

Research Fortnight

The Third Revolution

Part four of a major series investigating how new forms of capital and constitution are set to reshape higher education in England

'A dodgy PFI scheme'

THE OUTSTANDING BALANCE of loans owed to the UK government by graduates currently totals £35 billion. But with tuition fees rising to £9,000 a year in many cases, that figure is going to rise in the coming decades. By 2046, the government estimates it will peak at £191bn in today's prices. This perhaps optimistically low estimate, based on fees averaging £7,500 a year, is nonetheless a truly enormous sum—equal to a fifth of today's bloated, national debt.

For the next generation of students, this huge number just reflects what they already know—that they will end up owing far more than their parents' generation ever did. But for the government, the picture is reversed. The student loan book is set to become one of the UK state's biggest assets.

This valuable asset does not come from thin air. The money to provide the loans has to be borrowed by the government in the first place. To pay for the increase in student loans, the Treasury will be issuing billions of pounds of government securities—gilts—in the coming years. And this all goes to increase the national debt.

So from the Treasury's point of view, student loans have two sides. The student loan book is a welcome asset. But the corresponding gilts it must sell to finance the loans are a worrying liability.

How the government manages these two huge sums is probably the single biggest issue facing higher education in England today. For, quietly in the corridors of Whitehall, the government is actively exploring a variety of options. These in turn have the capacity to feed back into England's higher education policy. Indeed they are capable of determining the shape of the university system.

The impact is already substantial. The need to limit loans in order to keep government borrowing under

This is the first instalment of a three-part article, part 2 on straightforward options for reducing risk and part 3 on monetisation will follow.

4. Loans: long-term costs

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control is the reason given by ministers for one of the revolutions shaking the foundations of higher education—the introduction in 2012 of new controls on student numbers and the attempt to drive down university fees by developing a more competitive market.

But some of the options for the future could make today's turmoil seem like a mere footnote. While it may seem arcane and remote from university life, the management of the student loan book and the corresponding gilts—the macrofinances of the government's new student loan scheme—is in fact now at the heart of higher education policy in England.

Who pays, and when?

Some important decisions have already been made. As ministers have pointed out, the loans scheme they have promised is relatively generous, especially towards low-earning graduates. As a result, it is expected that many graduates will fail to repay their loans within the 30-year term.

The government has estimated that on a like-for-like basis that takes account of inflation it will only get back about 70p for every pound it lends. The other 30p will be written off at the end of the loan's terms. This 30p is the government subsidy on student loans that ministers have so often emphasised. It has to be covered as a line of government spending by the department responsible for universities, at present the Department for Business, Innovation and Skills.

David Willetts, the minister for universities and science, wrote in May that, "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.”²

RAB itself is simply one of many possible accounting conventions. It was introduced in 2001 as the standard method of accounting for all UK central government departments. But its application to student loans has momentous consequences. For in principle, there are three ways—or whens—that the lost 30ps, and the billions they duly add up to, could be recorded by the Treasury in the accounts.

Three ways to account

The simplest—if most fiscally dubious—approach would be to wait for each loan to close in 30 years time. Then the losses would be known exactly and the funds required to make good the loss could be “drawn across” from BIS spending. To labour this crucial point, the losses on the loans would then appear as expenditure in the BIS budget, just as the budgets of the research councils do, and they would create pressure to reduce these other budget lines.

In this case, the loss on 2012 loans would appear in government spending around 2045.

By contrast, the most conservative approach would be to pay for the loss in the year that the loan is made. In this case, the amount of the actual loss would not be known, so money would be drawn across from BIS spending to cover a provision against expected losses. The actual losses could turn out to be higher or lower than the provision, and this could result in extra spending, or a refund, in later years. But if the estimates are reasonably accurate, most of the losses could be covered now.

In this case, the bulk of the write-off on the loans issued in 2012 would appear in government spending in 2012.

This is the approach favoured by the long-term advocate of student loans, Nick Barr, professor of economics at the London School of Economics. “To take a practical example,” Barr explains, “New Zealand got this right in the 1990s and has a sensible system of public accounting. They estimated that 10 per cent of what they lent wouldn’t come back. So for every 100 they lent, 10 appeared as public spending in the year in which the loan was made. And 90 was the financial asset.”

