A REVIEW OF PREPAID TUITION PLANS FOR HIGHER EDUCATION

By

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and

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Joint Legislative Budget Committee
State of Arizona

November, 1987

STATE OF ARIZONA
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MEMORANDUM

DATE: February 26, 1988

TO: Senator Jack Taylor
Representative John Wettaw

FROM: John J. Lee, Principal Fiscal Analyst

SUBJECT: COMPREHENSIVE INFORMATION ON PREPAID TUITION PLANS FOR HIGHER EDUCATION BY OTHER STATES

Enclosed please find a copy of A Review of Prepaid Tuition Plans for Higher Education. As of November of 1987, thirty-six state legislatures and Congress were exploring some kind of prepaid tuition and savings plans for higher education, and seven states already enacted such plans into law.

The Joint Legislative Budget Committee Staff felt that comprehensive information should be available to our legislators as to what other states and Congress are doing in this area of prepaid tuition and savings plans for the future generations.

Hopefully, you and other legislators will find this report informative. The information has been updated on the pages of 106 and 107.

JJL:lh
Enclosure
xc: Senator Jacque Steiner, Chairman of Senate Education Committee
Representative Jim Green, Chairman of House Education Committee
Ted Ferris, JLBC Staff Director
Mike Braun, Senate Staff Director
Louann Bierlein, Senate Education Analyst
Kim Baker, Senate Minority Financial Analyst
Rick Collins, House Chief of Staff
Lynn Dunton, House Minority Staff Director
Pete Gonzalez, House Education Research Analyst

EXECUTIVE SUMMARY

A prepaid tuition plan for higher education is a recent development to help parents prepay for their children's future education. As costs of higher education have increased at much faster rate than the general price level in the past several years, parents, policy-makers and law-makers have very serious concerns that higher education in the United States is being priced out of the grasp of most Americans and endangering the most precious American Dream - educational opportunity. Rising education costs and cuts in federal student aid have made pay-as-you-go college almost impossible for most students. In response to this dilemma, thirty-six state legislatures and Congress have been exploring prepaid tuition and savings plans in an effort to ensure that students are provided with educational opportunities beyond the secondary education.

Congress and state legislatures around the country are aware that higher education is facing its long-term crisis due to many factors including the following:

(1) Tuition has risen faster than inflation for the seventh consecutive year since 1980.
(2) Students have accumulated massive debt: About half of all students in the United States now graduate in debt.
(3) In constant dollars, federal aid to students has been cut significantly.

To challenge the higher education cost crisis, Congress has proposed various federal savings plans for higher education:

(1) The Senate has introduced six bills to establish federal trust and individual education accounts.

(2) The House of Representatives has introduced three bills for federal trust and individual education accounts.

Seven states have enacted some form of prepaid tuition or savings plans into law. In December of 1986, Michigan became the first state to create a tuition guarantee program known as the Michigan Education Trust (MET). These plans are shown in a chronological order:

(1) Michigan Trust
(2) Wyoming Trust
(3) Tennessee Trust
(4) Indiana Trust
(5) Maine Trust
(6) Florida Trust
(7) North Carolina's Education Savings Bonds

In addition, Illinois and Massachusetts are in the final planning stages of enactment process for similar plans. They are known as:

(1) Illinois Education Accounts (vetoed) and Illinois Education Bonds
(2) Massachusetts Education Bonds and Massachusetts Certificates

The state prepaid tuition plans have four different types:

(1) The prepaid tuition contract plans allow parents to pay a specific and predetermined amount to a state trust fund early in their child's life in exchange for the trust's guarantee to later pay for that child's tuition at a state university. Contract price is based upon projections of tuition inflation and return on investment.

(2) The education savings accounts plan, in contrast to the prepaid tuition contract plan, would not require the active involvement of the state. As an incentive for parents to save, funds deposited in special education accounts at private financial institutions would be deductible for state income tax purposes.

(3) The tuition savings bonds plan allows the state to sell general obligation bonds as education savings bonds. Interest earnings are deferred until redemption. The bonds may pay a bonus rate of interest of up to one percent if used to pay for educational costs.

(4) The prepaid tuition certificate plan guarantees to pay for the beneficiary's future tuition by a state trust which offers the certificates in small denominations in exchange for a specified amount. Certificate price is based upon current tuition prices.

The federal plans have certain features that are similar to some states' plans. The payments toward the plans may be deductible from the federal taxable income, and interest earnings would not be subject to federal income taxes.

Recommendation

The prepaid tuition and savings plans are an alternative approach to lessen parent's as well as future students' burden on educational costs. These plans merit serious and careful consideration by the State of Arizona. Thus, it is recommended that a study commission consisting of state legislators, Governor, university officials, and interested private citizens with experience in education and finance be created to engage in an in-depth feasibility study of the various plans. If any of the Congressional proposals is enacted into law, such a federal plan can become an alternative to a state plan.

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ACKNOWLEDGEMENTS

This report was prepared by John J. Lee, Principal Fiscal Analyst, and Michael Bohnhoff, Higher Education Intern, of the Joint Legislative Budget Committee Staff. Michael Bohnhoff spent numerous hours contacting various state and federal officials to collect and verify pertinent information.

We acknowledge our appreciation to those officials and officers at National Conference of State Legislatures, Education Commission of the States, and many other state agencies and educational associations. We particularly thank Sharon Hart and Aims McGuinness of the Education Commission of the States, Lynne Schaefer of the Michigan Education Trust, Ross Hodel of the Illinois Board of Higher Education, Michael Noetzel of the Massachusetts Board of Regents of Higher Education, and Bruce Hooper of the University of Wyoming for their utmost cooperation and timely transmittal of information.

Without the support and guidance of Theodore A. Ferris, Staff Director of the Joint Legislative Budget Committee, this report would not exist. His foresight and advice are most appreciated.

Finally, this report is a product of Michael Bohnhoff's diligent effort and professional achievement during the months of August, September, and October of 1987.

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I. INTRODUCTION

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A recent report shows that the annual tuition charges for 1987-88 increased six percent at four-year public colleges and universities and eight percent at four-year private colleges and universities. This marks the seventh consecutive year that the rate of tuition inflation has exceeded the Consumer Price Index (CPI) figures for inflation.[1] As a result of this trend, many parents are increasingly concerned with how they will be able to pay for their children's college education. In response to these concerns, many states have either enacted or are considering a prepaid tuition plan.

Prepaid tuition plans are intended to protect parents of future college students from tuition inflation by allowing them to pay for their children's education years in advance. Although such plans have existed at a few private universities since 1985, Michigan became the first state to suggest a tuition trust program for its public universities. The state of Wyoming, which developed a similar plan that includes room and board, surpassed Michigan and became the first state to actually offer parents an opportunity to prepay their children's higher education costs.

The states of Tennessee, Indiana, Maine, and Florida followed Michigan and Wyoming's lead and enacted prepaid tuition plans. The legislatures of West Virginia and California passed similar bills. The Governor's of those two states, however, vetoed the plans due to concerns over their practicality.

These concerns have encouraged other states to investigate alternative plans. Such alternatives have been approved by the legislatures of North Carolina and Illinois. A Massachusetts study commission has also recommended two alternatives to the legislature which will be considered in the upcoming session. A recent study by the Education Commission of the States shows that in addition to the states mentioned above, twenty-five states considered a prepaid tuition plan or an alternative in the last legislative session.[2] (See Exhibit A at the end of this section.)

The Michigan-type trust plans are based on the assumption that the state can earn a rate of return on investment that is greater than both the rate of return an individual can earn and the rate of tuition inflation. Parents, or other interested parties, such as grandparents, can pay a specified amount on behalf of a beneficiary several years before he/she will start college. In exchange for the payment, a newly created state trust fund guarantees to pay the beneficiary's tuition at a state college or university. Payments are pooled by the trust and invested. The prepaid amount and interest earnings are then used to pay the beneficiary's tuition when he/she is college age.

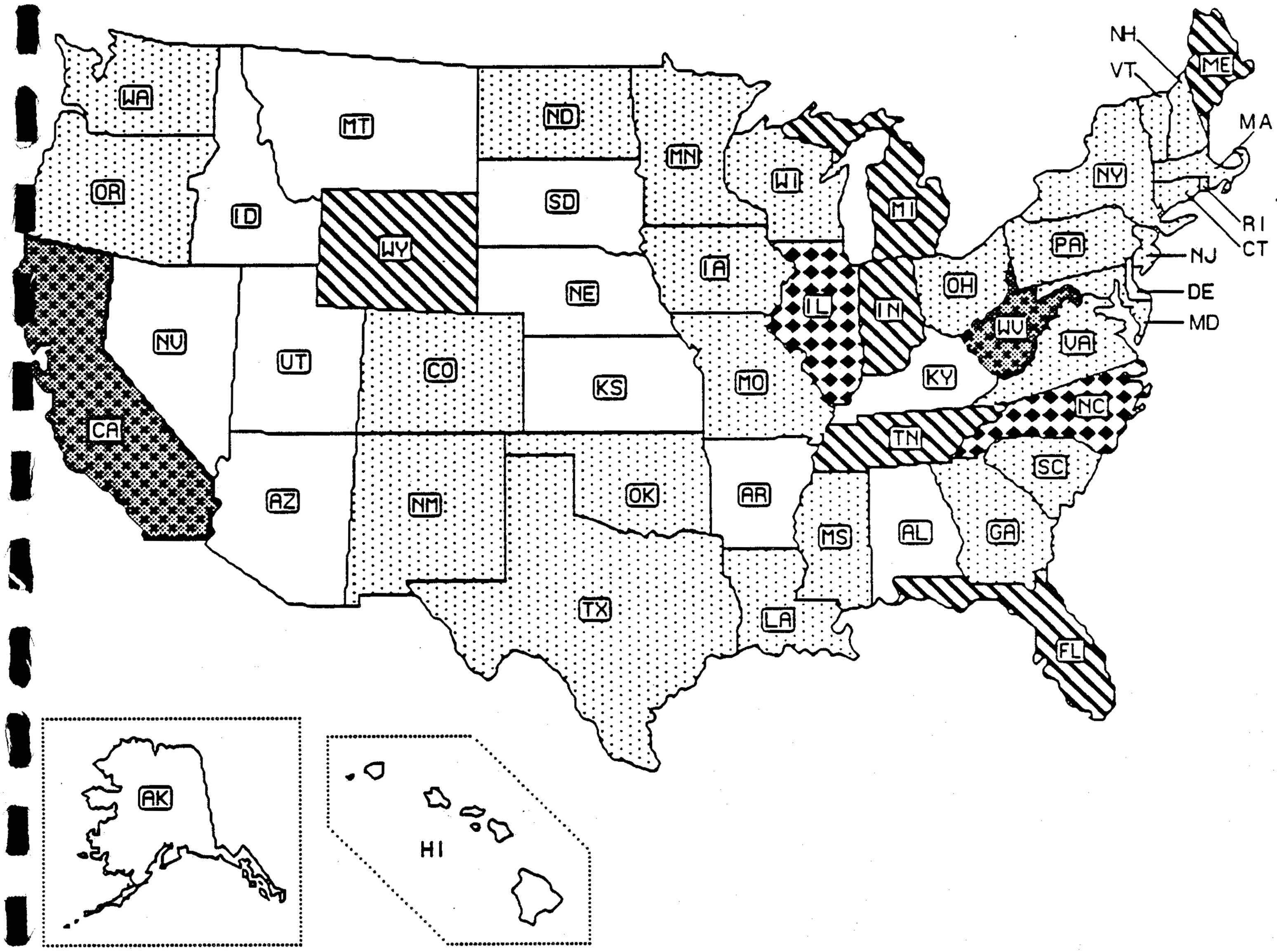
Proponents of the plans believe the prepaid price can actually be lower than current tuition prices. They contend that, through the investment expertise of trust officials, the pooled investments can earn a rate of return higher than tuition inflation. Through the compounding of interest on investment, the gap between tuition costs and the accumulated investment value would widen as time passes. With careful financial planning, the trust can offer discounts, knowing that the amount actually received, when invested, will grow faster than tuition costs. When the beneficiary is ready to attend college, the investment plus interest earnings will match the tuition costs.[3]

There are, however, a number of questions concerning the advisability of such programs. Concerns over the tax status, financial soundness, and effect on financial aid and tuition are often raised. Before a state rushes into a prepaid tuition plan, careful analysis is necessary.

This paper attempts to provide preliminary analysis of prepaid tuition plans and alternative education savings plans either enacted or seriously considered in various states. Each prepaid tuition plan enacted into law is first examined and outlined. Secondly, variations recently proposed in some states are also examined. The third section reviews similar plans proposed on the federal level. Finally, the various plans are analyzed, with attention given to concerns of both the state and the potential participants.

EXHIBIT A

STATE SAVINGS PLANS FOR COLLEGE EDUCATION COSTS



Prepaid tuition plan enacted. (6)

Prepaid tuition plan vetoed by governor. (2)

Prepaid tuition plan introduced into state legislature, but failed to win approval. (26)

State educational savings bonds enacted or expected to soon be enacted. (2)

(Source: Education Commission of the States study)

II. COMPARISON OF VARIOUS STATE PLANS

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If imitation is the sincerest form of flattery, Michigan officials should be very pleased. Shortly after the introduction of the prepaid tuition plan in Michigan, the legislatures of 35 other states were considering similar plans. Five of these states enacted a plan into law.

The following section examines the Michigan plan and similar plans enacted in Wyoming, Tennessee, Indiana, Maine, and Florida. Although the plans of the other states closely resemble the Michigan plan, there are a number of significant differences between the two plans. Differences exist in how the trusts will be administered, what education expenses will be covered by the plan, and what role community colleges and private universities will play in the plan.

