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A note on the strengths of variants on the real rate of interest including variable interest rates[1]

Variable *interest* rates within the current system

As we explained in our first submission to the Browne Review, the current student support system is one of the most generous in the world – it is also one the most expensive for the Government. In 2007 the Department for Education and Skills estimated that the cost of the in-built subsidies in the current loan system would be approximately £1 billion in 2006/07; over a quarter of total lending to students in England in that year. Similarly, we estimate that middle-income graduates currently receive a subsidy of almost 30% on their combined tuition fee and maintenance loan.

This expensive subsidy derives principally from two elements of the current system. The first is the write-off of debt after 25 years. This amounts to a substantial subsidy but one which is specifically targeted towards low lifetime earners, and aims to protect them from lifelong debt repayments. We therefore think that the write-off should be retained despite the costs. The second major source of the subsidy is the lack of a real interest rate. However, the introduction of a real rate of interest would make the student support system much more affordable and more equitable for the government.

There are several mechanisms for introducing a real rate of interest. **A mechanism of variable interest rates, where higher earning graduates pay a real rate of interest, whilst lower earners continue to enjoy a lower, subsidised interest rate, could be more progressive than a single rate of interest for all, whilst also making the scheme more affordable for the government.**

For example, a system of targeted interest rate subsidies was a feature of the student support system in New Zealand between 1992 and 2000. Student loans carried a real rate of interest equivalent to 1% above the government's cost of borrowing. However, if a graduate's income was low enough that income-linked repayments were insufficient to cover the interest on the loan, then the loan was adjusted so that real debt remained static.[2]

There are numerous other examples of variable interest rates being deployed within government student loan programmes to achieve policy objectives. Often the objective is to provide protection for low earning graduates, or those from low-income families, but sometimes they are deployed for quite different reasons (see Table 1). Therefore, it is clear that interest rates are a tool that could be used by the Coalition Government to achieve their policy objective of creating an even more progressive system.

[1] See The Russell Group's first submission to the Browne Review for further details about the strengths of a real rate of interest: http://www.russellgroup.ac.uk/uploads/Russell-Group-Submission-to-Review-of-HE-Funding-Jan-2010.pdf. This note is effectively the annex to that submission

[2] Barr N. and Johnston A. *Interest Subsidies on Student Loans: A Better Class of Drain*, LSE, March 2010

Table 1: International experience of variable interest rates within Government student loan schemes [3]

Country	Interest rate charge	Interest subsidy
Korea	Set by Government	Lower interest rates are charged to those from less well-off families and those from the lowest income families are not charged interest at all.
Taiwan	Set by Government	Depending on family income, the Government pays all, half or none of the interest repayments.
Portugal	Euro interest rate swap plus an additional charge	Rates of interest rate vary according to students' academic performance
Poland	Half of the discount rate of the National Bank of Poland	Forgiveness of debt and interest is given to those with outstanding academic achievement
New Zealand	Based on base interest rate plus an adjustment	Amnesty of interest payments is given to NZ graduates living abroad with outstanding student loans if they return home.
South Africa	Rate of inflation plus administrative charge	Students receive a rebate depending on the pass rate of the courses they have taken.

A further option to make the system more progressive, would be to introduce a targeted interest rate subsidy for low earning graduates, but only after several years following graduation. For example, a real interest rate could be applied on all loans for the first 5 years following graduation, but with an interest rate subsidy for those who remain lower earners beyond that point. This has the advantage of ensuring that those who begin as low earners, but then become very high earners do not benefit from an interest rate subsidy in the early years of repayment, which they ultimately do not need.[4]

A surcharge to reflect the costs of the lending, but with lower earning graduates exempt[5]

A further option is to introduce a surcharge on student loans, to reflect the lack of a real rate of interest, and the costs to the government of providing the lending. In Australia students who take out a government loan to pay for their tuition fees are required to pay an additional surcharge of this kind (set at 20%) Students (or their families) have the option to pay upfront, in which case they don't take up the loan and don't pay the surcharge.

Such a system could be made more progressive by exempting some of the lower earning graduates (those who are just above the threshold for repayment) from the surcharge, or even to vary the surcharge depending on earnings throughout the lifetime of the loan.

[3] *Government Student Loan Progams: An International Comparison 2009,* The International Comparative HE Finance and Accessibility Project, State University of New York at Buffalo

[4] Barr and Johnstone, ibid

[5] Barr and Johnstone, ibid

To make the system even more progressive (rather than simply encourage up-front payments), then the ‘discount’ (or exemption from the surcharge) given to the upfront payers could be reduced or eliminated. Students would still have the choice of paying upfront, but would not receive such a large or explicit benefit from doing so. In order to incentivise graduates to repay early, they could be offered voluntary bonuses for early repayment. This system has been adopted in Australia.