

## State College Savings and Prepaid Plans

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## Abstract

The growth of state prepaid plans and state savings plans (Sec. 529 plans, named after their IRS Code provision) has been nothing short of phenomenal, with several states having billions of dollars in their 529 reserves, and a number of states selling tens of thousands of contracts each year. Florida's prepaid plan is among the nation's premier programs, with over 750,000 beneficiaries and almost \$5 billion in assets. Every state now has a savings plan, and 18 have both a saving plan and prepaid plan. This growth, spurred by generous federal tax legislation, has brought exceptional professionalization into play, with several national financial organizations such as TIAA-CREF, Fidelity, and others providing services to states. The advantageous tax treatment has given rise to many states offering multiple programs with generous provisions and helpful features.

That said, a number of policy issues have surfaced, including federal tax treatment of the plans, financial viability during unstable economic periods, system complexity that makes it difficult to evaluate plans or comparison-shop, and understanding the proper role of states in a federal financial aid system. For example, a number of states have privatized these programs, setting up shops with turnkey elements. A small number of states have given full faith and credit protection to 529 plans, raising the possibility that a state's general fund resources will be used to bail out losing programs.

Several issues of state and federal taxation remain unclear, such as how 529 plans "count" in federal aid determination, and why gains on prepaid plans are included in the Expected Family Contribution, while proceeds from savings plans are not included in the EFC. Until Congress extends the 2011 sunset provision, parents or other potential

purchasers may be reluctant to purchase 529 plans, even though it is likely that Congress will act to extend the tax treatment before that cutoff date.

Finally, there remain important equity, institutional, and legislative policy implications. Among these are the extent to which these plans exacerbate the gap between the well to do and the financially – needy, the extent to which prepaid plans will distort the admissions process and need-blind financial aid/admissions, and the likelihood that enormously successful 529 plans may restrict needed tuition increases or trade off against legislative appropriation levels. There is evidence to support all these equity concerns. Additional questions that have not been addressed include the extent to which generous tax treatment actually stimulates additional family savings for college, or simply re-directs family investment strategies. At the end of the day, prepaid plans are popular vehicles for the more advantaged, but their success has within it a number of policy concerns that deserve attention by scholars, legislators, and families.

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## State College Savings and Prepaid Plans

**Michael A. Olivas**

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 CSP's 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 that I think is for its lottery, when it is revealed that all the hullabaloo is about the new prepaid tuition plan. Certain ticketholders even will receive scholarships... yet another state will give fully paid CSP awards to the first five children born in the upcoming year... I find myself mentally backdating 9 months from the due date, and realize I missed out.

By the end of 2002, every state plus D.C. now has a College Savings Plan, either the prepaid version, in existence since the 1980's, or a pooled-investment savings trust program. Several states have both, prompted by the 1996 legislation that created Section 529 plans, named after their IRS tax code provision. The prepaid plans, operational in twenty states, work on a very simple premise: parents or grandparents place a lump sum in a contract (or they 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 2003 tuition at a Texas public college is \$10,000 for each of 4 years, that \$10,000 (plus a small fee) invested in the Texas Tomorrow Fund in 2003 will be guaranteed to cover my newborn daughter's 4 years of tuition and fees in 2021 -- 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 their state (as does Texas) to these plans, pledging state funds to cover any eventual shortfall. In other states, you take your chances with the markets.

States have also created a kissing cousin to CSP's - savings program trust funds (SPTF), that enable persons to invest in a state-operated investment fund. (While they are state-operated, they are often managed by investment firms or large financial institutions, which are contracted to perform these tasks.) With recent federal legislation, these funds have 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. Many states have also given state income 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. When the Michigan Education Trust (MET) was challenged in the 1980's by the IRS, the MET lost its case at the trial level, but then won an important victory in the Appeals Court. When the IRS decided not to appeal, the way was cleared for 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 contracts 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 several of these state investments, as states have added full-faith-and-credit (as in Texas and Ohio) or declined to do so (voters in Oregon voted 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 1990's, I wondered how these programs could survive the MET experience and thrive as taxed, essentially for-profit organizations. Well, 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 1990's. As long as the stock market or bond market does well, these plan managers will look like geniuses, especially in light of the longterm nature of the portfolios (usually requiring at least 2 or 3 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. Of course, as the markets refused to defy gravity in the 2000's, several of these plans have not done as well. As I note, this development has placed several funds in trouble.

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 financial 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, Fidelity, and other money managers have recently begun to make their investment and insurance underwriting expertise available to state plans. Other states have hired the College Savings Bank to administer their investments. (CSB is the country's only bank devoted solely to college prepaid tuition financing.)

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 have suggested that two political considerations have kept this pacesetter state from enacting its own prepaid plan: 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 older 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 large 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 - and then the remaining states will follow. As of early 2003, such a plan still has not materialized, even under Democratic leadership, although California has had a state savings plan since 1999.