A. MICHIGAN'S MET PLAN

As stated above, Michigan was the first state to introduce a prepaid tuition program. The Baccalaureate Education Student Trust (BEST) was proposed by Michigan Governor Blanchard in early 1986 and was based upon similar plans used by a few private institutions. After a number of changes, the state legislature approved the plan under the new name of Michigan Education Trust (MET), which was signed into law on December 23, 1986 and became effective immediately. As required by the legislation, the MET plan must undergo in-depth actuarial analysis and receive a favorable ruling from the IRS, stating that the plan is free from taxation, before the actual contracts can be offered.[4]

The tax status of the prepaid tuition contracts, however, is questionable. There is a strong possibility that the IRS will consider the difference between the cost of the tuition paid by MET and the original payment to be investment earnings subject to taxation. Many legislators believed such an unfavorable ruling would discourage participation, making MET financially unsound. Should the IRS ruling be unfavorable, MET staff would be required to submit a report to the legislature with suggestions on modification of the program.[5]

Under the legislation, the trust fund will be administered by a board consisting of the state treasurer and eight other qualified individuals appointed by the governor and confirmed by the senate. Of the eight, only two may be state employees. In addition, the law requires the governor to appoint one member from a list of nominees submitted by the speaker of the house and one from a list submitted by the senate majority leader. Of the remaining seats, three are to be filled by a public college or university president, a community or junior college president, and a representative from a private Michigan university. Six of the eight members are to serve three year terms, while the remaining two, who will hold the position of president/chief executive officer and vice president of the trust, will serve at the pleasure of the governor.[6]

MET, which is located in the Michigan Department of the Treasury, has been granted broad authority and a great deal of independence. The enacting legislation gives MET the authority to hire staff, establish rules for participation, enter into necessary contracts, limit the number of participants, and engage in a wide variety of other administrative activities necessary to operate the trust. In addition, the board is directed to hire a "nationally recognized" actuary to annually evaluate the financial soundness of the trust. The law also gives the board the authority to invest the trust's funds in "any instruments, obligations, securities, or property determined proper."[7]

Assuming the plan receives a favorable ruling from the IRS, MET will begin offering prepaid tuition contracts to parents of children ranging from newborn to college age. The contracts, for a specified amount, will guarantee payment of tuition and fees up to an amount equal to the cost of the necessary credit hours for an undergraduate degree at any of the state four-year colleges and universities. Contracts for credit hours in amounts less than a full four years will also be available. MET officials, however, have not decided whether the minimum contract will be for a semester, year, or two years worth of credit hours. The legislation adds that the existence of a prepaid contract in no way affects the prospective student's chances for admittance to any of the institutions.[8]

The actual prepaid price will be determined by the results of the actuarial analysis currently being completed. The major factors influencing the price schedule will be the beneficiary's age when the contract is made, the choices of certain options in the plan, assumptions made by MET concerning the rate of return on investment and the rate of tuition inflation, and projections of operating costs.[9]

Since more money can be made by the trust if it has a longer time to invest funds, MET will establish a price scale based upon the number of years between when the contract is made and when the beneficiary will reach college age. The younger the child, the lower the purchase price.[10]

The Michigan plan also has a number of options which affect the purchase price of the contracts. The first option concerns refunds in the event the contract is canceled. MET will give refunds on prepaid tuition contract if the beneficiary dies, is not admitted to a state university, or, after reaching age 18, notifies the trust that he/she will not attend a state university or college. Refunds may also be given by MET under other circumstances approved by the board and specified in the contract. The size of the refund, however, depends upon whether the buyer selects Plan A or Plan B at the time of purchase.[11]

The terms of Plan A and Plan B differ only in the cost and the refund amount. Under the less expensive Plan A, the trust guarantees to pay the beneficiary's tuition at a state university for the number of credit hours specified in the contract, up to the number of credit hours required for a baccalaureate degree. The purchaser, upon cancellation of the contract, would be entitled to only the original payment, less a service charge. Any investment earnings would be retained by the trust.[12]

Plan B offers the same tuition guarantee. If, however, the contract is canceled, the purchaser would receive his/her original payment and at least some of the interest earned. The specific rate of return is still to be determined by MET, but the total refund will not exceed the average cost of tuition, regardless of the interest yield. Once again, a service charge would be deducted.[13]

The second major option concerns the extent of the tuition guarantee. Due to the discrepancy in tuition prices between the more expensive and the less expensive Michigan public universities, two differently priced plans will be available. Parents may select an option which will guarantee the full cost of tuition at any public universities in Michigan, regardless of the tuition costs.[14]

For a lower price, parents would be able to choose a plan which will guarantee to pay full tuition only at universities that do not charge more than 105 percent of the average tuition at all Michigan universities. Beneficiaries covered by this option who attend universities in excess of 105 percent of the average would be required to pay the difference between the cost of tuition and what the contract will pay. Although it has not yet been determined what the contract will pay in this situation, it will be between the average cost of tuition at all Michigan universities and 105 percent of this average.[15]

Currently, the University of Michigan, Michigan State, and Wayne State University are the only institutions with tuition in excess of 105 percent of the average of all state universities. Parents who anticipate their child may attend one of these institutions could pay the additional price for a full guarantee. This option is available under both Plan A and Plan B, discussed above.[16]

A third option concerns the method of payment. Participants will be given the choice of buying the contract for a lump sum at the time the agreement is made, or spreading payments out over time periods, such as yearly, monthly, or payroll deduction payments. The multi-payment plans will be more expensive. The payment amounts, however, will be established at the time the contract is purchased and cannot be adjusted by the trust.[17]

Beneficiaries not wishing to attend a Michigan state university have a number of options in addition to the refunds discussed above. Students may choose to attend a 2-year community college. MET would pay for the beneficiary's tuition at a community college up to an amount equal to the dollar value of the contract, had it been used at a state university. Any surplus could be used by the beneficiary to finish their education at a state university.[18]

Those beneficiaries not wishing to continue their education after completing a two-year degree would be entitled to a refund. The refunded amount would be determined by subtracting the amount paid to the community college from the amount that would have been due if a full refund had been chosen. The refund amount, therefore, would depend upon whether the purchaser chose Plan A or Plan B. If the beneficiary is covered under plan A, which does not include interest earnings upon cancellation, there would be little or no refund.[19]

Beneficiaries may also apply the MET agreement to cover part of the tuition at Michigan private institutions. If the beneficiary decides to attend a private higher education institution in Michigan, MET, on the student's behalf, will pay that institution an amount equal to the average cost of tuition at Michigan state universities. No provisions exist, however, for beneficiaries who wish to attend out-of-state universities. Beneficiaries seeking an out-of-state education would only be entitled to a refund under the terms of their contract.[20]

In addition to the age of the beneficiary and the specific plan options chosen, assumptions about the rate of return on investment and the rate of tuition inflation will also influence the purchase price. MET officials hypothesize that the rate of return on investment will be higher than the rate of tuition inflation, allowing participants to purchase prepaid tuition contracts at a price lower than present tuition. Actuarial projections of the rate of tuition inflation and return on investment will determine how much of a discount will be offered.[21]

Operating costs for MET will also influence the contract price. After its initial start up period, MET, under law, is to be totally self-supporting. MET officials must, therefore, adjust the contract prices to cover administrative costs.[22]

MET officials, in order to maintain the actuarial soundness of the program, may annually adjust the cost to new participants. If previous estimates proved to be too optimistic, MET would recover the loss by upwardly adjusting the price for new entrants. If previous estimates proved to be too conservative, the surplus would be dispersed by lowering the price for new participants.[23]

Another important aspect of prepaid tuition plans concerns the transferability of the contract and substitution of beneficiaries. The law allows MET to establish rules limiting the purchaser's ability to transfer prepaid tuition contracts to other purchasers and the substitution of one beneficiary for another. Although the rules have not yet been established, MET officials intend to prevent the contracts from being bought and sold like a security.[24]

The substitution of one beneficiary for another will most likely be limited to family members. A parent, for instance, will be allowed to substitute another child for the one originally named in the contract. Transfers from one purchaser to another to be used on behalf of different beneficiary will most likely be limited to transfers not involving compensation. A purchaser, for instance, who bought a prepaid contract on behalf of a beneficiary who does not attend college may donate the contract to a charitable organization, which will use it for a needy child's college education.[25]

A final note on the Michigan Education Trust concerns the effect of the legislation on the state income tax code. As with all states that have enacted a prepaid tuition plan and also have a state income tax, the interest earnings are exempt from state income taxation. The Michigan law, however, will also allow participants to deduct their payments to the trust from their taxable income for state income tax purposes. This provision, of course, will not affect the individuals federal income tax.[26] The states which followed Michigan's lead and enacted their own prepaid tuition plans chose not to include this provision in their legislation.

B. WYOMING'S APHEC PROGRAM

The Governor of Wyoming signed legislation on February 19, 1987 creating the Advance Payment of Higher Education Costs (APHEC) program. In addition to tuition, the Wyoming plan also guarantees room and board for a prepaid amount. Wyoming, unlike Michigan, chose not to wait for a favorable ruling from the IRS and has begun offering prepaid tuition contracts to parents of potential college students. The prepaid tuition contracts include a stipulation that, should the IRS rule interest earned from the contract is taxable, the individual participants must meet the obligation from their own funds, separate from the trust.[27] The enabling legislation was effective May 27, 1987, with the first contracts offered in mid-July of 1987.

In essence, the Wyoming plan is a simplified version of the Michigan plan. Instead of creating a new agency to administer the program, as in Michigan, the legislation directs the University of Wyoming to administer the program. The deputy treasurer of the University of Wyoming is directed to serve as program administrator. Rules and regulations concerning the payments from purchasers, accounting to purchasers, payments to institutions, termination of contracts, and other rules necessary for administration are to be made jointly by the program administrator, the state treasurer, and the executive director of community colleges. These three individuals constitute the governing board. Proposed rules must also be approved by a majority vote of both the University of Wyoming Board of Trustees and the Wyoming Community College Commission.[28]

The program administrator is directed to deposit the prepaid education funds into an account within the University of Wyoming's permanent endowment fund and invest it in the same manner as other endowment fund accounts. The governing board is instructed to review the status of the investments every three months and report the financial condition of the trust fund to the legislature every year. In addition, the administrator is instructed to hold operating costs to no more than two percent of the investment earnings of the account.[29]

The Wyoming prepaid price, like the Michigan plan, is determined by the number of years between when the contract is made and when the beneficiary will attend college, choices of certain options in the plan, assumptions about the inflation of educational costs and rate of return on investment, and anticipated administrative costs.[30]

Once again, the time when the contract is made and when the beneficiary will begin college is crucial to the price of the contract. The Wyoming plan, however, deals with the issue in a different manner than the Michigan plan. The Wyoming plan requires purchasers to enter into the contract at least ten years before the beneficiary is college age. In addition, the trust officials set a price for beneficiaries between birth and age one and add an additional charge for older beneficiaries. For every year that the beneficiary is older than one, the original cost is increased by a compound interest rate of 10 percent.[31]

For example, if a resident beneficiary is currently eight years old, the purchaser would have to pay $9,966 to guarantee four years of room, board, and tuition at the University of Wyoming. This is determined by multiplying the current prepayment price for a one-year-old beneficiary of $5,114 by ten percent compounded interest for seven years, since the beneficiary is seven years older than age one.

The Wyoming plan also requires participants to choose one of four different options concerning residency and institutional choice. Unlike the Michigan plan, the Wyoming plan allows non-residents to participate in the program. In addition, purchasers must choose between the University of Wyoming or the Wyoming community college system.[32]

The purchasers must, therefore, select a contract to cover educational costs at Wyoming community colleges at resident tuition rates, Wyoming community colleges at non-resident rates, the University of Wyoming at resident rates, or the University of Wyoming at non-resident rates. Since the community colleges have lower tuition rates and grant only two-year degrees, the cost of their contracts will be cheaper than the University contracts. Due to the lower tuition costs for residents, the contract for residents will be cheaper than the contract for non-residents in the community college system. Contracts for the University of Wyoming will, of course, also be cheaper for residents.[33]

Purchasers also have options concerning how many semesters they wish to prepay. The Wyoming plan allows purchasers to prepay room, board, and tuition in semester units. Purchasers who select the community college system may prepay for one to four semesters. Those choosing the University contracts may purchase one to eight semesters.[34]

As for assumptions about tuition inflation, Wyoming officials predict that tuition, room, and board for four years at the University of Wyoming will increase from the current $13,760 for residents to $24,272 in the year 2003. Costs for non-residents are expected to rise from a current $20,416 to $41,791 for the year 2003. The predictions were based on curvilinear analysis of tuition, room, and board costs for the last twenty-one years. It should be noted that increases in costs at the University of Wyoming for this period were well below the national average.[35]

Predictions for return on investment were based on past performance of the University of Wyoming endowment fund and current and projected economic conditions. The trust estimates that it can earn at least 8.25 percent return, which, according to projections, would be sufficient to maintain the financial stability of the trust under current prepaid contract prices.[36]

As stated above, Wyoming is the only state to actually set a price and offer contracts. The prepaid price for the University of Wyoming is $5,114 for residents and $8,806 for non-residents, which will purchase tuition, room, and board starting in the year 2003. The cost of these items in the year 2003 has been estimated at $20,416 for residents and $41,791 for non-residents.

