



The Heritage Foundation

Background

Executive Summary

No. 1301

June 24, 1999

ENDING THE DOUBLE TAXATION OF COLLEGE SAVINGS

STUART M. BUTLER, PH.D.

As Congress considers a tax bill this year, lawmakers can contribute significantly to the efforts of struggling families to save for college costs by removing the tax barriers to investing in state and private higher-education financing plans. Such plans encourage parents to put money in special accounts to pay for their children's college education in advance. Bipartisan bills now before Congress propose such changes, which also should be considered as part of the larger tax bill.

These tuition pre-paid programs achieve three crucial goals:

- **They provide families with a way to save for the cost of a college education, and in some cases provide some relief from double taxation.** The price of higher education has been rising sharply. According to the U.S. General Accounting Office, between 1980 and 1995, average tuition costs at public universities increased 234 percent; tuition expenses at private universities increased even more rapidly. Over the same period, the general rate of inflation and the average household income increased only about 80 percent.
- **They help take the uncertainty out of saving for college by "locking in" a price for the education well in advance.** It is very hard for

families to know how much they must put aside or what debt they or their children will have to incur to pay for a college education. For instance, if tuition and fees at a private university continue to rise at the same rate they have risen for the past few years, parents with a new child today will have to come up with just over \$100,000 (in today's dollars) when that child goes to college. If those costs rose two percentage points faster than they do today, more like the average increase since 1980, the tab would be more than \$150,000.

Two points less than today's rate of increase would mean that parents must save about \$75,000. Such uncertainty makes financial planning extremely difficult.

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- **They help achieve a general public policy objective of encouraging more family savings and less family debt.** Current federal policy gives large inducements for students and families to incur huge debts as a result of college costs. Savings and prepaid tuition plans help redress that imbalance between encouraging debt and encouraging savings.

Unfortunately, by not giving private plans the same tax breaks as state-sponsored plans, the tax code unfairly discriminates against families who choose to send their children to private colleges and universities. Moreover, even though the federal tax on interest earnings in state-sponsored plans is deferred, it is still payable. What is needed is tax treatment much like the treatment that applies to so-called Roth individual retirement accounts (IRAs), in which money saved is taxed once as earned income and interest earned on the savings accounts is tax-free.

To remove the current bias against tuition savings plans and reform the tax system, Congress and the President should:

1. **Extend current law tax treatment to tuition savings and prepaid plans established by private colleges and universities and private investment firms.** The law discriminates against families wishing to send their children to private colleges, because the deferring of taxes on state-sponsored plans does not apply to plans sponsored by private colleges. At the very least, Washington should extend deferred-income tax treatment to tuition prepaid and savings plans established and maintained by private colleges and universities, and even those established by private investment companies. This would place all savings and prepaid plans and all schools on an equal playing field.
2. **Make all interest earned through tuition savings and prepaid plans tax-free.** All tuition prepaid and savings plans should be extended the same tax treatment as regular education IRAs. In other words, the accrued interest earned through these plans—state and

private—should be tax-free when the student redeems the savings to pay for college costs. This would eliminate double taxation on interest earnings applied to this form of education savings under the current tax code.

3. **Make it easier for families to transfer education savings from one savings or prepaid plan to another.** Families that move from state to state often must cash out their plans and lose tax benefits, unlike the tax protection they get when they roll over an IRA. Congress should defer tax on interest generated by plans—or preferably make it tax-free—if the plan is cashed out and the funds transferred promptly to another plan. In addition, the federal government and states should explore ways to make such transfers easier to accomplish.

Lawmakers across the political spectrum, including Representative Bill Archer (R–TX), chairman of the House Ways and Means Committee; Representative Charles Rangel (D–NY), ranking minority member of the House Ways and Means Committee; and Senator William Roth (R–DE), chairman of the Senate Finance Committee, have introduced proposals to encourage states and the private sector to develop college savings and prepaid tuition plans. As Vice President Albert Gore remarked in a recent speech at Graceland College in Iowa, “We help people save for retirement tax-free, and help them pay their mortgages tax-free. Now we must help them save tax-free for one of the biggest expenses most families will ever face in life—sending a child to college.”

The Joint Committee on Taxation estimates that leveling the playing field between state and private plans, granting all tuition prepaid and savings plans tax-free treatment, and permitting transferability would cost the federal government just \$166 million over the next five years and only \$925 million over the next 10 years.