The RAB charge is a middle way between those two approaches. Here, the Treasury will still create a provision for the loans made each year based on estimated non-repayment. But those losses will be covered by drawing across 30 equal, annual instalments over the entire life of the loan. Since about 30 per cent is being lost in total, this means that in each of the 30 years about 1 per cent of the value of each cohort’s loans will be recorded in that year’s government spending.

The upshot is that with RAB, BIS spending on student-loan losses will be very small in the next few years but will continue to rise for 30 years. To understand the dynamic, assume for a moment that the number of students and

the value of loans they take out remains constant each year in the years to come, and that the government only starts to account for the losses of the 2012 cohort of loans in 2016, after the students have completed their degrees. Then the estimated loss of 1 per cent on a year’s loans of, say, £10bn—as estimated by the Office for Budget Responsibility³—equates to about £100 million.

So thanks to lending in 2012, in 2016 the BIS budget would show spending of £100m on the new loans scheme. But in 2017, the figure would double to £200m as losses on lending made in both 2012 and 2013 are accounted for. In year three, the figure would reach £300m, and in year four, £400m. By the time the system reaches operational maturity in year 30 (when, for the first time, we would have 30 1/30ths all together), a “full” RAB charge would have materialised. Spending by BIS, on this, would then be around £3bn a year. If nothing else changes, this would be the annual spend from this point, as new loans are taken out and old loans come to the end of their term.

So what? What difference does the RAB accounting convention make? If we contrast it with the more conservative New Zealand option of accounting for the losses on student loans in year one, then one consequence becomes clear. RAB reduces the budget deficit in the short term. By year 30, the RAB convention and the New Zealand convention would be recording the same amount in expenditure. But over the course of the preceding years, the New Zealand convention would have set aside £90bn, while RAB would only have recorded a little over £45bn.

This discrepancy is most apparent in the early years: with reference to the figures above, by year four of RAB only £1bn would have been set aside against an estimated future write-off of £12bn. So, very little of the cost of the generous package of student support promised by ministers today is scheduled to fall on this government, or even the next. It is a bill that is being left for the next generation to pick up.

An accounting trick

It is this realisation that led the Higher Education Policy Institute to describe the current wave of higher education reforms as being driven by an “accounting trick”.⁴

Neil Shephard, professor of economics at the University of Oxford and an expert on the student loan book, has compared the system to the now widely criticised Private Finance Initiative schemes, popular under the last government for financing the NHS.

“As things stand”, he says, “the proposed loan arrangements have echoes of a dodgy PFI: with optimistic assumptions, they look good when measured in public sector borrowing requirement terms [that is deficit reduction] but are likely to have a high long-run cost.”⁵

Trick or treat, the new system is now being put in place. It is time to consider the momentous consequenc-

es of this, which all revolve around a single word: risk.

One risk is that the actual amounts written off when the loans close in 30 years time turn out to be larger than the provisions made for them. In this case, the government of the day could find itself saddled with a large unexpected bill to pay.

This risk can, in turn, be broken down into several component risks. The government's estimate of losing about 30p on each pound of student loan is based on an assumption that has held good in the past, but whose future is not so certain, that wages will, on average, rise 2 per cent faster each year than inflation. But wages are now rising slower than inflation, and if the fallout for the UK from the credit crunch is a lost decade or two, Japan-style, then this may continue to be true for years to come. If so, the amount of student debt that needs to be written off will rise. This could be called the economic risk.

Then, there are the more prosaic modelling risks. The government's estimates, for example that of a peak student debt total of £191bn in 2046⁴, are based on an average annual fee of £7,500, student numbers remaining constant and 90 per cent taking out tuition fee loans. In addition, it is assumed that 80 per cent of eligible students take up maintenance loans. And there are a host of other arguable assumptions, such as equal numbers of male and female students.

Riskier and riskier

Not surprisingly, many independent analysts now query the government's original estimate of 30 per cent non-repayment, not least because fees have turned out to be higher than the £7,500 that had been planned for.

Hepi has suggested that 35 per cent would be a more realistic estimate.⁴ The London Economics consultancy says 37 per cent.⁶ The Million+ lobby group put it at 38 per cent.⁷ BIS itself used 32 per cent in an impact assessment that accompanied the recent higher education White Paper, *Students at the Heart of the System*,⁸ and, according to Hepi, may have produced a revised figure which it has not yet published.

These variations of around 5 per cent may seem slight but we are dealing with very large sums. If the government shifts from 30 to 32 per cent, Hepi estimates that this would result in an additional £190m of lost repayments. While the institute notes that if the true value is closer to that used by London Economics, then the government needs to allow for an extra £500m a year.

