HOUSE OF LORDS

Select Committee on Economic Affairs

Corrected oral evidence: The Economics of Higher, Further and Technical Education

Tuesday 24 October 2017

3.30 pm

Watch the meeting

Members present: Lord Forsyth of Drumlean (The Chairman); Baroness Bowles of Berkhamsted; Lord Burns; Baroness Harding of Winscombe; Lord Kerr of Kinlochard; Baroness Kingsmill; Lord Lamont of Lerwick; Lord Layard; Lord Livermore; Lord Tugendhat; Lord Turnbull.

Evidence Session No. 3 Heard in Public Questions 22 - 30

Witnesses

I: Dr Andrew McGettigan, freelance writer and researcher on higher education policy; Dr Gavan Conlon, partner, London Economics.

Witnesses

Dr Andrew McGettigan and Dr Gavan Conlon.

Q22 **The Chairman:** Dr McGettigan and Dr Conlon, welcome back to the Economic Affairs Committee.

At the time of the 2012 reforms, over half of graduates were expected not to repay the full amount of their loan. Should it have been anticipated that the reforms would not lead to price competition?

Dr Gavan Conlon: The answer is yes, but in some respects it has nothing to do with the loans being provided, and it is not about 2012 either. If you go back to 2003 when differential fees were mooted—they were introduced in 2006—Ministers were told explicitly that there would be no price competition with the £3,000 cap. Essentially, that information was not believed and, lo and behold, when in 2006 fees were raised to £3,000, because of the availability of loans to back that up, every institution in the country chose £3,000. Even with hindsight, in 2012 the exact same policy was rolled out—£9,000 fees backed by government loans—so there was no incentive for universities to charge anything other than £9,000. Any institutions that did were quickly punished, essentially, and in subsequent years they charged £9,000. Institutions were incentivised to charge £9,000, and the government loans facilitated their charging £9,000.

The Chairman: Do you agree with the president of the Higher Education Policy Institute who said that the removal of the cap on student numbers was a "final and desperate attempt to create a market in higher education where there has been none so far"?

Dr Gavan Conlon: There is an element of truth in that. It is a sanctioning device. Removing the student cap is a sanction on institutions, in that they are subject to the demand of students for particular courses at particular prices. Calling it a last—

Dr Andrew McGettigan: I would read it slightly differently, but perhaps you should finish and then I will come in.

The Chairman: Before you do that, Lord Burns wants to come in.

Lord Burns: You said that those who did not charge the full rate were punished. Could you describe a little more how they were punished?

Dr Gavan Conlon: In economic terms if there is a lack, say, of information signals in the marketplace about the content of a good or service, price acts as a signal of quality. In a situation where there is more limited information about a particular good—say, a university qualification from a particular institution—many qualifications appear similar to students.

Lord Burns: Did it directly lead from that, or did they actually get poorer applications?

Dr Gavan Conlon: I cannot speak about the quality of the applications, but I am sure there is an element of that. Institutions that charged less than £3,000 initially were considered to be offering a lower quality qualification.

Lord Lamont of Lerwick: Consumers, if I can use that word, have to make lots of complicated decisions in life. Price is not always the only indicator, and sometimes they have to make a bit of a guesstimate about quality. How do you think real competition could be combined with this system? What could be done to get proper competition?

Dr Gavan Conlon: If your policy objective is to achieve proper competition, the component of the fees and funding system that facilitates institutions charging the maximum fee is the availability of fee loans to allow students free higher education at the point of entry, so that the loans back up the fees. For instance, if we thought it a sensible idea to reduce the nominal fee by £3,000 or £4,000, that would have a minimal effect, because individuals would still rack up £30,000 to £40,000 of debt on graduation. Anybody in the lower half of the income distribution would repay for 30 years but they would never repay the loan. Loans are very important in facilitating institutions charging the maximum price at the moment.

The Chairman: Dr McGettigan, can you remember the question?

Dr Andrew McGettigan: I think I can. I would reiterate what Gavan has just said about price competition. Once you have an income-contingent loan, the headline tuition fee is not a price, because the cost of study is your loan repayment. Loan repayments are determined mostly by future income. A typical graduate, whether they graduate with £40,000 of debt or £49,000 of debt, because they have gone to an institution that charges £6,000 or £9,000, will see no difference in cost unless they are in the higher deciles of the income distribution. That means you have a problem. It is not that it is not price sensitive; it is not really a price at that point.

Lord Burns: But prices can change.

Dr Andrew McGettigan: The price is determined by your income. Because you are also taking out maintenance loans—if we did not have maintenance loans we would be talking about something different—you are talking about the difference in graduating with £40,000 or £50,000, and you will only see a difference in future loan repayments on that basis if you are a higher earner. In that case, you might say, "It is better for me to go to a higher-charging institution because it increases my likelihood of becoming a higher earner". The consumer cannot respond to the tuition fee as a price and should not be expected to. In that sense, if you want price competition, you have a problem with an income-contingent repayment loan with a large subsidy built into it.

I have a slightly different take on the history of the policy. In 2012, the expectation was that there would be a new tier of higher education providers coming in and charging less than £6,000. Students at those alternative providers would have access to student loans up to £6,000. Those new providers would deliver what we understand to be classroom subjects: law, business and other subjects that can be taught at a cost base under £6,000. The expectation was that they would be allowed to expand rapidly. They would have no caps on recruitment initially, and that would provide competition for the established provision. In that sense, 2012 was a transitional market, a bit like the break-up of a public sector monopoly. You maintain the recruitment caps on the established provision; you allow insurgent challenger institutions to come in without caps, and they are deliberately encouraged to charge less to produce price competition that was not there before.

That competition never materialised because, by and large, the most aggressively expanding alternative providers went to wholly new constituencies. They recruited a completely different kind of student. We might call that a subprime market; they went to communities less familiar with higher education. They went for a different audience, so they did not put downward pressure on the established provision.

That did not work—to come to the last gasp issue. We could not create that kind of market pressure on price, and we had to consider the other aspect, which, in neoclassical economics, is that, if you have unmet demand, you will not get price competition, so you take the caps off established universities and expect them to compete with one another, but initially the established universities were deliberately restricted in how they could respond to competition. There was only a very limited amount of leeway, which was the ABB policy. It is perhaps not necessary to get into the detail of that, but it was not seen to work, so we get a different approach to competition. Fundamentally, you cannot have price competition now with the kind of loan subsidy we have built in. That loan subsidy is now much higher as a result of the repayment threshold being increased.

Lord Burns: Does this mean that Lord Adonis is wrong to say that the fact that everybody charges the same is evidence that there is a cartel among major universities?

Dr Andrew McGettigan: Yes.

Dr Gavan Conlon: There is no cartel. It is economically rational.

Dr Andrew McGettigan: It is not a cartel.

Baroness Kingsmill: Why is it not a cartel? It may be the most rational behaviour and they may not have colluded with each other, but it can still be a cartel.

Dr Gavan Conlon: If they have not colluded with each other it is not a cartel. There is a strict definition. It is an egregious breach of competition law to engage in cartel activity.

Lord Burns: You are arguing that it is the income-contingent loans that are causing prices to be the same, not the fact that they are operating as a cartel.

Dr Gavan Conlon: It is the existence of income-contingent loans that meet the maximum fee allowed by government. That is causing it. The conditions are being put in place for all institutions to charge £9,000, but because of the issue of information points, a secondary market is in play among higher education institutions where they compete for bursaries and fee waivers. They charge £9,000 and they have to make a contribution, or a deduction for bursaries, to OFFA, as a result of the access agreement, so there is some degree of competition about who can offer the most discounts. They are two completely different issues.

