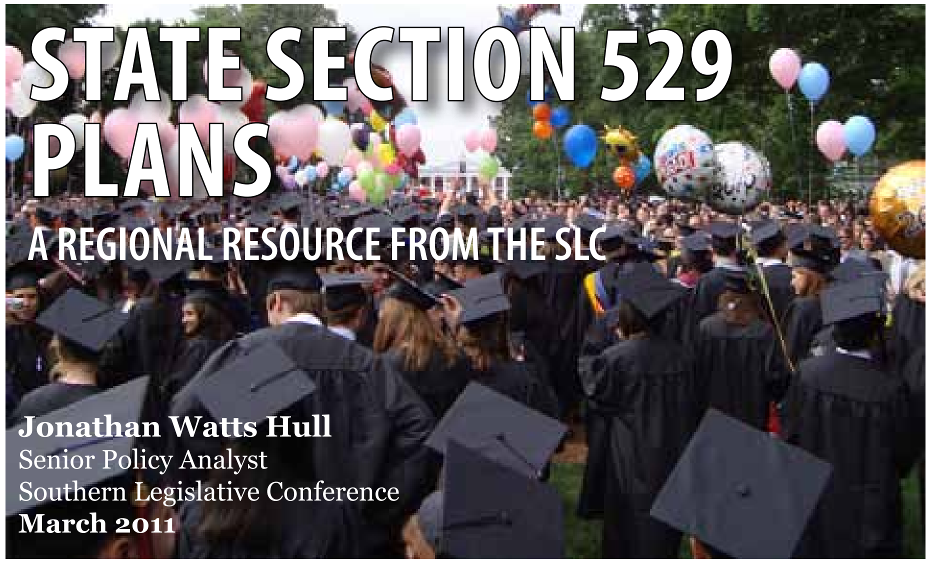
SOUTHERN LEGISLATIVE CONFERENCE OF THE COUNCIL OF STATE GOVERNMENTS

STATE SECTION 529 PLANS

A REGIONAL RESOURCE FROM THE SLC



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On March 25, 2009, the Board overseeing the Alabama Prepaid Affordable College Tuition (PACT) program announced that it would stop accepting new enrollments and seek assistance from the Legislature to keep the program solvent. The news left more than 45,000 Alabama families with questions about whether their investment into PACT would provide them the funds for college that they had expected.

Operated as a division of the state treasurer's office, PACT was established by the Legislature in 1989 as a tool to help parents, grandparents, and others save for college by prepaying state college tuition prior to college entry at the tuition rate of the year the contract is established. Overseen by a Board of Trustees, PACT receives actuarial and investment advice from outside consultants, with the actual investments managed by outside companies. For years, PACT had been successful in realizing returns on the money paid into the plan that were greater than tuition increases, thus providing solvency for the plan and a cushion for the state in paying out obligations. The program experienced 8 percent growth over much of its history through a pattern of heavy investment in domestic equities, mostly stocks. The Plan only had 30 percent of its assets in bonds and fixed income assets, which resulted in stellar gains when the economy was thriving and equity markets were flush. When the credit crisis hit in response to the mortgage meltdown in 2008, PACT's large exposure to stocks resulted in a 46 percent loss of value in the year-and-a-half leading up to the March 2009 announcement. This undermined its actuarial soundness and resulted in the program having assets to meet only half of its obligations.

The PACT program's difficulties are not unique to Alabama. Across the country, prepaid educational arrangements (PEAs) and college savings programs were hit hard by the economic downturn in the markets. Given the aggressive investment strategy of the PACT program, it has served as a sentinel program for trouble in other state college savings plans, highlighting the challenges these savings options face during a protracted economic slowdown.

Prepaid tuition plans are joined by state college savings plans as tax-preferred investments to encourage college planning. The very first plan of this kind was created in Michigan in 1988 when the state initiated a prepaid tuition plan that was shielded from state taxes. As several other states began operating similar plans, the Internal Revenue Service was compelled to provide explicit guidance on the tax preference these plans could enjoy. In 1996, the IRS created Section 529 of the tax code which authorized earnings on investments in prepaid trusts to be treated in a manner consistent with municipal bonds (and thus be exempt from federal tax as they were already free from state taxes). It also provided tax benefits to college savings plans as well, exempting them from tax until withdrawn, allowing the compounding of benefits to occur. These benefits were expanded in 2001 with rules making distributions entirely tax free, changes that were to sunset in 2010, but were made permanent in 2006. State Section 529 programs take two forms: prepaid tuition plans and college savings plans. Prepaid tuition plans allow families to lock in tuition at in-state institutions at current rates and pay all or part of the tuition up front. These may offer either a unit of tuition (essentially a "share" of the cost of current tuition) or a contract to purchase up to five years of tuition. In general, the value of the investment is guaranteed to meet or exceed in-state tuition inflation. Students who attend private colleges or schools in another state typically receive the average tuition for schools in the state offering the plan. Participation in PEAs often is limited to state residents and alumni of state institutions.

