

Funding Higher Education: Issues and Implications

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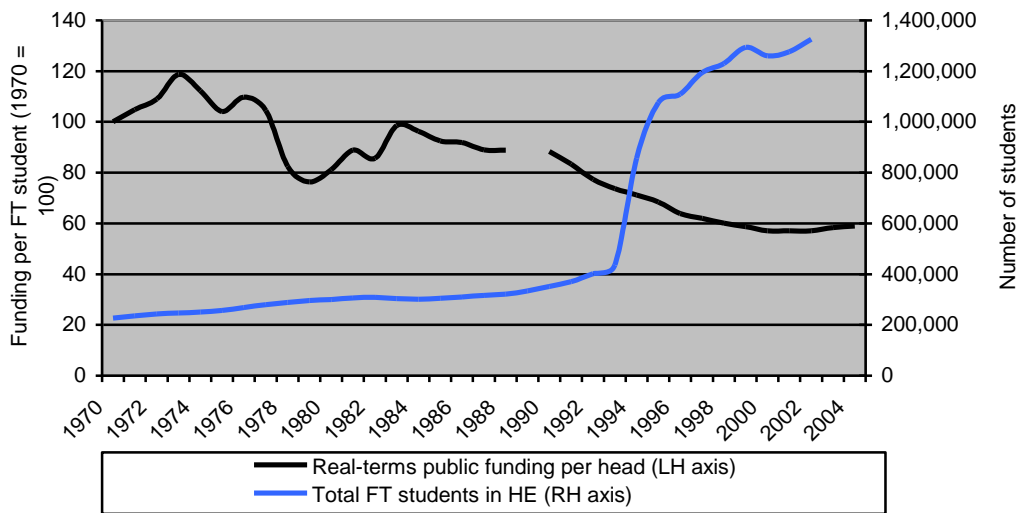
Many of you reading this article may be considering – or even in the process of applying for – a course at university. In that case, you are probably quite familiar with the recent reforms to the way higher education (HE) is funded in England and Wales. Some of those who apply, particularly those with lower family income, may end up better off under the new system as a result of their entitlement to the new grants and bursaries, while others will be worse off overall. But nearly all applicants can expect more debt upon graduation than their predecessors. If these changes are going to affect your finances now and in the future, then you will no doubt be curious why the new legislation was introduced. The Act itself was politically unpopular, but did it carry any economic justification? In this article we will explore the economic principles behind funding and attending university.

The Higher Education Funding Act, passed in 2004 amid controversy and implemented in 2006–07, introduced a raft of changes: up-front fees were abolished, replaced by deferred fees of up to £3,000 (£3,145 this year). In addition, grants and bursaries were reinstated for the poorest students. The debts that students accumulate will continue to be paid off at the fixed rate of 9% of income above a certain earnings threshold (£15,000), but any outstanding graduate debt is now forgiven after 25 years. Furthermore, in additional reforms announced last July (and implemented this year), graduates have the option to take a five-year ‘repayment holiday’ during which they do not have to pay back any of their student loan.

The feature that attracted the most attention in the media was, of course, the increase in fees and what the consequences would be for access to HE. The private sector contribution to the costs of university rose substantially in light of the 2004 reforms, and this policy shift has two motives behind it. The first is necessity: university used to be the preserve of a select few, but, as Figure 1 shows, the number of students attending

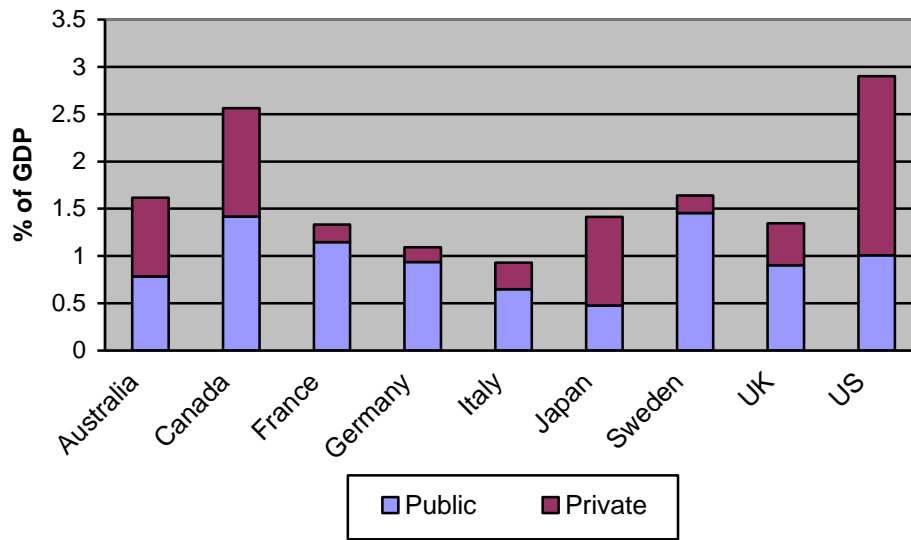
university has risen consistently and has shot up over the last 15 years in particular. Government expenditure on HE has not risen anywhere near as quickly, meaning that per-student funding has fallen over time and now lags behind the levels seen in the US, Canada, Australia and other nations (see Figure 2). At the same time, the government is keen on widening access to university, and to that effect has set a highly ambitious target of a 50% HE participation rate by 2010; this measure currently stands at 40%, and has remained broadly flat over the last few years. If the participation targets are to be met, the increased number of students cannot be paid out of the public purse without making sacrifices elsewhere in the public finances.