Dr Andrew McGettigan: There are submarkets in higher education. There are selective universities and there are universities that take the students they can get, but they are all charging £9,000, because in the end what would you be doing? If an institution charged £7,000, it would be saying that for every student it got it would be resourced £2,000 less per year, per student, which is an enormous sum. They would be making a decision to give those students less resource and, therefore, most likely a worse experience, and those students would see no difference in the repayments on their loans, because the difference between £7,000 and £9,000 is a difference of £6000 and a bit more for interest on graduating debt, and that will not cash out in the repayments. They would only see it if they went on to become a very high earner. We could argue that they would be more likely to become a very high earner if they had been to an institution that put in more resources in the first place. It is a bit of a roundabout expression, but that is the issue of whether or not you have a price. We have competition for students but we do not have competition on price, and in a certain sense you should not expect it at the moment.

The Chairman: They are no more a cartel than the pigeons in Trafalgar Square when grain is thrown in front of them.

Dr Andrew McGettigan: I do not mind answering the second question. If you want competition, you have to realise that you have a market where there is almost no switching, and where people are making a one-off purchase; the first choice they make about where to go to university removes their right, for the most part, to have any further loan on their studies. For the most part, you are asking people, at 17, to make decisions that are very committing. If you want something like competition, you will have to address that structural problem. You will also have to address the problem of credit transfer and modular provision, to allow people to switch between institutions more fluidly, and allow them to utilise what is provided by the state at different periods in their career. That is a much bigger challenge for competition.

Lord Lamont of Lerwick: Was the whole idea of competition there originally, at the very beginning of the student loan scheme, or was the idea to make people aware of the cost of their education, to make a comparison between that and their likely future earnings and take that into account?

Dr Andrew McGettigan: In the transition from pre-2012 to 2012, it was very important for the principle of the scheme to move towards what was, effectively, a voucher model. The money follows the student, and in a sense there is no up-front fee. There is a voucher with an unclear subsidy. The level of the subsidy in the voucher depends on future earnings. I think that was the deliberate intention.

At the same time, there was a strong preference to create a market in higher education, because the people behind it wanted something very different from any form of central planning, with any role for politicians to say, "This is the kind of provision we should have", or any sense that they know better than the consumer. There was a very strong sense in the design that you wanted a market because you would allow the choice to follow the student. Popular institutions would expand and less popular ones would contract, and, because of that mechanism, quality would out.

In the Browne report, it is very clear that competition is the rising tide that lifts all boats. There would be competition on quality and on price. Obviously, there was a value-for-money vector. It would be cheap and cheerful, or expensive but worth it. In the contours I have set out, that was the aim. I have no doubt about that.

Lord Kerr of Kinlochard: Surely, the abolition of maintenance grants has increased the problem for the 17 year-old. The idea that the loan has got much bigger means that living at home probably becomes more attractive. That diminishes competition in its effect, does it not?

Dr Andrew McGettigan: In one sense, you should say, "What is the deal?" There is a certain amount of cash on the table and you have committed to repaying 9% over £21,000, or 9% over £25,000, against what you have borrowed. If you have more cash, you might argue that it does not make much difference.

Lord Kerr of Kinlochard: It does not make much difference, but does the student perceive that?

Dr Andrew McGettigan: It is not perceived that way. That is what I was going to say.

Dr Gavan Conlon: If the removal of maintenance grants results in individuals being more likely to live at home, it certainly gives local institutions more monopoly power. One thing that was very intentional with the removal of maintenance grants in 2016-17 was that proportionate increases in maintenance loans were made available, but whether somebody is graduating with £50,000 versus £55,000, or versus £59,000, makes no difference. With the £25,000 threshold, 83% of borrowers will never repay the loan, so it makes make very little difference if it is £50,000, £45,000 or £40,000 on graduation.

Lord Kerr of Kinlochard: I am not sure that a 17 year-old quite perceives it like that.

Dr Gavan Conlon: Absolutely.

Dr Andrew McGettigan: You have also effectively created a tax on social mobility. Those from less wealthy backgrounds who go on to become very high earners will have higher loan borrowings, and will repay more than their peers on the income decile down the line; effectively, they will have an additional tax burden because they came from a poorer background. Because they have been socially mobile, they will have been taxed more. In some sense, that is not what the borrower sees at this stage. When we talk about these figures, we are making projections and modelling the policy, but a recent graduate does not know in which income decile they will be. What they see is the debt and the interest. We may have a tendency to talk about the real impact, which is the repayments, and the psychological effect.

Q23 **Lord Kerr of Kinlochard:** Paul Johnson told us that because there was not an effective market there was a need for a root-and-branch review—"a serious review". The Prime Minister told us at the party conference that there was going to be a major review of higher education. Jo Johnson told the House of Commons a week later that the system was kept under constant careful review and more detailed information on what is proposed would come out towards the end of the year. Do you think there is a major review going on?

Dr Gavan Conlon: It depends on the scope of the review. There may well be a review, but are we talking about the entire regulatory framework or just about higher education fees and funding? Are we talking about higher education fees and funding and what has not been talked about, which is vocational education and training, school funding, sixth-form colleges and wider sixth forms? The question is about the scope of the review. A lot of issues need to be ironed out. It is not just about fees or grants; it is about the payment mechanism—the income-contingent loan repayment. Is there going to be a review? I do not know.

Lord Kerr of Kinlochard: Do you think there should be?

Dr Gavan Conlon: So many changes have been made to the student loan system, which is already very complex, that my concern is that the review will say that we need to differentiate on price, by institution, subject or whatever it might be. At the moment, for student loan maintenance there are four home nations and five domiciles—England, Wales, Scotland, Northern Ireland and the EU—and full-time and part-time students.

Dr Andrew McGettigan: And sub-degrees.

Dr Gavan Conlon: There are sub-degrees. We have undergraduates and postgraduates. Every time, something changes. We have just raised the threshold to £25,000. The Student Loans Company in Glasgow must be in a state of shock.

Dr Andrew McGettigan: There are also people who have pre-2012 undergraduate loans for their undergraduate degree and post-2012 loans for their PGCE. Maybe I will not have to explain it, but they have two different thresholds, one at £17,775 and one going up to £25,000, and it is very unclear to them what is going on with their loans.

We have high fees, high debt and high interest. Optically, that is what all the concern is about; that is what the press has concentrated on in the last few years, and what we get is movement of the repayment threshold. That will make a difference. Almost all borrowers will benefit from it. As regards the technocratic position, it is much better; it is not regressive in the way cutting the interest rate would be.

Politically, it is terrible. Most people would say, "What is the point of loaning lots of money to people, charging interest on it and then writing off that interest and the original debt? Why not make fees smaller in the first place?" The review might be looking at interest rates. I suspect it is doing something different, but if there is no review we will have a system that is confusing for people. I am not sure of the rationale behind many of these things. We have a series of piecemeal changes that do not add up to a coherent design.

I suspect there is a review about recognition of the fact there is no price competition. What will be reviewed is the imposition of price differentials, whether by subject or by institution. You can limit fees, but the other thing to consider is that you can limit how much you loan to people. We have already established in the system, through the alternative providers, a scheme whereby the institution is allowed to charge what fees it likes but there are student maintenance loans of only up to £6,250 per year, under the current iteration. You do not have just fees to consider; you have the issue of whether you are going to be the lender to cover all those fees.

To throw another thing into the mix, the Browne review proposed that access to loans would be determined by a minimum UCAS tariff—the grades people have—set every year. Those above the entry tariff on their qualifications at A-level and equivalent would be able to access loans. That was a recommendation of the Browne review. Michael Barber, who was involved in that review, is now head of the Office for Students. I suspect that those kinds of things, which were rejected as part of the scheme, are now being looked at again.

Fundamentally, the issue for the Treasury is control of loan outlay; it is not so much control of fees. If someone has a place at an approved university, established universities have a right to the fee that covers the maximum.

Q24 **Lord Tugendhat:** Do you expect there to be a cut in the maximum fee for some universities, and would you welcome that?

