The future funding of higher education: has the Treasury got the sums wrong?

Pam Tatlow

Regardless of any Liberal-Democrat election manifesto promise, the die for higher fees was cast when George Osborne's October 2010 Comprehensive Spending Review (CSR) adopted the assumption that the public funding of teaching in English universities was a subsidy rather than an investment. In the ensuing and often heated debate about the impact on institutions, students and graduates, of allowing fees to rise to £9,000, surprisingly little has been said about the implications for the Exchequer, the taxpayer and the long-term sustainability of higher education funding in the future.

Accountancy vs economics

The primary reason why Osborne and Vince Cable, the BIS Secretary of State, settled on their approach was to reduce departmental spending - in other words, the planned Departmental Expenditure Limit (known as Resource DEL). The university teaching grant is counted directly within the Resource DEL, while *only* the estimated 'Accounting and Budgeting (RAB) charge' of student loans is counted within the DEL – in other words only the charge associated with the costs of providing these loans, taking into account repayments and write-off costs.[1]

Substituting tuition fee loans for the teaching grant will reduce BIS departmental expenditure by approximately 74% in the future. For example, if the RAB charge is approximately 26% and £2.8 billion of new fee loans are issued to replace a £2.8 billion reduction in teaching grant, the Department's Resource DEL falls by £2.072 billion per annum compared to the current DEL. In *accountancy* terms, the Osborne-Cable strategy achieves a reduction in departmental spending; however, given the changes to graduate repayments, this will be significantly less than the 74%. Furthermore, in *economic* terms this spending will simply be replaced in the future by borrowing, which has its own economic cost.[2]

1 The actual volume of new student loans issued is included within the Capital Annually Managed Expenditure (AME) item of the Departmental accounts (termed a financial asset)

2 The value of the new financial asset (i.e. new student loans) may be significantly lower than might currently be estimated when adopting the historic value of the RAB charge (approx 26.1%). The Department is committed to reviewing the estimate of the RAB charge if the estimate appears no longer to be accurate in estimating the level of interest rate subsidy or loan write off. Unless there is a fundamental improvement in either the earnings or employment outcomes of graduates in the future, 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.

£13bn added to public sector net debt

There has been very little Parliamentary discussion about the requirement for this additional borrowing even though the independent Office of Budget Responsibility estimated in November 2010 that increasing tuition fees would require the Government to borrow £10.7 billion to fund student loans in 2015-16 compared to the £4.1 billion it borrowed in 2010-11. According to the OBR, these higher cash requirements will cumulatively add £13 billion to public sector net debt by 2015–16. The OBR's calculations took no account of the increased costs arising from last-minute concessions made by the Government prior to the House of Commons vote on fees in December 2010. These are likely to further increase the Treasury's borrowing requirement. Interestingly, the OBR did not adjust its November forecasts in March 2011 in spite of the fact that many universities have said that they intend to charge the maximum fee of £9,000 per annum in 2012 (rather than the £7,500 that BIS had banked on). This suggests that the OBR expects the Government to cut student numbers rather than stump-up the extra borrowing required to fund higher fees.

Student numbers, economic growth and tax receipts

A cut in the number of students would mean a decline in the number of those qualifying with graduate qualifications in the future, raising questions not only about the credibility of the Coalition's reform of higher education funding but also about the Government's understanding of the link between graduate qualifications, economic growth and tax receipts.

