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ABSTRACT

College savings plans, which operate in 20 states, work on a simple premise: parents or grandparents place a lump sum in a contract or make monthly payments that guarantees the money will be sufficient for an equivalent of tuition and fees in a set period of time in the future. The state can guarantee the return by virtue of pooled assets. States have also created savings program trust funds that enable persons to invest in a state-operated investment fund. Recent legislation has given these funds tax-exempt status. In general, state plans have established well-run organizations, lobbied for tax relief, and gained the confidence of investors and state officials. Should the strong investment markets continue, the next generation of plans will become more innovative and flexible. However, there are some troubling seeds built into these systems. These concerns fall into three categories: (1) implications for equity, with the middle and upper classes most likely to benefit; (2) institutional implications, in that admissions might become predicated on ability to pay; and (3) legislative implications, as the programs have the potential to supplant, rather than support, state appropriates for higher education. While prepaid tuition plans have great potential, they also have far-ranging implications that require research and evaluation. (SLD)

College Savings Plans: Second Generation Progress and Problems

Michael A. Olivas

2000

COLLEGE SAVINGS PLANS: SECOND GENERATION PROGRESS AND PROBLEMS

Michael A. Olivas, University of Houston Law Center*

IF COLLEGE SAVINGS PLANS (CSP) DID NOT EXIST, someone would have to invent them. As I travel through various states, I almost get a lump in my throat seeing public service ads for CSPs on late night television. Texas has one that features a pretty young chicana, who asks her mom if she will be able to go to college. . .fade to a Florida family standing around a cake, celebrating a grandchild's birthday, complete with prepaid tuition certificates as popular birthday gifts. . .fade to another state's public service announcement for its lottery, when it is revealed that all the hullabaloo is about the new prepaid tuition plan, and certain ticketholders even will receive scholarships. . .yet another state will give fully paid CSP awards to the first five children born in 2000.

THE PLANS AND HOW THEY WORK

These plans, which operate in 20 states, work on a simple premise: parents or grandparents place a lump sum in a contract (or make monthly payments) that guarantees the money will be sufficient for an equivalent of tuition and fees in a set period of time in the future. Thus, if 1999 tuition at a Texas public college is $10,000 for four years, that $10,000 (plus a small fee) invested in the Texas Tomorrow Fund in 1999 will be guaranteed to cover my newborn daughter's four years of tuition and fees in 2017, 18 years from now. The state can guarantee the return by virtue of pooled assets, economies of scale, and careful actuarial practices. Some states even assure the full faith and credit of the state (as does Texas) to the CSPs, pledging state funds to cover any eventual shortfall.

States also have created a kissing cousin to CSPs–savings program trust funds (SPTF)–that enable persons to invest in a state-operated investment fund. With recent federal legislation, these funds gained tax-exempt status, covered additional college expenses (such as room and board), and allowed parents to defer the gains made from the investments and to delay and transfer the earnings to the beneficiary children, who are taxed at lower rates than are wage earners. States such as New York have also given state tax exemptions to the plans.

This panoply of state and federal tax treatments for both types of plans turned the tide; a decade earlier, these plans had no statutory tax exemption and were not even considered tax exempt by the Internal Revenue Service. The Michigan Education Trust (MET), challenged by IRS, lost its case at the trial level, but won an important victory in the appeals court. When IRS decided not to appeal, the way was cleared for the Congress to act. Since then, both types of plans have prospered. Florida has over $3.5 billion in prepaid contracts, while the Texas Tomorrow Fund sold nearly 50,000 contacts in its first year of operation. Additional developments have whirled by, as states make provisions for investments in private institutions, as the Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF) has established a program to manage these state investments, as states have added full faith and credit (as in Texas and Ohio) or declined to do so (voters in Oregon turned down such a proposal in 1998), and as even private colleges have formed consortia to pool prepaid investments for their institutions.

When I first examined these plans in the early 1990s, I wondered how they could survive the MET experience and thrive as taxed, essentially for-profit organizations. As it turns out, reports of the death of these programs were exaggerated, and I am glad to have been wrong. My concern was who would be required to pay for burying these programs: I thought it wrong for states to use general tax revenues to bail out programs that served the relatively well-to-do.