The cost for prepaid tuition at Wyoming community colleges has been set at $2,414 for residents and $3,579 for non-residents.[37] The program administrator may adjust these prices for new participants every year in order to maintain the financial soundness of the trust fund.[38]

The Wyoming plan also allows purchasers to cancel the prepaid tuition contract if the beneficiary dies, applies but is not admitted to the university or community college, or, after reaching age 18, informs the trust that he/she will not attend either the University of Wyoming or a Wyoming community college. The purchaser is entitled to the return of the original contract price plus four percent annually compounded interest.[39]

In addition to the refund, the plan also has some options for beneficiaries under a community college contract who wish to attend the University of Wyoming and those covered by a University of Wyoming contract who wish to attend a community college. Beneficiaries under a community college contract may have the value of their contract applied toward the costs of tuition, room, and board at the University of Wyoming. If, for instance, a beneficiary who is covered by a community college contract for the maximum of four semester chooses to attend the University of Wyoming, the dollar value for four semesters in the community college system is applied toward costs at the University of Wyoming.[40]

If a beneficiary covered by a University of Wyoming contract chooses to attend a community college, the contract value is applied toward costs at the community college. If, however, the value exceeds the costs at the community college, the beneficiary is not entitled to a refund. Any surplus is retained by the trust fund.[41]

C. TENNESSEE'S BEST PLAN

Tennessee became the third state to enact some type of prepaid tuition program. The bill, which created the Baccalaureate Education System Trust (BEST), was signed by the governor on May 4, 1987 and became effective immediately. Contracts, however, will be offered by the trust no earlier than July 1, 1988. Like the Michigan plan, the legislation also requires the trust to obtain a ruling from the IRS on the tax liability of the interest earnings. The ruling, however, does not have to be favorable in order for BEST to continue. The law only requires BEST officials inform the participants of whether or not the interest earnings are subject to federal income taxation.[42]

The legislation directs six state officials to serve as the board of trustees for the newly created trust. The state commissioner of finance is to serve as chairman. The other officials selected to the board are the state treasurer, comptroller of the treasury, secretary of state, chancellor of the state board of regents, and the president of the University of Tennessee.[43]

The treasurer is instructed to invest the funds of the trust in accordance with the investment policy established by the board of trustees. The policy, however, is governed by the same laws, guidelines, and restraints that govern the state retirement system.[44]

The administrative powers granted to the Tennessee BEST governing board are much more extensive than those granted to the

Michigan or Wyoming governing bodies. In addition to the ability to hire staff, limit participation, and establish rules for participation, the legislation allows the board to set all of the specific details of the plan.[45]

Unlike the Michigan and Wyoming laws, Tennessee's enacting legislation does not set refund policy and does not determine what role, if any, community colleges and private universities will play in the plan. These and all other details concerning the actual prepaid contracts are left to the discretion of the board.[46] The board has not yet met to resolve these issues.[47]

D. INDIANA'S BEST PLAN

Indiana, on May 6, 1987, became the fourth state to enact a prepaid tuition program. The legislation, which became effective on July 1, 1987, created the Baccalaureate Education System Trust (BEST). Like the Michigan and Tennessee plans, Indiana's plan must receive a ruling from the IRS on the tax liability of the interest earnings before offering contracts to the public. As with Tennessee's plan, the ruling does not have to be favorable in order for BEST to continue. The legislation only requires BEST officials to obtain the ruling and inform the participants of whether or not interest earnings are subject to federal income taxation.[48]

Indiana's BEST program is a division of the Indiana State Board of Finance and is supervised by a seven member board of directors. The state treasurer is to serve as one member, with the governor appointing the other six members to two year terms. At least one member must be a representative of a private Indiana college or university, and no more than two members can be state employees. In addition, no more than three of the appointed board members may be members of the same political party.[49]

The legislation gives the board the authority to establish rules for participation in the program, hire staff, limit the number of participants in the program, enter into contractual agreements, and engage in a wide rage of other administrative duties. The legislation also directs the board to annually evaluate or hire an outside firm to annually evaluate the actuarial soundness of the trust fund, the results of which are to be reported to the governor and the legislature.[50]

Although the board has been granted broad administrative powers, its freedom to make investment decisions is limited. The legislation, unlike the Michigan, Wyoming, and Tennessee acts, sets specific limits on the board's authority to invest the funds of the trust. The board may make long-term investments in U.S. government securities, securities issued by federal agencies, and corporate bonds, notes, and debentures. Limits, however, are placed on the amount of federal agency securities and corporate investments the trust may hold.[51]

No more than 50 percent of the total assets managed by the trust may be held in federal agency securities guaranteed by the United States government. No more than 25 percent may be held in federal agency securities not fully guaranteed by the federal government, such as securities issued by Federal Land Banks, Federal Home Loan Banks, and Federal Farm Credit Banks.[52]

Corporate investments can amount to no more than seven percent of the total assets held by the trust. In addition, the law instructs the board to give preference to investments in corporations based in or doing business in Indiana whenever the quality and yield of such investments are "equal to or better than" investments in out-of-state corporations.[53]

Short term investments, which can amount to no more than 50 percent of the total assets held by the trust, can be invested in U.S. Treasury obligations, repurchase agreements secured by the

U.S. Treasury obligations, Prime-1 commercial paper, and certificates of deposit.[54]

As with Michigan's MET plan, officials of Indiana's BEST program are waiting for the results of a detailed actuarial analysis before actually establishing a price schedule for participants. Once again, price will be determined by age of the beneficiary at the time of enrollment in the program, the options chosen by the purchaser, assumptions about the rate of tuition inflation and return on investment, and anticipated administrative costs.

Under Indiana BEST, purchasers must choose one of three plans. The plans, Plan A, Plan B, and Plan C, differ in the institutions covered and the policy toward refunds upon cancellation. Plan A, in exchange for a lump sum payment or periodic payments, guarantees to pay tuition at any state college or university for the lesser of either the average number of semester credit hours required for a baccalaureate degree or the number of credit hours required for a degree in the specific field pursued by the beneficiary. If the prepaid contract is canceled, the purchaser is entitled to a refund of the purchase price, less a service charge. All investment earnings, however, will be retained by the trust.[55]

Beneficiaries covered by Plan B would receive the same guarantee of tuition payments as those covered by Plan A. Upon cancellation of the contract, however, the purchaser would be entitled to a refund of the purchase price, less a service charge, and at least some of the interest income earned by the investment. The specific rate of return is yet to be determined by the board.[56]

Plan C applies to Indiana community colleges. The trust, in exchange for a lump payment or periodic payments, guarantees to pay the beneficiary's tuition at any Indiana community college in an amount equal to the cost of the number of credit hours required by the institution for completion of a two year degree. Upon cancellation of the contract, the purchaser is entitled to a refund of only the purchase price, less a specified administrative service charge. As in Plan A, any investment earnings would be retained by the trust.[57]

Plan B, because it covers the tuition for four years at a state university and gives larger refunds upon cancellation, will be the most expensive of the three plans. Plan C will be the least expensive since it only applies to the two year community colleges and refunds only the purchase price. Under each plan, refunds will be given if the beneficiary dies, is refused admittance after making proper application, or, after turning 18, informs the trust that he/she will not attend an institution of higher education. The legislation also allows the board to establish additional circumstances under which refunds may be granted.[58]

A number of issues are not addressed by the Indiana legislation. The legislation permits the board to set policies concerning beneficiaries covered by a community college contract who wish to attend a state university, beneficiaries covered by a state university contract who wish to attend a community college, and beneficiaries covered by either a community college plan or state university plan who wish to attend a private university. The board will also have the authority to set policies for transfer of the prepaid contract from one purchaser to another and the substitution of one beneficiary for another.[59]

E. MAINE'S SEED PLAN

The Governor of Maine signed legislation on June 30, 1987 which created the Student Educational Enhancement Deposit (SEED) program. The legislation, which was modeled after the Michigan law, became effective immediately. As with all previous plans, excluding Wyoming's program, the Maine legislation requires the newly created trust to obtain a ruling on the tax issues of the plan before entering into prepaid tuition contracts. The law, however, follows the Tennessee and Indiana approach, requiring the trust only inform participants as to whether or not the interest earnings are subject to federal income taxation.[60]

The legislation creates a board of directors to administer the SEED program, consisting of the state treasurer and six individuals appointed by the governor, with skills and experience in either the academic, business, or financial field. Of the six appointees, no more than two can be current state employees. In addition, four of the six appointees will serve three year terms. The other two shall serve at the pleasure of the governor. One of the six will be designated by the governor to serve as the chairman.[61]

The trust is located in the state treasury, but is directed to function as an independent agency, and has been granted broad authority to administer the trust. The enacting legislation gives the board the authority to hire staff, establish rules for participation, enter into necessary contracts, limit the number of participants, and engage in a wide range of other administrative activities. The board is also instructed to annually evaluate or hire a private firm to evaluate the actuarial soundness of the trust and to report the results to the governor and the legislature. These actuarial evaluations are also to be used to annually adjust the purchase price of the prepaid contracts.[62]

The legislation also grants the board broad authority to direct the investments of the trust. As stated by the legislation, the board may invest the funds of the trust in "any instruments, obligations, securities or property determined proper by the board."[63]

As in Michigan, Tennessee, and Indiana, trust officials intend to establish a price schedule based on the results of a detailed actuarial analysis. Once again, the factors which will determine price are the number of years between when the contract is made and when the beneficiary will be college age, options chosen by the purchaser, assumptions about the rate of tuition inflation and return on investment, and estimations of operating expenses.

Under the SEED program, purchasers will have to choose either Plan A or Plan B. The two plans differ only in price and refund policy. Under both plans, refunds will be given to the purchasers if the beneficiary dies, is not accepted to a state university, or, after reaching age 25, informs the board that he/she will not attend college. The legislation also allows the board to determine other circumstances under which refunds will be given. These additional circumstances, however, must be specified in the contract.[64]

Plan A guarantees to pay a state university an amount equal to the cost of the number of credit hours necessary for a baccalaureate degree on behalf of the beneficiary. If, however, the contract is canceled, the purchaser will receive a refund of only the original purchase price. Any investment income is retained by the trust.[65]

Beneficiaries covered by Plan B have the same tuition guarantee as those in Plan A. If, however, a refund is granted, the purchaser receives the original investment plus some of the interest earnings. The actual amount will be determined by an annual compound interest rate set by the board and specified in the contract. This plan, because of the added option, will be more expensive than Plan A.[66]

Purchasers will also have the option of paying for the prepaid tuition contracts in one lump sum or through periodic payments. The total cost will be higher for those who choose the periodic payment option. Trust officials, however, have not yet determined the specific payment options.[67]

In addition to the refunds discussed above, the SEED program has provisions for beneficiaries who choose a community college or a private university. If a beneficiary chooses a community college, the trust will pay his/her tuition at that institution, up to the dollar value of the contract, had it been used at a state university. Upon completion of the two year program, the beneficiary may apply the remaining value of the contract to tuition at a state university.[68]

The beneficiary, after completing the two year program, may, instead, choose a refund. The refund amount will be determined by whether the beneficiary is cover by Plan A or Plan B. The amount of money transferred to the community college or junior college, however, will be deducted from the refund amount. Therefore, those beneficiaries covered by Plan A would receive little or no refund.[69]

There are also provisions for those beneficiaries who wish to attend a private university, either in Maine or out-of-state. The trust will pay that institution an amount equal to the average tuition at state universities on behalf of the beneficiary. It is this last point which distinguishes Maine's plan from the other enacted plans. Michigan, Wyoming, and Florida have no provisions for beneficiaries wishing to attend out-of-state universities, other than refunds for withdrawal from the program. Depending upon the contract terms in these states, the resulting refund may include little or no interest earnings. Tennessee and Indiana have yet to determine their policy on this issue.

F. FLORIDA'S PREPAID POSTSECONDARY EDUCATION EXPENSE PLAN

Florida, like Maine, enacted a prepaid tuition plan on June 30, 1987. In addition to tuition, the Florida plan allows to individuals to also prepay room and board expenses. Contracts, however, will not be offered until an IRS ruling on the fund's tax status is received. As in Tennessee, Indiana, and Maine, the ruling does not have to be favorable. Florida officials will only be required to inform purchasers of whether or not interest earnings are taxable.[70]

A board composed of a combination of state officials and governor's appointees is established to administer the program. The state officials selected as members of the board are the insurance commissioner and treasurer, the comptroller, the chancellor of the board of regents, and the executive director of the state board of community colleges. Three additional members with knowledge and experience in accounting, actuary, risk management, or investment management will be appointed by the governor and confirmed by the state senate. The appointed members will serve three year terms.[71]

The board, which is located in the division of treasury in the Florida Department of Insurance, is granted a great deal of independence in the operation of program. The board is allowed to limit the number of participants, establish additional rules for participation, enter into contractual agreements, select an executive director, and engage in a wide range of other administrative duties.[72]

The selection of staff is the most distinguishing feature in the Florida plan. In addition to a small staff, the legislation directs the board to hire private firms to maintain the trust's records and to invest the funds of the trust. The law also requires the private firms involved in investing the funds of the trust to agree to cover cash deficiencies, should the funds fail to meet the trust's obligations because of "imprudent investing."[73]

The cost of the prepaid contracts will be based on the results of a detailed actuarial analysis. As with the plans in other states, the major factors will be the beneficiary's age when the contract is made, choices of options made by the purchaser, assumptions about the rate of tuition inflation and return on investment, and anticipated administrative costs.[74]

As with several other states, the Florida plan allows purchasers to choose between paying for the prepaid contract in one lump sum or spreading payments out over a period of time. Once again, the board will determine the specifics of the multi-payment plan.[75]

Participants, at time of purchase, will choose between either a plan for the community college system or a plan for the state university system. Under the community college plan, participants can prepay the beneficiary's tuition at any state community college. The contracts can cover the cost of the number of credit hours required for a two year degree. Contracts for smaller blocks of credit hours, such as one year's worth or one semester's worth, will also be available. The board is yet to determine the smallest number of credit hours to be offered.[76] The price, of course, will be based on the number of credit hours purchased.

The university plan has a similar structure, allowing purchasers to prepay the beneficiary's tuition at any state university. Contracts will be available to pay for credit hours in blocks up to the number necessary for a baccalaureate degree. Once again, the board will determine the minimum number of credit hours available for a prepaid contract.[77]

Those who prepay tuition under the university plan may also prepay the beneficiary's room and board at a state university residence hall. Students covered by the residence hall plan will be given a preference in placement over students not covered by such a contract. If space is not available, the beneficiary will receive a refund equal to the cost of residence hall room and board at the time he/she attends college.[78]

The legislation allows the board to determine the circumstances under which the purchasers can terminate a prepaid contract. The legislation seems to limit the size of the refund to only the original prepaid amount, with any investment income being retained by the trust. Florida officials, however, differ on the interpretation of this provision, with some believing the board has the authority to refund purchasers part of the interest earnings. This issue will have to be resolved by the board and other Florida officials.[79]

The Florida plan does have provisions for beneficiaries covered by a community college contract who wish to attend a state university, and for beneficiaries covered by a university plan who wish to attend a community college. If a beneficiary covered by a community college contract chooses to attend a state university, the trust will pay the university an amount equal to the value of the community college contract.[80]

Beneficiaries covered by a state university plan who wish to attend a community college may have the value of the state university contract transferred to the community college. If the value of the university contract exceeds the cost of tuition at the community college, the beneficiary can use the remaining amount to attend a state university or may request a refund. The amount transferred to the community college, however, will be deducted from the refund amount.[81]

The Florida plan also has provisions for beneficiaries who wish to attend in-state private colleges or universities. Under the plan, the beneficiary may have the trust transfer the value of the prepaid contract to the private college or university. This applies to the residence hall contract as well as either the university or community college tuition contracts.[82]

The board has a number of issues to address in addition to the ones mentioned above. Among them, the board will determine the policy toward transfers from one purchaser to another, the policy toward substitution of one beneficiary for another, and if there will be any limitations on how old the beneficiary can be at the time the contract is made. The board has not yet met to address these issues.[83]

III. ALTERNATIVE STATE PROPOSALS

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From the proceeding review of the enacted legislation, it is clear that Wyoming, Tennessee, Indiana, Maine, and Florida have, to a great degree, followed Michigan's example. All bills direct a trust fund to collect funds from purchasers, invest the funds, and later distribute those funds plus interest earnings to pay the beneficiaries' higher educational expenses. A number of other states, however, are investigating alternative methods of helping parents save for their children's college education.