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 longterm nature of such portfolios, combined with the economies of scale and tax exempt status of the plans, virtually assures their financial viability.) Moreover, as the plans spread, more innovative program features will likely result, such as multi-state 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, credit-scoring, 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 prepaid and savings plans will, likely as not, be seen as the catalyst for such creative approaches to this field.

### State Policy Issues

Prepaid and savings plans were creatures of state law, with Wyoming inaugurating the first prepaid plan in 1986, and with Kentucky's pooled-assets trust serving as the prototype for 529 Savings plans. In the early 1980's, both these plans were at considerable risk, both because they had not caught on as popular investment vehicles and because of the uncertain tax treatment, culminating in the Michigan prepaid program's loss in court in 1988 on whether or not the interest earned on the MET was taxable. The Sixth Circuit reversed the district court, and the IRS decided not to appeal the ruling against it. When Congress acted in 1996 to provide the requisite tax treatment to the plans -- making them Section 529 plans, for the revised statutory code chapter --the second problem was solved. The first problem, however, that the programs had not caught on, quickly resolved itself after the law provided an attractive tax shelter. Of course, there had been longstanding tax breaks available to the public, particularly the wealthiest tax-payers, but the vehicles all had unattractive features: for example, the Uniform Gift to Minors Act (UGMA) sheltered and transferred resources to students, but did not require the recipient to spend the money on college expenses. More than one

wealthy child blew his UGMA inheritance on a muscle car or another lifestyle that did not include college, and the donor parents or grandparents could exercise no control over the gift, once it was made.

Even with the substantial federalization of prepaid and savings plans, they remain state creatures, established and maintained by state legislatures and agencies. As of the end of 2002, all fifty states and the District of Columbia have established savings plans, and nearly two dozen also administer state prepaid plans. (Vice president Al Gore proposed a federal savings plan during his 2000 presidential campaign, but there have been no other serious efforts to reformulate the state plans into a comprehensive federal system.)

That the programs vary among themselves is an inevitable byproduct of their stateness, as is the variability of the plans' success, measured by the wide fluctuation in participants, the financial reserves, and the overall efficacy of the plans. Florida's Prepaid College Tuition Program has over three quarters of a half million contracts in play, and over \$4 billion in total assets; Wyoming's prepaid program, the country's first, closed its doors in 1995. Florida's demographics, with its many low cost public colleges and community colleges, its growing population, its many retirees who choose to invest in their grandchildren's futures, and its savvy and aggressive marketing of the plan have made it the Cadillac of prepaid plans. Contrast these advantages with small Wyoming, with a single public college and a static population base. In this case, all the states can array themselves along this ladder, with favorable features or built-in headwinds. In addition, states have begun to gain competitive advantages relative to each other by fashioning programs that are more attractive than those of the competition -- usually by

transcending borders and adding program elements that offer more competitive terms and features such as lower fees, more portability, tax exemptions, or guarantees. These extremely attractive dimensions also have serious drawbacks to states left behind or to consumers who do not gain access to the considerable comparative information available in the public domain through websites and publications.

Notwithstanding, these programs are state entities, even as they must meet Section 529 federal eligibility criteria for federal tax treatment purposes. As such, policy analysis requires attention at the state level, as well as at the federal level. Three major state level issues have emerged in the decade and a half since these plans began, and especially in the half dozen years since the enactment of the Taxpayer Relief Act of 1997: finance and financial stability, system complexity, and the proper role of states in a federal financial aid system. (Additional issues of state taxation in the federal tax regime are treated separately in the following section, and mirror the parallel tracks of state/federal program design and implementation.)

### Finance

The financial success of state prepaid and savings programs is not a slam dunk assured matter. After all, Wyoming closed the country's first such program, and others have found it a rocky road to program solvency. When inflation is low and when the stockmarket is rising, even modest state programs made geniuses of their managers. After all, most investors are in it for a long haul, purchasing their children's contracts that do not come due for many years: a newborn's payout will not come due for eighteen years, allowing a variety of investment strategies to states -- including a mix of stocks

and bonds, invested on an age-basis that becomes more conservative in the later stage of the transaction. Bundled together with many thousands of such contracts, a state's investment portfolio has many advantages, doing business as tax-exempt entities and having access to sophisticated markets that risk-averse individual investors do not possess. In a number of instances, states provide substantial public funds to establish or operate these programs, so much of their cost is subsidized. In 1994-95, for example, Ohio underwrote its prepaid program by investing \$1 million to reduce the cost of its prepaid contracts and to provide a full-faith-and-credit guarantee to the program. Virtually all the programs have been subsidized by the sponsoring state at some point in their operation, even those administered or operated by private investment companies or financial institutions. These state contributions have surely enabled the programs to become established and operational.

