

UNC Board of Governors Study of Prepaid Tuition Plans and College Savings Plans

In 1999, the General Assembly requested that the Board of Governors of the University of North Carolina study “the structure, management, and use of prepaid tuition plans and college savings plans in North Carolina” and recommend to the Joint Legislative Education Oversight Committee ways “to make the plans more attractive to parents and grandparents in saving for college costs.”

The General Assembly further requested that in making its study, the Board of Governors “consult with private colleges and universities and the Community Colleges System Office,” and that the Board of Governors also consider “similar plans of other states, including Iowa and New York.” The General Assembly requested that the Board of Governors report the results of the study to the Joint Legislative Education Oversight Committee by April 1, 2000.

Background

As the General Assembly requested, this report examines the features and benefits of various plans and compares North Carolina’s college savings program, the College Vision Fund, to other plans around the country.

Our state has no prepaid tuition plan, and this report recommends against establishing such a program in North Carolina. The national trend is moving decisively away from prepaid tuition plans and toward state college savings programs, and under adverse market conditions prepaid tuition plans pose risks to the state’s budget and to the quality of higher education.

This report considers three statutory enhancements to the College Vision Fund that emulate the best offerings of other state programs, and recommends one that maintains the best features of North Carolina’s plan and makes the program more attractive to parents and grandparents—namely, the addition of an equity investment option for participants in the College Vision Fund.

Specialized College Savings Options

Parents, grandparents, and other consumers today may choose from a wide variety of options as they plan for meeting the costs of higher education. Among these options are several specialized savings vehicles, including Education IRAs (Individual Retirement Accounts), Roth IRAs, and Qualified State Tuition Programs (QSTPs). The College Vision Fund is North Carolina’s QSTP.

Federal law permits states to establish QSTPs containing tax advantages that will encourage families to save for college. Internal Revenue Service Code, Section 529, adopted as part of the Small Business Job Protection Act of 1996, governs QSTP programs. Section 529, which establishes the criteria required of state plans in order for

their participants to qualify for favorable federal income tax treatment of investment earnings, gives states considerable flexibility in designing programs.

QSTPs fall into two categories: prepaid tuition plans and college savings plans. Some states had developed plans prior to the 1996 Act; however, the majority of states establishing plans did so after adoption of the Act. As of July 1999, 33 states had plans in effect, with 12 more intending to launch programs by 2001. Initially, most state programs were prepaid tuition plans; however, most programs established since the Act—and almost all plans now under development—are college savings plans, as North Carolina's is.

Forty-five states will have QSTP plans in effect by 2001. They break down as follows:

- 14 states: prepaid tuition plans only,
- 8 states: both prepaid tuition and college savings plans,
- 23 states: college savings plans only.

Of the 8 states offering both prepaid tuition and college savings plans, 7 added savings plans to existing prepaid plans and one (Maine) added a prepaid plan to an existing savings plan. Tables 1 and 2 list the QSTP programs in existence and planned.

Table 1. Existing Qualified State Tuition Programs (QSTPS) by State and Type

Year	States Adding Prepaid Plans	States Adding Savings Plans	States Dropping Prepaid Plans	States Dropping Savings Plans
1987	Wyoming ¹			
1988	Michigan			
1989	Ohio			
1990	Alabama	Kentucky		
1991	Alaska			
1992	Pennsylvania ²			
1995	Massachusetts			
1996	Texas Virginia			
1997	Mississippi Colorado Tennessee	Wisconsin Louisiana Indiana Utah		
1998	Washington Maryland South Carolina West Virginia Nevada Illinois	Connecticut North Carolina New Hampshire Delaware Montana New Jersey Iowa New York Rhode Island Colorado		
1999		Massachusetts Arizona Maine California Missouri Minnesota Vermont Virginia	Wyoming ¹	
2000	New Mexico	Tennessee North Dakota Illinois Wyoming Oklahoma Kansas Hawaii Florida		
2001		Oregon		
Source: A Review of State-Sponsored College Tuition Programs by Program Type, CSPN Conference, July, 1999				

¹ Disbanded prepaid plan in 1999. Will start savings plan in 2000.

² Considering converting prepaid plan to savings.

