the implications of freezing the income and interest thresholds in nominal terms for five years, with both rising in line with inflation (as measured by the Retail Prices Index, RPI) thereafter.

Table 1 shows the flow of funds between the government, universities and students under each of these scenarios, and Figure 1 shows the distributional implications of these reforms for graduates, comparing repayments made by decile of graduate lifetime earnings.

As shown in Table 1, changing the loan repayment threshold does not change the amount of money flowing to students or universities from the government. The only change this reform induces is a rise in the amount of loan repayments that graduates make to the government, both annually and in total over the repayment period.

All else equal, our estimates suggest that graduate repayments would increase by almost £4,000, on average, in net present value (NPV) terms – using the government's current

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<sup>7</sup> The provision of student loans is costly to the government for two reasons. First, not all loans will be repaid, since the debt is written off under certain circumstances (including death, permanent disability, and after 30 years). Second, the loans are (on average) made available at subsidised interest rates – in other words, the interest payable by the borrower is on average lower than the interest the government is assumed to pay on its debt (which is RPI+2.2%). In principle, this means that providing student loans would be costly to the government even if they were all repaid in full.

<sup>8</sup> For further details of the assumptions underlying this system, see Britton, Crawford and Dearden (2015).

preferred discount rate of RPI+2.2% - if both the income and interest thresholds were frozen in nominal terms for 5 years and then uprated in line with average earnings. There would be a reduction in the proportion of graduates with some loan write-offs at the end of the repayment period, from 69% to 64%, and the RAB charge would also be expected to fall, to around 36% (compared with around 44% under the default 2016–17 system).

From a public finance perspective, this reform would increase the rate at which public debt declines over time, as the value of the repayments collected each year would rise. There would also be less outstanding debt to write off at the end of the repayment period, meaning future borrowing would rise by less than under the default 2016–17 system.

Uprating the thresholds in line with inflation (as measured by RPI) rather than average earnings at the end of the 5 year freeze would produce additional savings for the government. This is because average earnings tend to rise more quickly than prices. If the thresholds were to rise in line with inflation, then we would expect more graduates to make higher repayments (and be charged a higher interest rate) in a given year.

Our estimates suggest that the effect of uprating the thresholds in line with prices rather than average earnings would be at least as large as the effect of freezing the repayment threshold in nominal terms for 5 years, with a further increase in average loan repayments of around £4,000 per student in NPV terms, which would reduce the RAB charge by an additional 9 percentage points to around 27%.

**Table 1. Money flows per student (£000s unless stated otherwise, 2016 money)**

	<b>Default 2016–17 system</b>	<b>5 year threshold freeze then rise in line with average earnings</b>	<b>5 year threshold freeze then rise in line with RPI</b>
RAB charge	43.8%	35.7%	26.9%
<b>Initial govt spending</b>	49.2	49.2	49.2
Taxpayer contribution	22.6	18.8	14.6
Graduate contribution	26.6	30.4	34.5
<b>University funding</b>	27.8	27.8	27.8
<b>Student funding</b>	21.4	21.4	21.4
<i>Of which:</i> Maint. loan	19.8	19.8	19.8
Bursaries	1.6	1.6	1.6
<b>Per 362,000 students</b>			
Total up-front govt spend	17,798m	17,798m	17,798m
Total long-run contribution	8,185m	6,811m	5,303m

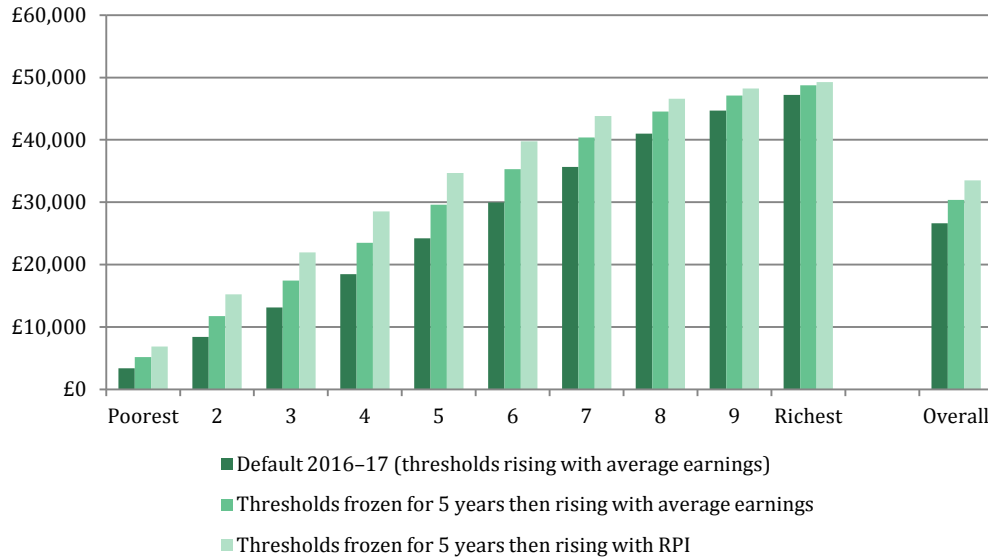
Note: All figures are given in 2016 prices in £000s, discounted using a discount rate equal to the government’s assumed cost of borrowing (assumed to be RPI+2.2%), unless otherwise stated. Assumes all students take out the maximum loan to which they are entitled, repay following their repayment schedule and have no unearned income.