But it is one thing to operate a program in the 1990's, when the stock market defied gravity, and it has proven to be another in the slowed-down, self-correcting stock market of the new century. In 2002 alone, Morningstar reported that average 529 stock funds it monitored had fallen by 21.2%, a better performance than the year's S&P 500-stock index, which performed even more poorly, at a 21.8% loss for the year. In 529 bond funds, the average 529 programs performed better, gaining 2.5% for the year; however, age-based bond funds keyed to five-year old children (with 13 years left before they cash out and attend college) declined by an average of 16%. And this occurred in a year when college tuitions rose by almost 10%, leaving even the most successful funds losing ground. In its first year of operation, the Texas Tomorrow Fund planned for a 9% payout in its prepaid program, and then discovered that the aggregate Texas public

college tuition and fees rose by 19%. Such a one year shortfall can be made up over time by improving estimates and adjusting program charges, but no portfolio can sustain longterm losses even if college costs did not increase. Sometimes, states have even discounted the costs, in order to attract program participants, as Michigan's MET program did in its early period. This mistake and the early tax problems caused the state to suspend its sales operations for a time until financial stability was restored.

But even with the favorable tax treatment meted out to the programs in 1997, and with several years of a robust market, the 2000's have seen substantial losses across the states. News reports and annual program reports have noted losses by most state plans, both prepaid and savings programs.

As a result, states have substantially increased the costs of these programs, added additional fees, and reduced benefits. As one example, in Maryland, the one-time payment to cover a four year degree in its Maryland Prepaid College Trust rose 30.5% for an infant and 20.2% for a ninth-grader (whose contract would ripen in three years after 12th grade). The 2003-04 cost increases will be almost 10%, with 6% increased each year after. The College Trust's fiscal year 2001 reserves were \$238 million, with an "actuarial deficit" of \$30.5 million. These paper losses show that if the revenue/expenditure continues without correction, it will be short \$30.5 million on already-existing contracts when they come due. In fiscal years 2000 and 2001, the portfolio lost 7.8% and 8.8%, respectively.

Maryland's situation is not unique. Ohio projected a \$46 million deficit after its portfolio performance in 2001-2002, and in four separate increments, raised the cost of each credit unit a total of 53%. Virginia raised the cost of its plan by 25% in 2001-2002.

Washington State increased prices by 24% in fiscal year 2001-2002. Pennsylvania maintains several investment funds, and in the first three months of the funds performances, the returns ranged from a high of plus 1.88% to a low of minus 19.06%. New Jersey's losses ranged from up 1.6% to down 7.34%. In most of these plans, any losses to be made up will affect new subscribers, who will be charged more to subsidize the losses in earlier fund participant portfolios.

Some states are so concerned about their prepaid or savings programs that they are closing (Wyoming), are considering closing (Florida, Tennessee, Colorado), are limiting or delaying enrollment periods (West Virginia, Colorado, Maryland), or are allowing dissatisfied participants to withdraw without the usual penalties (Colorado). Conflicting reports have even suggested the enormously – popular Florida Prepaid College Plan could be in trouble (even with its three quarters of a million contracts and \$4 plus billion reserves), and even as the state finally enacted a state savings plan in 2002, the Florida College Investment Plan. While the total investments in 529 plans have grown (\$9 billion in 2002 alone), and while there is evidence that more parents and other donors have heard of Section 529 plans, these stutter – steps, program restrictions, and losses do not appear to bode well overall, especially in a market downturn. One saving grace is that most of us are risk-averse and unlikely to do better in the stock market than are the major investment firms currently operating state program portfolios. And who knew bonds would perform well? Evidently, the lower transaction costs (for some funds), market advantages due to large size, and tax savings still make these fund attractive to many investors seeking a diverse portfolio for their children's college expenses.

## System Complexity

A good way to appreciate the complexity of 529 plans is to consider traditional retirement plans or 401K programs, and then make them more complicated. Virtually no state operates its prepaid or savings plans the same way as does another state. For example, Joseph F. Hurley, whose annual book The Best Way to Save for College rates state plans, records the following criteria for each:

- Eligibility, or who can open an account
- time or age limitations on beneficiary or on use of account assets
- age-based investment options
- static investment options
- underlying investments
- fees and expenses (annual/enrollment/withdrawal)
- broker distribution
- contributions (maximum/minimum)
- account changes (beneficiary changes, transfer ownership, successor owners, rollover/transfer assets, investment options)
- full fair and credit
- state income tax deductibility
- exemptions from creditors
- subject to involuntary transfer or alienation
- reciprocity with other state plans

In addition, there are many other complicated features, such as whether programs involve a state's private colleges (Texas); whether a state plan's withdrawal provisions



conform to federal law (California, Arkansas); where there is a cancellation penalty (Illinois); whether payroll deductions are permitted (Idaho); whether tuition alone is covered, or tuition and college fees (Virginia); whether receipt of a scholarship provides special refund provisions (Texas); whether there are special provisions for death, military service, disability, state financial aid eligibility, and a myriad of other conditions.

Of course, these many options reflect the maturity of investment markets and make the various plans extremely popular with parents and other investors, especially those plans that offer enhanced portability and tax benefits as program choices.

Additionally, investors have many choices among investment funds, especially in state savings plans: Alaska offers eight age-based options and four static portfolios, while Tennessee and Vermont offer eleven age-based funds, all managed by TIAA-CREF. Texas maintains thirteen fund options. Each state also maintains at least one major diversified investment portfolio for its base funds. California even offers a “social investment” portfolio, one that invests only in stocks considered socially and environmentally progressive, such as not including alcohol or tobacco interests.