Dr Andrew McGettigan: It depends on whether you are proposing to restore resource through some other mechanism, such as direct grants to institutions. We have a funding scheme that works very well for Oxford, Cambridge, LSE and a few other highly selective institutions that have very good capture of the job market, if I may put it like that. We have a loan scheme that makes no sense for the vast majority of undergraduate borrowers. If you take a punitive line, which is my interpretation of Lord Adonis's view, you would say to some institutions, "You are not good enough to charge £9,000". I would be completely opposed to that. Those are institutions that need a different kind of direct funding. If we think they are the institutions that are doing the most for social mobility, and the most work on widening participation, we should restore direct grant to enable them to lower their fees, but perhaps that is not quite what you are suggesting.

Lord Tugendhat: You have expressed quite clear views about variable fees for subjects, depending on whether they are classroom or laboratory subjects. Can you repeat your proposition?

Dr Andrew McGettigan: Under the pre-2012 funding scheme, institutions had different per student funding, depending on what subject they were studying. For a classroom subject, they had about £2,700 per person as a direct institutional grant, and then they charged £3,300, which added up to about £6,000 per year per student. Laboratory subjects had a higher level of resourcing, up to about £7,000.[1] The point is that, by setting the maximum cap at £9,000, overnight there is a resource surplus. The classroom subject was previously getting £6,000; it can now get £9,000. You might be inclined to look at the old figures, which were based on the cost of provision—it would cost this much to teach—and suggest that the maximum fee should be set lower for what used to be called band D subjects. They are basically classroom subjects: some social sciences, humanities, law, business and economics.

Lord Tugendhat: Within university administrations, do you feel that issues of prestige, seniority, weight in the faculty and that sort of thing would make it difficult for universities that teach a wide range of subjects to differentiate in this way?

Dr Andrew McGettigan: I am not sure I understand the question. At the moment, if you have a wide range of subjects, you may be getting the benefit of cross-subsidy from the classroom subjects.

Lord Tugendhat: In a university that teaches a variety of subjects, from archaeology to zoology, obviously each faculty believes that it is the most important one, or a very important one. I remember that Dr Leavis at Cambridge used to say that English was the most important faculty at Cambridge. Different people have different aspirations, and it might be difficult to charge less in Dr Leavis's faculty, for instance, than in a scientific faculty, even though the costs are quite different.

Dr Gavan Conlon: I would not have thought that academics would stoop so low as to be ranked from 1 to 10 in the most expensive and the cheapest courses within an institution. If there is ever variation in fees

[1] Note by witness: c. £7,250 was the pre 2012 figure for 'Band C' subjects; those in Band B were resourced up to nearly £9,000 in 2011/12.

charged by subject, it is for the individual institution to massage the egos of the relevant people who have had their nose put out of joint.

Lord Kerr of Kinlochard: To come back to competition, will the introduction of the teaching excellence framework or the Office for Students make any real difference in creating transparency and hence competition?

Dr Andrew McGettigan: My personal feeling is that the teaching excellence framework is meant to be an alternative synthetic signalling function. Gold, silver and bronze are easy for students to understand. If there is no price signal, create another signal that is meant to be related to teaching quality. It has a vast amount of metrics feeding into it and it is presented in a very simplistic, if not simple, fashion to the would-be consumer. That is how I have always understood the purpose of the TEF.

The Office for Students is a separate matter. My sense is that it would have been seen to be successful if a wholly new kind of higher education provider had come into the country. Maybe there are three kinds in mind. One would be, say, a US or Chinese university operating in our system where students have access to our loans and they have access to our grants. Another could be that a very large multinational gets a fast track to set up a university—Google, Facebook or DeepMind. They have access to grants and their students have access to loans. Alternatively, something like a private equity company comes along and says to a business school that is unhappy that all of its surplus fees are being used to cross-subsidise laboratory subjects that it will spin off the top 10 or 20 professors and set up its own company; the company can keep its surpluses and set salaries where it wants.

My sense of the Office for Students is that, in particular, the regulations around the fast track to probationary degree-awarding powers and the achievement from zero to university title in five to seven years are all designed to tally with return on investment cycles. There is other stuff going on, but the real point of the Office for Students is to bring in a new kind of competition that looks nothing like the alternative providers that came in in 2010 and 2015, which went the wrong way and did not provide anything new and innovative.

I know there are questions about the different aspects of regulation, but if the Office for Students was successful, we would see inside our system a completely different kind of entity. The issue people should be aware of is that an institution does not have to be based in the UK tax system for its students to have access to loans. It can be for profit, and based overseas for tax purposes. We already have in our system the means by which something new is about to happen.

Q25 **Lord Layard:** I wonder whether we can go into the arcane question of the RAB charge. Could you explain to us exactly how it works, and when it enters the public deficit, for example? Related to that, how does the notional debt service that is occurring appear in the government accounts? Moving on from that explanation, could you give us your comment on the effect of the target RAB charge on the exposure of the Department for Education budget and so on?

The Chairman: Perhaps you could deal with it briefly.

Dr Andrew McGettigan: Fundamentally, we are talking about departmental accounts. The RAB charge does not enter national accounts. Departmental accounts are accruals accounts, so when a commitment is made, that commitment has to be recognised in the accounting. National accounts are cash in, cash out, so the RAB charge technically never appears in the national accounts. You may want to come back to me with questions about what happens in the national accounts afterwards.

The loans are loss-making, and known to be so when issued. They are, therefore, impaired. The face value on the loans does not match what you think you will get back in net present value terms. The RAB charge is merely a recognition that there is a loss and that the loan outlay is greater than the equivalent value of repayments today. The RAB covers that impairment on the loans issued in-year.

On loans issued last year, the impairment was thought to be 29% of face value, so for every pound you issue, you expect to get back the equivalent of 71p. You will lose 29p in the pound. The RAB charge covers that 29%, and that is set aside as a provision in the departmental accounts. The RAB is an allocation as well as a charge, so at spending reviews the DfE, as part of its budget, is given an allocation to cover the loan impairment and it utilises that each year. The question then is whether there is enough RAB allocation to cover the RAB charge. Effectively, the RAB charge is just the accounting, budgeting name; it means "Resource Accounting and Budgeting" [RAB] charge to recognise the fact that the loans you are issuing are not worth their face value.

The RAB charge is used to top up an impairment pot. You track the value of the loans. Say the face value of the loans is £89 billion as at 31 March 2017, and you think they have a carrying value of £61 billion. The impairment of £28 billion is the difference between the face value and the fair value, and each year that changes. You have utilised the provision for write-offs et cetera, but each year when you issue new loans, you put the anticipated impairment into that provision. Effectively, the RAB charge is the expected impairment on loans issued in that financial year.

Lord Turnbull: From the current point of view of the department, it runs two kinds of programmes. It deals with nursery schools, schools, sixth-form colleges and so on, and it has a budget for that. Then it has the RAB charge. I do not know how on earth you manage that if something happens. You may not have done anything different from what you previously expected, but someone changes a number somewhere and the RAB charge goes up. Does it make any sense to say to the department, “That means your budget is costing more on the higher education side, so you have to do less on all the other things you do”?

Dr Andrew McGettigan: Projected graduate earnings would be an example of a change. You are making projections 30 to 35 years into the future. You have a model of what you think graduate earnings are going to look like, and if those projections or other macroeconomic variables change, the cost of your scheme changes.

Lord Turnbull: How on earth can you run a department where changes in that can cause changes in everything else you do, which you are controlling month by month?