The alternative plans that have generated the greatest interest and support can be classified as the individual education account plan, the educational savings bond plan, and the tuition certificate plan. The Illinois legislature passed both an individual education account plan and an educational savings bond plan. The Governor of Illinois vetoed the individual education account plan. He, however, signed the educational savings bond bill after using his authority to delete certain sections of the bill. The legislature must approve these changes before the bill will become law.

North Carolina has enacted an education savings bond plan similar to the Illinois legislation. State officials hope to start selling bonds in the near future.

In Massachusetts, a commission created by the Governor to study prepaid tuition plans has released a preliminary report supporting an educational savings bond plan and a tuition certificate plan. This section examines the details of each of these alternative state plans.

A. ILLINOIS' INDIVIDUAL EDUCATION ACCOUNTS PLAN

As stated above, the Illinois legislature passed an individual education account bill. The Governor, however, vetoed the bill, believing that the state income tax deduction provided only small incentive to save, but would significantly reduce state revenues.[84] Similar legislation was introduced in Missouri, but failed to win legislative approval.[85] The plan is included in this paper, however, because it represents an alternative to the Michigan-type prepaid tuition contract plans.

The Illinois individual education accounts bill was intended to give parents an opportunity to invest in an account similar to an individual retirement account (IRA). Under the plan, parents, grandparents, and others interested in helping finance a child's education could have deposited money in an account with a bank, savings and loan, insurance company, or some other financial institution until the child reached age 18. The money would have earned interest, and would have been available to help pay for educational expenses when the beneficiary was ready to attend college.[86]

As an incentive for investment, the donors would have been allowed to deduct the amount invested, up to $2,000 per year, from their taxable income for state income tax purposes. The interest earnings from the account would also have been exempt from state income taxation. Both provisions, however, applied only to state income taxes. The contributions would not have been deductible for federal income tax purposes, and the interest earned would also have been subject to federal taxation.[87]

Upon reaching college age, the beneficiary could have used the proceeds from the account to pay for educational costs at any postsecondary institution, either in Illinois or out-of-state. If the beneficiary died or did not attend college, the tax exemption would have been lost. The contributors would have been entitled to the return of their investment plus interest earnings, but would have been required to pay state taxes on both the income that had been excluded and the interest earnings.[88]

This plan was distinctive from the Michigan style state trust fund by the very limited role of the state. The state would have given no guarantee that the interest rate offered by the private financial institutions would have kept pace with tuition inflation. The legislation would not have created any new state agencies and would only have required the Illinois Department of Revenue to monitor the use of the new tax exemption.[89]

B. ILLINOIS' TAX EXEMPT SAVINGS BOND PLAN

Another alternative to the Michigan type trust fund is the college savings bond approach. The Illinois legislature passed a bill establishing such a plan, which was recently approved by the Governor. As mentioned above, certain sections of the bill were first deleted by the Governor with an "amendatory veto." Under Illinois law, a governor may make changes in a bill passed by the state legislature before signing it. The changes, however, must be approved by the legislature before the bill becomes law. If the legislature approves the changes, the law will be immediately effective. The first bonds would then be sold in early 1988.[90]

Under the Illinois act, the state would sell a new general obligation bond under the name of Illinois College Savings Bonds. The bonds would be zero coupon bonds, meaning there are no current interest payments. The bonds, instead, pay a specified compound interest rate on a specified date of maturity. The bonds will be available to anyone, and would be sold in small denominations to encourage participation by low and middle-income families.[91]

The college savings bonds would pay at least the same interest rate as other Illinois general obligation bonds. In addition, the bonds may also pay up to an additional 1/2 of one percent compounded interest if they are used to pay educational costs at either a private or public institution of higher education located in Illinois. The amount of additional interest given, if any, will be determined by the governor and the director of the Illinois Bureau of the Budget, and specified at the time of sale. As with other general obligation bonds, the interest earnings will be exempt from federal and state income taxes.[92]

The legislation also creates a Baccalaureate Trust Authority to aid in the administration of the new bond program. The authority will be composed of the state treasurer, the director of the Illinois State Scholarship Commission, the executive director of the Illinois Board of Higher Education, the director of the Illinois Bureau of the Budget, the director of the Illinois Economic and Fiscal Commission, and eight appointed members. The speaker of the state house of representatives, the house minority leader, the president of the state senate, and the senate minority leader will each appoint one of the eight members. The governor will appoint the four other members. Each appointed member will serve a six year term.[93]

The duties of the authority are mostly limited to advising the governor and the director of the bureau of the budget on a number of policy issues. The authority will make recommendations on what denominations the bonds will be sold in, how the maturity dates should be scheduled, what, if any, limits should be placed on the amount of bonds that a single household may purchase, how the bonds should be advertised, and what additional rate of interest should be given for redemption at an in-state postsecondary institution.[94]

Although the interest rates and the denominations of the bonds have not been set, hypothetical examples have been offered to illustrate how the bonds would work. One example uses the interest yield of seven percent compounded semi-annually and $5,000 as the value of the bonds at maturity. The example shows bonds maturing in five years, ten years, and fifteen year, each being worth $5,000. Since interest accumulates over time, the bonds would be sold at a discount, with lower prices for bonds maturing at later dates. In this example, bonds maturing in five, ten, and fifteen years would cost $3,545, $2,513, and $1,781, respectively. As stated above, the interest earnings would not be subject to federal and state income taxes.[95]

To expand this example, bonds used to pay for educational costs might be redeemed for a value greater than $5,000. Assuming the governor and the director of the bureau of the budget set the bonus rate at the maximum allowed rate of 1/2 of one percent, the fifteen year bond would be worth $5,374 at maturity. The ten and five year bonds would be worth $5,248 and $5,123, respectively.

Although the state plays a greater role in this plan than in the individual education accounts discussed above, its role is still more limited than in the tuition trust plans. As with the education accounts, there is no tuition guarantee. The parents, not the state, will bear the additional financial burden if the rate of tuition inflation exceeds the rate of return on investment.

Illinois officials, however, believe the program will accomplish two very important goals. First, the plan will focus parent's attention to the need to begin saving for their child's future educational needs. Publicity about the growing costs of a college education and available methods of saving to meet these costs is an expected result of the program.[96]

Officials also believe that, in combination with this increased awareness, the incentives of the program will encourage parents to start saving. The parents will have a tax free, low risk investment that pays a bonus if the child attends college in Illinois. If, however, the child does not attend college or chooses an out-of-state university, the parent will only loose the bonus amount of interest.[97]

The tax status and flexibility of the college savings bonds plan is a big distinction from the trust plans. Once again, due to the the tax-exempt status of state general obligation bonds, the interest earnings are exempt from taxation, regardless of what the funds are used for. Although the tax questions for the trust plans are still being reviewed by the IRS, it is widely agreed that, in the event of a withdrawal from the trust program, any interest earnings paid as part of the refund would be subject to taxation.

The college savings bonds would also have a more flexible withdrawal policy than the trust programs. Parents who use the bonds for purposes other than their children's education costs will loose only the bonus interest.[98] Under the trust programs, withdrawals are limited to certain circumstances determined by the enabling legislation or the governing board. Refunds, depending on the particular trust plan, may be limited to only the initial purchase price.

As a final point, it should be noted that the Illinois savings bond plan, unlike the trust plans, does address the issue of what impact the program will have on financial aid. The legislation contains a clause that allows families to have up to $25,000 in college savings bonds without it adversely affecting the children's eligibility for scholarships, grants, or guaranteed loans offered by the Illinois State Scholarship Commission. The college savings bonds would simply not be included in the determination of the family's resources.[99] This clause, however, would not be binding of federal financial aid programs, such as the Pell Grant program.

C. MASSACHUSETTS' COLLEGE SAVINGS BOND PLAN

As discussed above, the Massachusetts Board of Regents recently released a preliminary report on the results of its study of prepaid tuition plans and other education savings plans. One of the two plans recommended by the study commission was a college savings bond plan similar to the Illinois plan. Once again, the bonds would be zero-coupon general obligation bonds, offered in small denominations, exempt from federal income taxation, and would pay a bonus if redeemed for higher education costs.[100]

There are only two significant differences between the Illinois law and the Massachusetts plan. The Illinois law allows the state to pay a bonus interest rate of no more than 1/2 of one percent above the specified market rate. The Massachusetts report recommends the bonus rate be one percent higher than the bonds' market rate. In addition, this bonus interest would be available at universities outside of Massachusetts as well as those in state.[101]

Using the same example as in the discussion of the Illinois college savings bond plan, the cost of a bond with a face value of $5,000 at maturity would be $1,781 for a fifteen year bond, $2,513 for a ten year bond, and $3,545 for a five year bond. If, however, the bonds are used for higher education costs, the additional one percent compounded interest would make the 15 year bond worth $5,776 at maturity. The ten and five year bonds would be worth $5,506 and $5,247, respectively.

D. NORTH CAROLINA'S EDUCATION SAVINGS BONDS

The state of North Carolina surpassed Illinois and Massachusetts and became the first state to enact a college education savings bond plan. The legislation was enacted on July 21, 1987 and became immediately effective. The state expects to begin selling the bonds in late November or early December of 1987.[102]

Since the bonds are state general obligation bonds, the interest earnings are exempt from federal income taxation. No restrictions are placed on the use of the bonds and anyone may purchase them. Unlike the Illinois law and the Massachusetts plan, no bonus rate of interest will be paid for bonds redeemed to pay for higher education costs.[103]

Before the development of the educational savings bonds, the smallest denomination of state general obligation bonds was $5,000. The educational savings bonds will be sold with a face value of $1,000. The actual cost of the bonds will be determined by the bonds rate of interest, which has not yet been determined. State officials believe, however, that the rate of interest on the bonds will be approximately nine percent.[104]

If the interest rate is set at nine percent, the cost of a bond with a face value of $1,000 upon maturity would be $274 for a fifteen year bond, $422 for a ten year bond, and $650 for a five year bond. Supporters hope the low investment cost, the tax free status of the interest earnings, and the publicity resulting from the creation and sale of these bonds will encourage parents to invest in the bonds as a means of saving for their children's college education.[105]

E. **MASSACHUSETTS' TUITION CERTIFICATE PLAN**

In addition to a college savings bond plan, the Massachusetts report also recommends the creation of a tuition certificate plan similar to the prepaid tuition contract plans. As with the prepaid tuition plan, the certificate plan, for a prepaid amount, would guarantee a specified beneficiary's tuition at a state university or community college. The payments are pooled and invested in a trust fund, with the payments and interest earnings later used to pay the beneficiary's tuition.[106]

There are, however, a number of interesting differences between the two plans. The most significant of these are how the prepaid price is determined, what options will be available for those beneficiaries who attend a community or private college, and how refunds will be determined.

Under the tuition certificate plan, the newly created trust would sell certificates in denominations of $50 and up. The low minimum price is intended to encourage lower and middle-income families to participate in the program. A chart on the back of the certificate would indicate the percent of tuition the certificate would pay at each participating college or university upon redemption. The plan would cover all state institutions of higher education. In addition, private universities, both in and out of Massachusetts, could choose to participate.[107]

The listed redemption values would be determined by tuition charges at the time the certificate is purchased. The certificates would pay the same percentage of tuition upon redemption as the purchase price would have paid for in the year it was issued. For instance, if $500 would pay for 25 percent of a years tuition at a specified state university in 1987, a $500 dollar certificate bought in 1987 would pay for 25 percent of a years tuition when it is redeemed, regardless of the actual tuition costs at that time. If, in 1987, $500 would pay for 10 percent of annual tuition costs at a participating private university, a $500 dollar certificate purchased in 1987 would pay for 10 percent of the annual tuition costs at that private university upon redemption.

The money collected from the sale of the tuition certificates would be pooled and invested in a newly chartered state trust. The Massachusetts report does not detail how the trust would be managed, except that the governing board would include a representative of the state and officials from state post-secondary institutions and participating private universities. The board would be responsible for the administration of the program and investment of the collected funds.[108]

The job of the board would be much easier under the tuition certificate plan than under the Michigan type prepaid tuition contract plan. Under the tuition contract plan, the prepaid price would primarily be determined by projections of the rate of tuition inflation and the rate of interest earnings. Assuming the projections predict interest earnings will grow at a rate faster than tuition inflation, the trust would offer discounts at time of purchase. Discrepancies between the actual rates and the projected rates, however, could cause serious financial difficulties for the trust.[109]

Under the tuition certificate plan, the trust would only have to achieve a rate of return equal to the rate of tuition inflation. Unexpectedly high tuition inflation would not be a problem as long as it was matched by the return on investment. This more limited goal is certainly not an unreasonable expectation. Many colleges, based upon past experience, predict the rate of tuition inflation to be 2-3 percent higher than the CPI figure for general inflation. The rate of return on investment is estimated to be five percent higher than the CPI figure for inflation.[110]

Even with the more conservative approach of basing the cost on current prices, there is still a danger that the rate of return on investment would not equal the rate of tuition inflation. There is also the possibility that the rate of return will exceed the rate of tuition inflation. The Massachusetts plan would require the public and participating private universities to share the financial burden if the rate of tuition inflation is higher than the rate of return. The plan would also allow the universities to benefit if the rate of return is higher than the rate of tuition inflation.[111]

When the universities redeem the tuition certificates they have received from the students in lieu of tuition payments, the certificates are treated like shares in a mutual fund. If the rate of return on investment fails to match the rate of tuition inflation, the trust would be able to reimburse the universities for only part of costs of the beneficiaries' tuition. The universities, however, would be entitled to at least a minimum rate of return. This minimum rate would be determined on the basis of the rate of tuition inflation at the particular university and the CPI rate of inflation. The universities would be entitled to redeem the certificates for the original purchase price plus a rate of return on investment equal to the lesser of the rate of general inflation measured by the CPI or the university's rate of tuition inflation. If the trust was unable to pay this minimum rate of return, the state would loan the necessary funds to the trust.[112]

If, however, the rate of return is greater than tuition inflation, the universities would be entitled to the original purchase price of the certificate plus the accumulated interest earnings, even if that amount exceeds the cost of the tuition that the certificate purchased on redemption by the student.[113]

There would, of course, also be certain limitations on this policy to protect the trust and the state. First, the trust would be entitled to pay for its administrative costs from the interest earnings. Secondly, the trust would keep track of the money paid to each university in excess of the cost of tuition it provided to the beneficiaries. If, in future years, the trust had financial difficulty, the surplus money paid earlier to the university would be deducted from the amount of money owed to the university under the guaranteed rate of return, discussed above. Likewise, if the trust had previously paid any money to the university under the guaranteed rate of return, the university would be required to return that money out of future surpluses.[114]

Under this plan, as with the prepaid tuition contract plans, the individual educational accounts, and the college savings bonds plans, there will be participants who will wish to withdraw from the program. The Massachusetts proposal would refund the purchaser the original purchase price plus a specified rate of return. The rate of return would vary with the reason for the participant's withdrawal. If the withdrawal was due to the death or disability of the beneficiary or family financial hardship, the purchaser would receive the original purchase price of the certificate plus all accumulated interest earnings. If the beneficiary wished to attend a college or university not participating in the program, the refund would be the original payment plus a compound rate of return. This rate would equal either the rate of return on investment or the average rate of tuition inflation at participating universities, whichever is less. This figure would be reduced by two percent if the refund was requested for some reason other than the ones mentioned above.[115]

In addition to the lower risk of linking the purchase price for certificates to current tuition prices instead of actuarial projections, proponents of this plan contend it will be much easier to administer than the prepaid tuition contract plans. Under the prepaid tuition contract plan, the transfer of a beneficiary from a university to a community college plan, for instance, would be administratively cumbersome, usually requiring the cancellation of the contract and the calculation of what should be transferred to the community college and what should be refunded to the original purchaser.