However, these plans placed their bets on a bull market, and won. Even conservatively managed funds (some bound by state investing practices that limit equity stocks and innovative investment vehicles) have outstripped higher education's annual rate of inflation, which has consistently doubled the Consumer Price Index in the 1990s. As long as

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the stock market does well, these plan managers will look like geniuses, especially in light of the long-term nature of the portfolios (usually requiring at least two or three years of investments and often covering children who will use the money a dozen or more years hence). The rising tide has floated many boats.

In another salutary development, these plans have attracted competent managers and given rise to a strong infrastructure of technical and government support mechanisms, both in the public and private sectors. The College Savings Plan Network, an arm of the National Association of State Treasurers, holds regular workshops and conferences for the industry. Private consulting firms and services exist to assist and manage programs for the states. Some of the most successful plans have privatized the operations and investments of CSP programs. The flexibility of the private sector has allowed the investments to build up, with few new public employees added to state rolls. As noted, TIAA-CREF has begun to make its investment and insurance underwriting expertise available to state plans. Other states have hired the College Savings Bank–the country's only bank devoted solely to college prepaid tuition financing–to administer their investments.

Thus, state plans have networked, established well-run organizations, lobbied for tax relief, and gained the confidence of investors and state officials. Ohio, for example, not only accorded the state's full faith and credit to the CSP program, but invested over one million dollars, enabling it to bring its operating costs down. In California, discussions with legislative officials suggested that two political considerations have kept this pacesetter state from enacting its own CSP: full faith and credit considerations, especially after the Orange County fiscal disaster, and the fact that development of a CSP was a major plank in the gubernatorial campaign platform of then-State Treasurer Kathleen Brown, making it an untouchable initiative for the eventual winner, Pete Wilson. Moreover, liberal State Senator Tom Hayden introduced the legislation, making it dead on arrival in the Republican-dominated legislature. Nonetheless, it is only a matter of time before California resolves these issues and enacts a CSP, as it has the perfect, fertile climate for such a plan: many students in excess of the state's capacity to build new institutions, a thriving private sector system of independent colleges, several elite and nearly elite public institutions, a booming economy, and very low tuition in the public institutions. These characteristics, plus California's generally progressive good-government climate, will soon combine to produce a solid prepaid plan, with or without full faith and credit. Then, the remaining states will follow.

THE NEXT GENERATION

As for the next generation of such plans, such as those likely to grow up in California and New York, two states with new college trust fund programs but not prepaid tuition plans, the programs will become very innovative and flexible, should strong investment markets continue. (Even bear markets provide solid investment opportunities in bonds and other high grade debt instruments. Over the long haul of college investments, the long-term nature of such portfolios, combined with the economies of scale, and tax-exempt status of the plans, virtually assure their financial viability.) Moreover, as the plans spread, more innovative program features will likely result, such as multistate compacts (especially for regions with small populations, such as New England or the Pacific Northwest), increased reciprocity among states (letting the beneficiaries take portable plans across states), relaxed residency requirements (in an attempt to sell the plans, letting purchasers or beneficiaries be residents of another state), increased participation by private institutions (guaranteeing returns on investments but not guaranteeing that the plans will cover private college cost increases), and offering attractive consumer options (single course purchase options, mix and match plans for inter-institutional mobility, room/board/book/fee/tuition/ allowance packages–the whole enchilada, not just tuition), and other finance options (such as increased use of indexed debt mechanisms, refinanced home mortgages, and income-contingent payment or repayment schemes). College going is sure to become more like homebuying, with the full range of purchase and finance options. College savings plans will, likely as not, be seen as the catalyst for such creative approaches to this field.

In a variation of "every cloud has a silver lining" thinking, however, I would argue that this movement, while salutary in its overall stimulation of college going and initiation of parental planning and contribution to their children's college payment, has troubling seeds built into its system, ones that may not be evident for several years to come, and will certainly appear many watches from now. These concerns fall into three categories, which I label Equity Implications, Institutional Implications, and Legislative Implications.