Figure 1. UK HE funding and participation, pre-reforms



Source: *Higher Education Funding Policy: Who Wins and Who Loses?*, IFS Commentary No. 98, March 2005
 Note: Missing data point for 1989 due to change in data source

Figure 2. International HE funding, 2005



Source: *Education at a Glance 2008*, OECD

The second reason reflects a growing awareness of the private benefits of going to university: higher salaries, lower unemployment rates, faster career progression, and so on. The argument here is that, in an economic equilibrium, there should be a direct link between the private benefits and the private costs of going to university. In 2007 the OECD estimated that in the UK, degree-educated workers earned around 65% more than workers whose highest qualifications were A-Levels or equivalent; furthermore, the economic evidence suggests that these financial benefits have grown over time.

Nevertheless, despite the increases in fees, the contributions from students and graduates do not reflect anywhere near the full cost to universities. Under the old system, prior to 2006–07, private fee contributions accounted for only 8% of the overall teaching cost. The remaining 92% was picked up by the taxpayer. Even after the introduction of the reforms, which almost tripled the maximum fees payable, the net private contribution is now only around 23%. So HE remains to this day heavily subsidised by the government. Apart from political philosophies, such as paternalism, why should this be the case? Think back to your economics lessons on market failure and you may have an idea.

It is generally accepted that investment in education creates positive *externalities* – that is, when an individual acquires some education, it affects other parts of the economy in ways that he or she may not take into account. There are many potential social benefits of education: higher taxes paid into the public coffers by graduates; productivity spillovers between skilled workers; lower crime rates; a more cohesive, cultured society; perhaps even better health! These are all good things, but if people make educational decisions based only on the private marginal costs (such as tuition fees) and private marginal benefits (such as higher earnings), then the amount of schooling they acquire is ‘inefficiently low’ from society’s perspective. How can the government solve this inefficiency? Microeconomic theory dictates that a subsidy is needed to reduce the private marginal cost of education so that individuals consume more of it.

Even in the absence of externalities, there is still a reason for government intervention in the market for higher education: borrowing constraints. Consider an economy where education was a commodity that you had to pay for up front from your own pocket – no grants, no student loans, no subsidies. How would you finance this investment? You might get some money from your parents or from a part-time job, but the contributions from these sources probably would not be sufficient. You would therefore have to enter the credit market and apply for a bank loan.

But how does the bank know that you will be able to pay back the loan? It doesn’t, and neither do you. The risk of defaulting on the loan depends on your lifetime earnings, which are highly uncertain. You may not have any collateral to secure the loan against – the degree itself certainly won’t count, because it is of no use to the bank. This problem, known as *imperfect information*, means that banks will be reluctant to lend to students, and even if they do make loans, the interest rate may be high in order to compensate the bank against the risk of default. Furthermore, risk-averse students may be reluctant to apply for the loans anyway: debts upon graduation are certain, while the prospects of high earnings are not. Even a slim possibility of insolvency might be enough to deter students from borrowing. Lower borrowing would lead to less investment in education

and qualifications. So, on top of any positive externalities, borrowing constraints may cause people to make educational decisions that are not socially optimal.

The funding reforms of 2004 and 2007 alleviated the problem of borrowing constraints by reducing the reliance on private sources of finance. First, the government now provides a loan equal to the fees, which effectively defers the fees until after graduation and makes university free at the point of consumption. Secondly, additional funds were introduced to cover living costs. Maintenance grants have been reinstated for students from poor families, up to a maximum of £2,835 per year for those whose parents earn less than £25,000. Students eligible for the full grant are also eligible for a bursary from their university if it charges the maximum tuition fee (in 2007–08, these amounted to about £1,000 per year on average). Meanwhile, all students are eligible for a maintenance loan to cover living cost: this varies from £3,365 to £4,575 per year depending on parental income.

Of course, ‘free at the point of consumption’ is not the same as ‘free’, and students will accumulate sizeable debts throughout university that must be repaid later on. Even those from the poorest families can expect to graduate from a three-year degree with a debt of around £19,530 in 2008–09 prices (assuming the full tuition fee is charged in each year). Students from richer families can potentially graduate owing over £23,000.

Surely debts of this magnitude present a formidable barrier to university if students are risk-averse and uncertain about their future earnings? Not necessarily. Even before the reforms, loan repayments were linked to the ability to pay so as to remain affordable: the more you earned, the more you paid back. Additionally, the government subsidised the loan by charging a low nominal interest rate broadly equal to inflation.

These features have been retained in the new system, but are now accompanied by debt forgiveness 25 years after graduation: any unpaid debts at that point are simply written off. Not only might this allay fears about how long students will have to make repayments for, but it also provides an *insurance* mechanism in the case of low future

earnings. If you earn consistently high salaries after graduation you will pay off your debt in full; if you are a low earner, you will make smaller repayments, take longer to pay the debt off and may eventually have some of it forgiven. Indeed, recent IFS research on the distributional effects of the new funding system has estimated that graduates with the lowest lifetime incomes will only pay back around £9,000 on average, due to the interest subsidy and debt write-off; meanwhile, the highest-earning graduates can expect to pay back over £15,000 on average. In addition, the five-year repayment holiday announced in the 2007 reforms means that students can choose to postpone – or take a break from – their debt repayments, giving them extra flexibility.

This article has summed up some of the theoretical motivations and recent policy developments in the way higher education is funded in England and Wales. The system may evolve further as the government tries to meet the challenges of increasing HE participation, broadening the social make-up of university students and maintaining well-funded universities. To that end, an HE funding review is expected at some point in 2009 and will consider further potential reforms. The current system is already elaborate and further tweaks will probably make it even more complex, but while many young people could understandably be baffled by all the features of HE funding, the concepts outlined in this article should leave you well-equipped to analyse the economic merits and consequences of any future policy changes.