Americans understand the value of a college education and have continued to prepare financially for the costs of post-secondary schooling even as the economy has slowed. The role that state 529 plans play in these preparations is important, although not central. Overall, 60 percent of parents are saving for college for their children (while impressive, the corollary is that 40 percent are *not*), even though 86 percent intend to pay for some of their children's college expenses, including nearly 60 percent who intend to pay for at least half of these costs. According to a 2010 report from Sallie Mae, only 12 percent of American college savings is in college savings plans, less than the amount that is held in retirement plans, investments, and general savings accounts. Nonetheless, Section 529 plans are used by nearly one-third of all college-saving parents, with 24 percent of those parents saving for college through a 529 savings plan, and an additional 8 percent enrolled in a prepaid tuition plan. On average, parents have $13,907 saved in a college savings account (the invested value in a prepaid account is slightly higher at $14,481).

According to the same report, saving for college starts early for those parents who do it, with 80 percent beginning the process before the child turns seven, and fully 98 percent having begun by the time the child turns 13. This dovetails well with the strengths of state Section 529 plans, in that they perform best over long accrual periods. These plans face obstacles to participation by families, particularly those with low- and middle-incomes, in part due to a lack of familiarity. Less than half of parents not using a Section 529 savings plan report being familiar at all with them, and only 8 percent of parents in this category reported being very familiar with them, indicating a correlation between familiarity and participation. Familiarity with these savings options increases with income, even among parents who do not take advantage of them.

Interestingly, the initial push for prepaid tuition programs was spearheaded, not by state higher education boards, but by state treasurers. In the 1990s, as states began to investigate the options for expanding college savings among residents, the National Association of State Treasurers (an affiliate of The Council of State Governments) promoted the programs at the state and federal level, eventually securing advantaged tax treatment in the federal tax code. Because of this history, programs are routinely managed out of state treasurers' offices, typically with independent boards overseeing the operation of the fund by a private contractor. Prepaid plans operate as structured investments, calculating that returns on investments will exceed increases in tuition. The extent to which they are successful results in a windfall for the programs; the degree by which they fail represents an obligation (implicit, if not explicit) on the state to make up the shortfalls.

College savings plans are state-managed investments used to pay for qualified educational expenses, including tuition, books, room and board, and supplies. Savings plans operate much like other investment plans and have neither guarantees nor links to tuition costs. Plan values are capped at an amount calculated as the total of four years of undergraduate and three years of graduate school tuition, a figure which varies between $224,465 and $368,000, depending on the state. Participation typically is not limited to in-state residents, although state tax benefits may only apply to investments in the home-state program (43 of 48 states offering plans allow non-residents to participate). Moreover, there is no restriction on individuals holding savings accounts in multiple states (although there are penalties for not using the investments for approved educational expenditures), which could result in a single student having tax-advantaged accounts in as many as 44 states, each with a balance of at least $224,465, and most with potentially more than $300,000.

Every state except Tennessee operates at least one 529 plan (Tennessee closed its plan in 2008 and endorsed Georgia's plan), and most offer two or more. Nine states in the South offer prepaid tuition plans, although only three of them guarantee the investment, and only two are still open for enrollment. In the region, only Missouri extends the state tax deductions or credits for contributions to out-of-state plans, although the absence of a state income tax in Florida, Tennessee and Texas makes this a moot point in those states. In states where there is more than one plan, the principal difference is most often the addition of advisor-sold plans to state-managed ones. Table 1 lists the state plans available.

Full Faith and Credit

Prepaid tuition programs are structured investments designed to realize gains in excess of tuition increases under normal circumstances. In the event of an economic cataclysm, however, the fund may not have sufficient liquidity to meet all of its obligations. For many state tuition programs, the result has meant a shortfall that is passed on to its participants in the form of reduced aid. A handful of programs are backed by the full faith and credit of the state, with any shortfall made up by the state. When most prepaid tuition programs were designed, there was an unfailing optimism in the potential for the stock market to continue to expand and create returns that would outstrip any increase in tuition which historically ranged below 5 percent, making the extension of this state guarantee a risk of a presumably remote nature. As tuition skyrocketed and the stock market failed, however, states have been forced to reconsider the guarantee extended to these investments, causing a few to close earlier programs and re-establish them under different terms.