Implications for Equity

The bottom line for supporting CSP plans, such as the Alabama Prepaid Affordable College Tuition (PACT) plan or the Texas Tomorrow Fund, is that they provide an investment vehicle for parents (or grandparents or other "givers," like I would be to my nieces, nephews, and godchildren), that guarantees a return on the investment sufficient to pay for a specific amount of tuition in years to come. By pooling the funds and gaining a certain market leverage, a well-run fund can get a better return on the money than can you or I. Further, the program can anticipate future tuition levels and predict with relative certainty how much has to be paid out at a certain time. Thus, run properly, it almost cannot lose: the state takes in the money up front and pays out at the back end, and over time. Program costs are either included as a cost of doing business–as part of the long term "float"–or by a premium (for example, a set or sliding percentage fee). Unless bond markets go haywire or something cataclysmic occurs (à la the Mexican Bolsa or Orange County), program actuaries can predict the cash flow, program participation ratios, and other technical details. Texans have participated in record numbers, far surpassing the first-year experience in Florida, the country's premier program, run with excellent management, low-cost colleges, and almost 500,000 contracts to date.

But it is very likely to be wealthy and upper-middle class Texans who profit from this venture. The equity issue is not farfetched, but both intuitive and evident from programs in other states. Take Michigan, which sold its first contract in 1988. In 1990, Professor and Law Dean Jeffrey Lehman published an influential article, "Social Irresponsibility, Actuarial Assumptions, and Wealth Redistribution: Lessons about Public Policy from a Prepaid Tuition Program," in the *Michigan Law Review* (Lehman, 1990). In 1993, he followed with a careful study of the Michigan Education Trust's decision to expand its subscriber base by offering a monthly payment option (Lehman, 1993). In his earlier article, Lehman had charted the redistribution of state subsidy benefits upward to the most-advantaged Michigan residents. In 1990, partially in reaction to this criticism, the MET board changed its way of selling contracts to allow purchasers to spread the payments over a set period of time–on an installment plan. It was anticipated that this would permit families with lower incomes to participate, especially since the size of monthly payments is often more salient to low-income consumers than is the total obligation.

Lehman found that the availability of the monthly payment option reduced the "skewedness" of the original MET purchaser profile, but not by a substantial margin, and measurement discrepancies between the periods before and after the change made exact comparisons difficult. Even so, in 1990, the richest 2/5 of the Michigan population with children had purchased 61 percent of the MET monthly payment option contracts. More recent figures for Florida suggest that purchasers there also constitute the more advantaged citizens. When the purchaser profile is combined with the original state investment to start the program, it is a remarkable, and remarkably regressive, redistribution of state resources to the wealthy.

Any subsidy or bailout of a CSP would come from state general revenues, requiring all to pay for the advantaged purchasers' continued advantage. Even in Michigan, where there was no legal full faith and credit provision, the governor said the state had a "moral full faith and credit" obligation. A variant of this scenario happened in Ohio recently, where general state revenues of $1 million were used to reduce the price of the state's tuition units. If full faith and credit is not in force, subsequent purchasers will pay for poor planning. In the first year of the Texas operation, before the voters approved a constitutional amendment to extend full faith and credit to the CSP, the program underestimated costs by 10 percent. A shortfall has to be made up from somewhere, and now the state's citizens will foot this bill.

Paradoxically, the clear indication of state investment, willingness to use a state's full faith and credit, and incorporating general revenues into the program are signposts that IRS (and judges) will look to in determining whether a CSP will be tax exempt. If all the program participants share proportionately in a loss (as in bad investments or a shortfall), that seems fair. I urge legislatures to constitute CSPs so that the state's taxpayers will contribute very few general fund dollars to either the startup or any bailout provisions. On equity grounds, it seems very unfair to tax those who cannot afford or who are unable to attend college, so that their more advantaged neighbors can do so more easily. I do not know where the fair tipping point is, but it may be some "borrowing against" the future and repayment to the state for out-of-pocket startup costs.

I know and respect the Biblical admonition that we will always have the poor among us, but I do not believe they should have to ante up just so that wealthier parents can have an additional savings vehicle for their children to go to college and more easily consume the considerable state investment already in place. This is particularly true in a time when the federal government is in a pell-mell rush to create similar tax subsidies, which are decidedly regressive. At the least, states should not underprice their product, as occurred in Michigan. Why should CSP purchasers receive a 20 percent discount? Indeed, I believe a surcharge for program fees is a better way to raise operating funds.