Dr Andrew McGettigan: The RAB allocation and the charge are, effectively, in a ring-fenced part of the expenditure limit, and you cannot use that resource to cover anything else. You have been allocated the RAB—the last time the RAB allocations were made was 2016—and it turns out in 2017 that you do not have enough. You have to have a conversation around the supplementary estimate process about whether you should have more to cover it. Some of these things are not in the control of the department. I think that is the thrust of your question. In that case, you have a negotiation saying, "That is not in our control; we cannot control bank base rates, for example, which affect the value of the pre-2012 loans". The departmental accounts are the means of control; that is where control over the loan scheme occurs. You are given an allocation and you utilise it. What happens when conditions in the world have changed so that the loan scheme looks much more expensive than it was? That relates to the target impairment. I think that was the original question.

I am not clear that the target RAB works in the way it did in 2014-15. Things have changed, and it is not entirely clear what the rationale for those changes is. The target RAB is the point at which negotiations stop, and you trigger a rules-based budgeting reallocation. The target RAB is currently set at 36%. This conversation has to take place in parenthesis at the moment because the RAB charge will change dramatically because of what has been announced. At the moment the target RAB is 36%, and the RAB was 29%. Should the RAB go over 36%, it triggers a completely different process: access to annually managed expenditure; 29/30ths of the excess RAB go into that special facility, and you have to find a 30th of whatever is in that facility from your other cash allocations. The point is that there are negotiations. When you go above the target RAB, the negotiations stop and the rule-based system comes in. You have to find the cuts from elsewhere, but it is only a 30th of the excess, or the shock, that you have utilised in annually managed expenditure. I can put this in a written statement.

Lord Turnbull: I understand your explanation. What I cannot understand is why it makes any sense as a way of controlling a government department.

Dr Andrew McGettigan: There is a certain incentive. You are putting the ball back into the Department for Education. This was developed in BIS. It makes a difference, because BIS's budget was much smaller and the student loans are a much bigger part of BIS's budget proportionately.

If the facts on the ground change and you want to persist with a loan scheme that supports £9,000 tuition fees and maintenance loans, and you have varied from the projections behind the original design of the scheme, effectively, you are required to find savings elsewhere.

The way it was described to me when I met the Treasury HE team back in 2014 was that the introduction of the target impairment and the allied budgeting process was designed to incentivise BIS to think about its priorities, and to recognise that it could not absorb the impact of the macroeconomic shocks from within its budget, but it still had to be incentivised to do something.

The Chairman: Does that answer your question, Lord Layard?

Q26 **Lord Layard:** I want to move to the other issue of where this appears in the national accounts. The loan does not count as government expenditure.

Dr Andrew McGettigan: No.

Lord Layard: But at some point part of the loan is written off.

Dr Andrew McGettigan: Yes.

Lord Layard: Does that count as government expenditure, and when does it count as government expenditure?

Dr Andrew McGettigan: The loan outlay and repayments are not classified as expenditure and income, which is what you might expect. Instead, what is recognised as income is interest receivable, so interest accruing is recorded as income, and that benefits the deficit today. You can write off a loan account because of death and disability, which happens every year; or you can have a policy write-off—30 years after repayments first fall due, there will be a write-off—and that counts as capital expenditure. On the income and expenditure side of things in the national accounts, interest is accruing; it is capitalised interest and that is income. Thirty years after repayments first fall due, you look at the nominal balance you are writing off, and that is capital expenditure. The net position between income accruing and the write-off in cash terms is the loss on loans. That looks unexpected, because you would think that the loss on loans is loan outlay minus repayments, but because of the accounting identity, it is exactly the same thing as interest receivable minus write-off, or the other way round, depending on whether you are making a loss or a surplus.

That is unexpected, if not bizarre, because we know that the interest accruing is very unlikely to be repaid, so we are scoring the receivable as income before we have necessarily received it, and we anticipate that we may never even receive it.

That is a way to recognise the fact that we are issuing a loan. With a normal loan, it makes some sense. You record your interest receivable as income, your loan is paid off and there is nothing to write off; and the cash surplus you have made on the loan, ignoring for the moment the cost of borrowing, is the income receivable.

In a way, that makes sense for pre-2012 loans as well, because there is very low interest. The interest rate on pre-2012 loans is only 1.25%. You are expecting write-offs to be much lower, so there will not be an enormous nominal write-off at the end of the loan period. With these 2012 loans, particularly now we have raised the repayment threshold to £25,000, the effect will be that deficit is flattened for all the years up to when the write-off occurs, and when it occurs there will be a big hit as capital expenditure. If you use something like the current balance as your deficit measure, you do not even see the expenditure.

But none of this has cash implications.

The thing to grasp is that you have recorded the loss on loans by recording those transactions as income and expenditure, but when you write off the student loan account there is no cash implication. All the cash transactions have already happened when you loaned the money and the repayments came in, so the expenditure will not require you to borrow money to affect public sector net debt at that point.

There is a standard story about the relationship between the deficit and the debt. Each year's deficit adds to the stock of debt. That does not happen with student loans, because with student loans the driver of change in debt is public sector net cash requirement, not the deficit. If you want to follow the impact of student loans on something like the public sector net debt, you have to follow the cash transactions.

It is an unusual way of doing things, but that is partly the problem of using a cash in, cash out system rather than an accruals system for national accounts, and partly to reflect the fact that you want to capture that you are using a loan—creating a financial asset and using financial transactions—and therefore you do not want them to be treated the same way as current expenditure.

Lord Layard: From the Government's point of view, it is a wonderful presentational device. You lend loads of money to somebody, and the first thing to happen is that it does not appear and nobody hears about it. Next, the deficit is reduced by the attributed interest, and finally there is big capital expenditure in 30 years' time, which is much better than now. This is very material to the possibility of reforming the system. It is so presentationally advantageous to the Government to preserve it this way round that anything more realistic would be almost bound to look worse.

Dr Andrew McGettigan: You have to be wary of the distorting effect of student loans in the headline statistics. It is not so much a problem with the national accounts.

Lord Layard: I mean the government accounts.

Dr Andrew McGettigan: It is a problem with the statistics and the fiscal mandate. You are targeting headline statistics, and their composition matters. Student loans have an increasingly significant distorting effect on those statistics. It is perhaps not so much a question of reforming national accounts as taking a step back and realising the presentational force of the headline statistics. The fiscal mandate is what the Government present to the country as, "Judge our macroeconomic and fiscal competence on hitting these targets". The issue is the statistics in the targetry rather than whether you should recategorise student loans as income or expenditure in different ways.

Q27 **Baroness Bowles of Berkhamsted:** It looks like a trader's paradise. If I can short-circuit some of the questions, the major point is, what effect will the raising of the repayment threshold have on the RAB charge? There have been some comments about that. You said that around 30% would go up to 45%. An answer given in the Chamber said that it was around 30% at the moment, and it would go up slightly to between 30% and 40%. I would like it to be as slight as 10%. That seems to take it over the threshold of around 38% where you talk about things happening. Perhaps you could shed a little more light on when it is between 30% and 45%. Who benefits most? It looks as though it is the middle-income students. Is that right?

The more general point is the concern that this is yet another change in policy. When we look at changing policy, and the fact that it can be done while loans are in progress during the 30-year period, students have no confidence. How does that affect any purchase of the loans, because how will people know what they are buying? As that slides, surely the amounts that will get repaid and the cash flows change.

Dr Gavan Conlon: Originally, under the £21,000 threshold, the total cost of putting a cohort of students through the system—all English-domiciled undergraduate students studying anywhere in the UK, plus any EU students studying in English HEIs—including tuition fee loans, maintenance loans and teaching grants, was about £5.637 billion. We estimate that the RAB charge associated with that is between 27% and 28%. That is different from the IFS analysis, because that does not include EU students. There are various restrictions; it assumes things such as 100% completion rates, and there are other issues, but the most comprehensive analysis suggests that the RAB charge is about 27% or 28%. Under the raised threshold, we estimate that the total additional cost per cohort is about £2.853 billion. Raising the threshold corresponds to a 50% increase in the economic cost of putting a cohort of students through the system. It is potentially a very, very expensive policy.