The tuition contract plans also require the trust to create a complex price schedule based on the beneficiary's age and the choice of certain options in the contract. The tuition certificate plan, with its conversion chart for each participating college or university, would easily handle those students who transfer from one institution to another. There would also be no need to separate pricing for different ages. This simplified administration would save the trust a great deal in operating costs.[116]

A final note concerns federal income taxes. Because of the similarity between the prepaid tuition contract plans and the tuition certificate plan, the ruling from the IRS on the tax status of the Michigan plan will have a great impact on the tuition certificate plan. Supports contend, however, that if the IRS rules such programs are subject to taxation, it would still be possible to write the law in such a way that the tax liability will be assessed upon use. It may also be possible that the liability will be the beneficiary's responsibility and, therefore, subject to a lower tax rate. If either of these possibilities became a reality, it would greatly increase the plan's attractiveness.[117]

IV. FEDERAL PROPOSALS

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In addition to the number of states which have enacted or are considering some type of state sponsored savings plan, there have been a recent number of similar federal proposals. Bills have been introduced into Congress which would create a tax-exempt tuition trust plan, a federal tax exemption for individual education accounts, and a federal education savings bond program. In addition, two current presidential candidates have made similar proposals as part of their campaign platforms.[118]

It is difficult to estimate how these proposals will fair in the United States Congress. Legislation has been proposed by a number of members from both parties. Some doubt, however, that Congress would be willing to make a new tax preference so soon after enactment of the Tax Reform Act of 1986, which sought to reduce tax exemptions. It is also important to note that earlier proposals to make higher education expenses deductible from federal income taxation failed to gain approval.[119]

The following section examines proposals recently introduced in Congress. The first proposal was introduced in the House of Representatives by Congressman Pat Williams of Montana and would create a federal education trust fund similar to Michigan's MET plan. It is followed by a similar proposal introduced by Senator Claiborne Pell of Rhode Island. The third proposal was introduced by Senator Robert Dole of Kansas and would create tax incentives for investing in education accounts at private financial institutions. It is followed by a similar proposal supported by

Senator Dennis DeConcini of Arizona and Congressman William Lipinski of Illinois. The fifth proposal was also introduced by Senator Dole and would authorize the federal government to issue college savings bonds. The final proposals were offered by two presidential candidates, Vice-President George Bush and Representative Richard Gephardt.

A. THE PARENTAL ASSISTANCE FOR TUITION INVESTMENT ACT

This act, introduced by Representative Williams, would create the National Postsecondary Education Savings Trust program, enabling parents or other interested parties to contribute to a federal trust fund to save for a beneficiary's future college education. In brief, the Trust would establish guidelines of how much should be invested to cover future tuition based on projections of the rate of return on investment and the rate of tuition inflation. The Trust would apply the invested amounts and interest earnings to the beneficiary's college education. The most attractive aspect of the plan for investors is the proposed changes in the federal tax policy. Depending upon the income of the investor, all or portions of the contributions to the fund would be deductible from adjusted gross income for federal income tax purposes. The interest earnings would be exempt from income taxation for all investors.[120]

To administer the new trust program, the legislation establishes a Board of Trustees comprised of cabinet officials, representatives from public and private colleges and universities, and individual citizens. The Secretary of Education and the Secretary of the Treasury will serve as ex-officio members of the Board. The president will appoint ten members to serve four year terms. Of the ten, five will be representatives of institutions of higher education and five will be members of the general public. No more than five of the ten may belong to the same political party, and all ten will be subject to Senate confirmation.[121]

Although the legislation grants the Board of Trustees broad administrative powers, it limits the Board's authority to determine investment policy. Investments would be limited to United States government obligations guaranteed in both principal and interest. The Secretary of the Treasury, serving as managing trustee of the Board, would manage the investments.[122]

The Board, using projections of the rate of tuition inflation and return on investment, would also establish a schedule estimating how should be invested to cover average tuition for beneficiaries ranging in age from newborns to college age. Separate schedules would be prepared for the different types of postsecondary institutions, such as private four-year universities, public four-year universities, and community colleges. Parents would be able to invest a suggested amount, a smaller amount, or a larger amount in a lump sum or in periodic payments, such as yearly, monthly, or payroll deduction payments.[123]

The beneficiary, upon reaching college age, can direct the Trust to make payments from the fund to pay tuition at any postsecondary education institution in the country. There is, however, no guarantee that the Trust will pay the full tuition at the particular institution. The payments will only equal the original investment plus accumulated interest earnings.[124]

As stated above, the legislation offers exemptions from federal income taxes as an incentive to investors. All interest earnings used to pay educational costs would be exempt from income taxes.[125]

In addition, the investor would be allowed to deduct from zero to 100 percent of the amount contributed on behalf of a legal dependent from the taxable family income, depending upon the family's adjusted gross income. Under this plan, families with adjusted gross incomes below $125,000 could deduct 100 percent of their contributions to the Trust from their annual taxable income, up to the maximum allowed deduction of $2,000 per beneficiary. Total deductions would also be limited to $48,000 for all years, per beneficiary. For those families with income greater than $125,000, the $2,000 cap is reduced by ten cents for every dollar of gross income over $125,000. A family with income of $135,000, for instance, would only be able to deduct the first $1,000 of contributions to the Trust for each beneficiary. No deductions would be allowed for families with gross incomes of $145,000 or more. After 1988, these income levels would be indexed to inflation.[126]

As with the state plans discussed above, the policy toward refunds in the event of withdrawal from the plan is an important consideration. Under the law, the investor will receive a refund of the original investment amount plus accumulated interest earnings if the beneficiary dies, or after reaching age 21, informs the trust that he/she will not attend a postsecondary educational institution. The Trust is also allowed to establish additional circumstances under which refunds may be granted. The investor will also be entitled to a refund of any funds available to the beneficiary that are in excess of the educational costs.[127]

There would be a tax liability for the investor, however, if a refund is obtained. The interest earnings would be subject to taxation. There would also be an additional tax penalty in order for the federal government to recover the money lost from exempting the original investment. Ten percent of the interest earnings would be forfeited to the IRS as the penalty. This penalty, however, does not apply if the refund is a result of the death of the beneficiary.[128]

B. THE NATIONAL EDUCATION SAVINGS TRUST ACT

This act introduced by Senator Pell is intended to serve as the Senate version of Representative Williams' bill, discussed above. Most of the differences between the two bills are minor. There are, however, significant differences concerning the deductibility of the contributions to the Trust.

Under the Senate version, less tax deductions would be allowed for higher income families. Families whose adjusted gross income does not exceed $25,000 would be entitled to deduct 100 percent of the contributions from their taxable income. Those families whose gross income is between $25,000 and $60,000 may deduct 50 percent of the contribution to the trust fund. Contributors whose family's adjusted gross income is greater than $60,000 but less than $100,000 dollars would be allowed to deduct 25 percent of their payments to the Trust. No deductions would be allowed for contributors with adjusted gross incomes of more than $100,000. As in the House bill, these income levels would be indexed to inflation.[129]

The Senate bill also contains additional items not included in the House bill. One important addition concerns financial aid. The legislation states that, when calculating a beneficiary's eligibility for student financial aid, only 75 percent of the value of the student's trust fund will be considered as his/her financial resources.[130]

Another interesting addition concerns the use of the fund for the education of the investor in an emergency situation. If the investor has been unemployed for over a year and has been eligible for unemployment compensation, he/she may use the trust fund to pay for the cost of job retraining at an acceptable post-secondary educational institution.[131]

C. DOLE'S EDUCATION SAVINGS ACCOUNTS ACTS

Senator Robert Dole has introduced four bills designed to encourage individuals to save for their children's college education. Three of the bills would change the federal tax code to encourage parents to deposit money in education savings accounts at private financial institutions on behalf of their children. The multiple number of bills is designed to "encourage discussion on how to create the most effective and efficient incentives" for saving for higher education.[132]

Under the plan most strongly endorsed by Dole, parents, or other individuals concerned with a child's education, could open an account at a bank or other acceptable financial institution on behalf of a child. Federal income taxes on interest earnings would be the responsibility of the beneficiary and would be deferred until he/she reaches age 25. Upon reaching age 25, ten percent of the interest earnings would be added to the beneficiaries gross income and, therefore, subject to income taxes at the individual's tax rate. This would continue for the next nine years, covering all interest earnings of the account.[133]

In addition to this benefit, fifteen percent of the contribution could be subtracted from the amount the investor owes in federal income taxes for the year.[134] (This tax credit applies to the dollar amount paid as taxes and should not be confused with a tax deduction, which reduces adjusted gross income.) The tax credit, however, would be limited to $150 per beneficiary for 1987. Beginning in 1988, the $150 limit would be indexed to inflation.[135]

Although there are no restrictions for participation based on income, there are a number of requirements and limitations. Under the proposal, there can only be one beneficiary per account. If more than one taxpayer contributes to the account, the $150 dollar tax credit is distributed among the contributors in proportion to the amount of their contribution.[136]

In addition, the funds from the account must be used to pay for the beneficiary's tuition, fees, books, supplies, room, and board at an acceptable institute of higher education. If the funds are used for other purposes, the interest earnings of the account are included in the investors gross income at that time. The investor would also have to pay a tax penalty. Ten percent of the interest earnings would be forfeited to the federal government as the penalty. This penalty, however, would not apply if the beneficiary had died or had been disabled.[137]

As stated above, two similar proposals have been made by Senator Dole which closely resemble the first proposal. One plan would differ from the original only in that there would be no tax credit on the amount contributed to the account. Tax on interest earnings, however, would again be deferred until the beneficiary reaches age 25. The final version of the education savings account plan would allow the tax credit as in the original, but would require the interest earnings be subject to income tax at the time they are earned.[138]

D. THE DeCONCINI-LIPINSKI EDUCATION SAVINGS ACT

Senator DeConcini has recently introduced a bill similar to Senator Dole's plans, discussed above. An identical bill has been introduced in the House of Representatives by Congressman Lipinski. It would offer federal income tax breaks to encourage parents to open individual education accounts at private financial institutions on behalf of their children. This version, however, differs from the Dole proposals in exactly how the tax law will be changed.

The DeConcini-Lipinski plan, instead of deferring the tax liability until the beneficiary reached age 25, would make interest earnings exempt from federal income taxation. The bill would also allow parents and other contributors to deduct the amount of money invested in the account from their adjusted gross income. The annual amount of income that can be deducted, however, is limited to $1,000 per beneficiary. These tax breaks are available to all taxpayers, regardless of income.[139]

As with the other federal plans, the tax advantages are lost if the proceeds from the account are not used to pay for the beneficiary's tuition, books, and living expenses at a post-secondary educational institution. Interest earnings from the account would be subject to taxation. In addition, 10 percent of the interest earnings would be forfeited to the government as a penalty.[140]

E. EDUCATIONAL SAVINGS BONDS ACT

The last bill introduced by Senator Dole concerning saving for higher education would authorize the federal government to issue educational savings bonds. The bonds would be issued in the name of a beneficiary, bear an interest rate equal to federal long term interest rates for bonds, and would pay interest only upon redemption.[141]

In addition, the interest earnings on the education bonds would not be subject to taxation as long as the bonds were used to pay for tuition, fees, books, and reasonable living expenses at an institution of higher education. No more than $1,000 dollars worth of bonds, however, could be purchased per year on behalf of a single beneficiary.[142]

A similar bill has been introduced in the House of Representatives by Congressman Paul Henry of Michigan. This bill, however, sets no limits on the amount of bonds that can be purchased.[143]

F. PRESIDENTIAL CAMPAIGN PROPOSALS

Two presidential candidates have also proposed a type of educational savings plans as part of their campaign platforms. Vice-President George Bush supports a college savings bond plan, similar to savings bond plan introduced in Congress by Senator Dole. Interest from the federal education bonds, if used for educational purposes, would be exempt from federal income taxation.[144]

Representative Richard Gephardt, Democratic candidate for president, has discussed the creation of the Individual Development and Education Account (IDEA) program. The plan would allow parents to establish educational savings accounts for their children. Federal matching funds would be provided to low-income families.[145]

V. OVERVIEW OF PREPAID TUITION PROGRAMS

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It is clear from the above discussion of legislation enacted into law in Michigan, Wyoming, Tennessee, Indiana, Maine, and Florida, the multiple plans passed by the Illinois legislature, the North Carolina plan, the proposals from the Massachusetts Board of Regents study commission, and the bills introduced in both houses of Congress, there is a great deal of interest in establishing governmental programs designed to assist citizens in saving for their children's college education. Before rushing into a program, however, a number of issues must be examined.

The most important questions concern desirability of such programs for both the state and the individual. This section will address this issue with attention given to the various state and federal proposals. Attention will also be given to the views of both proponents and opponents of such plans.

A. DESIRABILITY FOR THE STATE

A number of factors must be considered by state officials when determining what (if any) type of advanced tuition payment plan should be pursued. The issues of whether the program is needed, which citizens will benefit, cost of the program to the state, benefits to state resulting from the program, and financial dangers for the state must all be considered.