Institutional Implications

I also fear that at some point institutional behavior will change, so that admissions might be predicated on ability to pay. Let me project a plausible scenario, borrowing from Texas and Florida, whose demographics are similar. Florida's CSP has sold over 500,000 contracts, and soon will have hundreds of thousands of contracts in play, spread over approximately 25 years; this includes children just born all the way to college seniors consuming the paid-for benefits. If this were in Texas, and meant that 15,000 contracts were coming due each year, let us say that 2/3 of them wished to attend college in Texas and the others did not enroll or went out of state. This would mean 10,000 funded freshmen competing for spots in Texas institutions. Let us say 500-1,000 wanted to attend Rice, Trinity, Baylor, and Southwestern, the elite private institutions in the state. This would leave 9,000-9,500 funded students applying to University of Texas, Texas A&M University, Texas Tech University, the University of Houston, and the state's other public and private two- and four-year colleges. The admissions pressure on the University of Texas and Texas A&M University, already evident as they scale back to more manageable size, will be enormous.

Now say you are the president of University of Texas, considering two exactly-equally qualified students, let's say Mexican Americans from the Valley. But one is fully funded and the other will require a combination of state, federal, and scarce institutional funding. Who are you going to admit? Mind you, the fact that one student is smart enough to be born into a family that saves for college education is no reflection of personal character; indeed, growing up successful in a family *without* financial resources has often been seen as a plus in admissions decisions.

And I do not exaggerate the admissions pressures. Due to Texas' booming economy and other reasons, enrollments have slackened somewhat, and in a strictly enrollment-driven system such as in Texas, there is a slight current underutilization of higher education, some "excess capacity." But Texas Coordinating Board data conservatively predict that in a mere 16 years there will be 155,000 more students clamoring for higher education in Texas (*CB Report*, 1998). If minority achievement increases, we could have 400,000 more students by 2010. (In 1999, Texas public universities alone enrolled over 400,000 students.) Let's say we split the difference: by 2015 we will have 290,000 more students than we do today. This is nine additional Universities of Houston. Moreover, a college tuition savings plan will stimulate savings and likely stimulate college attendance. (And I would argue that any of the "Higher Education-Lite" proposals for televising distance learning will be inadequate to deal with this problem.) Even if the savings go to substantially the same students who would have enrolled without a Texas Tomorrow Fund, its existence is bound to increase–in fact, it is *designed* to stimulate–college going and college investment. That is, a successful plan will likely stimulate a greater need for college seats in Texas. You could do the same calculations for Florida and see the pressures those 50,000 contracts each year will have on Florida International, the University of Florida, or Florida State. The seduction to activate the CSP electronic funds transfers will be very powerful, and the Florida institutions will ignore the pressure at their peril.

Thus, I believe my admonitions about the merging of admissions and ability to pay are conservative and the pressures at the institutional level will prove to be irresistible. While no CSP guarantees admission, all certainly will guarantee higher expectations about admissibility on the part of purchaser parents, who are likely to become an angry cohort of taxpayers. No warning label or disclaimer about admissions standards will serve to placate this group.

Legislative Implications

This leads to my third major concern, the legislative fallout from a successful CSP. After ten years of a successful Texas Tomorrow Fund, widely advertised in English, Spanish, and Vietnamese, there will be a very large accumulated pool of money, completely dedicated to higher education. For example, in 1998 alone, Florida earned a pooled fund of almost $500 million; even Michigan, with its originally adverse tax ruling and a year of suspended sales for reorganization, sits on over $500 million. Will the state legislatures continue to appropriate state general revenues for an enterprise that has so many potential guaranteed-paid applicants in the pipeline? In other words, will this program *supplant* state support rather than *supplement* appropriations? And just to make it interesting, what will happen if the answer is to free tuition levels to rise to "market levels"?