Dr Andrew McGettigan: So it goes to £8.45 billion?.

Dr Gavan Conlon: It goes from £5.637 billion to £8.491 billion per cohort. We have estimated that the RAB charge increases from 27.6% to 45.1%. These are all undergraduate students. Institutions are unaffected.

As to the beneficiaries, on average, the size of the loan balance on graduation, with accumulated interest, will decline for all students, so the result is that individuals who would have been more likely to repay their loan will repay earlier. There are a couple of factors. It is not that, for instance, low-earning graduates will benefit disproportionately from this policy, because they will continue paying 9%, this time over £25,000, but they will pay 9% over £25,000 for 30 years. Clearly, they will be accumulating interest and they will still never repay the balance of the loan.

Dr Andrew McGettigan: But the very lowest earners never went above the £21,000, so they will not go above the £25,000. I think there was an official statement this morning that the Government think the RAB is now somewhere between 40% and 45%. The question about the target RAB and the RAB allocations is probably a distraction now, because the DfE will have to be given more resource to pay for it. It will have to be allocated the extra funding. It cannot be asked to find it from elsewhere; that would be absolutely ridiculous. There cannot be a target RAB of 36% if the RAB is 45%. It does nothing. It will not incentivise anybody; it will just be a rather silly imposition. Everything would have to change at that point. My feeling is that, since the last general election, the target RAB has not been utilised in the way it was intended, and probably not since the year before with the change of Chancellor.

Lord Turnbull: You are talking about the extra cost as though it is an extra cost to the Government. Is not another way of looking at it that in 2012 we expected the threshold to be indexed? Then there was a greedy grab by the Treasury to get more money by freezing it. That stunt has not worked and it has been forced to retreat to where it was. It was an attempt to get more money that failed, rather than an addition. Basically, we are back to where we were in 2012.

Dr Gavan Conlon: There is some truth in that. Freezing the thresholds for repayment is, essentially, a short-lived stealth tax. As Andrew said earlier, if it is an attempt to reduce the costs associated with putting cohorts through the system, we have seen other changes to try to drive down the costs—for instance, the removal of maintenance grants in 2016-17 and their replacement with income-contingent loans, which at the time had a RAB charge of 27% or 30%. Some smoke and mirrors is going on. You remove expenditure today on grant, because that is real cash going out the door, and replace it with loans that we can kick down the road. There have been ongoing attempts to limit the costs to the Exchequer associated with higher education, but aggregating all the costs pre-2012, and looking at the costs now because of the inflated size of the loan book, and given the sheer volume of loans and the proportion of individuals never even repaying the proportion written off, compared with the low-fee, low debt outcome, the high-fee, high-debt outcome is more costly to the Exchequer over the longer term.

Dr Andrew McGettigan: That is the long-run cost, and the accounting plays out very differently. One way to think of this is that the Labour Party went into the election making a pledge to abolish tuition fees, and that has a benefit to future cohorts of students. Changing the repayment threshold changes what everyone who started since 2012 repays. You are making an offer to existing borrowers, existing students and future students, so politically you think it is a better offer. On the figures, as Gavan said, people will repay less, but the complexity and optics are completely opaque. You will see high fees, high debt and high interest; you will not see that 50% subsidy. That is an average subsidy. Some people will have 100%, and some will have 0%. Effectively, when an applicant wants to know what they will repay, you have to say that they might repay a lot or nothing. You cannot give that information.

In those terms, politically it does not make much sense. It looks to me like a knee-jerk reaction that has not really been thought through, and it means that how you present the loan scheme to people becomes much more complicated. Effectively, those income-contingent loans are policy-contingent loans. You are telling people that they are taking out a loan and the Government will change the terms. We have not even had two years of repayments, and we have seen the repayment threshold moved twice. People will be in this scheme for 30 or 35 years, and it makes them extremely uncomfortable—rightly so.

Baroness Bowles of Berkhamsted: If it is a shifting policy, and therefore what is being paid back is shifting, how does that affect how you can sell it?

Dr Andrew McGettigan: The loans currently earmarked for sale are the pre-2012 loans, not these loans. The terms on the pre-2012 loans are fixed—in practical terms.

Baroness Bowles of Berkhamsted: You are saying that nothing after then—that is in these flexi terms—can be sold.

Dr Andrew McGettigan: Let us say you are the purchaser. You would be very worried about the "democratic risk" of a future Government changing the terms of loans such that it meant you would get less from the loans you purchased. In order for a potential purchaser to price the loans, you would want to fix, as far as possible, all the variables. The interest rate on pre-2012 loans is the lower of bank base rate plus one percentage point or RPI. Currently, it is 1.25% nominal; it is very low interest, and the threshold has been indexed to RPI. The pre-2012 index is going up in line with RPI. The post-2012 index is going up in line with average earnings. You are sending some confusing messages to people by having two different indices.

The Chairman: I am sorry to interrupt you. We have to break for a Division. We will adjourn for 10 or 15 minutes, and resume as soon as people can get back.

The Committee suspended for a Division in the House.

Q28 **Lord Livermore:** My question is about the interest rate on post-2012 loans. Is it a concern that the current rate of interest may incentivise higher earners to repay early or to find alternative forms of finance?

Dr Gavan Conlon: Fundamentally, there is no harm in incentivising someone to repay early when they have taken out a loan.

The Chairman: I am really sorry. We have to adjourn again.

The Committee suspended for a Division in the House.

The Chairman: Apologies for the interruption. Lord Livermore, you were half way through your question.

Lord Livermore: I think Dr Conlon had just started answering.

Dr Gavan Conlon: You were asking about interest rates as an incentive to early repayment.

Lord Livermore: I think you answered that. To follow that up, does it matter to the integrity of the system if wealthy people are exiting it early, and only less wealthy people remain in it?

Dr Gavan Conlon: I think it does. Encouraging early repayment is fantastic from the perspective of the Exchequer. It will ultimately drive down the RAB charge and the proportion of the pooled loan book that is written off. Designing a system where there is potential for opt-out causes problems because you end up with a loan book with an expectation of less good debt.

That leads to a further question about any potential sale of the loan book. The discount of fair value would have to be much larger to sell the residual loan book. I think there are problems. A system where, let us assume, the wealthiest can access alternative forms of finance would be a poor intention in the design of a student finance package.

The Chairman: Am I being stupid? You say it is a good thing for them to pay early. If we look at the table produced by MoneySavingExpert, people on a starting salary of £45,000, who are better-off students, by the end of it repay £149,000, having borrowed £51,600. They pay back three times as much as they borrowed. If they decide to pay off the loan, does it not mean that the transfer from students who are better paid does not occur? Am I missing something?

Dr Gavan Conlon: Those figures are in nominal cash terms every year for the next 30 years. An individual will, in expectation, see their graduate earnings increase over time. Those estimates relate to cash values. In real terms, discounted to the present day, the numbers are very different.

The Chairman: Would you be able to provide us with a note explaining that in detail?

Dr Gavan Conlon: I can give an example. We undertook a piece of work for the University and College Union that looked at exactly that: the size of graduate repayments and when they occurred. We looked at them in real present value terms, today’s cash, as opposed to nominal terms over the next 30 years. It is very different. They do not strip out inflation or any time preference.

Lord Livermore: Is it the case that the richest decile pays 106%?

Dr Gavan Conlon: It is certainly the case at the moment—it is actually a bit higher. Individuals in the highest-earning graduate deciles will have a negative RAB charge, which means that they are making contributions to the system, or, in other words, that the Exchequer is making a small amount of money from it.

Lord Livermore: But if they pay it off early, that positive contribution does not apply.

Dr Gavan Conlon: You are selling the right for them to prepay their tax liability.

Lord Livermore: Does that make the system less progressive?

Dr Gavan Conlon: Possibly.

Baroness Bowles of Berkhamsted: Or does the fact that you have the money up front compensate you?