There are some critics of prepaid tuition plans who believe such programs are unnecessary. They contend that there are a number of investment opportunities currently available to parents who wish to invest for their children's education, making any state plans redundant.[146]

This argument, however, fails to consider the difficulty of finding investments that will keep pace with tuition inflation. The average rate of tuition inflation for public and private colleges and universities from 1965 to 1985 was 2.7 percent higher than the CPI measure for overall inflation. In comparison, stocks increased 2.1 percent over the CPI rate for inflation in the same period. The more secure investment of five-year treasury bonds would have only attained a rate of return 0.12 percent greater than the CPI inflation rate.[147]

Clearly, finding investments to keep pace with tuition inflation would be very difficult for the average investor. Investments offering high rates of return also involve increased risk. In addition, the interest earnings on most investments are subject to federal income taxes, reducing the amount of money available for funding of a child's college education.[148]

The state can provide assistance to the great majority of parents who lack investment expertise in a number of ways. First, the state can hire professional money managers with extensive investment experience. In addition, with the pool of money collected from the individual participants, the state can diversify investments, reducing the chance of serious damage caused by a single bad investment. The state is also in a better position to absorb the effects of years in which the rate of return is lower than anticipated. Such years can be offset by years in which the rate of return exceeds expectations.[149]

Questions have also been raised about which individuals would benefit from prepaid tuition plans. Critics contend that such programs would only be of benefit to higher and middle-income individuals, since lower-income individuals find it difficult to save money.[150]

Proponents of prepaid tuition plans concede this point, but add a number of qualifications. They contend that although higher-income families will have the resources to participate, there will be far less incentive for them than middle-income families. Since higher-income individuals would likely be able to pay for their children's college education out of their annual income, they would not be attracted to such a specific investment plan. They would, instead, seek investments offering more flexibility.[151]

Proponents also contend that middle-income families are in need of assistance. In addition to the rising costs of a college education, the amount of financial aid available to middle-income families is on the decline. Prepaid tuition plans would encourage and assist middle-income families to save for their children's college education, at no cost to the state. Once established, tuition trust funds would be self-financing and would also repay the state the original funds used to start the program.[152]

Although a prepaid tuition program would, as the above discussion indicates, primarily be provided as a service to its citizens, there would also be some benefits for the state. Citizens who are aided by the state in saving for their children's college education are likely to be grateful to the state for the assistance. The program would also promote enrollment in-state universities by making it possible for more students to afford the costs of higher education. The state would then be the beneficiary of a better educated population.[153]

The crucial question, however, is whether or not prepaid tuition plans will be financially stable. An unstable plan could damage the state higher education system and/or cost the state a considerable amount of money. The stability of the plan will depend upon the type of prepaid tuition plan selected and how well it is managed.

Of the plans discussed above, the Illinois independent education accounts plan and the various plans introduced on the federal level are the least likely to encounter financial difficulty. This is for the simple reason that the individuals, not the state or federal government, must bear the risk that tuition inflation may grow faster than the rate of return on investment. Under these plans, the investor receives only the interest earnings actually made by the private financial institutions or the federal trust.

As mentioned above, North Carolina has enacted an education savings bond plan. A savings bond plan has also been approved by Illinois legislature and is being considered in Massachusetts. These plans involve very little risk to the state. The bonds, which would guarantee a specified rate of return, would be part of the state's general obligation bonds. Presumedly, these bonds are in little danger of financial instability. If, however, the bonds pay a bonus rate of interest when redeemed to pay for education expenses, the state would have to plan to cover the additional costs.

A greater degree of risk for the state is associated with the Michigan-type tuition contract and the Massachusetts-type tuition certificate plans. Both of these plans require the state to guarantee tuition. Of the two, the tuition contract plan has the higher risk.

In review, prepaid tuition contract plans will establish price schedules for participants with different prices for different ages. The actual prices will be determined by a detailed analysis of tuition inflation and likely rates of return on investment. Proponents of tuition trust plans contend that the rate of return will exceed tuition inflation and, therefore, trust officials would be able to set the price for prepaid tuition contracts below current tuition costs. Wyoming, the only state having set prices, is currently offering contracts for future tuition, room, and board for 37 percent of current costs.

When the Michigan plan was introduced, state officials pointed to the high rates of return on investment earned in recent years by the state pension fund. Under the direction of the Michigan Department of Treasury, the state pension fund earned a 23 percent rate of return on investment in 1985 and has maintained an average rate of return of nearly 19 percent for every year since 1981.[154] An average rate of return of 13 percent has been earned by the pension fund for the last nine years.[155]

Recent projections of the possible rate of return on investment for the Michigan Education Trust have not been as optimistic as earlier projections. Although trust officials have not yet completed the actuarial study, preliminary results are available. The study predicts the average rate of return on investment for the next 18 years will be between nine and 11 percent. Tuition inflation is anticipated to increase by an annual rate of 6.5 percent.[156]

Under these assumptions, tuition costs for four years of education at Michigan public universities will increase from the current average of $8,000 to $24,853 in eighteen years. The amount of money that must be invested on behalf of a newborn child depends upon the projected rate of return on investment. For a nine percent rate of return on investment, a parent would have to invest $5,269 dollars. With a 10 or 11 percent rate of return, a parent would have to invest $4,470 or $3,798, respectively. These prices are only rough estimates and do not include funds needed to cover administrative costs and numerous options available in the Michigan plan. The graph at the end of this section illustrates the growth of investments at nine, 10, and 11 percent to meet the growth of tuition inflation at 6.5 percent.

Critics of prepaid tuition plans have pointed out financial dangers in giving discounts based on actuarial projections. An underestimation of the rate of tuition inflation or an overestimation of the rate of return on investment may cause serious financial problems for the trust. In addition, administrative costs may be higher than anticipated, which could create or intensify financial problems.[157]

The possible danger is illustrated by an example offered as testimony before an Illinois task force created to study prepaid tuition plans. The witness uses a hypothetical example of a prepaid tuition plan offering a price discount to newborns based on the assumptions of a 10 percent rate of return on investment and a six percent rate of tuition inflation. If the actual rate of return on investment is just one percent less than the predicted 10 percent rate of return, the trust would be short $2,848 per beneficiary when they reach college age. Likewise, if the actual rate of tuition inflation is only one percent higher than the predicted rate of inflation, the trust would be short $2,345 for each beneficiary.[158]

Supporters of prepaid tuition plans contend that such shortfalls can be avoided by increasing the cost for new participants once it is clear that the original assumptions were incorrect. The new price would be high enough to recover the shortfall for the original participants as well as to cover the costs of the new participant's education needs. This, it is argued, would be similar to pension funds, which can require higher contributions by participants when financial difficulty is encountered.[159]

Critics, however, consider this analogy to be flawed. Unlike pension funds, in which membership is a condition of employment, enrollment in a prepaid tuition plan is completely voluntary. Increasing the cost of prepaid tuition contracts would decrease their attractiveness to potential investors. It is contended that a trust may be forced to increase prices due to inaccurate forecasts only to find itself unable to attract enough new participants under the revised price schedule to remain financially solvent.[160]

Under this scenario, the trust and the state, would have a number of options. Unfortunately, none is very attractive. The first option would be for the trust to default on its obligation to the beneficiaries. Such a serious step, however, would certainly have legal and political consequences for the state.

Another option would involve the state appropriating the funds necessary for the trust to remain solvent. This, however, would result in less money available for funding of other state needs.[161] It would also be contrary to the goal of providing assistance to middle-income families without additional cost to the state.

A third option available to a state with a tuition trust fund in financial difficulty would be to require the state universities and colleges to accept the beneficiaries at a reduced rate of tuition. The universities would then have the burden of recovering the lost revenues from other sources or reducing costs. Additional funds could be raised by increasing certain student charges, such as nonresident tuition. This would require one group of students to partially subsidize the education of another group of students. Universities could also request more funds from the state legislature. Such requests, if granted, would again mean less state money available for other needs. If, instead, the universities are forced to decrease their costs to cover the deficit, the result may be a reduction in the quality of education for all students.[162]

Critics also believe that a prepaid tuition plan can cause problems in less obvious ways than a major financial crisis. A prepaid tuition plan, they contend, would serve as an artificial influence on the price of tuition. If, for instance, the trust had based the prepaid price on a projected annual compound rate of tuition inflation of six percent, officials may be reluctant to increase tuition at a greater rate, even though such an increase may be warranted by other factors. This, once again, would result in the need for higher appropriations from the state general fund.[163]

Supporters of prepaid tuition plans believe the financial dangers are not as great as suggested. The state, it is contended, can also reduce its risk by setting limits on the number of participants in the early years and by imposing penalties for withdrawal from the program. By limiting the required number of participants needed in the program, the state limits the amount of money necessary to cover the obligations of the trust in the event of financial difficulty. It will also make it easier to find the required number of additional participants under increased prices needed to offset any deficit caused by previous inaccurate projections.[164] The legislation of every state that has enacted a prepaid tuition plan includes a provision allowing the governing board to limit the number of participants.

In addition to limiting participation, the boards can also impose penalties for individuals who withdraw from the plan. The penalties involve the trust withholding a portion of the interest earnings made from the participant's original investment and vary in severity. The funds not returned upon withdrawal can be left in the trust to earn additional interest earnings until a financial crisis requires their use.[165]

Concerned about the risk assumed by the Michigan-type prepaid tuition plans, some state officials have attempted to design programs that limit the risk to the state but still, give parents a tuition guarantee. The Massachusetts certificate proposal, discussed above, was designed with this goal. Since the Massachusetts plan sets the cost of the prepaid tuition certificates at the current price for tuition, the rate of return on investment only has to match the rate of tuition inflation. The Michigan-type plan, in contrast, requires the return on investment exceed inflation by a predicted rate.[166]

States must also be concerned with the effect of a prepaid tuition plan on revenue collections. For states with state income taxes, each plan would have an impact on revenues, since the plans exempt interest earnings from state income tax. If individuals would have saved in some taxable savings plan, a portion of their interest earnings would be owed to the state. Proponents contend, however, that many individuals would not have the ability or inclination to save without the state plan. The benefits of such plans, they add, far outweigh the relatively small loss of income to the state.

In addition to the loss of taxes on interest earnings, some plans would result in greater losses in revenue to the state. The Michigan plan, unlike the other trusts, allows program participants to deduct the contract purchase price from taxable income for state income tax purposes. The other states that enacted a prepaid tuition trust chose not to include this provision.

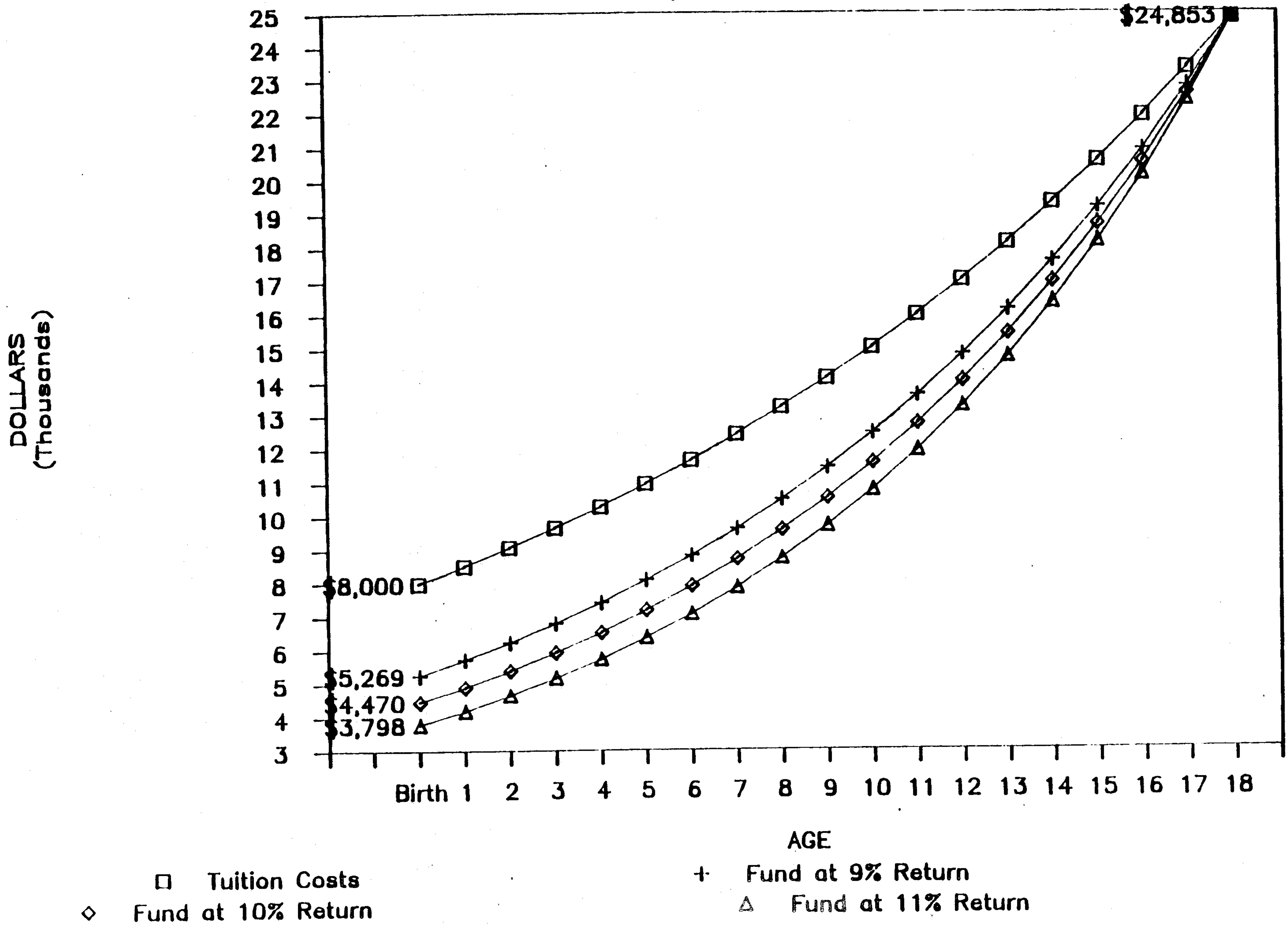
The Illinois individual education accounts plan would have allowed participants to deduct investments in education accounts from gross income for state income tax purposes. The Governor of

Illinois, however, vetoed the bill because of this tax exemption.[167]

In review, it is in the interest of the state to assist its citizens in saving for their children's higher education needs. Such assistance is of particular help to middle-income families who find it difficult to pay for their children's education and have difficulty qualifying for financial aid. The state is rewarded with good will from the public and a better educated society. This, however, involves some risk to the state. The degree of this risk depends on the type of program chosen by the state and how well it is managed. For these reasons, a prepaid tuition plan must be carefully designed and administered.