Again, I will use Texas as an example, but could use almost any other state to make my point. The fund, actuarially premised on steady, predictable tuition rates, will find it difficult to stick with its careful figures–which drive the plan's engine–if tuition rates exceed investment rates. Any ratcheting effect here will doom the careful equilibrium necessary for balancing both ends of the equation. Again I ask, where will Texas get the funds to build nine new UH campus-equivalents in 15 years? State support for higher education in Texas has declined as a portion of overall expenses, and the state historically ranks low in per capita support of postsecondary education. The Texas Tomorrow Fund, instead of being a wonderful device for stimulating parental savings, could become an attractive nuisance either by dampening legislative support for general institutional appropriations or as a large, unintended ratchet to keep up tuition rates unrealistically low. As noted earlier, Texas undershot its costs in year one by nearly 50 percent, leaving the shortfall to be amortized across all latecomers.

A corollary concern, fees, also guaranteed by the CSP, have virtually no control. A cynic might observe that the Texas legislature has enacted a silent fee system to guise its political unwillingness to take the heat for raising tuition rates. One good thing to come from this legislation may be a more open consideration of fees, tuition, and residency structures in the states. All of these details have real institutional consequences. Now, there is in place a governmental counterweight to keep tuition levels low, even though they should probably rise in states such as Texas and Florida, which charge too little for their product. In Virginia in 2000, there were smaller actual dollar appropriations for public colleges than for 1999. This does not even take inflation into account.

Moreover, if legislators do the right thing and increase public tuition substantially, these plans will lose over the long run, or one year's class will subsidize the others. There is nothing inherently wrong with this, but several years of imbalance, a market correction, or a long bear market could certainly erode any plan reserves.

Other Policy Concerns

College savings plans pose all these concerns, and additional ones: parents might do better in their own investments than will these state-run programs, and so these savings plans will simply reallocate parents' overall savings, not stimulate new college savings. With the tax breaks now in place for the plans, it is unlikely that any amateur investors will do better, and many parents are risk-averse, so professional money managers may be the better investors. As of Spring 1999, only Massachusetts had both a prepaid tuition and a college savings plan, but the next several years will see growth of both plans in remaining states, such as Virginia.

Another issue is what to do when a program ends, as happened in 1995 when the Wyoming Advance Payment of Higher Education Costs Program closed after eight years due to poor participation rates. Because the state is obligated to honor all the contracts sold during the life of the program, it may become the equivalent of a civil war widows fund–one that has to function until the last participant dies or chooses not to enroll in college. Perhaps the program can be absorbed into a regional pact or neighboring state's plan. Washington State, for example, began a CSP in 1997, and it would likely help both states to combine their resources.

How do these programs "count," when parental income forms are filed, to determine the aid package for their child? Many states exempt the prepaid and savings plan contracts from consideration, or allow them to count as the expected parental contribution (Hurley, 1999). This income-shifting mechanism removes wealth from parents and reallocates it to their children (this also mimics the income tax treatment of the plans), making it possible that students will be eligible for more federal, state, or institutional aid.

CONCLUSION: RESEARCH AND EVALUATION ISSUES

My views on post-secondary prepaid tuition plans grow out of extensive research on this complex subject, familiarity with the national and state trends, wide consultation with prepaid fund and trust fund officials, and discussions with a large number of legislators and treasurers in states with such funds or contemplating either program. I believe these programs hold great promise, but they also hold far-ranging implications, a number of which have been unanticipated and which could undermine general public support for the programs.

Earlier, especially during the pendency of the complex litigation over the Michigan fund's tax status, I was concerned (like many observers) with the viability of the programs. This corner has been turned, however. Given developments in federal revenue policy, tax legislation may be the only available means to infuse massive amounts of money into discretionary college funding initiatives. To be sure, federal taxation is a fluid and dynamic area of change, but I believe even the most negative tax determination (i.e., that the program is *not* tax exempt) could still allow a state program to maintain itself by amortizing the tax burden across all contracts. This development frees me to be constructively critical of many details, while being enthusiastic about the overall existence of such plans. It is almost unpatriotic to be against a program that assists parents in saving for their children's college educations. Rather, I now fear the programs' likelihood of "success."

For the reasons I have explained here, I want more information on the plans, and more evaluation. Most of the plans have shown little concern for evaluating their results or conducting research on their portfolios. Success has been measured largely by the numbers of contracts or how many dollars are invested in the plans. Surely, these cannot be the sole markers of success. Why no post-mortems on the Wyoming experience, analyses of Michigan's resurgence, research on Texas' under-estimation of first-year costs? For these programs to be genuinely successful, they need to undertake critical, searching self-analysis. I conclude by offering a partial research agenda, one that would likely answer nagging equity concerns, institutional implications, and legislative questions.