Dr Gavan Conlon: You could look at it either way.

Dr Andrew McGettigan: One of the enormous complexities of income-contingent repayment loans is that they are very unlike fixed period repayment loans. With a fixed period repayment loan, the periodic cash payment is fixed, and because we assume we will live in an economy with a certain amount of inflation, the value of the first payment is the highest in real terms. The first payment has the most value. The cash stays the same, but the real value diminishes.

The problem with income-contingent repayment loans, particularly now with a loan repayment threshold of £25,000, is that they push the majority of cash payments back 15 to 20 years after graduation. That means that the time value of money is a very important consideration for working out the cost. The cash figures are fundamentally misleading. Perhaps Gavan can confirm this for me. I think most of the loan models we are talking about assume that average earnings will increase by 4.3% a year, and graduate earnings increase on top of that. The compound effect of those average earnings means that, if people are repaying £100,000, we model them as earning £130,000, £150,000 or £200,000 in 2045. The value of those future repayments is not stable. You cannot use cash, in that sense, to look at that commitment. Unfortunately, that is something borrowers are not familiar with.

One of the other features of income-contingent loans is that, when we do a basic corporate finance valuation and think about discount rates—in theory, everyone should have their own discount rate—suddenly we have an enormously complex comparison on our hands. Do people opt in or out of the student loan repayment based on alternative loans they can get, or repay up front? That is a calculation most of us would be uncomfortable making. Gavan and I can do it, but to generalise and give individuals personal finance advice on that basis is very difficult.

In the end, I do not think any parent should be put on the spot to say, "Is it potentially cheaper for me to remortgage to put my two or three children through university, because I can get a secured loan with a lower interest rate?" We should never put people in that situation. It should be clear that the government-backed loan is not simply the best deal on the table but a good deal. Some people will choose to pay up front, whether or not they are making the right decision. That is fine, but nobody should be looking at accessing private commercial loans to repay student loans.

That is where the presentational issue around the interest rate is extremely pertinent, because most people, when thinking about debt, habitually use the interest rate as a price signal. They compare apples and oranges, or whatever. The 6.1% real interest rate for those earning £45,000, which will accrue against their accounts, is fundamentally different from the interest rate on a commercial loan because, as we have discussed, the interest accruing is not necessarily interest that is likely to be repaid. When repayments will occur is potentially very far in the future, so the cash value is not a guide to current net present value. These are extremely complex issues that nobody should be presented with as a comparison at this time. That it is happening is an enormous problem for the scheme.

On the question about incentivising early repayment, if the very high earners repay early, they are likely to repay less in net present value terms. You might think that is bad for the Exchequer because in the long run it is getting less value in repayments, but there is a strong preference for cash today. It could very well be the case that a real rate of interest is there to encourage early repayment. The thing we have not really talked about is that, when the real rate of interest was introduced, the Government were telling the world that the discount rate was RPI plus 2.2%. A taper from RPI to RPI plus three percentage points was in the ballpark of the Government's cost of borrowing at that time. Now that the discount rate has been lowered to RPI plus 0.7% for student loans and other similar financial assets, there is a disparity between the interest rate and the cost of borrowing. That concerns people, but they can also look up the price of gilts.

Lord Burns: We were told by Lord Willetts that the reason for the high rate of interest was to make the system more progressive.

Dr Andrew McGettigan: It removed a subsidy for high earners. The pre-2012 loans currently have an interest rate of 1.25%, but a high earner will pay out of that very early, because it is less than real interest.

Lord Burns: Lord Willetts was suggesting that the reason for having the interest rate was not to encourage early repayment, but simply to make it more progressive. My interpretation of the Chairman's question was: if it had the effect of making people pay back early, would that not reduce some of the resources that otherwise would go to the Exchequer?

Dr Andrew McGettigan: The net present value, yes; but if you have a preference for cash today, you are saying, "Will I have all those extra repayments in 15 or 20 years' time, or will I have slightly less value today but I have it today?" That is the kind of decision you would be thinking about. In a sense, the Treasury's preference for selling student loans tells you that it has a preference for cash today over long-run value.

Dr Gavan Conlon: On progressivity, there is a big issue. Having scaled real interest rates was designed so that individuals who earned more paid a higher rate, but the student loan repayment mechanism has worked out in such a way that at any point in time individuals who earn more will pay more compared with individuals who earn less. We would think that is progressive and sensible. For 17 years out of 30 that is indeed the case; high earners pay more than lower earners, but the problem is that lower earners continue to pay from year 17 or 18 all the way up to year 30. Adding up the total value in real terms—forget about cash values—

Lord Burns: I thought the 6.1% interest rate was to try to offset that.

Dr Gavan Conlon: But it has not achieved that, so the system is not even progressive. Individuals with lower levels of earnings, because they are locked in for 30 years, pay more over that period in real terms—today's money terms—than those who repay a larger amount for each of 17 years. On a like-for-like basis, individuals in occupations that pay less will end up paying more.

The Chairman: Are you saying that is not progressive?

Dr Gavan Conlon: Correct.

Lord Burns: We have not seen those calculations.

Dr Gavan Conlon: They are published.

The Chairman: Could you provide us with them?

Dr Gavan Conlon: Yes.

Dr Andrew McGettigan: Is part of your distribution that you think some people will overpay, paying more than the equivalent of what they borrowed? I do not think the system had that as a design feature. It tried to minimise it, but because you have changed the discount rate by a stroke, you have increased the value of all repayments. Forget all the other changes. Suddenly, people in the upper deciles look as if they are repaying significantly more than the value that you loaned them. The discount rate change is one of the factors, I had in mind when I mentioned that there has been a series of piecemeal changes that mean that it becomes difficult to understand the point of different aspects of the loan scheme and how they all work together. If you now have a very different interest and discount rate, you are basically sending a signal that you are trying to extract more value from somewhere.

The Chairman: Are you saying that the Government have been making it up as they go along, and the progressive argument has emerged as a consequence of the change? What are you saying?

Dr Andrew McGettigan: There was a deliberate attempt to bend the distribution curve. When your cost of borrowing is RPI plus 2.2% but you are charging interest at RPI or lower, effectively, you are providing an interest rate subsidy to high earners who repay earlier than they would otherwise have done. If you introduce a real interest rate, you will bend that distribution curve upwards and remove that aspect of the subsidy from the schemes, so there is only a write-off subsidy. Effectively, there is still an interest rate subsidy on the pre-2012 loans. That is an explicit intention of the move to a real interest rate.

At the same time, the argument in favour of income-contingent loans over, say, a graduate tax was that you would not get overpayment, by which I mean that high earners would not be repaying significantly more than the equivalent of what they borrowed. That was minimised in what happened in 2011 and 2012, but with the change in discount rate in 2015 those distribution curves look very different. More people will repay more than the present value of what they borrowed, and more of them will repay significantly more, but that is a feature of changing the discount rate. The change in the discount rate changed the political debate around loans.

Lord Burns: Because high earners pay off their whole loan at an earlier point than low earners, by the time you take into account the interest rate cost, even allowing for the time value of money, in real terms and discounted, people on low incomes are paying a higher proportion of their loans than high earners.

Dr Gavan Conlon: That is what I am saying. It sounds incredible, but high earners are eating into the interest and repaying the capital quickly; they are making repayments and eliminating the entire loan balance after, say, 17 years.

Lord Burns: What do they have to earn to do that?

Dr Gavan Conlon: We did a piece of work that looked at standard occupations. We looked at nurses and midwives, engineering professionals, IT professionals and legal professionals. We used information from the Labour Force Survey and broke it down by gender and looked at the size of the loan balance on graduation. Then we looked at the repayments based on Labour Force Survey information using OBR forecasts.

Lord Burns: Roughly, what income do people need to repay after 17 years?