Risks to demand

So far, Osborne and Cable have said very little about the impact of the fee increases (albeit part mitigated by subsidised fee loans) on the wider economy. As an economist, Cable will appreciate that the most fundamental laws of economics suggest that, all other things being equal**,** tuition fee increases will result in a reduction in the quantity of higher education demanded. The extent to which demand will fall is a key issue. However, the elasticity of student demand – in other words the sensitivity of the market to price increases – was recently assessed[3]. The Institute For Fiscal Studies (IFS) concluded that an increase in tuition fees by £1,000 per annum – holding all other factors constant – would be expected to lead to a 4.4 *percentage point* decline in participation. The IFS also estimated that a £1,000 per annum increase in loans increases participation by 3.2 percentage points but that;

> *"a £1,000 increase in loans or grants is not sufficient to counteract the impact of a £1,000 increase in fees – the coefficient on fees being significantly higher than both loans and grants.'*

3 Dearden, L., Fitzsimons E., and Wyness, G. (2010), "The impact of the 2006-07 HE Finance reforms on HE participation", Department for Business innovation and Skills Research Paper Number 13, September 2010

In a nutshell, the higher fees in 2012 which are an inevitable consequence of Osborne's decision to withdraw taxpayer investment from university teaching, pose a real risk to demand.

Will the Exchequer be worse-off ?

The graduate earnings premium has been used by a succession of Ministers in the previous, as well as the current, Government to justify the introduction of graduate contribution systems. What is good for graduates is also good for the Treasury. It is not clear whether and how the Treasury and BIS have factored in the well-documented evidence of the net *Exchequer* benefit associated with undergraduate degree level provision[4]. Based on research commissioned by the Royal Society of Chemistry[5], this stands at approximately £81,875 (per graduate) overall in 2010 constant prices. If the IFS conclusions about the impact on demand of higher fees are correct, the total economic loss to the economy from the reduction in the number of graduates could be as much as £3.72 billion per annum in present value terms. Incorporating these wider economic impacts into the analysis implies that rather than the 2012-13 tuition fee and student support changes making the Exchequer *better off,* once the wider future taxation effects are considered, the Exchequer will be more than £2 billion per annum *worse off* in the future.

Public investment in education supported by OECD

The strong economic arguments in favour of the continued funding of undergraduate degrees by the Treasury, even at a time of austerity, was endorsed by the Organisation for Economic Co-operation and Development (OECD) in 2010 which concluded that;

> *"public investments in education, particularly at the tertiary level, are rational even in the face of running a deficit in public finances. Issuing government bonds to finance these investments will yield significant returns and improve public finances in the longer term.[6]"*

The decision to withdraw taxpayer investment from higher education teaching in English universities is therefore highly questionable.

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4 The **gross Exchequer benefit** represents the present value of the benefits to the Exchequer associated with the provision of an undergraduate degree relative to an individual in possession of 2 or more GCE 'A-Levels'. The present value of the Exchequer benefits associated with a degree are characterised by the enhanced tax, National Insurance and VAT paid by an individual over their lifetime relative to possession of 2 or more GCE 'A-Levels' in present value terms. The **net Exchequer benefit** is the gross Exchequer benefit minus the present value of the Exchequer costs associated with funding a degree. These costs include the direct costs (such as HEFCE funding and student support) and indirect costs (foregone taxation receipts during qualification attainment).

5 Royal Society of Chemistry and Institute of Physics (2005), 'The economic benefits of higher education qualifications', a report produced by PricewaterhouseCoopers LLP, January 2005

6 OECD *Education at a Glance 2010*

Whatever the wider benefits of higher education to society (and there are many) there is no sound *economic* case for the wholesale withdrawal of direct taxpayer investment from higher education teaching. On the contrary, the short-term 'gains' pursued by Osborne and Cable to reduce the Departmental Expenditure Limit appear to be little more than a mirage which obscures much higher net borrowing and future losses to the taxpayer. Being clever with the accounts is no substitute for taking an economic view of what counts and the current plans are unlikely to provide a sound basis on which to either build the economy or secure the future long-term sustainability of higher education in England.

Pam Tatlow *is Chief Executive of the university think-tank, million+ and has worked at a senior level in education, health and public affairs*

million+ *engages in advocacy and publishes research and analysis with the aim of ensuring that individuals from every walk of life have opportunities to benefit from access to universities which excel in teaching, research and knowledge exchange*