First, this is a field in which there has been strangely little introspection. Each state needs to undertake evaluation plans on a regular, even annual, basis both to see the results of their targeted information and to plan for future products and services. Once they have established a baseline data set, they can model simulations, test innovations, and experiment. The availability of these data would be an important first step.

Second, more sophisticated research, such as the zip code analysis of MET contract purchasers, would be possible. Many other such initiatives would be possible if the data were made available to scholars and researchers seeking to understand financial aid policy. Program and legislative staff contemplating legislation would find data extremely useful in proposing legislation or regulations, as would public policy analysts generally.

Finally, the more the public, especially parents, understands these programs, the more likely the constituent support. People recognize that the finance mechanisms for college are changing, as they are in private markets, generally, and building public support is essential for such plans, especially with the complex and confusing options. Analyzing Wyoming's under-participation or Michigan's problems or Florida's possible over-participation can lead to policy changes and program improvement. One thing is clear: these programs have become popular because they address an important social issue. Staying ahead of this curve is an important byproduct of these plans, one that may enable them to gain the long-term support and confidence they will require.

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GOALS AND IMPLEMENTATION ISSUES FOR STATE PREPAID TUITION AND COLLEGE SAVINGS PROGRAMS

Joan Marshall, Maryland Prepaid College Trust*

STATE PREPAID AND COLLEGE SAVINGS PROGRAMS are growing exponentially across the country because they are providing real value, convenience, and "peace of mind" to families who are trying harder to prepare themselves financially for their children's and grandchildren's college education. While growth in participation in these plans is substantial, much more consumer awareness and accurate understanding of them is needed.

THE GOAL

One of our hopes at the state level is that parents will soon consider participating in Section 529 plans for future higher education costs as commonly as they enroll in 401K plans for their retirement savings. Why do we seek this goal?

1. *Too many families are taking on far too much debt*–often as much as tens of thousands of dollars–to send their children to college. There is clear evidence that families of today's college students have generally not saved nearly enough to cover the costs. This trend does not seem to be improving. Consider the following two factors:

- *Tuition has been consistently rising at double the rate of inflation.* The College Board reported recently that tuition and fees are up an average of 4.4 percent at public four-year colleges and 5.2 percent at private four-year colleges, while the consumer price index rose 2.7 percent in 1999.[1] To no one's surprise, loans are providing an ever-increasing amount of the extra money students need to pay these costs.
- *More students are taking out loans to finance increasing college costs and the size of those loans is increasing.* From 1980 to 1995, the U.S. Department of Education's loan portfolio increased from $2.2 billion to $11.5 billion.[2] A decade or more ago, about 60 percent of federal financial aid (the largest source of student aid) was in the form of grants, with about 40 percent in the form of loans. This situation has now reversed, so that in the last academic year, loans made up 59 percent of a record $68 billion in financial aid (Levinson, 2000).

2. Most families today (73 percent) say they are saving for their children's education and most consider it to be as important as saving for retirement. However, a survey completed in 1999 by the College Savings Plan Network (CSPN), an affiliate of the National Association of State Treasurers (underwritten by TIAA-CREF and BankOne), indicates that these families typically are not saving enough or on a regular basis. Even worse, the most commonly used savings vehicle indicated in the survey is passbook savings accounts (47 percent), which simply do not keep pace with tuition inflation (College Savings Plan Network, 1999).

WHY DO THE STATES CARE?

To the extent that families are better prepared financially to meet higher education costs, overall accessibility of higher education opportunities will be expanded. Too often, one of the main reasons why students elect not to attend college is because sufficient funds are not available. Clearly, increasing the accessibility of higher education will lead to a better educated workforce, which should, in turn, strengthen the states' economies and contribute to state economic development efforts to attract employers, particularly those in high tech, higher paying industries.

The ability of a state to increase significantly the number of families who are better prepared to meet higher education costs should eventually relieve pressure on that state's need-based financial aid requirements. While federal aid is the largest source of financial aid, it is worth noting the Chronicle of Higher Education's report that in 1995-1996 nearly 20 percent of full-time, full-year college students were receiving state financial aid.

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