Dr Gavan Conlon: They would need to be in the eighth decile. For a man, it is in the region of £50,000 to £60,000 in net present value terms.

Baroness Kingsmill: What about women?

Dr Gavan Conlon: It is close to the ninth decile—the top 10% of earners.

The Chairman: Perhaps you would provide a piece of paper on that.

Q29 **Baroness Kingsmill:** What we have been talking about for the last hour and a half is extremely complex and difficult, yet it is something that 17 year-olds are expected to understand to make sensible choices. We have to say that as a funding scheme it is a bit of a dog's breakfast, is it not? One of the reasons why is that there are so many conflicting objectives. One is to finance the universities, which we have not mentioned at all; another is to broaden the number of people who can go to university in the first place; and another is perhaps to improve standards by competition. Possibly, one might argue that price competition in the provision of a social service like education is never going to work and what we need is some heavy-duty regulation on quality rather than anything else.

Those are my views, but what are your views on how we could improve the situation? I am supposed to ask you about the sale of the pre-2012 book, but you have more or less answered that. Perhaps you could tell me how you would design the scheme in a way that achieves at least some of those objectives, and simplifies it for the average 17 year-old who will have to make choices about where they go to university.

Dr Gavan Conlon: A couple of events have occurred that need to be considered first. I do not think we can look at higher education in isolation. Everybody has been talking a lot about full-time undergraduates aged 18-19 going to university. There has been decimation of part-time study across some home nations, particularly England. That is a huge issue and it has not really been addressed. Part-time students are treated differently in the support they receive. That is one issue.

Another wider issue is about the level of resource for vocational education and training, and individuals in sixth-form colleges, for instance. If we look at the difference in the amount of resource available for, say, English students in higher education institutions in England and compare it with those in a general FE college, the gap is quite staggering. Trying to have a review of higher education fees and funding without considering all those wider interlinked issues means we will have more of a dog's breakfast, as you described it. Further changes will be made to deal with the problem of fees and funding for full-time undergraduate students, but unless an appropriate comparable offer is made to part-time students to reverse the decline in part-time take-up, we will still have many problems. Many things have to be looked at, not just this small component.

Baroness Kingsmill: Say you could start from scratch.

Dr Gavan Conlon: It is a good place to start. There have been so many changes over the years: repayment holidays, which were mooted several years ago; the removal of maintenance grants; the change in the threshold; we have plan A and plan B; part-timers are different; and the role of NHS bursaries, which effectively resulted in a 71% increase in the cost of undertaking a nursing qualification, and a decline in the number of students entering nursing and midwifery, even though the Government made an extra 10,000 places available. So many changes have taken place that there is constant application of band-aids to something with substantial holes in it.

Baroness Kingsmill: Dr McGettigan, do you have a comment on that? I would be interested to hear your comment on how it could be improved.

Dr Andrew McGettigan: I tend to agree with everything Gavan said. We have focused on full-time undergraduates and the degree to which their funding is not transparent, but the other routes available to young people and people retraining are even more opaque. There is a problem. In the end, can you have a market with a rational consumer? If I want to know about baked beans, I can go to the local supermarket and each week buy a different kind of baked bean. I can say, "I know which one I prefer, so I will choose that one in future". I can inform myself directly.

How do you inform yourself about the 140 universities in England, and probably another 300 further education colleges that offer degrees, or sub-degree undergraduate qualifications? There are alternative providers. How on earth do you do that? This is a problem, because the way the market is meant to work is that we learn on the back of students which universities are good and which ones are bad, but those students only get one time to go through university. If they end up with a provider that turns out not to be of good quality, certain metrics will appear to enable future applicants to learn that, but they will have had the bad deal through no fault of their own, with no way of redressing it.

We have an education system that means people make too many committal decisions too early. It starts at 16 and happens at 18. What is on offer? It is not just that we have too few part-time and sub-degree courses. We have degrees that are increasingly single honours academic. We are losing combined honours and joint honours. The system is fundamentally not flexible enough to work as a market, so we are getting homogenising effects. If someone is thinking about whether to study part time or full time, they see that it is 9% over £25,000 and 9% over £25,000. Does that mean they should just go for the full-time option?

Baroness Kingsmill: People do not choose only because of the cost. I am talking about the funding.

Dr Andrew McGettigan: But they are not being presented with a good set of options. People have to recognise that part-time flexible provision is more expensive. You cannot fund it just on a pro rata fee basis; you cannot fund it through loans, because the majority of people who want it are bound by equivalent and lower qualifications, and they are not being funded by their employers. The big issue, if you are really concerned about productivity crises in the country, is that you have to look at opportunities for retraining and things like that. The shape of the sector is wrong.

Lord Burns: Are you saying that you do not agree with the notion of income-contingent payments for higher education?

Dr Andrew McGettigan: No. I agree with income-continent repayment loans; they have enormous virtues. The problem is that once you go from a graduating debt of £20,000 to a graduating debt of £40,000 all sorts of things come to the fore. They are exactly how we should fund the majority of maintenance support. I am opposed to the current level of fee.

Lord Burns: You are not opposed to the principle.

Dr Andrew McGettigan: No, not at all.

Dr Gavan Conlon: I do not oppose the principle. The issue is the volume of the loan. The level of earnings people would have to achieve to repay it invalidates the income-contingent loan system.

Q30 **Lord Burns:** Paul Johnson told us that there were much bigger problems with the higher education system than financing, and he wanted everyone to stop obsessing about it. Do you agree with him?

Dr Gavan Conlon: I agree with him. The HE fees and funding system is in a state of disrepair, and many of the changes that have occurred in the last couple of years have essentially been moving money round the table. The Government used to give HEFCE funding to institutions; now they give it to the SLC to give it to individuals, who then repay it through the HMRC, et cetera. Money is just moved round the table. The bigger issues are things such as the decline in part-time education. That is potentially catastrophic. For a decade, there has been a reduction in the number of part-time students. We should stop obsessing about the funding system. There are many more important things to consider.

Lord Burns: To go back to income-contingent payments, there is an issue of complexity, which I understand, but there is also an issue about level. Do I interpret you as saying that it is not only complexity, but that there is an attempt to pitch them at too high a level in real terms?

Dr Gavan Conlon: You mean the 9%.

Lord Burns: Yes.

Dr Gavan Conlon: One issue is that, in an attempt to recoup sufficient funds to keep the RAB charge manageable, you have to select a repayment rate such as 9%, but for many earners the repayments will last for 30 years and that places a burden on them over their entire working life. It has an impact on their access to other things, such as buying a house, et cetera. Banks do affordability tests to try to assess the extent to which an individual is able to repay a loan.

Lord Burns: Can I stop you there? I thought Baroness Kingsmill was trying to get from you some idea of how you would make changes. What would you like to see in an income-contingent payment system? You have not really answered that question. You told us all the things that are wrong with the present one, but not what would be a workable system.

Dr Gavan Conlon: I will be vilified for this, but if there was a clean slate, first, for simplicity, there should be a lower rate of repayment and it should be reduced from 9%. Secondly, it should last longer. Thirdly, it should start not at £25,000 but at a lower rate that is compatible with the current PAYE taxation system. The marginal effect of 9%, with a 41% or 42% rate of tax and national insurance, means that individuals have a marginal rate of taxation of 51% for 25 years of their working life, and that is quite damaging. It might be easier to have a system where there is a lower rate of repayment but it starts earlier, but I will be vilified for that.

Lord Burns: Will you? Join the club.

Dr Andrew McGettigan: I think I said earlier that the scheme works if you concentrate on the five to 10 most selective universities in the country. It does not work for the rest of the sector. What you need is targeted institutional grants that enable those other institutions to lower their fees. You need to resource them differently, whether by widening participation targets or recognising their cost base and providing them with institutional grants. You could then have a much clearer, focused idea of redistribution in the system, and it would be very clear what you were endeavouring to do.