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ENDING THE DOUBLE TAXATION OF COLLEGE SAVINGS

STUART M. BUTLER, PH.D.¹

As Congress considers a tax bill this year, many lawmakers are seeking ways to address specific, everyday concerns of Americans that will conform with the goal of long-term tax reform. One central feature of tax reform should be the elimination of double taxation of savings so that the money families try to save for retirement, future health needs, a down payment on a house, or four years of college education for their children will be taxed only once. Currently, money saved is taxed twice: first when it is earned and again when it generates interest.

Consistent with the goal of ending double taxation of savings, Congress can contribute significantly to the efforts of struggling families by removing the tax barriers to investing in state and private higher-education financing plans. Such plans encourage parents to put money in special accounts to pay for their children's college education in advance. Bipartisan bills now before Congress propose such changes; these proposals should be considered as part of the larger tax bill.

The families of more than 730,000 college-bound students nationwide have invested nearly

\$4 billion in state-sponsored prepaid tuition and savings plans since Florida and Michigan established the first of these plans in 1988.² These plans permit them to save for a tuition price that is fixed in advance—a college “futures contract.” Thirty-six states and the District of Columbia have these plans in operation, and another six are in the planning stages. In the private sector, several investment companies and banks offer special tuition savings programs, and a consortium of over 120 private institutions is developing the first national prepaid tuition plan.

Congress encouraged the creation of state-based savings programs by passing tax policies that eased the double taxation normally applied to savings. A

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1. The author thanks Heritage intern Larissa Cooper for her assistance with this *Background*.

2. College Savings Plan Network, *Special Report on State College Savings Plans, 1998*, Tables 2 and 17.

provision of the Job Protection Act of 1996 (H.R. 3448)³ made state savings plans and prepaid programs for higher education more attractive by deferring federal income tax on interest earned. Moreover, at the time the savings are cashed in, the accrued interest income is taxed at the child's tax rate, which usually is less than the tax rate faced by parents.

These tuition pre-paid programs achieve three crucial goals:

- They provide families with a way to save for the cost of a college education, and in some cases provide some relief from double taxation.
- They help take the uncertainty out of saving for college by "locking in" a price for the education well in advance.
- They help achieve a general public policy objective of encouraging more family savings and less family debt.

Even though current state and federal law gives some encouragement for these programs, however, much more needs to be done to end the double taxation by Washington that eats away at how much families can save in these programs. In particular, the federal tax code does not treat public and private college education alike—it unfairly discriminates against families that choose to send their children to private colleges and universities. Moreover, even though the tax on interest earnings is deferred, it is still payable. What is needed is tax treatment much like the treatment that applies to so-called Roth individual retirement accounts (IRAs), in which money saved is taxed once as earned income and interest earned on the savings accounts is tax-free.

To remove the current bias against tuition savings plans and reform the tax system, Congress and the President should:

1. **Extend** current law tax treatment to tuition prepaid and savings plans established by private colleges and universities and private investment companies;
2. **Make** all interest earned through tuition savings and prepaid plans tax-free; and
3. **Ensure** that families can transfer education funds from one savings or prepaid plan to another tax-free.

The Joint Committee on Taxation estimates that leveling the playing field between state and private plans, granting all tuition prepaid and savings plans tax-free treatment, and permitting transferability would cost the federal government just \$166 million over the next five years and only \$925 million over the next 10 years.⁴

Lawmakers across the political spectrum, including Representative Bill Archer (R-TX), chairman of the House Ways and Means Committee; Representative Charles Rangel (D-NY), ranking minority member of the House Ways and Means Committee; and Senator William Roth (R-DE), chairman of the Senate Finance Committee, have introduced proposals to encourage states and the private sector to develop college savings and prepaid tuition plans. Vice President Albert Gore has offered a proposal as well. Indeed, as the Vice President recently declared, "We help people save for retirement tax-free, and help them pay their mortgages tax-free. Now we must help them save tax-free for one of the biggest expenses most families will ever face in life—sending a child to college."⁵

Congress should not miss this opportunity to build on such broad bipartisan support for prepaid tuition and higher education savings plans and achieve an important tax reform that holds the potential for helping millions of Americans.

3. P.L. 104-188.

4. Joint Committee on Taxation, "Estimated Revenue Effects of the Chairman's Mark of Proposals Relating to Education Incentives," JCX-21-99, May 17, 1999.