As attractive as these choices are, an observer cannot help but question whether a state program really requires eleven or thirteen investment choices for contract purchasers, each with a different fee structure, investment mix, or track record. The marginal advantages may not be evident in any annual review, while the state’s supervisory role is made more complicated by the extremely complex bid and review process, especially in states with intricate procurement and investment regulations. This lack of transparency is the clear disadvantage, held up to the mirror of enhanced investor choice. There are likely too many choices for most investors, the system’s complexity

rendering comparable choice shopping too complicated for most investors, particularly for those who participate because they are risk-averse and do not feel comfortable simply investing in traditional instruments and beating the markets. I have a law degree and a PhD, have studied these state programs since their early versions, have written two books on the subject, own contracts in five states, and still cannot compare the plans across various states. There is almost too much dynamism in the plans, as states vie with other to offer more plans and more complex options so as to attract more contract purchasers. A system can have too many choices, and can intimidate or paralyze unsophisticated buyers, especially in such churning markets.

This system complexity can become a barrier to market entry for some. The early state prepaid programs did not pose this issue, as purchasers simply bought into a contract that either performed well or did not, and in states with guaranteed state full faith and credit, the investment results literally made no difference to the purchasers (save for their concern about overall program efficacy, as in the Wyoming case). Consumers of state savings and trust plans, however, invest both for the substantial state and federal tax advantages, and for enhancing their investment returns. This lack of transparency is another result of system complexity and too many choices.

Yet another issue is that the range of investment options may have unintended consequences, such as plans that may encourage purchasers to place all their eggs in one basket. I have been concerned about the rise of single mutual funds as state options, both with and without brokers, in several state plans, such as those in Utah, Texas, and Nebraska. My concern is that many people in traditional marketplaces might choose mutual funds due to their broadly-based mix of stocks (or bonds, in some instances),

when individual contract purchaser needs may be poorly suited for such vehicles. For example, a neutral fund will likely track the performance of the Dow-Jones or Standard & Poor markets, when an investor with a teenaged or middle school child will need to better today's disappointing market performance. Use of a single mutual fund may not be a well balanced choice for college going plans: college attendance will likely come soon after high school, whereas retirement age is subject to many features and can be postponed in real life. Joseph Hurley made this point dramatically in an October, 2002 editorial to his service subscribers to [www.savingforcollege.com](http://www.savingforcollege.com), when he noted a similar concern in his Utah Educational Savings Plan, a single 100% equity mutual fund option, offered by the private Vanguard Institutional Index Fund. While he notes that he is, in principle, for "greater investment choice," he is also concerned that such options will lead parents to place all their college savings plans eggs in one basket, rather than diversifying across several options, especially age-based ones that shift their investment mix as the beneficiary approaches college age. No doubt, he was also influenced by the mutual fund's poor performance in 2001-2002, when it lost over 30%, but his overall point is a good one, a situation exacerbated by system complexity. Whenever information, such as how to best allocate and invest in state programs, is at a premium, the persons least likely to participate or prosper are the less-well educated, the poor, and minorities. Thus, system complexity in state prepaid and savings programs -- even in states with low barriers to entry and monthly payment options -- attract and reward the most advantaged and knowledgeable participants, much like the college application process itself, which so clearly serves the interests of advantaged and wealthier students. If information and investor savvy are needed for these dynamic investments, state prepaid and savings will

widen the gap between wealthy and poor, majority and minority, street-smart and less-well-educated.

Role of the states:

As noted earlier, these prepaid and savings plans are creatures of state law, even if it took federal tax deductions and exemptions to breathe life into the plans. (In 1993, my book on prepaid plans worried about who would pay for the funerals of the plans then in existence; my 2000 book raised fundamentally different questions about the runaway success of the savings and prepaid programs.) A subtle thing happened on the way to success, following the 1997 Taxpayer Relief Act: Qualified State Tuition Programs (QTSP's) morphed into Qualified Tuition Plans (QTP's). Whither the state role in state plans? Was this change symbolic, either because of the federalization of the programs (after all, it was I.R.C. Section 529 plans in play) or preceding the 2002 legislative changes that made it possible for private institutions of higher education to offer their own plans, either singly or grouped into college consortia, or because private investment firms now perform much of the heavy lifting in state plans?


There is some truth to all three scenarios, and states may further confuse audiences by camouflaging or dismissing the state role in the plans. Consider the recent following ad for New Mexico's "The Education Plan's College Savings Program," which appeared in the State Capital's daily Santa Fe New Mexican:



"I've got grandchildren in high school and in preschool. How can I save for each of them?"

Over the course of the last 20 years, the cost of a college education has increased by nearly twice the rate of inflation, as measured by the Consumer Price Index.

It's important to know your options and start putting money away now. Call me for more information on Scholar'sEdge<sup>SM</sup>, a 529 higher education savings plan.