Table 2. Planned Qualified State Tuition Programs (QSTPs) by State and Type

	States Planning to Add Prepaid Plans			States Planning to Add Savings Plans	
	Maine			Michigan Ohio Alaska Pennsylvania Texas Mississippi Maryland West Virginia	
Source: A Review of State-Sponsored College Tuition Programs by Program Type, CSPN Conference, July, 1999					

Policy Goals and Program Benefits

States establishing QSTPs seek to deliver one or more of the following eight goals or benefits. The first three objectives are inextricably linked.

1. ***Make college affordable.*** Families meet higher education expenses by borrowing, saving, or paying from current income. Most use a combination of all three methods. Both prepaid tuition plans and college savings plans encourage families to save in advance, lessening the financial effect of college expenses on current income and reducing the family’s debt burden. The result is a more affordable college education for most families.
2. ***Encourage savings for college.*** Specifically, QSTPs encourage savings over borrowing in the college financing equation. UNC undergraduates who borrow for college graduate with an average debt burden of more than \$11,000, and that total is rising. States around the country are establishing a policy objective of stabilizing or reducing this debt burden, in an effort to increase the college-going rate, reduce the college loan default rate, and enhance the economic prospects for young families.

Prepaid tuition plans seek to accomplish this objective by encouraging families to make full or partial prepayments, usually of tuition and mandatory fees, at mostly in-state public institutions. State college savings plans seek to meet the objective by providing tax advantages and other incentives for families to make investments that may be used to finance a college education at any accredited institution.

Experts deem both approaches to be effective at encouraging savings, although they typically recommend the savings plans for their flexibility and for the possibility that funds invested in them may grow faster than the rate of increase in tuition costs.

3. ***Increase the college-going rate.*** Policy-makers have concluded that increasing the level of family savings for college raises the college-going rate in two ways: the presence of savings makes the decision to enter college easier financially, and the process of planning and saving for college increases the likelihood that children in the family will aspire to college and prepare academically for it.

4. ***Provide tax advantages to participants.*** QSTPs contain tax advantages designed specifically to achieve the desired public policy goal of boosting private savings for college. All QSTPs enable earnings on contributions to compound free from federal income tax until they are withdrawn, when they are taxed at the beneficiary's rate—typically 15%—rather than at the higher rates usually paid by participants. Earnings thus accumulate significantly faster than they would if they were taxed annually.

Twenty-six states (including North Carolina) exempt earnings from state income taxes entirely. Thirteen states also exempt some or all of the contributions. One state matches a percentage of participants' contributions.

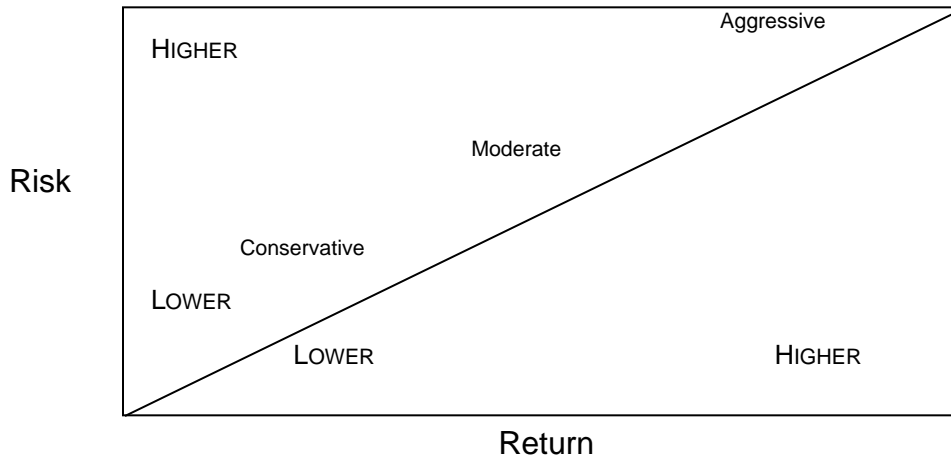
5. ***Manage risk.*** Risk is significant concern both for families saving for college and for states that maintain QSTP plans.
 - a. ***Risks for families.*** For families, risk associated with participating in a QSTP primarily takes two forms. The first is the risk that the plan will impose limitations on the money the family has saved depending on the beneficiary's choice about whether and when to attend college. College savings plans are fully portable and impose no such restrictions, while some prepaid tuition plans provide a better return on investment when families use their savings at in-state schools.