5. Remarks of Vice President Albert Gore at Graceland College, Lamoni, Iowa, May 16, 1999.

THE NEED FOR PREPAID TUITION AND SAVINGS PLANS

The Rising Cost of Higher Education

Parents face two severe hurdles in trying to save for their children's college education. One is obvious: the heavy cost. But the other—the uncertainty of what an education may cost many years in the future—is just as imposing. The price of public higher education has increased sharply over the past two decades, compared with the average family income and the general rate of inflation. Between 1980 and 1995, for example, average tuition costs at public universities increased 234 percent, and tuition expenses at private universities increased even more rapidly. Over the same period, the general rate of inflation and the average household income increased only about 80 percent.⁶

Still, a college education significantly increases an individual's earning power—usually making college a wise investment. According to the U.S. General Accounting Office (GAO), “a graduated college student in 1980 earned about 43 percent more per hour than a person with a high school diploma. By 1994, this earnings advantage increased to 73 percent.”⁷ Thus, while families are finding it increasingly difficult to pay for college without incurring a tremendous amount of debt, not going to college can be a very expensive decision in the long run.

The Uncertainty of Future College Costs

Unfortunately, it is very hard for families to know how much they must put aside or what debt they or their children will have to incur to pay for a college education. For instance, during the past 15 years, the annual increases in private college costs fluctuated between 5 percent and 8.6

percent.⁸ Increases in tuition at public universities fluctuated even more.

To understand just how great an uncertainty this fluctuation means for a family's financial planning, consider a young couple saving for their newborn child's college education. If tuition and fees at a private university continue to rise at the same rate they have risen for the past few years, parents with a new child today will have to come up with just over \$100,000 (in today's dollars) when that child heads off to college. If those costs rose two percentage points faster than today's pace, more like the average increase since 1980, the tab would be more than \$150,000. Two points less than today's rate of increase would mean that parents must save about \$75,000. Such uncertainty—a difference of \$75,000—makes financial planning extremely difficult.

Until recently, the federal government responded to the rising cost of tuition by creating programs that (1) give cash grants to qualified students, (2) guarantee private student loans, or (3) lend money directly to students. For most families, this means that the federal government simply has made it easier to go into debt. Moreover, existing federal programs, including President Clinton's HOPE and Lifetime Learning tax credits passed in 1997, probably have boosted tuition inflation because they provide no incentives for colleges to control costs or for families to avoid debt.

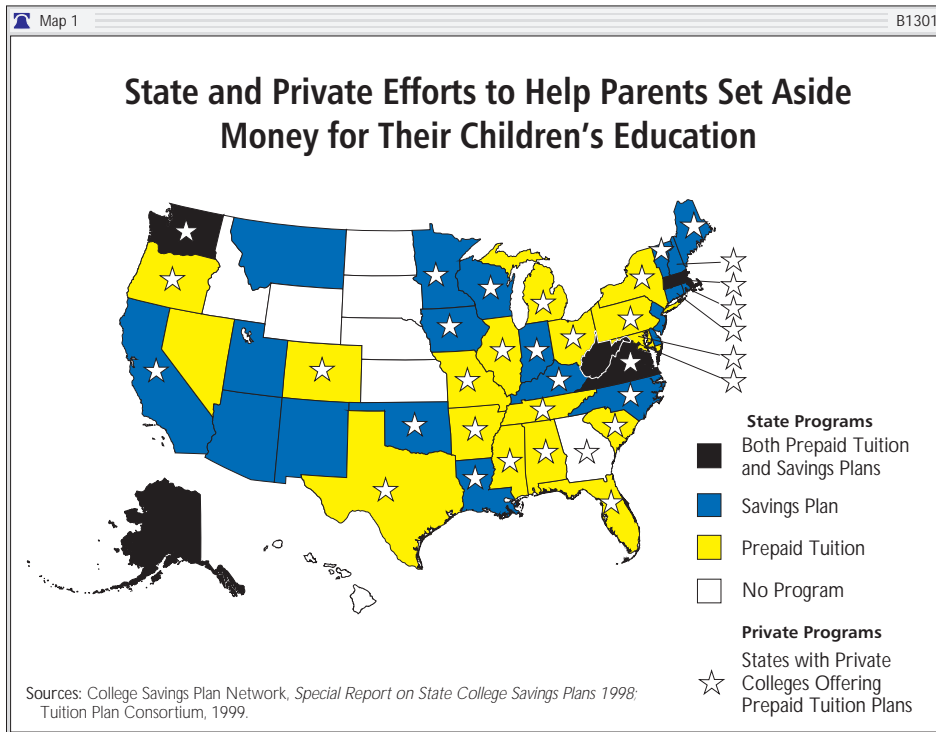
The Development of Prepaid Plans

Fortunately, several states, as well as a handful of private firms and a consortium of over 120 private colleges and universities, are making saving for college easier and more certain. The most innovative such step—prepaid tuition programs—allows parents to purchase a contract denominated in units of education (such as one semester). These contracts typically can be purchased at today's