Scholar'sEdge<sup>SM</sup> 

Contact Laurie McDuffie at SMITH BARNEY  
505-988-7725 citigroup



SCHOOLHOUSE  
CAPITAL, LLC



OppenheimerFunds<sup>SM</sup>  
The Right Way to Invest

OppenheimerFunds is a member of SIPC. Scholar'sEdge accounts are protected up to \$500,000. For details, please visit the SIPC website at [www.sipc.org](http://www.sipc.org).

Scholar'sEdge<sup>SM</sup> is an Internal Revenue Code Section 529 Trust available to all U.S. residents offered by The Education Trust Board of New Mexico. Schoolhouse Capital, LLC, a wholly owned subsidiary of State Street Corporation, is the program manager for Scholar'sEdge and OppenheimerFunds Distributor, Inc. is the distributor of Scholar'sEdge. Some states offer favorable tax treatment to their residents only if they invest in the state's own plan. If you are not a resident of New Mexico, you may want to investigate whether your state offers its residents a 529 plan with alternative tax advantages. The tax bill exempting earnings on qualified withdrawals from Federal income taxes expires December 31, 2010, requiring Congress to take further action to extend those provisions beyond that date. This product is neither FDIC insured nor guaranteed and may lose value. Scholar'sEdge assesses an annual Program Fee of 35 basis points on assets in each Investment Portfolio invested in the A-Structure, and an annual Program Fee of 120 basis points on assets in each Investment Portfolio invested in the C-Structure, to cover the costs associated with Scholar'sEdge, including but not limited to, customer service, online account access, plan administration and distribution. Please read the Customer Agreement, Disclosure Statement and Privacy Policy and the mutual fund prospectuses prior to investing, available at [www.scholaredge529.com](http://www.scholaredge529.com) or by calling 1.866.529.SAVE, for more complete information, including fees and expenses.

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As in Arthur Conan Doyle's The Hound of the Bakersvilles, this publicity piece is more interesting for what it does not show: nowhere in the ad does the official, legal name of the program appear ("The Education Plan's College Savings Program"), nor is there a local or state address for the program, re-styled "ScholarEdge," a trademarked program of Smith Barney/Citigroup, Schoolhouse Capital, LLC, and Oppenheimer Funds. There is a local phone number, and the very-fine print does mention The Education Trust Board of New Mexico and the caveat that New Mexico non-residents need to investigate their home state's "alternative tax advantages." However, there is no other reference to the state, and this ad is so generic it could appear in almost any state's publication.

This Savings plan was established in 2000, along with a state prepaid plan ("The Education Plan's College Savings Program"), also subject to The Education Trust Board of New Mexico and administered by Schoolhouse Capital, LLC. If one calls the Santa Fe phone number at a time other than regular office hours, there is no recording to identify the program; the program is not listed in the 2002 Santa Fe Phone Directory. The website is not located on a Santa Fe server, and the program information requires a toll-free long distance, out of state call. Where is the "New Mexico-ness" of this New Mexico State program?

I do not mean to pick on the New Mexico plan, as I am certain nationalization of these plans has led to similar generic advertising in many, if not most of the states. And no savings plan is offered by any state without the active involvement of private investment funds or banking institutions, certainly a salutary development, especially as the plans allow non-residents to purchase shares or enroll in state institutions. This

evolution has been a good thing, to be sure.

But my cynical side cannot help but characterize such programs as ones that rent-a-state, operating these programs as branch offices of a larger network of financial services institutions. TIAA-CREF, the immense insurance company/financial services company that recently lost its federal tax –exempt status due to congressional action, administers and operates over a dozen state plans. Again, I stress that there is nothing unethical or even suspicious, but state programs outsourced to private markets and operators cloud discussions about the proper role of states, state agencies, state regulations, state taxation, and state-ness. My late father was a certified public accountant in New Mexico, where he had several Indian tribes and gaming companies as clients. During the last years of his life (he died from a car accident in 1997), he told me several times that New Mexico's Indian tribes and pueblos were being disserved by gaming interests, who subcontracted tribal gambling and casino operations, but who did not build up or develop an infrastructure of Indian self-reliance or self-determination.

Of course, Indian gaming interests (or another similar state program, state lotteries) may not be the perfect analogy, but there is a genuine public policy question of whether such a privatized infrastructure fully serves the state host interests. In the alternative, it diminishes arguments that these are truly state programs if they are turnkey operations, simply state-located. And closing a privatized program is clearly easier than would be closing a genuine state program. One has to wonder about the staying power of such operations.