These risks are exacerbated by the design of the loan scheme itself. Using a model of salary paths from the Institute for Fiscal Studies, Nick Barr and his colleague Alison Johnson have produced a model of government receipts that shows a marked bulge at the end of the loan period.⁹ In short, since most graduates only reach high earnings late in their career, it will be decades before the true losses to the govern-

ment on the scheme become clear.

Then there are the known unknowns. The government's scheme of income-contingent repayment loans of up to £50,000 with lifetimes of 30 years is so novel that there is little relevant experience to rely on.

As BIS told Hepi: "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."⁴

London Economics summarised the whole problem of the loan portfolio in its submission to the Higher Education Select Committee in the House of Commons. "Unless there is a fundamental shift up in either the earnings or employment outcomes of graduates in the future," it argued, "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."⁶

The big picture is that government borrowing for student loans is going to account for a growing and eventually substantial portion of the UK's national debt. The losses on this borrowing are in turn going to account for a substantial line of government spending in the years to come. But attempts to estimate the size of the actual losses are beset by many uncertainties. There is a real but unquantifiable risk that the losses will be significantly higher than estimated. And as things stand, future governments, and therefore ultimately the taxpayer, will be responsible for making good any excess losses.

Getting rid of the risk

Two objectives for government policy emerge logically from this situation, and will need to remain in place for decades. First, the exposure to the risk must be limited by keeping the expansion of the student-loan book under strict control. Second, ways must be sought to shift the risk from the shoulders of government onto others.

The options for this risk-sharing role are limited: students, universities or private investors. All are being considered in Whitehall. Meanwhile, the government has already taken steps towards the first objective; controlling the size of the student-loan book.

The two biggest determinants of the size of the loan book are the number of students going to university and the level of fees set by universities. In terms of

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student numbers, the government has always set limits for universities, and in recent years has clawed back block funding for teaching from those institutions that have over-recruited.

But now, the number of students who will have access to loans at each university will be controlled by government. In contrast to the expansion towards unmet demand at the heart of the Browne review's proposals, the government will maintain an overall cap on students and thus set an overall limit on the total annual loan outlay. This overall

number will be reduced by 10,000 by 2012-13 as the additional places created in 2009-10 will be removed.

Although the government's aim is to remove all number controls, Willetts explained in February: "It is simply not possible to remove all controls at this stage because we need to manage government spending."¹⁰

On the level of tuition fees, the White Paper introduced direct incentives for universities to cut fees, and hence the total amount loaned. Today's centrally controlled recruitment allocations will be reduced so as to create a new pool of 20,000 student places. These places have been put out to tender, with only institutions charging average fees of £7,500 or less eligible to bid. Bids will be assessed on quality, price and demand, and results are expected at the end of February.

In addition, low-cost education providers will be allowed to enter higher education, encouraged by looser controls over who can offer degrees and improved access to loans for their students.

Places at such alternative providers will include accelerated two-year degrees and new forms of part-time distance learning. These courses are expected to be cheaper for students and to require less support in loans for both fees and maintenance than full-time, three-year

degrees at established universities. Each place won by such providers from the pool takes away a place from rivals, thus directly replacing a more expensive place with a cheaper option. In addition, this form of competition is intended to drive down prices across the sector especially as the government has announced that it expects to expand the number of places in this pool in subsequent years.

By controlling student numbers and the level of tuition fees, the government can achieve much of the control it needs over the overall size of the student-loan book.

For the second objective—shifting the risk of additional losses off the government's shoulders—there are several options being considered in Whitehall. Some of these options are straightforward, such as shifting students from state loans to private lenders. Some have more transformative consequences. For example, data generated by the student-loan system can be used to measure loan non-repayment rates at individual institutions, and even, individual courses. This could enable the government to reduce the risk of graduates failing to repay their loans by steering universities to set lower fees or alter the courses on offer to improve repayment rates.

The heavy hand of the market could encroach further into the heart of universities, and at a considerable cost to their traditional autonomy.

Other solutions are even more complex and include securitisation, credit default swaps and other kinds of financial engineering—instruments that lay at the heart of the credit crunch. Each one has a different character, and different consequences for higher education. These will be discussed in the next two parts of this article.

Next in The Third Revolution Loans: reducing risk

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