Table1 State Section 529 Plans Overview

State	College Savings Plan (number)	Prepaid Tuition Plan	Guaranteed?	Accepting new participants?
Alabama	2	Yes	No	No
Arkansas	2	No	--	--
Florida	1	Yes	Yes (with limitations)	Yes†
Georgia	1	No	--	No
Kentucky	1	Yes	Yes	No
Louisiana	1	No	--	--
Mississippi	2	Yes	Yes	Yes
Missouri	2	No	--	--
North Carolina	1	No	--	--
Oklahoma	2	No	--	--
South Carolina	2	Yes	No	No
Tennessee	0	Yes	No	--
Texas	2	Yes	No	Yes*
Virginia	3	Yes	Yes	Yes
West Virginia	3	Yes	No	No

†Florida's prepaid tuition plan opens annually from mid-October through January and then closes. The state guarantee only extends to tuition, and does not include rooming costs or fees.

*Texas closed its original prepaid tuition program, the Texas Guaranteed Tuition Plan (originally called the Texas Tomorrow Fund), in 2003, when tuition rates were deregulated by the state. The state replaced it with the Texas Tuition Promise Fund.

Investment Options

College savings plans are either sold by financial advisors or directly to investors. Advisor-sold plans include fees and charges to cover the costs of the manager, including load fees based on asset purchases or transfers, maintenance fees, and periodic assessments based on a percentage of the account balance. Directly sold plans, those in which the investor makes the investment decisions, do not have these load fees but are subject to periodic maintenance fees. Fees on advisor-sold plans generally are in line with those for similar investment programs, such are retirement accounts, and can average around 15 percent or more, depending on the plan and its performance.

Within most college savings plans are a number of options for maximizing outcomes and managing risk. The most popular option among 529 plans is an age-indexed plan, which gradually, and automatically, shifts the balance of investments from equities to fixed income assets as the beneficiary approaches the age of enrollment. These plans maximize the potential for growth when the investment has a long time to mature, but protects the principle when the enrollee is less able to absorb losses. In many states, investors also may choose among mixes of equities and fixed income assets, depending on their comfort with varying levels of risk. Most plans offer several options, including balanced funds, those composed entirely of equity or fixed income assets, and money market funds.

Recent Trends for 529s

While these plans have performed very well overall since their inception, the recent economic downturn has positioned 529 plans between two related pressures. The first was the quick erosion of value in the equities share of the plans as the economy crashed, reducing their returns and, in some cases, resulting in an actual contraction of value. The second pressure is rising tuition, which has increased at a rate in excess of inflation for several years. With severe strains on state budgets, higher education systems are among the few truly discretionary areas of the budget, making them vulnerable to reductions in state aid. Moreover, as the recession lengthens, an increased number of students are entering post-secondary institutions to seek new skills and credentials to improve their employment prospects, adding to the costs for higher education. To accommodate the larger population and reduced state aid, many state schools have turned to increasing tuition and fees, which widens the gap between the assets of state 529 plans and their obligations.

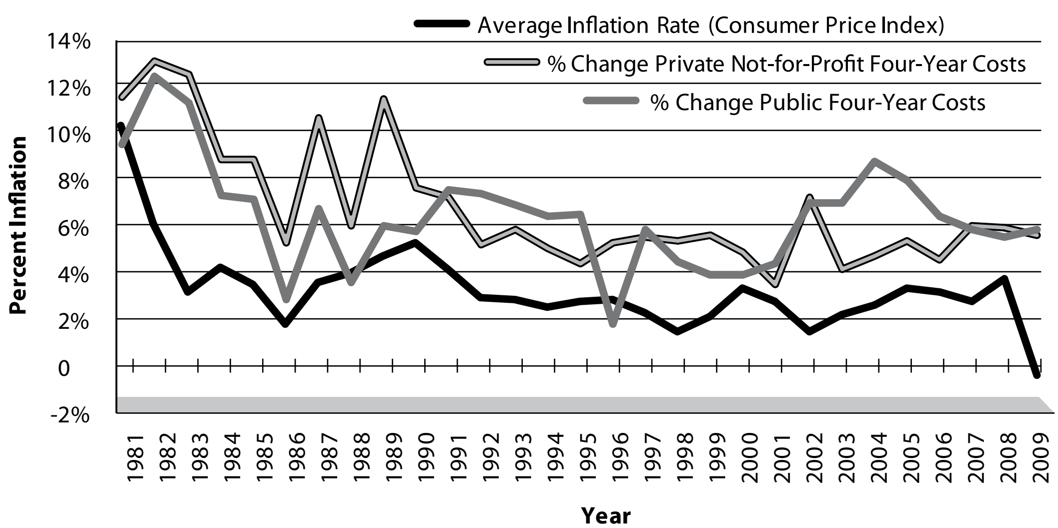
For guaranteed prepaid tuition programs, this situation is catastrophic, as the state or a state entity often is responsible for providing the shortfall between assets and obligations. For college savings plans, the complication is dire: individuals were saving for a determined share of college expenses only to find they are significantly short of that target. While this situation does not mandate state action to shore up these programs, the lack of confidence in them, and the effect it can have on college participation, is a matter of state concern.