MICHIGAN EDUCATION TRUST FUND

(6.5% Tuition Inflation)



B. DESIRABILITY FOR THE INDIVIDUAL

As stated above, saving for a child's college education is not an easy task. Parents are often bewildered by the numerous investment decisions involving risk, rate of return, and income taxes. Prepaid tuition plans have sparked a great deal of interest in the states which have either enacted or are considering such legislation. Critics of prepaid tuition plans, however, question how good of an investment such plans will be for the participants. The attractiveness of prepaid tuition plans depends upon a number of factors including tax status of the plan, the rate of return, provisions for withdrawal from the plan, the effect on financial aid, and limits on institutional choice.

An important question not yet resolved is the tax status of prepaid tuition plans. As with the question of risk to the state, the tax status of the prepaid tuition plan varies with the type of plan. The tax issue was originally raised when the Michigan prepaid tuition trust plan was introduced. There is a strong possibility that the difference between the original payment and the appreciated value of the prepaid plan will be considered interest earnings and, therefore, subject to taxation. Such a ruling would have and adverse affect on prepaid tuition plans. If the interest earnings are subject to taxation, the purchaser or the beneficiary will have to pay in federal taxes an amount which could be as much as 28 percent of the interest earnings, depending upon whether the tax liability is the purchasers or the beneficiaries and what his/her tax rate is.

Many believe an unfavorable ruling by the IRS would discourage participation in the plan, making the trust financially unsound. For this reason, Michigan legislators included a provision in the enacting legislation which would prevent the trust from becoming operational in the event of an unfavorable ruling. The legislature would then decide whether to modify the plan in hopes of gaining IRS approval, offer contracts even though there would be a tax liability, or allowing the plan to die. Although none of the other states that have passed similar legislation include this provision, officials in both Indiana and Tennessee have expressed opinions that the legislature may repeal the plan if an unfavorable ruling is received.

Michigan trust officials are currently waiting for a private letter ruling on whether or not the difference between what was originally paid and the appreciated value of the tuition contract is subject to taxation. They contend that their plan is nothing more than the purchase of goods in advance, not an investment. The advanced purchase of an airline ticket is a commonly used analogy. Individuals may purchase tickets months in advance. If, later, the cost of tickets for the same flight increases, the fortunate individuals who bought tickets at the lower rate are not required to pay taxes on the difference between the new price and what they originally paid. Therefore, it is reasoned, there should be no tax liability on the prepaid tuition plan.[168]

A number of tax experts, however, are skeptical about Michigan's chances of getting the favorable ruling from the IRS. The major flaw in the preceding airline ticket analogy concerns refunds in the event of withdrawal from the plan. Michigan and the states with similar plans that have set a refund policy, offer at least one plan that returns a portion of the interest earnings to the participant upon cancellation of the contract. Such interest earnings will clearly be subject to taxation. In addition, the availability of this option may result in the IRS declaring the plan an investment and requiring everyone enrolled in the plan to pay taxes on the plan.[169]

It is also possible, however, that the alternative plan, which returns only the original payment in the event of a refund, will not be subject to taxation.[170] This may give the purchaser a tax advantage, but would seriously limit the flexibility of the plan. Participants with a beneficiary that dies or decides not to go to college would have only the original purchase amount which, if invested somewhere else, would have earned interest.

Officials in a number of states are anxiously waiting to see the results of the IRS ruling on the Michigan plan. In addition to Wyoming, Tennessee, Indiana, Maine, and Florida, which have enacted prepaid tuition contract plans, officials in Massachusetts will be very interested in the Michigan ruling due to the similarities between the Michigan legislation and their proposed certificate plan.

In addition to whether or not there will be a tax liability on the interest earnings, there are also questions of when will the tax have to be paid and who will have to pay it. Tax experts feel more confident about the possibility of designing a plan that can defer taxation until the contract is used to pay for educational costs, rather than creating one that will be exempt from taxation. In addition to the advantage of deferring taxes, tax experts believe it may also be possible to transfer the tax liability to the beneficiary. Assuming the student beneficiary will be taxed at a rate lower than the parent, the tax savings could be considerable.[171]

With the Illinois and North Carolina education bonds, the tax status is more definite, as well as more encouraging. Due to the tax-exempt status of state and municipal bonds, the interest earnings on this type of general obligation bond would also be free from federal income taxes under current law. The Illinois individual education account plan, however, does not fair as well. There is no question that the interest earnings would be subject to federal taxation.[172]

The federal plans, as discussed above, would exempt interest earnings from federal income taxation. In addition, each plan offers some type of additional tax incentive, making them very attractive to investors.

In addition to the possible tax liability associated with the plan, potential participants must evaluate the plan on a number of other issues. A crucial issue concerns whether or not the individual would be able to find alternative investments offering a rate of return equal to the particular prepaid tuition plan. Once again, the answer will vary with the type of plan.

The Michigan-type prepaid tuition trust plans offers a rate of that will at least equal the rate of tuition inflation, since the trust guarantees to pay the beneficiary's tuition at a state university. The supporters of the trust plan also hope to offer the prepaid contracts at a price below current tuition costs, giving beneficiaries a rate of return that exceeds tuition inflation. As stated above, tuition inflation has consistently exceeded the rate of general inflation as measured by the CPI by 2-3 percent each year. It is very difficult for individual investors, particularly those without a great deal of financial expertise, to find investments paying this high of a rate of return. There is also a question of risk involved. Those investments with a potential of paying a high rate of return on investment are also involve greater risk.[173]

The education savings bonds plans and the individual education accounts plan would not guarantee tuition. The education savings bonds would pay a specified rate of return equal to the rate of return for state long-term general obligation bonds. In addition, a bonus rate of interest up to one percent would be paid on certificates redeemed to cover educational costs. The desirability of this investment, therefore, would hinge on the condition of the bond market.

The rate of return paid by an individual education account would vary with the different financial institutions offering the account. Investors, therefore, would have to look for the institutions offering the highest rate of return on such accounts.[174]

The Massachusetts tuition certificate plan would give investors a rate of return tied to tuition inflation, since the certificates guarantee tuition and are priced at current tuition prices. If, for instance, tuition increased at a compound rate of seven percent from the time of purchase to redemption, the value of the certificate would also increase by a rate of seven percent.[175]

The rate of return on the federal plans would depend upon the type of plan. The Williams and Pell proposals would create a federal trust which could only invest in fully guaranteed United States government obligations. The rate of return, therefore, would depend upon the condition of the market for this type of investment. The Dole and DeConcini-Lipinski individual education accounts plans would encourage individuals to invest in education accounts at private financial institutions. As with the similar state education accounts plan, the individual investors would have to search for the institutions offering the highest return on investment. The rate of return on the education savings bonds would be the same as the other federal savings bonds.

Another important issue for the individual investor concerns the policy in the event of the withdrawal from the plan. There is always the chance that the beneficiary will die, become disabled, or not wish to attend college. There is also the possibility that the family will encounter some unexpected financial crisis. It, therefore, is in the individual's interests to find a plan with a flexible withdrawal policy.[176]

Under the prepaid tuition trust plans, the rate of return on investment upon cancellation of the contract will vary by state. Michigan, Indiana, and Maine intend to allow individuals the opportunity to choose between two plans. One offers a yet to be specified rate of return upon cancellation of the contract. The other plan, for a lower price, offers a return of only the original investment upon cancellation. The investor will have to choose between the lower price and flexibility. The Wyoming plan will pay four percent annually compounded interest upon withdrawal from the plan. Florida and Tennessee have not yet decided what their policy will be.

The alternative plans offered in Illinois and Massachusetts offer a greater degree of flexibility. Under the Illinois individual education accounts plan, the investor would be entitled to the full amount of interest earnings if used for other than educational purposes. He/she would then, however, have to pay state income taxes on the interest earnings. In addition, the investor would also have to pay state income tax on the original investment which had previously been exempted from state taxation.

Under the North Carolina, Illinois, and Massachusetts savings bonds plans, all bond holders would be entitled to a specified rate of return when the bond matures, regardless of how the bonds are used. Those who do not use the bonds for post-secondary education costs, however, would not be entitled to any bonus interest rate.

The Massachusetts tuition certificate plan would allow a fairly flexible cancellation policy. Refunds due to death or disability of the beneficiary or family financial crisis would pay the original investment plus all interest earnings. If withdrawal is due to the beneficiary's desire to attend a college or university not covered by the plan, the beneficiary will receive the original payment plus a rate of return equal to either the compound rate of return on investment or the average rate of tuition inflation, whichever is less. This figure would be reduced by two percent if the refund is due to some reason other than the ones specified above.[177]

Under the federal plans proposed in Congress, the original funds and interest earnings could be used for other than educational purposes. The interest earnings, however, would then be subject to taxation. Unless the refund was due to the death of the beneficiary, there would also be an additional tax penalty.

In addition to the issues discussed above, the investor must also consider what will happen if the beneficiary wishes to attend a community college, a private in-state university, or an out-of-state university. Plans which allow the beneficiary to get most or all of the benefit from the prepaid tuition plan, even if one of these other institutions are chosen, will be the most appealing to the individual investor.[178]

All of the prepaid tuition contract plans, with the exception of Wyoming, allow most all of the benefits to transfer to any accredited in-state private university. All of these plans also establish either separate contracts for community colleges or have provisions for transfer of benefits to community colleges.

The plans, however, are not as flexible for beneficiaries who wish to attend an out-of-state university. Only Maine plans to allow the transfer of the full value of a tuition contract to out-of-state universities. The other prepaid tuition contract states that have set policy on the issue will require the beneficiary to cancel the contract and receive a refund. Depending upon the state and options chosen in the contract, this may include little or no interest earnings.

In contrast, the individual education accounts plan, the education savings bond plans, and the tuition certificate plan provide a great deal of flexibility for use at out-of-state universities, community colleges, and in-state private universities. The education accounts plan would allow the beneficiary to use all interest earnings at out-of-state universities as well as all in-state institutions. The education savings bonds would allow all regular interest earnings to be used at out-of-state universities.

Unlike most of the tuition contract plans, the Massachusetts prepaid tuition certificate plan would allow out-of-state universities to participate if they so choose. If a beneficiary wishes to attend a university not participating in the program, an amount equal to the original investment plus a compound rate of return will be transferred to that university on behalf of the beneficiary. The compound rate of return will equal the lesser of the rate of return on investment or the average rate of tuition inflation at the participating universities.

The federal plans would allow the greatest flexibility for beneficiaries who wish to attend an out-of-state university. All of these plans would permit the beneficiary to use the full benefits of the plan at any acceptable postsecondary institution in the United States.

A final major issue of concern to potential investors is the affect these plans would have on eligibility for financial aid. As with all assets, the value of the prepaid tuition plan would be included in the family's assets. Greater assets will reduce the beneficiary's eligibility for financial aid.[179] Investors would have to weigh whether it would be better to save now or hope the child will qualify for financial aid when he/she is college age. The decline in the amount of financial aid available for students, particularly those from middle-income families, will certainly weigh heavy in the individuals decision.

Most of the education savings plans do not address the issue of the effect on financial aid. Two exceptions, however, are the Illinois savings bonds plan and Senator Pell's federal proposal. The Illinois plan would not include the first $25,000 held education savings bonds as family assets when determining the student's eligibility for aid under the state financial aid program. The Pell plan would allow only 75 percent of the funds held in the federal trust program to be included as family assets in determining eligibility for federal financial aid programs.

Clearly, there are a number of factors an individual must consider before investing in a prepaid tuition plan. In general, the plans which offer the most complete guarantee at the lowest price have the most restrictive withdrawal and transfer policies. The investor may have to decide whether what the plan promises is worth the loss of flexibility.

VI. SUMMARY

VI. SUMMARY

From this review, it is clear that education savings plans have attracted a great deal of interest across the nation in a short time. The plans are intended to help citizens, particularly those in the middle-income range, save for their children's college education. In addition, proponents contend such programs will be completely self-supporting. As discussed above, four different types of state prepaid tuition or college savings plans have been either enacted or proposed. (See Appendix A.)

Michigan was the first state to consider such a plan and, in December of 1986, enacted legislation to create a state prepaid tuition contract plan. Similar plans were enacted in Wyoming, Tennessee, Indiana, Maine, and Florida.

In general, the prepaid tuition contract plans will allow parents to pay a specific amount to a state trust fund early in their child's life. In exchange, the trust guarantees to later pay that child's tuition at a state university. The trust will invest the pooled funds and, when the beneficiary reaches college age, will use the original investment and the accumulated interest earnings to pay his/her tuition.

In addition to protection from the high rate of tuition inflation, proponents believe two other distinct advantages for parents will result from prepaid tuition contracts. State officials in Michigan and in states with similar plans believe they will be able to offer tuition contracts at prices below current tuition charges. Prices will be based on projections of tuition inflation and the rate of return on investment. They also contend that interest earnings will be exempt from federal income taxation.

This last point, however, is still in doubt. Michigan has applied for a private letter ruling from the IRS on this issue. A favorable ruling is necessary before the Michigan Trust can issue contracts. Tennessee, Indiana, Maine, and Florida must also receive a ruling from the IRS before offering contracts. The ruling, however, does not have to be favorable. Wyoming is the only state currently offering prepaid contracts.

Rather than follow Michigan's lead as closely as the other states have done, Illinois, North Carolina, and Massachusetts chose to design their own plans to aid citizens in saving for their children's higher education costs. Illinois is close to enacting a college savings bond plan, assuming the legislature approves changes made in the original bill by the Governor's use of an amendatory veto. Another Illinois act that would have created state income tax exemptions for private education accounts was vetoed by the Governor. North Carolina has also enacted an education savings bond plan. The Massachusetts Board of Regents, under the Governor's direction, conducted a study of prepaid tuition plans and recommended an education savings bond plan similar to the Illinois and North Carolina plans. The board also recommended a prepaid tuition certificate plan, which, in many ways, resembles the Michigan-style prepaid tuition contract plan. These alternative plans are briefly summarized below.

The education savings accounts plan, in contrast to the prepaid tuition contract plan, would not require the active involvement of the state. As an incentive for parents to save, funds deposited in special education accounts at private financial institutions would be deductible from gross income for state income tax purposes. In addition, the interest earnings would also be exempt from state income taxation. The beneficiary, upon reaching college age, could use the original deposits and the interest earnings to pay educational costs. There would be no guarantee, however, that the funds would cover full tuition. Although the Illinois legislature endorsed this plan, the governor vetoed the bill on the grounds it would have provided little incentive for savings and would reduce state revenue.