The second source of risk for families is the possibility of loss of principal through a plan's use of an aggressive investment strategy. For example, equities have appreciated substantially over a number of years and seem attractive today, but a major market downturn that does not end before a beneficiary's college-going years arrive could imperil a family's savings. Similarly, interest-rate risk, which is greatest when terms to maturity are long, can lead to substantial loss of principal in portfolios that are heavily weighted with bonds. North Carolina's College Vision Fund utilizes a more conservative investment strategy than growth-oriented mutual funds or long-term bonds to substantially reduce the risk of loss of principal.

Of course, some North Carolina families may wish to devote a portion of their college savings portfolios to higher risk, higher return investments, knowing that the portion of their portfolios invested in the College Vision Fund is growing through use of a low-risk strategy.

Figure 1 illustrates the risk-return tradeoff in the capital markets.

Figure 1. Risk and Return in the Capital Markets



Source: Salomon Smith Barney, Inc.

- b. *Risks for states.* For states that maintain QSTP plans, those with savings programs face no risks. However, in states with prepaid tuition plans, there is risk to future students, state budgets, and educational quality when the cost of providing undergraduate education to students attending in-state public institutions on the prepaid tuition plan rises more rapidly than the rate of growth the state achieves on the funds invested in the plan.

Figure 2 illustrates this risk by comparing a hypothetical North Carolina prepaid tuition plan whose funds are growing at 6% per year to the rising cost of undergraduate education at in-state public institutions. The figure displays the total per-student cost of education, comprised of per-student general fund operating expenditures and tuition and fees, rising over the next 20 years at the same rate they have grown over the past 20 years, with the growth at 6% per year of the fiscal year 1998-1999 per-student cost of education.

The risk to the state is clear. By fiscal year 2018-2019, the office of the State Treasurer would hold about \$43,600 for each student whose parents in 1998 prepaid tuition for one year, while the average cost of providing a year of undergraduate education in the University of North Carolina System will have grown to about \$57,400, if the average growth in education costs over the last 20 years persist through 2018.

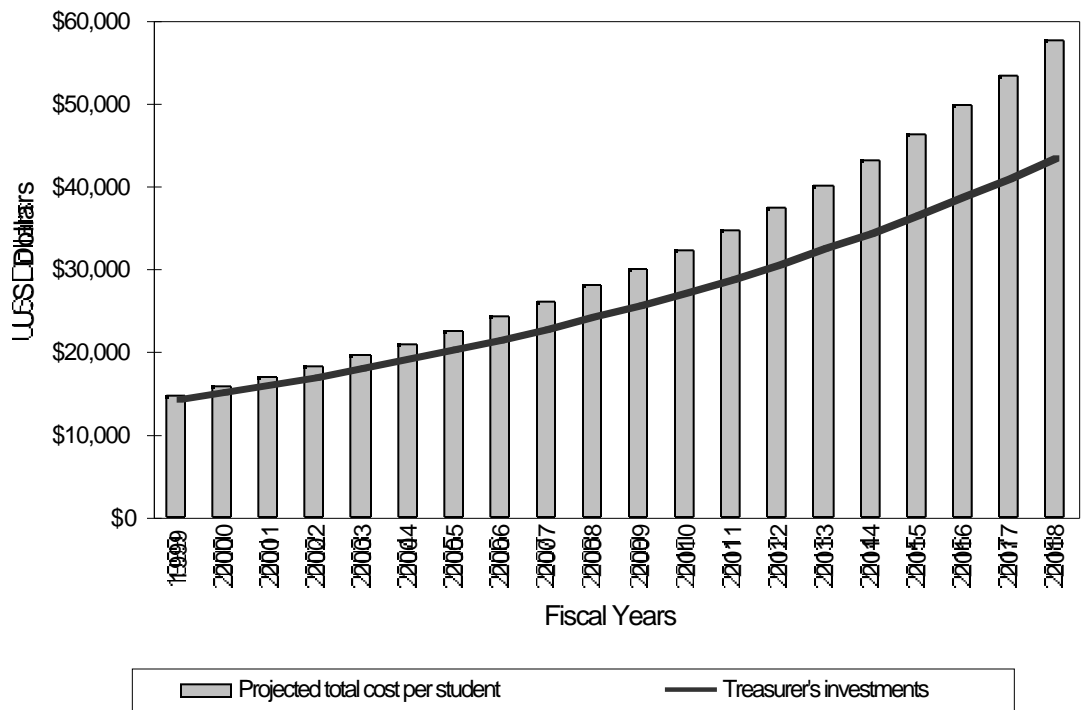
The yearly shortfall of \$13,800 per student—a statewide total of \$1.6 billion if the fiscal year 1998-1999 undergraduate population does not increase by 2018—would require the Governor and the General Assembly to choose from several difficult options to close the gap.