While there are open questions concerning the state-ness of state prepaid and savings plans, there can be no doubt that there are state investments at play. Several

states offer full faith and credit on their prepaid plans; most states offer tax exemptions or tax deductions in their plans, which details vary widely. These investments are both real and imagined, in the form of foregone tax revenue or credit guarantees, should the plans fail to meet their contractual obligations at some point. And even in states that do not offer the state-guaranteed full-faith-and-credit (FF&C), such as with Michigan's MET prepaid plan, state officials may maintain a "political FF&C" policy. When the MET was under attack by the IRS to render its operations taxable, then-Michigan governor John Engler publicly pledged to backstop the program's reserves, if need be, even without any legal requirement to do so. The New Jersey Better Educational Savings Trust, a savings plan rather than a prepaid plan, has a formal "Moral Obligation" provision that requires the NJBEST program to request legislative funds in the event of a shortfall. Other states also have ambiguous status for their prepaid plans, such as Pennsylvania's which is called the Guaranteed Savings Plan, but which does not have the state's backing of full faith and credit. The program, began in 1993, has published a detailed, 28 page booklet so that persons considering joining the \$493 million fund are fully on notice that the plan, despite its name, is not actually "guaranteed." In 2002, the plan had an actuarial shortfall of \$26 million. A similar situation occurred in Colorado's Prepaid Tuition Funds, which required a \$7.7 million infusion into the \$62 million program in June, 2002, by the Fund's parent, the Colorado Student Obligation Bond Authority. Since that time, the Fund has allowed purchasers to opt out of the program without penalty. This cannot shore up purchasers' or investors' confidence.

By the end of 2002, only eight states offered state prepaid plans with the full faith and credit backing of the state, a guarantee that the state would honor its contracts even if



the fund reserves were not available: Florida, Illinois, Maryland, Massachusetts, Mississippi, Ohio, Texas, and Washington. In 1998, Oregon voters went to the polls and voted down FF&C to its savings plan.

Another function exclusively reserved to state determination is that of residency and reciprocity. First, by establishing rules to determine who is eligible for in-state residency and by charging tuition differentials for non-resident students in public institutions, states play the crucial role in residency determination. Cases going back to the 19<sup>th</sup> Century, a number of U.S. Supreme Court decisions, and a substantial research literature all chart this well-established role for the states. While the details differ, often wildly, most states required a twelve-month period of residence, as well as domiciliary intent to make the state the student's true, permanent, fixed abode, evidenced by voting, paying taxes, holding licenses, working, and other indications of residence and domicile. Designation as a resident entitles a student to pay lower (resident) tuition and to be eligible for special admissions considerations (such as in limited-enrollment curricula or programs). States also provide many exceptions and exemptions for persons not able to fully establish or document their residency, such as military, certain aliens, finances, and others with unusual personal circumstances.

These determinations are important in the state prepaid and savings programs in several crucial ways. First, the amount of public colleges' tuition charged varies substantially between residents and non-residents: at the University of Michigan Law School, for example, 2002-3 resident tuition was \$25,000, while non-resident tuition was \$31,000. Second, for 529 program participants, this residency determination may determine eligibility for the state plan. For instance, beneficiaries of the Texas

Tomorrow Fund, the state's prepaid contract plan, must be either Texas residents for at least 12 months preceding the date of the TTF application or even more unusually, the non-resident child of a purchaser who is a Texas resident. In addition, if a beneficiary moves from the state before she attends college and withdraws TTF funds, she may retain her classification as a resident, even though by Texas residency criteria, she would not be eligible to claim residency status. This is an enormous windfall, one near-unique to the Texas prepaid plan. In virtually every other state with a prepaid plan, students must be deemed residents at the time they enroll in a public college to be eligible for the lower tuition. I have served a faculty chair of the University of Houston's Residency Appeals Committee for seventeen years, where we hear dozens of appeals from unsuccessful non-resident claims each year, and this feature trumps all the usual criteria for establishing Texas state residency. A savvy Texas parent who purchases a TTF contract and who may plan on moving away from the state can, with modest sums, guarantee their child a resident student contract even should the beneficiary not be eligible for the lower tuition by virtue of the child's domicile in Texas. Given Texas' relatively high barriers to residence (for example, requiring that the applicant be "gainfully employed,"), this is an extraordinarily generous benefit. (Some border states award in-state benefits to foreign nationals in Canada or Mexico.)

In truth, both savings and prepaid plans have become more portable, both within states and across states. For example, students in most states can use the 529 funds to attend public or private institutions into which they are accepted, with the dollar amounts pegged to an aggregate amount, either the mark of public college tuition (as in Ohio and Alabama) or an amount up to the estimated average costs of an undergraduate education

in the state's private colleges (in Texas). In this fashion, the beneficiaries of state plans can apply to colleges in almost any other state.

These developments have been for the good, as earlier plans had more geographical restrictions, which discouraged some potential purchaser parents who were unwilling to restrict their children's options to in-state public colleges, and therefore chose not to purchase 529 plans with such restrictions. As private institutions make plans to enact their own programs, this portability and mobility should increase, as private colleges do not differentiate tuition on a resident/non-resident basis. One could also expect additional developments that will lessen state residence barriers, as there will likely appear state exchanges, reciprocity, and inter-state consortia to allow regional compacts. Fully developed plans could even include reciprocal state tax deductions or exemptions where both states (the home state and receiver state) have state income taxes. Now that all states have college savings plans in operation, negotiating these reciprocal compact programs is the logical next step.