The tuition savings bonds plan also has a more limited role for the state than the prepaid tuition contract plan. Under the plan, the state would sell general obligation bonds in small denominations as education savings bonds. The bonds defer interest payments until redemption and would pay the same interest rates as other long-term general obligation bonds. In addition, the bonds may pay a bonus rate of interest of up to one percent if used to pay for educational costs. As with the education savings accounts plan, the savings bonds plan will not guarantee that the rate of return on investment will match the rate of tuition inflation.

The final major state plan is the prepaid tuition certificate plan. Like the prepaid tuition contract plan, the tuition certificate plan, in exchange for a specified amount, guarantees to pay for the beneficiary's future tuition, regardless of the rate of tuition inflation. The plan creates a state trust to collect payments from parents, invest the funds, and disperse the payments and interest earnings to pay the beneficiary's tuition costs. The prepaid price, however, is based on current tuition costs and no discounts on price will be offered. The certificates would be offered in small denominations and would have a conversion chart on the reverse side showing what percent of a years tuition the certificate would purchase upon redemption at state and participating private universities.

In addition to the state plans, a number of federal plans have also been introduced in Congress and by presidential candidates. Representative Williams and Senator Pell have introduced bills which would create a federal trust fund to collect money from parents, invest the collected funds, and disperse the original investment and interest earnings to any postsecondary institution in the country. The interest earnings would not be subject to federal income taxes. Parents, depending upon income, would also be able to deduct payments from their taxable income. Senator Dole has introduced a bill which would amend the tax code to encourage parents to invest in education accounts at private financial institutions. Senator DeConcini and Representative Lipinski have introduced a similar bill. Dole also introduced a bill which would authorize the federal government to issue education savings bonds with tax-exempt interest earnings. (See Appendix B).

From the review of the various plans, it seems the tuition certificate plan proposed in Massachusetts strikes the best balance between the needs of participants and the concerns of the state. The tuition certificate plan does give participants the security of knowing that the child's future tuition is paid. At the same time, the trust fund's investments need only keep up with tuition inflation. This goal is much easier to achieve than the Michigan-type tuition contract plan's requirement of having return on investment exceed inflation by a specific rate.

VII. RECOMMENDATION

VII. RECOMMENDATION

Clearly, the possible benefits of a prepaid tuition plan are very attractive. The possible negative effects, however, should not be ignored in a rush to institute any such program. A number of issues should be carefully examined before the state of Arizona institutes a program. In addition to the general feasibility of prepaid tuition plans, one must determine how such a plan will work in Arizona. To perform this analysis, a number of major issues must be considered.

The rate of tuition inflation that can be expected for Arizona public universities and the possible rate of return on investment are, of course, key issues in evaluating the suitability of any plan. The cost of registration fees for Arizona residents in the last ten years has increased by an annual compound rate of 10.69 percent. Whether this rate will continue, level off, or increase is worthy of further study. In addition, the rate of return on investment that could be earned by an Arizona education trust must also be examined.

A number of specific details must also be carefully considered. The foremost question concerns what type of plan is best for Arizona. The choices include the tuition trust plan, the private education accounts plan, the savings bonds plan, or the tuition certificate plan. Other major issues for examination include what role Arizona private and community colleges should play in a plan, what should be the policy for use of benefits at out-of-state universities, what should be the policy for withdrawal from the plan, and who should bear the burden if the plan encounters financial difficulties.

In addition to these issues, the possible effects of other states' plans on Arizona should also be considered. As mentioned above, a number of the state prepaid tuition plans would discourage beneficiaries from attending college in another state. Some or all of the interest earnings is likely to be kept by the trust. If the list of states offering such plans continues to grow, and the plans attract a large number of participants, fewer students may leave their state to attend college elsewhere. This trend could adversely affect the Arizona university system, which attracts a large number of non-resident students.

If such a situation could occur, it may be in the interest of Arizona to design a prepaid trust plan and establish reciprocal agreements with other states. Such agreements would allow beneficiaries in each participating state to transfer the full cash value of their prepaid tuition plan to another participating state. It may also be in the interest of the state to actively support the federal plans, which allow full transfer of benefits from one state to another. Such plans, through the proposed income tax incentives, would be serious competition for state plans.

From the discussion above, it is clear that prepaid tuition plans merit further consideration. Therefore, it is recommended that a study commission consisting of legislators, state university officials, a representative of the governor's office, and interested private citizens with experience in the field of finance and education be formed to engage in an in-depth study of the various plans. Such a commission would determine whether or not a prepaid tuition or savings plan is advisable for Arizona. If the answer is yes, the commission could then develop a specific plan. Such a cautious approach would, hopefully, result in a well designed plan that would have broad support from state and university officials, as well as from the public.

VIII. UPDATE

VIII. UPDATE

There have been several interesting developments on both the state and federal level since the completion of this report. As new legislative sessions begin, prepaid tuition plans and other state assisted education savings plans are expected to once again be a major issue in many states. States that enacted plans last year are in the process of implementing their particular programs.

Prepaid tuition plans in Michigan, Tennessee, Indiana, Maine, and Florida are yet to offer tuition contracts to potential participants. These states are still waiting for an IRS ruling on tax liability before they can offer contracts. Michigan Education Trust (MET) officials hope to have an IRS ruling "any day now." If no ruling is received in the near future, however, MET officials intend to to ask the state legislature to remove the language requiring a favorable IRS ruling from the authorizing legislation.

Wyoming was the only state to approve a prepaid tuition plan without requiring some type of IRS ruling before contracts could be offered. One-hundred sixty families have invested over one million dollars with the newly created state trust.

Although most of the prepaid tuition plans are in limbo, Illinois and North Carolina have started selling their higher education savings bonds. North Carolina was first, selling $200,000 worth of bonds offering an 8.1 percent rate of return. The demand for bonds outstripped supply, leaving many potential buyers disappointed. The state is considering rationing the bonds in future sales.

Illinois began selling higher education savings bonds in mid-January of 1988. As in North Carolina, demand exceeded supply and many potential purchasers were left empty-handed. The board of higher education sold $93 million worth of bonds, but was unable to fill another $157 million dollars in requests. The minimum maturity date was five years and the maximum was 20 years. Bonds with maturity dates for each year between five and 20 were available. The bonds were sold at interest rates ranging from 6.3 percent for the minimum 5-year bond to 7.9 percent for the maximum 20-year bond. State officials plan another sale later this year.

On the federal level, President Reagan's budget proposal for the coming fiscal year endorses a federal education savings bonds plan. The proposal is similar to the Dole and Bush proposals discussed above. Some are concerned, however, that such a proposal would cost the federal government one billion dollars annually in lost tax revenue. Congress must decide whether the benefits of assisting parents in saving for their children's college education is worth this cost.

IX. APPENDICES

APPENDIX A

STATE PREPAID TUITION PLANS

	MICHIGAN TRUST	WYOMING TRUST	TENNESSEE TRUST	INDIANA TRUST	MAINE TRUST	FLORIDA TRUST	ILLINOIS EDUCATION ACCOUNTS	ILLINOIS EDUCATION BONDS	MASSACHUSETTS EDUCATION BONDS	NORTH CAROLINA EDUCATION BONDS	MASSACHUSETTS CERTIFICATES
DESCRIPTION	Creates a state trust fund to collect payments, invest funds, pay students's tuition when college age.	Similar to Mich. plan. Includes room and board. Plan for community colleges also.	Creates trust similar to Mich. Board will establish program details.	Similar to Mich. Contracts for community colleges also available.	Similar to Mich. Also allows for beneficiary to attend out of state school.	Similar to Mich. Also has contracts for room and board.	Would allow taxpayers to deduct money put in education accounts from state income taxes.	State would sell tax exempt zero coupon education bonds. May pay bonus of 1/2% interest if used for education.	Similar to Illinois bond plan. Would pay a 1% bonus if used for higher education.	Similar to Illinois bond plan. No bonus interest for educational uses.	Resembles Mich. plan, but bases cost on current tuition. Easier to administer than Mich. plan.
DATE ENACTED	12/23/86	2/19/87	5/4/87	5/6/87	6/30/87	6/30/87	Vetoed by Governor.	Upon legislative approval of Governor's changes.	NA	July 21, 1987	NA
EFFECTIVE DATE	12/23/86	5/22/87	5/4/87	7/1/87	6/30/87	6/30/87	NA	Upon enactment	NA	July 21, 1987	NA
ANTICIPATED DATE AVAILABLE	Subject to IRS favorable ruling	Currently offered	After IRS ruling(a)	After IRS ruling(a)	After IRS ruling	After IRS ruling	NA	Not yet determined	Not yet determined	November or December '87	Not yet determined
STRUCTURE OF GOVERNING BOARD	State treasurer and governor's appointees.	State treasurer, University of Wyoming and Community College official.	State officers, university system and Community College officials.	State treasurer, and governor's appointees.	State treasurer, and governor's appointees.	State officers and governor's appointees.	No governing body. State Rev. Department would monitor use of tax exemption.	Advisory board consisting of state officials and appointees.	The governing body is not identified.	No new agency. The state Local Government Commission will oversee bond sales.	Nonprofit trust with state treasurer and university reps. as members.
WILL INVESTMENT BE DEDUCTIBLE FROM STATE INCOME TAXES?	YES	NA(b)	NA(b)	NO	NO	NA(b)	YES	NO	NO	NO	NO
WILL PART OF INTEREST EARNINGS BE REFUNDED UPON WITHDRAWAL FROM PLAN?	YES/NO(c)	YES	Yet to be decided	YES/NO(c)	YES/NO(c)	Yet to be decided	YES	YES	YES	YES	YES

	MICHIGAN TRUST	WYOMING TRUST	TENNESSEE TRUST	INDIANA TRUST	MAINE TRUST	FLORIDA TRUST	ILLINOIS EDU-CATION ACCOUNTS	ILLINOIS EDUCATION BONDS	MASSACHUSETTS EDUCATION BONDS	NORTH CAROLINA EDUCATION BONDS	MASSACHUSETTS CERTIFICATES
WILL THERE BE A SEPARATE PRICE SCHEDULE FOR COM-MUNITY COLLEGES?	NO	YES	Yet to be decided	YES	NO	YES	NA	NA	NA	NA	YES
WILL THERE BE PROVISIONS FOR ATTENDENCE OF IN-STATE PRIVATE COLLEGES?	YES	NO	Yet to be decided	Yet to be decided	YES	YES	YES	YES	YES	YES	YES
WILL THERE BE PROVISIONS FOR ATTENDENCE OF OUT-OF-STATE COLLEGES?	NO	NO	Yet to be decided	Yet to be decided	YES	NO	YES	YES	YES	YES	YES
WHAT WILL THE PLAN GUARANTEE?	Tuition	Tuition, room and board	Tuition	Tuition	Tuition	Tuition, room and board	No guarantee	No guarantee	No guarantee	No guarantee	Tuition
ESTIMATED IN-STATE TUITION FOR 1987 YEAR.	$2,684 (U. of Michigan-Ann Arbor)	$778 (U. of Wyoming)	$1,404 (U. of Tenn.-Knoxville)	$1,859 (U. of Indiana-Bloomington)	$1,590 (U. of Maine-Orano)	$1,090 (U. of Florida)	$2,092 (U. of Illinois-Champaign)	$2,092 (U. of Illinois-Champaign)	$2,049 (U. of Mass.-Amherst)	$819 (U. of N.C.-Chapel Hill)	$2,049 (U. of Mass.-Amherst)
ESTIMATED ONE TIME PURCHASE PRICE FOR 1-YEAR-OLD.	$4,000-5,000(d)	$5,114(e)	Not yet determined	Not yet determined	Not yet determined	Not yet determined	Not yet determined	Not yet determined	Not yet determined	Not yet determined	Not yet determined

(a) Officials in Tennessee and Indiana have expressed opinions that the legislature may repeal the enabling legislation if a negative ruling is received from the IRS.
(b) Wyoming, Tennessee, and Florida do not have state income taxes.
(c) Michigan, Indiana, and Maine will offer alternative plans, one of which will pay interest upon withdrawal.
(d) This figure is the most recent estimate. Actual figures are not yet available.
(e) Guarantees room and board as well as tuition.

APPENDIX B

Proposed Federal Savings Plans For College Education Costs

BILL NUMBER	S. 1572	H.R. 2509	S. 1659	S. 1660	S. 1661	S. 1533	H.R. 3003	S. 1662	H.R. 3064
HOUSE OF ORIGIN	Senate	House of Representatives	Senate	Senate	Senate	Senate	House of Representatives	Senate	House of Representatives
TYPE OF PLAN	Federal Trust	Federal Trust	Individual Education Accts.	Individual Education Accts.	Individual Education Accts.	Individual Education Accts.	Individual Education Accts.	Federal Educ. Savings Bonds	Federal Educ. Savings Bonds
SPONSOR	Senator Pell	Rep. Williams	Senator Dole	Senator Dole	Senator Dole	Senator DeConcini	Rep. Lipinski	Senator Dole	Rep. Henry
DESCRIPTION	Would create a federal trust to collect donations from parents, invest funds, and use payments and interest earnings to pay part of beneficiary's college costs.	Would create a federal trust to collect donations from parents, invest funds, and use payments and interest earnings to pay part of beneficiary's college costs.	Would use tax incentives to encourage parents to open individual education accounts on behalf of children.	Would use tax incentives to encourage parents to open individual education accounts on behalf of children.	Would use tax incentives to encourage parents to open individual education accounts on behalf of children.	Would use tax incentives to encourage parents to open individual education accounts on behalf of children.	Would use tax incentives to encourage parents to open individual education accounts on behalf of children.	Would authorize federal government to issue college savings bonds.	Would authorize federal government to issue college savings bonds.
TAX INCENTIVE	Interest earnings would be tax exempt. Contributors could deduct from zero to 100% of contribution, depending upon income.	Interest earnings would be tax exempt. Contributors could deduct from zero to 100% of contribution, depending upon income.	Tax on interest earnings would be beneficiary's responsibility and deferred until he/she is 25 years old. Contributors could subtract 15% of contribution from tax debt, up to $150.	Tax on interest earnings would be beneficiary's responsibility and deferred until he/she is 25 years old. No tax credit for contributors.	Contributors could subtract 15% of contribution from tax debt, up to $150. Interest earnings would be subject to taxation.	Contributors could deduct invested amount from adjusted gross income, up to $1,000 per beneficiary. Interest earnings would not be taxed.	Contributors could deduct invested amount from adjusted gross income, up to $1,000 per beneficiary. Interest earnings would not be taxed.	Interest earnings from bonds would be tax exempt. A limit of $1,000 would be placed on the amount of bonds that could be purchased each year.	Interest earnings from bonds would be tax exempt. No limit on purchase amount.

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