Those options are a \$1.6 billion a year tax increase or an equivalent level of cuts in the quality of the offerings of the University of North Carolina System; a

reduction of \$1.6 billion in other state programs; an annual \$13,800 tuition increase for students not attending on the prepaid tuition plan; or defaulting on the program.

Of course, a prepaid tuition program could employ a formula discounting the value of participants' contributions by a factor designed to compensate for rates of education cost increases that exceed anticipated investment yields, but such an action would severely limit the attractiveness of the new program to North Carolina parents and grandparents.

Figure 2. Comparison of Projected Total Per-Student Cost of UNC System Undergraduate Education and Growth of Treasurer's Investments at a 6% Annual Rate of Return



Sources: Office of Fiscal Research, NC General Assembly, for General Fund Operating Expenditures; Statistical Abstract of Higher Education in North Carolina, for Per-Student Tuition and Fees

- c. *Risks for the public.* The converse of this risk is the possibility that strong performance in the investment portfolio of the prepaid plan, together with broad public participation in the plan, could lead to pressures to raise tuition to levels that keep pace with the plan's investment returns. In either case, risk is clearly greater in states that operate prepaid tuition programs rather than college savings plans.

It seems clear that by maintaining a sound college savings plan and declining to venture into a prepaid tuition plan, the state of North Carolina can assist families who wish to accumulate low-risk savings for college while at the same time avoiding significant risk to the state and its future.

6. ***Provide flexibility of payments.*** Prepaid tuition plans and college savings plans provide similar flexibility with regard to contributions. Both allow participants to make lump sum or periodic contributions, or a combination of the two, and to increase or decrease the amount of their periodic contributions.

College savings plans generally provide more flexibility than prepaid tuition plans with respect to costs that the programs deem to be qualified educational expenses, which beneficiaries may meet with savings from the program. This distinction is particularly sharp between recently-enacted college savings plans and early prepaid tuition plans.

7. ***Provide portability across states lines and public-private sectors.*** Early prepaid tuition plans enabled participants to save for attendance at in-state public institutions only. In today's economy, with higher education choices more diverse and families more mobile than ever, these limitations proved to be much more confining than the marketplace would accept. Much of the impetus for the dramatic rise of college savings plans has been their portability. In response, prepaid tuition plans have added portability features to their offerings.

Expert Opinion on Prepaid Tuition Plans versus College Savings Plans

Joseph F. Hurley, CPA, author of *The Best Way to Save for College*, writing in the *Journal of Accountancy* of November, 1999, concludes that "most new QSTPs are savings plans; these are generally judged superior to prepaid tuition plans. Savings plans offer more flexibility than prepaid tuition plans."

The *Wall Street Journal* of September 23, 1999, reported that "early versions of the plans have been around since the late 1980s, but they had their drawbacks. Most were prepaid tuition plans designed to protect against tuition inflation. Participation was restricted to state residents, and investors typically got full value only when used for colleges within their state's borders. . . . Prepaid plans still hold the most money, but it is now the savings plans that are growing fastest in number."

On May 25, 1999, the *Philadelphia Enquirer*, reporting on the college savings program being added to the existing prepaid tuition plan in Pennsylvania, said "the Tuition Account Program is an ugly ducking on its way to becoming a swan." The addition of the savings component, concluded the *Inquirer*, "would make the program something of a hybrid between the old-style prepaid tuition plans such as Pennsylvania's, and other states' newer 'savings' type programs."

The *Memphis Commercial Appeal* reported on May 24, 1999 on the new "state-sponsored, tax-deferred college savings fund" being added to "Tennessee's two-year-old college tuition prepayment program." The report quotes State Treasurer Steve Adams as saying, "we're trying to make the program more flexible and user-friendly to encourage more people to save for college tuition."

In a January 18, 1999 review of college savings options, Reuters summed up the differences in prepaid tuition plans and college savings plans from the consumer's point of view:

If saving for your children's college education is high on your 1999 to-do list, there is good news from state treasurers. Many of them, emboldened by 1996 legislation and aware of complaints about stodgy prepaid tuition plans, have unveiled new tax-favored savings programs that really make sense for the college bound.