6. U.S. General Accounting Office, *Higher Education: Tuition Increasing Faster Than Household Income and Public Colleges' Costs*, GAO/HEHS-96-154, August 1996, p. 5.

7. *Ibid.*, pp. 14-15.

8. U.S. Department of Education, National Center for Educational Statistics, *Digest of Education Statistics, 1997*, Table 312.



that will offer families future tuition at a discount from today's tuition rates. This discount, according to the plan organizer, may be as steep as 50 percent for families with a newborn child. Discounting tuition in such a manner will give many more families the opportunity to afford a college education for their children without going into severe debt or depending on hand-outs from the federal government. From the colleges' point of view, this is sound economics because it means they will have a stable source of income in advance.

tuition prices (or, in the case of one plan currently being designed, at a discount from today's prices) even if the buyer's children will not reach college age for many years. When the time for college arrives, parents redeem the pre-purchased units of tuition for education credits regardless of the cost at that time. This is much like pre-purchasing an airline ticket to lock in a cheaper fare.

Such plans will control tuition costs further by introducing market forces into the financing of higher education. As private investment companies become involved in managing the money invested through tuition savings and prepaid plans, they have an incentive to watch carefully the internal accounting of colleges and universities to ensure that everything possible is being done to curb tuition inflation.

How Tuition Savings and Prepaid Plans Help Families

These innovative programs are significant because they help reduce uncertainty and enable more American families to afford a college education for their children. But they also achieve another long-term goal: Rather than shackle families and graduates with years of debt, as current policies have done, these plans encourage families to finance their children's college education through savings.

In some cases, these plans actually will help reduce the cost of college. For example, Tuition Plan, a consortium of over 120 private colleges and universities located throughout the country (see Map 1), is establishing a prepaid tuition plan

A Market in College Futures Contracts?

Tradable Plans. It is likely that a market in prepaid tuition contracts will begin to emerge in which families will be able to trade the contracts they have purchased with other families as their circumstances change. This innovation would allow parents to exchange a plan at one college for a plan at another college if they or their child decided not to attend the institution for which they had saved. This would address the drawback in many state programs today, in which parents lose some of the value of their interest earnings in the savings plans if their child switches to an out-of-state college. Addressing this deficiency would encourage more families to sign up for plans, since one element of risk would be removed.

How would such a trading system work? Assume that Mr. Jones has purchased a bond for one semester at Howard University, but his daughter decides to attend the University of Notre Dame. He could decide to trade the Howard University bond to Mr. Smith, who previously purchased a bond redeemable at Notre Dame, and any difference in value would be made up in cash. As with any market, such a college futures market would generate industry ratings that determine the relative value of each contract based on underlying factors—such as the quality of education being provided by each institution and the measures employed by the institution to improve value for money and to control costs. Individual colleges and universities concerned about the positive or negative signals these ratings are sending to the pool of future students and their families would have an incentive to work to keep or earn a good rating.

An Options Market. Many other market-based mechanisms likely will emerge as tuition savings and prepaid plans develop. For example, it is possible that families in the near future will be able to purchase a “call” option at a small price now for the right to buy a tuition contract at a later time at a fixed price. This means that, for a modest price today, a family could lock in the right to make the full payment for a futures contract for a college education sometime in the future—but still well before their child attended college.

Parents might want to do this if they have a modest income today but expect a higher income in the future (for example, when the mother returns to work after the child is older), or if they sold their house and became “empty nesters.” As with any futures market, parents essentially would

be locking in a future price without having to pay for the product today. In short, families planning for the education of their children should soon be able to take advantage of the full range of financial instruments the market has developed and uses today in other areas.