Reviewing these state-level policy issues, an observer need not be Delphic to comment upon the general "privatizing" of this movement, in light of the development of private markets and financial institutions actually implementing many states' savings and even prepaid plans, the involvement of private and even proprietary institutions of higher education as recipients of students enrolled with 529 plan resources, and the relaxed residency requirements for purchase options that allow parents who live in nearly any state to buy contracts for beneficiaries who will want to attend colleges almost anywhere. I raised questions about the diminished "state-ness" of state savings and state prepaid tuition plans and forces at play that will likely lessen the states' roles in these state

programs. Additional forces include the success of private sector savings plans such as that of the College Savings Bank, the Section 529 eligibility of private institutions to establish individual or consortial savings plans, and similar devices (such as UPromise) that allow consumers to save college funds by retail purchasers that generate “frequent flier”-like points towards college tuition and other clever options such college tuition gift certificates and college gift registries, pledging programs that are likely to grow as parents seek ways to pay their children’s future tuition bills. When they get married, buy them a China setting or two English literature courses.

There can be no doubt that the private market incentives and public tax advantages have stimulated these state college savings and prepaid programs. In 2002, nearly \$20 billion had flowed into these investments, even in a depressed stock market. This development has been a public-private sector collaboration that has exceeded most observers’ expectations, especially those who remember the tax problems of the early prepaid programs and the period before the 1997 federal law changed the landscape entirely.

A number of policy issues remain unresolved, but they will likely be worked out as the plans expand and mature. These include issues of state and federal taxation: The interaction of state and federal tax issues, such as how parents and other purchasers can take advantage of the complex and overlapping 1997 Taxpayer Relief Act college provisions and those of the 2001 Economic Growth and Tax Relief Reconciliation Act of 2001, especially the complex education provisions of tax credits, tax deductions, and tax exclusions that are included in the Hope and Lifetime Learning Credits, deductions of educational expenses and student loan interest payments, Education IRA’s, and Employer

– Provided Tuition Assistance provisions. These complicated and detailed provisions present the same system complexity that was seen as problematic in the Section 529 Qualified Tuition Plan provisions, only more so.

Because of the different state-level income taxation issues at play in the fifty-plus jurisdictions, a variety of taxation issues have arisen, including state plans that penalize non-resident 529 purchasers (as in Illinois) and actually favor non-residents (as in New York). Some state plans excludes state tax on payouts, while others have no such exclusion, rendering comparability almost impossible, either for purchase price comparisons or actual use calculations. In some state plans, such as that in Virginia, due to the way state contracts are drafted, the state may lose money on resident beneficiaries but will likely come out ahead on all beneficiaries who attend colleges outside the state.

As technical as these state tax issues appear, additional federal tax issues have also arisen, as yet unaddressed by the IRS or Congress. Some of these include how Medicaid “countable resources” count, 1099 tax reporting provisions, income averaging, how to treat 529 plans when the student receives a scholarship (the “scholarship penalty”), criteria for Qualified Higher Education expenses, “self-help” provisions, and issues involving saver’s credits. Not all these issues affect a large number of contract-purchasers or beneficiaries, but two tax issues continue to vex all participants: interaction with financial aid programs and 529 sunset provisions.

Even five years after the 1997 legislation that created 529 programs, it is unclear how prepaid or savings plans will affect the beneficiary’s financial aid package. This entire process is extraordinarily complex, and turns on whether or not the student is a dependent, has siblings in college, has assets, or has parents with earned income. In

traditional arrangements, parents are expected to pledge a certain percentage of their income and assets to their dependent children's college education; the calculations turn upon the parents' submitting a financial aid form, the Free Application for Federal Student Aid (FAFSA). If the child is under consideration for private colleges, the parents will also likely be required to complete and submit an "institutional methodology" form called the PROFILE, administered by the College Board's College Scholarship Service. This form, an extremely detailed review of assets, is used to dispense institutional aid.

The FAFSA formula roughly measures the individual college's Cost-of-Attendance (COA), a composite of tuition, fees, and other expenses needed to enroll in that institution and live for the academic year. A given student's financial need would be calculated by subtracting the Expected Family Contribution (EFC) from the COA. Herein lies the crux of the problem: Are Section 529 plans counted in financial aid determinations (such as the EFC)? Well, yes and no. Federal law requires that prepaid tuition plans reduce the COA, meaning that in most instances, the assets of the contracts will reduce the "financial need" of a student. However, assets from Section 529 Savings plans do not count on the COA side, but shift to the EFC ledger for parents who hold the contracts, and are counted at a lowered rate; even better, if a grandparent owns the contract, it is as if it doesn't exist at all. In some instances, however, such as if the parents are relatively lower income (with an adjusted gross income of less than approximately \$50,000 in tax year 2001-2002), no 529 assets will be counted. This differential treatment is as confusing as it is meaningless -- to parents, putting money into a 529 plan should not turn on whether it is an asset, forcing their hand into a prepaid or savings plan on the basis of whether the child ends up in a public or private college,

whether it is the grandparents or parents who actually fund the plan, and whether or not they will, at some future date, be eligible for asset reduction due to the fine print. Again, this system complexity reduces public understanding and confuses choices.