They are better than prepaid tuition programs in a number of ways. They offer federal tax deferral on college savings that can be used at any college in any state without penalty, and many offer state tax benefits on top of that. . . . These programs offer solid savings and earnings potential without the pitfalls of the prepaid plans. There's no penalty for students who take the money to a private school or to a school outside of the state in which they have saved.

Many states are starting new programs and some states that had established prepaid tuition plans are considering a shift into these new savings plans.

Structure, Management, Operations, and Use of North Carolina's College Savings Plan

A. Structure and Management

On August 3, 1996, the General Assembly enacted the Current Operations Appropriations Act of 1996. Section 16.7 of the Act amended Article 23 of Chapter 116 of the General Statutes to create the Parental Savings Trust Fund, thereby enabling the development and administration of the College Vision Fund.

The College Vision Fund is a partnership of four public and private entities:

1. The North Carolina State Education Assistance Authority (NCSEAA), the statutory home of the program;
2. College Foundation, Inc. (CFI), which administers the program under a contract with NCSEAA;
3. The office of the State Treasurer, which invests the program's funds as permitted by statute; and
4. Education Financing Services, LLC (EFS), which provides marketing and technical expertise to the program.

NCSEAA is a political subdivision of the State of North Carolina. The General Assembly established NCSEAA in 1965 to administer "a system of financial assistance, consisting of grants, loans, work-study or other employment, and other aids, to assist qualified students to enable them to obtain an education beyond the high school level by attending public or private educational institutions." N.C. Gen. Stat. § 116-201 (1994). Since 1966, NCSEAA has contracted with CFI for loan servicing and other administrative functions.

CFI is a nonprofit corporation chartered in 1955 under Chapter 55A of the General Statutes to assist North Carolinians in financing the costs of postsecondary education. (The Foundation operates as a supporting organization within the meaning of section 509(a)(3) of the Internal Revenue Code.) CFI is responsible for marketing, account maintenance, record keeping and accounting, collection of payments, disbursement processing, customer service, and other administrative matters related to the College Vision Fund.

The office of the State Treasurer holds and invests the funds deposited in the Parental Savings Trust Fund pursuant to N.C. Gen. Stat. §116-209.25. The Treasurer holds and invests the funds in an institutional trust fund of NCSEAA and not as property of the State.

EFS, a North Carolina company owned by financial institutions operating in the state, assists NCSEAA with marketing, public relations, software, and other support for the College Vision Fund. EFS developed the College Vision Fund concept and has granted NCSEAA an exclusive license to implement the program in North Carolina.