Source: Authors’ calculations using IFS’s graduate repayments model.

If we were to instead assume that only the income threshold is frozen in nominal terms – with the interest threshold uprated with average earnings throughout – it would make a small difference to these estimates: essentially the RAB charge would fall slightly more (as more graduates would be charged a higher interest rate and hence make slightly higher loan repayments), but the additional repayments would be made towards the end of the repayment period – because the majority of graduates do not reach this threshold, and those that do are more likely to do so towards the end of their careers – and

repayments made many years into the future are heavily discounted, thus the overall effect in terms of NPV repayments and the RAB charge is relatively small.

Figure 1. Expected average NPV repayments by decile of graduate lifetime earnings (2016 money)



Source: Authors' calculations using IFS's graduate repayments model.

Figure 1 shows that low- to middle-income graduates would be hit hardest by a threshold freeze. This is because high income graduates tend to earn enough to repay their loans in full anyway; they would just do so slightly more quickly with the threshold freeze. We estimate that a median graduate earner (earning around £23,000 per year in their early 20s, rising to £34,000 in their early 50s, both in 2016 prices) would see their annual repayments rise from £900 under the default 2016-17 system to £1,100 with a 5 year threshold freeze, assuming the thresholds then rise in line with average earnings thereafter. A graduate with this earnings profile would be expected to repay £27,000 in 2016 money in total under the default 2016-17 system, compared with £33,000 in total in 2016 money under the system where both the income and interest thresholds are frozen in nominal terms for 5 years. Their repayments would be even higher if the thresholds were to rise in line with inflation rather than average earnings following the 5 year freeze.

## Issues to consider

Our estimates are for a new cohort of students entering university in 2016-17. The consultation asks for views on whether these changes should be applied to all students who have entered university since 2012, or only to new students entering university from 2016-17. We do not provide a view either way, but only note that it should be made clear to students/graduates once a decision has been made this time round that their repayment terms may change again from 2021-22. Greater emphasis should perhaps also be placed on ensuring students are aware that they may face changes to their loan terms in future when initially taking out their loans.

It is not clear from the consultation document what will happen to the interest threshold (above which students are charged the highest interest rates on their loan). While it makes relatively little difference to the likely implications of the reform for graduates or the government, the government should be clear in its response what will happen to this threshold. They may also wish to consider the wider pros and cons of maintaining a threshold close to – but not the same as – the higher rate tax threshold, and indeed of maintaining an interest rate taper at all, given that it makes the system very complicated.

Finally, we note that the student loan system continues to rely on the Retail Prices Index as its measure of inflation. Paul Johnson, in his independent review of UK consumer price statistics, recommended that RPI should not be used when issuing new contracts, uprating taxes or benefits, and, if possible, when issuing new index-linked bonds.<sup>9</sup> The issuance of student loans would presumably be included in this list. This concern not only relates to the interest rate students are charged on their loans (currently RPI plus up to 3%), but also the discount rate applied when assessing the value of future student loan repayments (currently RPI+2.2%). It was announced in the Summer Budget that the government would review the discount rate used, potentially bringing it more into line with the current cost of government borrowing (i.e. reducing it). It would be useful for the government to consider whether RPI remains the most appropriate measure of inflation to use in the student loan system as part of this review.

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<sup>9</sup> See <http://www.statisticsauthority.gov.uk/reports---correspondence/current-reviews/range-of-prices-statistics.html>.