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THE CRUNCH

As college costs continue to soar, families across America are confronting a financial burden they find difficult if not impossible to manage alone. Throughout the last decade, college tuitions have risen faster than the rate of inflation. At the same time, our tax system and the lack of good investment opportunities have served as disincentives for parents to save--which has further compounded the problem.

Existing programs like student loans are unable to address a problem of this scope. Nor are recently proposed college tuition savings plans (which call for state or federal subsidies) likely to suffice.

The search for a method to encourage savings for college without drawing on limited public resources has led to a new investment idea, prepayment of tuition. Prepayment has the potential to increase families college savings without state or federal subsidies and to simultaneously provide financial benefits to colleges and universities.

Nearly every state legislature has discussed college savings or prepayment plans and several have plans in place. An even greater number of individual college plans and commercial plans have already appeared.

Although difficult to implement, prepayment plans have the potential to totally restructure higher education finance in the decades ahead.

In order to make clear the importance and potential of prepayment plans, the principal advantages and disadvantages of state, national, and commercial savings plans will first be quickly reviewed, followed by a comparison with state and national prepayment plans.

STATE SAVINGS PLANS

After Michigan announced its plan to permit families to prepay for higher education, a flood of new proposals followed. Many states have simply copied the Michigan legislation, changing only the state name and relevant statute numbers. A number of states, however, rejected the prepayment concept and attempted to introduce a state-based savings plan. Illinois is using tax-exempt bonds. New York is working on a savings plan with "up front" subsidies for potential low-income savers. Kentucky is trying to create tax advantages using an "endowment."
State savings plans are invariably tied to future attendance at one of the state institutions. To the extent that state lawmakers are unwilling to assist families who believe that out-of-state attendance is their best option, state programs will remain seriously flawed. A single investment approach with state imprimatur avoids complexity but is a disservice to the state's citizens.

NATIONAL SAVINGS PLANS

A national plan is one way of overcoming the problem of restrictions on out-of-state use in state plans. One of the new savings programs that have been proposed at the national level would employ U.S. Savings Bonds, which are sold at a deep discount and feature a variable interest rate with a fixed minimum.

A simple and straightforward plan to use U.S. Savings Bonds was passed in the last Congress and will take effect in 1991. This plan is likely to be attractive to parents, not so much from any inherent financial advantages but because it will combine the phrases "tax advantage," "college savings," and "government sponsorship." Unfortunately, the rate or return is modest and unlikely to keep pace with college tuition increases. However, this plan may at least help discourage state plans that pose barriers to interstate attendance.

COMMERCIAL SAVINGS PLAN

These are plans with a variety of advantages. Most provide access to the advice and expertise of investment professionals, and many offer a wide range of savings alternatives. Some of the commercial plans are general savings plans with specific college savings applications. They have essentially no public cost because the government is not involved in the venture, and because the investor bears the major risk.

The CollegeSure CD, marketed by the College Savings bank, is an unusual commercial plan because it is designed specifically for college savings and because the risk involved is shared by the investor, the bank, and the Federal Deposit Insurance Corporation (FDIC). The risk to the investor in a CollegeSure CD is that the value may not increase rapidly enough to cover the rise in college costs. While the CollegeSure CD can offer some peace of mind to families who want to prepare for the future, the steep rates of tuition increases, compared to the rate of inflation, would indicate that investments in standard short-term financial instruments will almost always be preferable.

STATE PREPAYMENT PLANS

Prepaying for college has the potential to provide greater benefits than savings plans both to families and to colleges. Simply put, a "tuition fund" can gain access to expertise and, more importantly, can take a long-term investment perspective that families cannot.

Tuition prepayment plans first received attention as a way for a single institution to lock in future market shares. The idea has since spread to the state level, where legislators and policy makers have mixed motives. Some lawmakers are unabashedly trying to keep students in-state. Others want to help families pay for higher education, wherever the offspring might enroll.

So far, most states have followed the Michigan model. Common features of these plans include 1) lump sum up-front payments, 2) use at in-state public institutions only, and 3) central state control of the funds.

A plan as originally conceived in Massachusetts demonstrates the possible directions for state prepayment plans. The major features of the proposal were:

* the plan covers a range of tuitions and types of institutions;

* colleges and universities would play an integral role in the management of the plan;

* the plan would be priced conservatively, so there would be very limited, if any, pubic cost; and

* the plan would eliminate most penalties for out-of-state attendance.

State prepayment plans such as these have obvious advantages, but there are potential problems as well. The primary disadvantage derives from the restrictions placed on the use of funds. In addition, if state plans are to be financially sound, they must prevent the unrealistic financial expectations that often result from political promises. These plans can become entangled in the politics involved in tuition increases, as well.

NATIONAL PREPAYMENT PLANS

State prepayment plans would become more effective if they were implemented at the national level. There are three ways to pursue a national plan: 1) through a consortium of state plans; 2) through federal sponsorship; or 3) through the leadership of a federation of colleges and universities. All three of these options would face major obstacles, but each deserves serious study. Higher Education associations and service organizations should consider the creation of a financial intermediary for the sale and investment of future tuition funds.

CONCLUSION

Helping families save for higher education is a crucial issue facing policy makers and higher education officials. If parents can be encouraged to create "new" savings for future college expenses, higher education will benefit while the nation's perilously low savings rate will be transfused. The creation of targeted savings for higher education has, fortunately, become a highly visible public policy concern. As states are actively seeking ways to assist families in saving for higher education, federal legislators are turning their attention to this issue and commercial products that fill (or seem to fill) the need are surfacing.

However, most of the initiatives to date have been at the state level and have failed to address the out-of-state attendance issue. National and commercial savings plans offer alternatives, although somewhat unsatisfactorily. A well-structured national prepayment

plan is essential if we are to bring the nation's college tuition crisis in check.

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