As daunting as this system complexity is, and as much uncertainty is build into the system, at least until Congress, the IRS, or the Department of Education acts authoritatively, the biggest threat to all state prepaid and savings plans is a simple one: All federal 529 legislation provisions of EGTRRA will sunset or expire on December 31, 2010 - - a point in time that will likely impact most 529 contracts in play now and until that time. Unless Congress acts to extend the 529 provisions (and those of Coverdell Accounts and other financial aid program), there is no guarantee that the favorable tax treatment of QTP's will continue. It is almost inconceivable that the Congress will not extend the sunset provisions, as it is certain that a great deal of political pressure will be brought to bear on them. However, until Congress does act, there will be this sword of Damocles hanging over 529 accounts and the fifty states.

In all, it has been a remarkable five years since 529 plans were given their federal status, and the widespread developments have greatly strengthened through the comprehensive financial markets and investment firms that operate the plans and sell most of the contracts. Since late 2002, every state and DC have college savings plans, while a small (20) but growing number of states have established college prepaid programs, including twelve with the state's guaranteed full faith and credit.

Despite the phenomenal growth and comprehensiveness of these state plans, a number of questions and policy concerns arise. 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), one 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 in the future. 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 (a 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 750,000 contracts to date. Of course, poor market performance, at least over the short haul, has hurt virtually all stock investments.

But it is very likely to be wealthy and upper-middle class Texans who profit from this venture. The equity issue is not far-fetched, 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 in the Michigan Law Review, “Social Irresponsibility, Actuarial Assumptions, and Wealth Redistribution: Lessons About Public Policy from a Prepaid Tuition Program.” In 1993, he followed with a careful study of the Michigan Education Trust’s (MET’s) decision to expand its subscriber base by offering a monthly payment option. 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. (I am reminded here of my brother, a former car salesman in New Mexico and California, who marvels at how customers seem more concerned with their monthly payment rates than they are with the total price of the cars he sells.)

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 two-fifths of the Michigan population with children had purchased 61 percent of the MET monthly payment option contracts. More recent figures for Florida and Texas suggest that purchasers in these states also constitute their 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 that state’s 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. In the first year of the Texas operation, before the voters approved a Constitutional amendment to extend full-faith-and-credit to the state’s 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 the 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 CSP’s 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 admonishment 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 any state’s CSP purchasers receive a 20 percent discount? Indeed, I believe a surcharge for program fees is a better way to raise operating funds, and this has been the practice for the most recent startups.

### Institutional Implications

I also fear that at some point institutional behavior will change, so that admissions might be predicated upon ability to pay. Let me project a plausible scenario, borrowing from Texas and Florida, whose demographics are similar. Florida's CSP has sold over 750,000 contracts, and soon will have over a million 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 actually wished to attend college in Texas; 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 500-1000 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 2 and 4 year colleges. The admissions pressure upon 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 her college education is no reflection of her 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: in a strictly enrollment-driven system such as we have in Texas, there is some slight current underutilization of higher education, some "excess capacity." But Texas Coordinating Board data conservatively predict that in a mere 12 years, there will be 155,000 more students clamoring for higher

education in Texas. If we get lucky and 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 University of Houston's. Moreover, a college savings tuition 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 will certainly 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 10 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 to make my point. The Fund, actuarially premised upon 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. And again I ask, where will Texas get the funds to build the 9 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 I noted earlier, Texas undershot its costs in Year One, by nearly fifty percent, leaving the shortfall to be amortized across all latecomers.

As 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, fees, 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, who charge too little for their product. In Virginia, the year 2000 saw smaller actual dollar appropriations for public colleges than the 1999 levels. This does not even take inflation into account, or a stagnant federal economy that has led to state deficits and falling support for higher education.

Moreover, if legislators do the right thing and substantially increase public tuition, these plans may 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

Section 529 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 actually 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 January, 2003, only a handful of states had both a prepaid tuition and a college savings plan, but the next several years will see growth of both plans in remaining states.

Another issue is what to do when a program ends, as happened in 1995 with the 8-year old Wyoming Advance Payment of Higher Education Costs Program, which closed due to poor participation rates. Because the state is obligated to honor all the contracts sold during the life of the program, the program 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. As stock values have declined, other states have seriously considered pulling the plug on their programs.

### Conclusion, Research, & Evaluation Issues

My views on postsecondary prepaid tuition plans grow out of extensive research on the subject, familiarity with the national and state trends in this complex area, 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. My thinking on these programs has evolved to the point that I believe them to hold great promise but also to 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. However, this corner has been turned. 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 for conducting research on their portfolios. Success has been measured largely in the numbers of contracts or in 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' underestimation 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 where 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 zipcode analysis of MET contract purchasers, should 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, understand these programs, the more likely their 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 underparticipation or Michigan's problems or Florida's possible overparticipation 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 longterm support and confidence they will require.



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