Reforming the Tax Treatment of Plans

The proper tax treatment of tuition savings and prepaid plans should be such that the interest earned on the money saved in the plans is tax-free. This would be the same as the tax-once approach to savings used in individual retirement accounts (IRAs). Currently, however, only state-sponsored tuition savings and prepaid plans enjoy special tax treatment. In the case of these state plans, the accrued interest in the program is not taxed at the state level. Moreover, thanks to a provision passed by Congress in 1996 as part of the Job Protection Act, federal income tax on the interest generated in these plans is deferred until the student enters college and the value of the plan is redeemed. This interest is taxed at the child’s tax rate, which usually is lower than the rate that applies to parents.

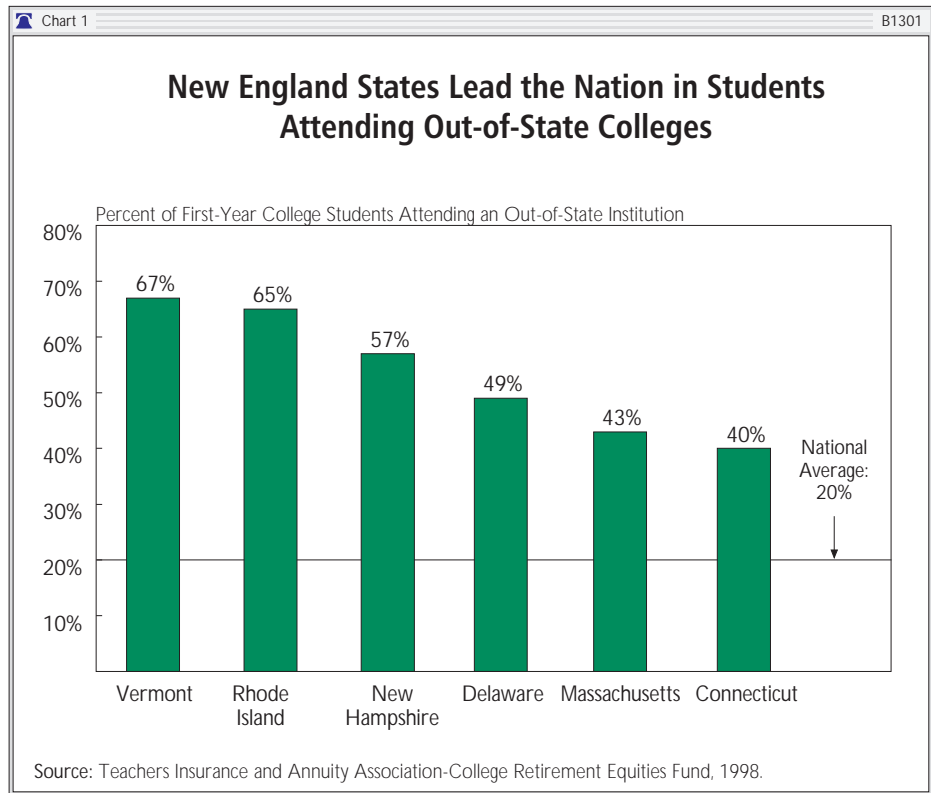


Table 1

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State Savings and Prepaid Programs, 1999

