HE Finance: Lessons from the UK

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Summary of UK system

- High average loans for a typical degree
  - 2016 system average loan is around £57,500 (c. $80,000) so very large

- Students pay 9% of all earnings about £21,000 (c. $30,000 US)
  - Repayment rate of 9% one thing that has remained constant in UK

- Interest rate of 0-3% + inflation

- Debt written off after 30 years
  - Proportion of loan debt that will not be repaid depends on number of assumptions but likely to be around 30% but with high uncertainty though more likely to be lower rather than higher
Lesson 1 from UK – Income Contingent Loans work

- ICLs have been running since 1998 and approximately 90% of all students in England take out loans
  - Application is easy (on-line), well advertised by all Universities when they offer place and very high take up rates
  - When apply give your National Insurance (social security) number to ensure subsequent collection/tracing of future graduates is easy
  - EU students get fee loans and have a slightly different but equally easy application process

- When student graduates and gets job, employers deduct student loan repayment each pay period
  - Student loan and social security repayments based Real Time Pay in period cf income tax which is reconciled retrospectively (at end of financial year)
  - CRUCIAL TO HAVE REAL TIME DEDUCTION
Lesson 2 – You need some caps in place

• All the risk from ICL student loans is on government – very little on Universities
  – Same with current US system

• So need to cap loan amount

• When fees increased from £3,000 to £9,000 in 2012 – increased loans by same amount as increase in fees
  – government thought would be variation in fees

• But with ICL’s – no risk to universities of charging higher fees
  – And this is what happened…
Average Fees Charged in England

<table>
<thead>
<tr>
<th>Year</th>
<th>£</th>
</tr>
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<tbody>
<tr>
<td>2012</td>
<td>8400</td>
</tr>
<tr>
<td>2013</td>
<td>8800</td>
</tr>
<tr>
<td>2014</td>
<td>9000</td>
</tr>
<tr>
<td>2015</td>
<td>9500</td>
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<td>2016</td>
<td>9500</td>
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Lesson 3: Need a centralised, simple and transparent ICL system where everybody who needs a loan opts in

- English system successful - virtually everybody opts in (90%)
- Why?
  - Loan terms are very competitive (below almost all alternative forms of finance), require no collateral and ensure students do not have prohibitive repayment schedules
  - Ensure that future career decisions /family formation decisions are not influenced by student debt worries as if in low paid job or taking career break, your student loan repayments are very low or non-existent
  - Easy to apply for –
- BUT NOT PERFECT
  - Abolition of student grants wrong, saves virtually no money, and is where means testing should apply (NOT LOAN SYSTEM)
Lesson 4: If want to impose real interest rate need to write off loans to ensure progressivity

• Since 2012 England has imposed a real interest rate on student debt
  – 3% real whilst they study
  – 0% if left Uni and earn less than £21,000, 0-3% if earn between £21,000 and £42,000, 3% above £42,000

• Interest rate should be higher than government cost of borrowing but lower than alternative market options to ensure everybody opts into scheme
  – This ensures high earning graduates actually pay loan in full quickly
  – Always more progressive to have higher interest rate than higher repayment rates to protect low earners but need to minimise risk of early repayment by higher earners (trade-off)

• Forgiveness/Term of loan – the shorter the term the higher the progressivity of ICL system but less revenue

• Exact design depends on parameters but can design a cost neutral system with social insurance very easily
Lesson 5 – HE finance scheme should be simple, transparent, and stable and future proof

- UK system has seen continual change over the last 18 years
- Too many changes too often......
- Make a system to last – decide parameters which are relatively future proof and which could cope with likely future changes without significant cost implications
  - Have loan length, interest rate, repayment rate(s) so make sure these are future proof
    - Think of clever and flexible ways to specify parameters e.g. interest rate is base rate + x % points; income threshold is y% of median earnings
  - UK system currently suffers as threshold for repayment too high and repayment rate fixed and too low on average for the large loans that are now available
Illustration – UK Style loan in U.S.

• $25,000 loan
  – 10 year mortgage style loan – Interest Rate 4.3%
  – ICL with repayment rate of 10% and Interest rate of 3.8% (lower)

EXAMPLE:

• Low earning female BA Grads in the 20th centile of the earnings distribution (relatively well off)
  – Based on current US earnings (no real growth)
  – Standard economic assumptions
Women in 20th Centile – Lifetime earnings in today's price

Age

$0

$10,000

$20,000

$30,000

$40,000

$50,000

$60,000

$70,000

$80,000
How much of loan repaid?

• Mortgage style loan
  – Even with a default rate of 7% or lower – loans fully repaid in today’s money
  – But average burden of loan over first 10 years of labour market have very perverse labour market and family formation effects

• What about for ICL loan?

• How much repaid? Guess?
  a) 80%
  b) 90%
  c) 98%
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Conclusions

- Income contingent loans work, and have widespread international application

- A well designed system can be:
  - Fully self funding (reduce government outlays)
    - Higher earners pay more than their loan and offset low income students who pay less than their loan (but pay less than under current system as pay back more quickly)
  - Reduce perverse labour market and family formation incentives of mortgage style loans for low earning graduates
  - Better design for ALL graduates (losers banks currently doing loans)
    - All better off in terms of labour market incentives and/or total cost of borrowing in today’s money
  - Simple to administer and have very low default rates due to the fact that the average burden can never exceed repayment rate
References


Claire Crawford, Rowena Crawford and Wenchao Jin (2014) “Estimating the public cost of Student Loans”, funded by the Universities UK

Claire Crawford and Wenchao Jin (2014) “What do the 2012 reforms mean for students”, funded by the Sutton Trust


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English HE finance system – History (not used)

- Had system of ICL since 1998 when up front fees first introduced in 1998
- Originally ICLs just for maintenance but from 2006 available for fees and maintenance
  - Currently available for fees up to £9,000 pa plus maintenance (min £5,200 pa)
- Grants (student aid) abolished in 1998, re-introduced in 2005 and will be abolished again from 2016
- Up until 2012 outstanding debt just uprated with inflation but since 2012 uprated by inflation + interest rate 3% (max rate)
- Debt is written off after fixed time which has ranged from 25 to 30 years (important for progressivity of system particularly with real interest rates)
  - Current proposal to increase to 35 years
- Repayment is at 9% above an earnings threshold which has ranged from £10,000 to £21,000 with no/inflation/earnings uprating
  - Currently £21,000 (likely to be frozen in nominal terms for 5 years)