Lord Burns: The Government are labelling which are the low-value universities rather than the universities themselves.

Dr Andrew McGettigan: I am not quite sure what you mean by low-value universities in that context.

Lord Burns: If you say that for a certain group of people you will give a larger grant and, therefore, the fees they pay and their loans will be lower, you are immediately setting out a system of discrimination across universities, are you not?

Dr Andrew McGettigan: The idea that we have a system that is working for the variety of institutions we have is mistaken. On the one hand, institutions such as Oxford and Cambridge, with turnovers of £1.5 billion to £1.8billion a year, have enormous wealth to draw upon, and, on the other, there are institutions struggling on £100 million with completely different historical legacies to manage, in infrastructure, et cetera. There has to be some recognition that we are trying to impose a market on an enormous, historically stratified system with huge inequity among institutions. You are trying to impose a one-size-fits-all funding model on top of it.

The more fundamental problem with the higher education system is the idea that the market can be the solution. I understand the principle that you do not want to be a Minister making decisions about which places you will fund. You do not want to be a monomaniac or megalomaniac who thinks they know what the best shape should be, but to have this kind of market free-for-all is not benefiting the majority of students. You could tie funding to things such as more part-time and flexible provision, and potentially incorporate the other tertiary education institutions. It does not necessarily all have to be done by universities, but it should be far less piecemeal than it is.

The Chairman: Lord Turnbull, Baroness Harding and Lord Lamont are anxious to come in. If we could have very short answers, we will try to fit them in before we have to adjourn.

Lord Turnbull: You have indicated how we might change the system in the longer term. For the moment, we have something that at its core has some principles on which we probably all agree: graduates should pay more; richer graduates should pay more than that; and we can deregulate universities. It seems to me that what is required is something that in the short term stabilises the situation; otherwise, we will end up throwing the baby out with the bathwater because there is a national panic about this. What are the things you can act on in the short term that you might vary, and what are the things where you would say, "For God's sake, don't touch that"?

Dr Gavan Conlon: I do not have an answer. The problem is that we have too many variations of student loans—pre-2012, post-2012 and so on—for any stabilisation of the system. Now we have another two iterations for the Student Loans Company to deal with, which will take two or three years to operationalise. I do not have an answer for that.

Lord Turnbull: Basically, we have to tough it out. The Government have made some changes, so we have to tough it out and then think again.

Dr Gavan Conlon: The biggest risk, or the biggest determinant, is the RAB charge. The funding of higher education is essentially graduate earnings. If graduate earnings are weak, you will not pull in the money; if they are strong, we are in a much nicer, friendlier position. The worry for me—I do not think this is in our power, although some say it might be—is that the level of graduate earnings is depressed. It has been depressed and it continues to be, and the OBR forecasts are that it will remain depressed. That is the same for graduates and non-graduates, so everybody is pretty much in the same boat. That is the real concern. As long as we do not have a buoyant economy, the funding of higher education will be a consequence of that, however it is designed, and its current design will be inappropriate.

Dr Andrew McGettigan: The loan scheme is not meant to be self-financing. Currently, it has to have resource from somewhere else. If you are prepared to support a 30% RAB, that is one thing, but you might well be prepared to support a 45% or 50% RAB. That is a decision for resourcing and budgeting; you say that you will take the money from somewhere else.

The scheme is not financially unstable. There is a huge problem in how the public understand it and engage with it, and there is perhaps a more fundamental problem of public goodwill. Every time you touch it, you make people look at it and they do not like what they see. The more you tinker with it, the more it becomes clear that it is a policy-contingent repayment loan and people are in there for 35 years. Who knows what a Government are going to do in 20 years' time? They could say to graduates, "You owe us this money and we want more of it back than earlier ones did". That is an absolutely reasonable worry for people to have, particularly when they are faced with the idea that they could get out of it by paying upfront.

The Government have to look at the interest now. That will make it more costly, as Gavan said, but they are sending completely the wrong signal. They have to reduce the interest rate. Not to do that is political kamikaze, even if you know it will end up being more costly. Then there is the more fundamental problem: why are we funding it this way? It is not just because of the accounting advantages of grants as current expenditure and loans as financial transactions; there is the idea that the voucher is essential to the market. The market is the wrong way to think about this.

The worst thing the Government could do is to come in punitively and reduce fee levels for particular institutions because they are not seen to be good universities. That would be draconian and extremely counterproductive.

Baroness Harding of Winscombe: Taking you back to your comment about graduate earnings, and that, if they grow, the scheme is much easier and that the opposite is true, I want to try to bring us back to more practical real-world trade-offs. We have talked about part-time courses, but not about shorter or longer courses. Do you think we should be pushing for a system that has more two-year courses, as opposed to three-year courses, or, as Lord Willetts suggested to us a couple of weeks ago, the other way round—more four-year courses? If we are in a two-year world, should we, as Jo Johnson appeared to suggest, be happy to see universities charge more per year for such a course? I am conscious that I have just added even more permutations to the complexities for the Student Loans Company, but practically do we increase graduates' earnings if we have two-year or four-year courses, or is three the magic number?

Dr Andrew McGettigan: I think the concern for accelerated degrees is a mistake. We should be moving away from committal forms of that kind and looking much more at putting funding into part-time and flexible provision. The question about the accelerated degree is maintenance support. It is not so much the fee loan. Are you going to fund those students for 40 to 45 weeks, because the current system is not intended to support them in that way? An accelerated degree may be a viable option only for wealthier students, and, by and large, the places where they are offered have a significantly higher proportion of international students—for example, the University of Buckingham. Institutions such as the University of Buckingham, whose students can borrow only up to £6,000 for the fee, are charging higher fees, and they want the loan to be expanded to cover that. They have an existing provision and it is seen they do not have a level playing field to fund that support. I do not think that will resolve any of the problems that pertain to the situation of home students.

Dr Gavan Conlon: I am agnostic about whether it is a two-year, three-year or four-year degree. The issue is that the degree qualification should mean something, in the sense that it should be some type of signal in the labour market, apart from all the wider non-economic attributes that it should encompass. It might be the case that two-year degrees or accelerated degrees are considered the cheap option, whether it be true or otherwise, and they end up not commanding the premium in the labour market that the individual who paid for that qualification might expect, so there might be a negative signal associated with them. There needs to be a much more mature market for that, with equality or parity of esteem between the different lengths of qualification. I do not think it will solve all the problems.

More generally, there is a real issue about the proportion of individuals in possession of three-year qualifications with different grades of honours. The lack of signalling information associated with qualifications is quite a worry. It is about quality.

Lord Lamont of Lerwick: I think we can all agree, especially after this hearing, that it is all a terrible mess, not least because of conflicting objectives and the tweaks that have been made to the system. One can understand why students are extremely dissatisfied, but from the point of view of universities, does the basic system not have some advantages? Has it not increased resources per capita for the university student? Secondly, Dr Conlon described it as moving money from one box to another, but has it not also given some universities more financial autonomy?

Dr Gavan Conlon: Yes. I am keeping the answer short. You are absolutely right. I agree.

Dr Andrew McGettigan: The HE sector was spared austerity, and the uncapping on recruitment is a huge boon to some institutions. There are institutions that have lost students since 2012, but overall the sector has more funding. Universities have benefited in a certain sense, but, unfortunately, university management has probably shown itself to be too close to the Government on certain issues, such as the abolition of maintenance grants and the freeze of the repayment threshold in 2015. It has a public perception problem—I am trying to avoid the word "collusion"—about the way it has encouraged and sought some of the changes that have been brought in, which do not appear to be for the benefit of the graduate borrower. The other problem with universities is rent. Lots of students feel that they are being gouged on rent.

The Chairman: We will put those points to them when we see them next week. I thank both of you for a very impressive and informative session. I thought the Barnett formula was complicated. I now realise that there is something even more complicated.