	Name of Program	Program Type	Start-up date
Alabama	Alabama Prepaid Affordable College Tuition	Prepaid	Mar-90
Alaska	University of Alaska Advance College Tuition Payment Plan	Prepaid/Savings	Nov-91
Arizona	Arizona Family College Savings Program	Savings	Aug-98
Arkansas	Name to be Determined	Prepaid	Jul-99
California	Golden State Scholarshare Trust College Savings Program	Savings	Oct-98
Colorado	Colorado Prepaid Tuition Fund	Prepaid	Sep-97
Connecticut	Connecticut Higher Education Trust	Savings	Jan-98
Delaware	Delaware College Investment Plan	Savings	Jul-98
District of Columbia	National Capital College Savings Trust	Savings	Oct-98
Florida	Florida Prepaid College Program	Prepaid	Jul-87
Georgia			
Hawaii			
Idaho			
Illinois	Illinois Prepaid Tuition Program	Prepaid	Nov-97
Indiana	Indiana Family College Savings Program	Savings	Sep-97
Iowa	College Savings Iowa	Savings	Sep-98
Kansas			
Kentucky	Kentucky Educational Savings Plan Trust	Savings	Jan-90
Louisiana	START Saving Program	Savings	Jul-97
Maine	Maine College Savings Program	Savings	1998
Maryland	Maryland Prepaid College Trust	Prepaid	Sep-97
Massachusetts	U.Plan - The Massachusetts College Savings Program	Prepaid/Savings	Feb-95
Michigan	Michigan Education Trust	Prepaid	1988
Minnesota	Name to be Determined	Savings	1999
Mississippi	Mississippi Prepaid Affordable College Tuition Program	Prepaid	Feb-97
Missouri	Missouri Family Higher Education Savings Plan	Savings	May-99
Montana	Family Education Savings Program	Savings	Oct-98
Nebraska			
Nevada	Nevada Prepaid Tuition Program	Prepaid	Oct-98
New Hampshire	Unique College Investing Plan	Savings	Jul-98
New Jersey	New Jersey Better Educational Savings Trust	Savings	Aug-98
New Mexico	Name to be Determined	Savings	May-99
New York	New York State College Choice Tuition Savings Program	Savings	Sep-98
North Carolina	College Vision Fund	Savings	Jun-98
North Dakota			
Ohio	Ohio Prepaid College Tuition Program	Prepaid	Oct-89
Oklahoma	Oklahoma College Savings Plan	Savings	Jan-99
Oregon	Oregon Prepaid College Tuition Program	Prepaid	Nov-98
Pennsylvania	Tuition Account Program	Prepaid	Sep-93
Rhode Island	Name to be Determined	Savings	Jul-98
South Carolina	South Carolina Tuition Prepayment Program	Prepaid	Sep-98
South Dakota			
Tennessee	Baccalaureate Education System Trust (BEST)	Prepaid	Jun-97
Texas	Texas Tomorrow Fund	Prepaid	Jan-96
Utah	Utah Educational Savings Plan Trust	Savings	Nov-96
Vermont	Vermont Higher Education Savings Plan	Savings	Jan-99
Virginia	Virginia Prepaid/Savings Education Program	Prepaid/Savings	Dec-96
Washington	Guaranteed Education Tuition	Prepaid/Savings	Jun-98
West Virginia	West Virginia Prepaid College Plan	Prepaid/Savings	Oct-98
Wisconsin	EdVest Wisconsin	Savings	Jun-97
Wyoming			

Source: College Savings Plan Network, *Special Report on State College Savings Plans 1998*.

There are, however, two fundamental problems with this tax treatment:

First, the money is still double-taxed at the federal level, although at a somewhat lower-than-normal rate. Money put into the plans is taxed first when it is earned; then the interest generated by this already taxed money is subject to a second round of taxes when it is used, albeit deferred until used and taxed at the child's rate. So these savings for education do not enjoy the same tax-once policy as IRAs enjoy.

Second, even this limited federal tax treatment does not apply to savings and prepaid tuition plans developed by private colleges. The interest earnings accrued in these plans are subject to state and federal income tax. Thus, the federal tax code is heavily biased in favor of state colleges.

WHAT NEEDS TO BE DONE TO STRENGTHEN THE PLANS

State governments, private colleges and universities, and private financial firms already are leading the way in developing these innovative methods of financing a college education. But by retaining most double taxation on these savings programs, the federal tax code still restrains savings for higher education while subsidizing families and students who choose instead to plunge into debt. By correcting this tax bias, Congress and the President can clear away the remaining obstacles to the expansion of savings, prepaid tuition, and other innovative plans. Specifically, Congress and the President should:

1. Extend current-law tax treatment to tuition savings and prepaid plans established by private colleges and universities and by private investment firms. Twenty states have established prepaid tuition plans that allow resident families to lock in today's tuition rates for tomorrow's education. Moreover, 27 states and the District of Columbia have tuition savings plans that do not guarantee families a

particular amount of education but do provide a secure savings vehicle for families preparing to meet the costs of higher education.⁹ (See Table 1.) Federal income taxes on the interest earned through all of these state-sponsored accounts are deferred until the account is cashed in to pay for college. Then taxes are paid at the student's rate, which is typically lower than that of the parents.

Current law, however, discriminates against families wishing to send their children to private colleges, because this easing of double taxation on state-sponsored savings plans does not apply to plans sponsored by private colleges. This places private schools at a distinct and unfair disadvantage vis-à-vis their public counterparts. To correct this distortion, Congress and the President should, at the very least, extend deferred-income tax treatment to tuition prepaid and savings plans established and maintained by private colleges and universities, and even those established by private investment companies. This would place all savings and prepaid plans and all schools on an equal playing field.