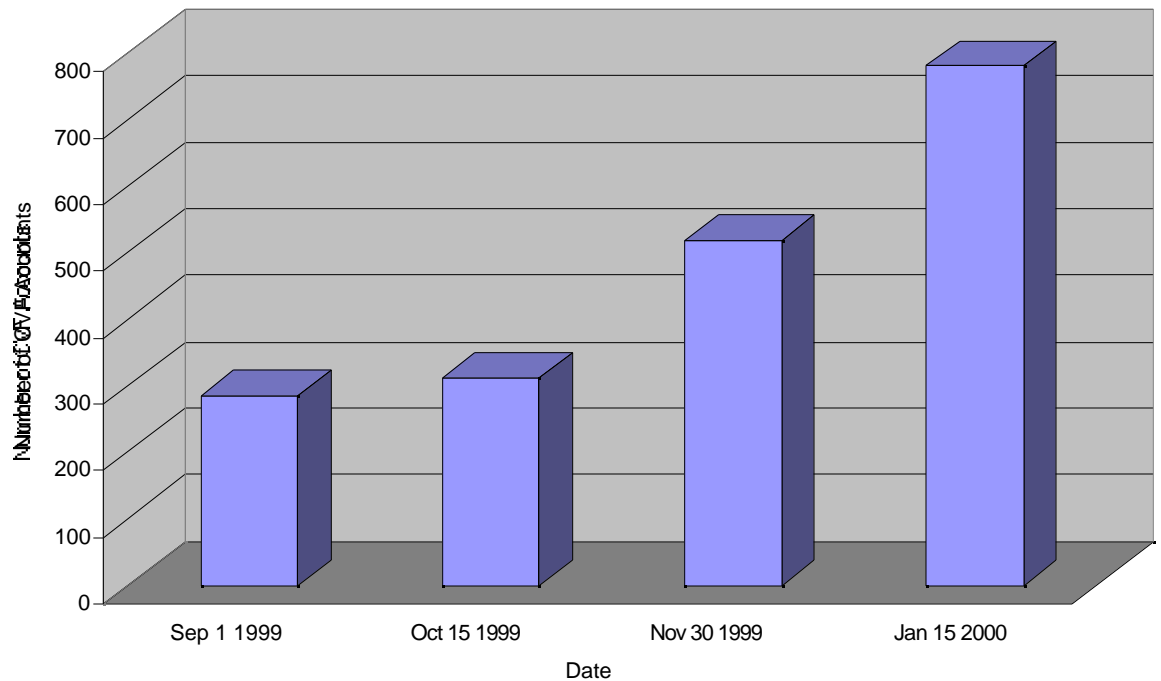
B. Operations and Use

From the fall of 1996 to the fall of 1999, NCSEAA and its partners obtained SEC (Securities and Exchange Commission) clearance to operate the program, hired and trained staff, developed computer hardware and software systems, and conformed the program to proposed IRS regulations.

In September of 1999, the College Vision Fund began aggressively promoting its service. Between September 1, 1999 and January 15, 2000, the number of College Vision Fund accounts jumped from 285 to 781, and the value of the funds invested rose from \$1.25 million to \$2.26 million.

Figure 3 displays the growth of the College Vision Fund from the onset of the initial advertising campaign in September of 1999 through January 15, 2000.

Figure 3. Growth of the NC College Vision Fund, 9/1/99-1/15-00, by Number of Accounts



Source: The College Vision Fund

Comparison of the North Carolina College Vision Fund and Other State Programs

1. **Risk and return.** IRS rules stipulate that the program participant may not control investment decisions. Thus, in North Carolina as in other states, the program makes all investment decisions. In North Carolina the investment portfolio is specified in the statute.

Only 15 of 45 state savings plans offer a guaranteed return on investment, and the trend seems to be away from such a guarantee. The College Vision Fund is one of the 30 savings plans not offering a guaranteed return.

Some states offer multiple plans, which provide options as to the level of investment risk, and participants elect one of the options upon opening the account. In such programs, however, the participant may not switch between plans after making the initial election.

Other states, including New York, automatically change the program's investment mix as the age of the intended beneficiary changes, providing a higher risk, higher return portfolio in the beneficiary's early years and a lower risk, lower return portfolio as the beneficiary's college-going years approach. In this model, plans

invest in both bonds and in equities, and weight the investments toward equities when beneficiaries are young and toward bonds when beneficiaries approach college age.

This strategy can produce higher yields over time than does the North Carolina program; however, it comes with a higher degree of risk to participants. While stocks have clearly appreciated rapidly over the past several years, an equity strategy might entail loss of principal in a bear market. The policy choice for college savings plans is between a slow and steady rate of return with minimal risk and an increased rate of return with additional risk.

Currently, North Carolina offers only one plan, which emphasizes safety over high return. It offers a simple and steady plan that appeals to those not now saving for college at all and to those saving far less than the amount realistically required to finance a significant portion of a college education.

For the minority of families that already invest for college, the yield on the College Vision Fund seems low at first glance. However, it compares favorably with Certificates of Deposit and, when tax advantages are accounted for, it offers a good rate of return coupled with a very high degree of safety. Today's 5% stated College Vision Fund yield is, after tax considerations, roughly equivalent to a taxable yield of 7%. Thus, the College Vision Fund serves for all investors as the conservative portion of a balanced portfolio that includes equities and other higher-risk investments, and as the depository for higher-yield investments that investors cash out of as the beneficiary's college-going years approach. It does not, however, exempt any portion of the returns from higher-risk investment from taxation.

Currently, the program invests all contributions in the Treasurer's Short Term Fund. The statute permits a limited diversification of the College Vision Fund's portfolio, providing that a portion of the portfolio may be invested in the Treasurer's Long Term Fund. Once accumulated deposits reach a level that assures the program's ability to meet withdrawal demand at any time under a variety of market conditions, the College Vision Fund will invest part of its portfolio in the Treasurer's Long Term Fund to increase yield to participants.

However, investing a portion of the portfolio in equities would require statutory changes. In the Recommendations section below, this report suggests that such a change in the law may be appropriate under certain circumstances.