2. Make all interest earned through tuition savings and prepaid plans tax-free. Not only should all tuition prepaid and savings plans receive equal treatment, but they also should be extended the same tax treatment as regular education IRAs. In other words, accrued interest earned through these plans—state and private—should be tax-free when the student redeems the savings to pay for college costs. This would eliminate double taxation on interest earnings applied to this form of education savings in the tax code. It would eliminate one of the penalties in the current system of higher education financing imposed on families who work hard and save for college. And it would take a major step toward encouraging Americans to use savings for higher education, rather than encouraging students and parents to take on a huge debt.

9. Five states—Alaska, Massachusetts, Virginia, Washington, and West Virginia—either have established or are establishing both a prepaid tuition program and a tuition savings plan.

3. Make it easier for families to transfer education savings from one savings or prepaid plan to another. Families should have the flexibility to accommodate to their changing needs. For example, families that move from state to state, or that are unhappy with their current method of saving for college expenses, should be able to transfer their savings from one savings or prepaid plan to another. Conventional IRAs currently benefit from this treatment; an individual unhappy with the performance of a specific mutual fund within an IRA can sell the holdings in that fund and roll the money into another fund without incurring a tax penalty.

The key policy change needed for this to be the case with respect to education plans is for the increase in value of the account to remain tax-deferred—or preferably tax-free—if the plan is cashed out but the funds are transferred promptly to another plan. In addition, the federal government and the states should explore ways to make these transfers much easier to accomplish. Ease of transferability would allow additional market-based products and mechanisms to emerge that could expand the options families have available in saving for college.

TUITION PLANS AND THE 1999 TAX BILL

Although these provisions would provide significant relief to the millions of students and their families who plan to take advantage of tuition savings and prepaid plans over the next five years,¹⁰ there would be no significant accompanying revenue loss to the federal government. The Joint Committee on Taxation has estimated that leveling the playing field between state and private plans, granting all tuition prepaid and savings plans tax-free treatment, and permitting transferability would result in a loss to the federal government of just \$166 million over the next five years and \$925 million over the next 10 years.

Broad Bipartisan Support. Lawmakers from across the political spectrum already have taken the beginning steps toward making these three important policies a reality. In particular:

- Senator Jeff Sessions (R–AL), along with Senator Bob Graham (D–FL) and four other members of the Senate Finance Committee, has sponsored S. 13, the Collegiate Learning and Student Savings Act (C.L.A.S.S. Act). This bill would make interest earnings in all state-based tuition savings and prepaid plans and earnings through private prepaid plans tax-free. Representative Joe Scarborough (R–FL) and more than 50 cosponsors have introduced a companion bill in the House (H.R. 254).
- Representative Kay Granger (R–TX) and more than 70 cosponsors have introduced the Higher Education Affordability and Availability Act (H.R. 464), which would make all interest earnings in all tuition savings and prepaid plans tax-free.
- Representative Bill Archer (R–TX), chairman of the House Ways and Means Committee, included a provision in last year's House-passed Taxpayers' Relief Act (H.R. 4579) to level the playing field between existing state-sponsored plans and those established and maintained by private colleges and universities.
- Representative Charles Rangel (D–NY), ranking minority member of the House Ways and Means Committee, included the same provision in his tax bill last year (H.R. 4597), which was supported by every Democrat on the Ways and Means Committee.
- Senator William Roth (R–DE), chairman of the Senate Finance Committee, recently included language in his education tax bill (S. 1134) that would accomplish the three reforms outlined above. S. 1134 was approved by the Senate Finance Committee on May 19, 1999.

10. College Savings Plan Network, *Special Report on State College Savings Plans*, 1998.

Vice President Albert Gore, in a commencement address delivered at Graceland College in Lamoni, Iowa, set forth as one of his top seven education priorities the establishment of a tuition savings plan that would allow families to use their savings throughout the nation. Said Gore, "We help people save for retirement tax-free, and help them pay their mortgages tax-free. Now we must help them save tax-free for one of the biggest expenses most families will ever face in life—sending a child to college."¹¹

As federal lawmakers begin crafting this year's tax relief bill, they would do well to remember not only the tremendous benefits offered by tuition savings and prepaid plans, but also the broad bipartisan support for making the interest earned through all these plans tax-free.

QUESTIONS ABOUT PREPAID AND SAVINGS PLANS

Q. Won't prepaid tuition and savings plans benefit only the wealthy?

A. In fact, the experience of existing state plans indicates that it is working, middle-income families who benefit most. For example, families with an annual income of less than \$35,000 purchased 62 percent of the prepaid tuition contracts sold by Pennsylvania in 1996. The average monthly contribution to a family's college savings account during 1995 in Kentucky was a very modest \$43. And in Virginia, families can purchase an entire education at a community college for their newborn by saving only \$12 per month.

Q. What effect would the widespread use of tuition savings and prepaid plans have on federal and institutional grant and loan programs?

A. The goal of state and privately operated education savings plans is to increase savings for college. Since there are only three ways to pay for college (save, work, or borrow), any increase in savings is likely to result in a decrease in work during college or borrowing. Therefore, a decrease in student loans and decreased participation in

work/study programs would be expected. This is a desirable outcome. The more parents and students are paying in advance for their education, the less they get into debt, since it would leave more time for study.

An increase in family savings also would mean that existing federal grant programs and institutional scholarship programs could be targeted to assist the truly needy more effectively. During the 1995–1996 school year, 46 percent of students from families with incomes between \$30,000 and \$39,999 received Pell Grants worth an average of \$1,060 each. State and private savings and prepaid programs are most attractive to families in this income range. If middle-class families save more, federal grants could be redirected to those who are most in need (those who cannot afford to save even a small amount of money).

Under current law, moreover, many families who save money for higher education costs are penalized in the federal grant process. This is because any money saved by the family is counted as assets and can offset federal grant money. These programs should be redesigned to encourage education savings plans.

Q. Why are private colleges and universities establishing a prepaid plan when some states already allow family savings to be used at private schools?

A. Many state-sponsored tuition savings and prepaid plans advertise that families may use savings accrued through their plans at private colleges and universities not only within the given state, but also at schools in other states. However, there are limitations on this application of state-based savings. Specifically, no state plan can guarantee tuition at an out-of-state school. Instead, if a student chooses to attend an out-of-state school, as roughly 20 percent of students nationwide do (see, for example, Chart 1), he or she receives only the cash value of the savings accumulated in his or her state-based account plus some predetermined

11. Remarks of Vice President Albert Gore, Graceland College, Lamoni, Iowa, May 16, 1999.

amount of interest. This may or may not cover tuition at the student's school of choice.

Yet many families seek the security that accompanies a guaranteed amount of education offered through prepaid programs. These families use prepaid plans as a form of insurance that eliminates the uncertainty of wide fluctuations in tuition inflation. For this reason, it is important that private colleges and universities be allowed to establish tuition prepaid and savings plans of their own design. Such innovative plans, together with the creation of a futures market on which contracts from different plans can be traded, represent the most effective way to establish a truly national tuition prepaid plan.

Q. Won't extending tax-favored treatment to plans established by private colleges and universities disproportionately benefit the wealthy?

A. It is a common misperception that only wealthy families send their children to private colleges. In fact, 38 percent of students at private, not-for-profit institutions during the 1995–1996 school year were from families with incomes of less than \$40,000. This was close to the 41.5 percent of students from similar family backgrounds who attended public institutions of higher education.¹²

Promoting increased savings for college also would enable private colleges and universities to target limited institutional aid more accurately toward students from truly needy families that cannot afford to save even a minimal amount for their education. Thus, extending tax-favored

status to tuition prepaid and savings plans established and maintained by private institutions would increase the general accessibility of college education.

CONCLUSION

American families have accumulated more college debt during the 1990s than during the previous three decades combined. Recognizing that this trend must not be allowed to continue, 42 states and the District of Columbia have established tuition savings and prepaid tuition plans. Now a nationwide consortium of more than 120 private schools, with more than 5 million alumni, has launched a similar plan for private institutions.

These plans are extremely popular with parents, students, and alumni. They make it easier for families to save for college rather than face the prospect of a heavy debt burden. The prepaid tuition plans also take the uncertainty out of the future cost of college.

Unfortunately, however, the tax system remains biased against these innovative savings plans, and especially against those offered by or for private colleges. It is time for Congress and the President to recognize the value of such plans, eliminate the existing double taxation of interest earned through the programs, and end the current disparity between public and private colleges and state and private tuition savings and prepaid plans.

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12. U.S. Department of Education, National Center for Education Statistics, *Profile of Undergraduates in U.S. Postsecondary Education Institutions: 1995–96*, NCES–98–084, May 1998, Table 4.5b.