2. ***Optional loan and lower monthly payments.*** Families meet higher education expenses in three ways: they save in advance, pay from current income, or borrow and pay from future income. Most families today meet college expenses through a combination of all three methods, because they typically do not save enough in advance to meet the full cost of college and are unable to dedicate sufficient current income to pay the full amount.

North Carolina's College Vision Fund recognizes this reality by offering a feature that is unique among state college savings plans. The program offers an optional loan

that may be combined with the monthly savings plan, enabling participants to defray college costs over a longer period of time through a single fixed monthly payment amount that is invested during the (pre-college) savings phase and used to retire the loan during the (post-college) repayment phase.

3. **Tax advantages.** All QSTPs enjoy federal tax advantages: earnings are not subject to federal income tax until they are withdrawn, when they are taxed at the beneficiary's rate—typically 15%—rather than at the higher rates usually paid by participants. (Withdrawals are subject to a penalty if the funds are not used for qualified educational expenses). Thus, earnings compound free from federal taxation and accumulate faster than would be the case if they were taxed annually.

Most QSTPs also enjoy advantages under state tax rules. In North Carolina, earnings are not subject to state income tax at all. Twenty-five other states also exempt earnings, as Table 3 shows.

Table 3. QSTPs with Earnings Free from State Income Taxes, by State

States Where Earnings Are Free from State Income Taxes³		
Alabama	Arizona	Colorado
Connecticut	Illinois (prepaid)	Indiana
Iowa	Kentucky	Louisiana
Maine	Maryland	Massachusetts (prepaid)
Mississippi	Missouri	New Hampshire
New Jersey	New Mexico	New York
North Carolina	Ohio	Pennsylvania
South Carolina	Utah	Vermont
Virginia	Wisconsin	

Source: A Review of State-Sponsored College Tuition Programs by Program Type, CSPN Conference, July, 1999

Thirteen states go further, exempting from current income tax some or all of the contributions to the plan each year. New York and Iowa, two plans often cited as leaders in the field, are among those offering such pre-tax contributions. This tax advantage provides a significant boost to the effective rate of return on the plan's investments.

Table 4 lists the states whose plans contain this feature.

One state, Louisiana, matches from 4% to 14% of participants' contributions, based on each participant's income, instead of offering pre-tax contributions.

³ 26 exempt; 13 not exempt; 6 with no income tax

Table 4. QSTPs with Deductible Contributions, by State

States Where Contributions Are Deductible from State Taxes⁴	Limit on Size of Deductible Contribution, If Any
Iowa	
Kansas	\$2,000
Maryland	\$2,500
Michigan	
Mississippi	
Missouri	\$8,000
Montana	\$3,000
New Mexico	
New York	\$5,000 single, \$10,000 married
Oregon	\$2,000
Utah	\$1,290
Virginia	
West Virginia	

Source: A Review of State-Sponsored College Tuition Programs by Program Type, CSPN Conference, July, 1999

4. **College planning information.** As part of the College Vision Fund application process, CFI provides students and their families with a comprehensive college planner with information on paying for college, college costs, and financial aid. No other state QSTP offers this valuable service.
5. **Effect on student eligibility for federal financial aid.** The Department of Education has ruled that the federal financial aid form (FAFSA) will treat prepaid tuition plans and college savings plans differently. Federal rules treat a college savings plan favorably, as an asset of the program participant (usually the parent or grandparent). The rules treat a prepaid tuition plan as a resource of the student's, reducing his or her financial need on a dollar-for-dollar basis and dramatically diminishing his or her financial aid package.

For families intending to apply for financial aid, college savings programs like North Carolina's offer a clear advantage over prepaid tuition plans.

Recommendation

This report recommends an important statutory change that will enhance the attractiveness of the North Carolina College Vision Fund to investors seeking higher returns than are currently possible at the low level of risk now assumed by the Fund.

The General Assembly should revise the statute creating the College Vision Fund to permit the Fund to invest a portion of its portfolio in equities. Whether this is accomplished through the diversification of one portfolio, or through the addition of another fund option, should be determined by NCSEAA and Fund officials. Of course, other means, such as state matching or making Fund payments tax deductible from state

⁴ 13 deductible; 26 not deductible; 6 with no income tax

income taxes, can add to the net return of the North Carolina College Vision Fund, but these modifications would require additional tax subsidy for the program. Given the many competing demands for state funds, this report recommends instead a proposal that does not increase taxpayer cost.