Increased college tuition rates are exactly what state prepaid tuition plans are intended to provide protection against. When these plans were first developed, tuition inflation generally ran at less than 8 percent, meaning that a modestly conservative investment plan would stay ahead of inflation, and a reasonably aggressive plan could earn much more than the increased costs. Tuition inflation did not remain in line, however, and over the past 25 years, tuition typically has outstripped inflation by a considerable degree. Figure 1 compares the inflation rates for public and not-for-profit private four-year institutions to the average inflation rate for the United States.

What is evident is that while inflation has declined markedly from the double-digit levels of the early 1980s, tuition has remained consistently above the average annual rate of inflation, usually running about twice the rate of inflation. During the recession of the early 2000s, many states reduced their overall support for public institutions, a move that resulted in tuition spiking up by nearly 9 percent in 2004, even as the average inflation rate was just over 2.5 percent. Moreover, as consumer prices moved into deflation in 2009, tuition at most public and private institutions rose by more than 5.5 percent. The rise in tuition even as the economy has cooled has resulted in added stress for prepaid college tuition programs. While the many state programs use varying mixtures of investment strategies, all have some exposure to the stock market, and some a considerable amount given the necessarily high rates of return they must achieve in order to stay ahead of tuition. This exposure has undermined their fiduciary soundness.

There are numerous reasons for the disconnect between tuition and inflation, a topic that is beyond the scope of this report. Primarily, tuition increases did not exceed the average anticipated return on investments until late 2008, which meant that even when tuition rose above the rate of inflation, the assets invested in a state 529 plan rose even further, providing returns sufficient to meet program obligations as well as accumulating reserves against future outlays (and often a healthy return for the investment company managing the fund). However, as illustrated by Figure 1, when the housing bubble burst, tuition did not decline, but actually accelerated its increase, resulting in a yawning chasm between obligations (or expectations, in the case of non-guaranteed 529 plans) and available assets.

Figure 1 Inflation Rates: Consumer Price Index and College Tuition (Private and Public)



Sources: The College Board, Trends in College Pricing 2009; Bureau of Labor Statistics, Consumer Price Index History Table, accessed March 9, 2010.

Recent Activity

State Activities Focusing on Prepaid Tuition

State prepaid tuition plans have experienced stresses that have resulted in some significant changes to the programs. Responses have typically included increasing fees or enrollment amounts, curtailing enrollment, or conversion of the program. In the South, four states (Florida, Mississippi, Tennessee, and Virginia) have continuously operating prepaid tuition plans open for enrollment. Six programs (Alabama, Arkansas, Kentucky, South Carolina, Texas, and West Virginia) have closed their programs to new investors, although one of these (Texas) has reopened under new rules, and another state plan (Alabama) reorganized and reopened following a liquidity crisis.

Alabama

The Prepaid Affordable College Tuition (PACT) program in Alabama slid into crisis in 2008 and stopped accepting new enrollees in early 2009. For some programs, this action would have been sufficient to minimize exposure and protect assets to satisfy the plan's obligations. However, the PACT program's heavy dependence on stocks meant that the program still remained insufficiently capitalized to fully satisfy its outstanding obligations.

Among the actions initially taken by the PACT Board was to freeze tuition funds issued to schools for the 2009 year at 2008 levels. Students whose schools charged above the 2008 average for statewide tuition in 2009 would be responsible for the difference. One option advanced by the state was for the state institutions to absorb the loss by freezing tuition for PACT students, a move Troy State and Alabama State adopted for three years, but which other schools in the state declined to pursue, citing state budget cuts as a cause for tuition increases and the inability to further reduce their operating funds. The plan offered participants full refunds upon request, although this sum likely would not be enough to pay for tuition and could have some unforeseen tax implications. The Legislature considered several actions relating to PACT in the 2009 session but did not take action.

In a report issued in March 2010, the state treasurer (who serves as the program administrator) announced that, barring any action from the state, the program would cease to make tuition payments after fall semester 2011 because the program would not have sufficient funds to refund participants if it continued beyond that point. This report came amid discussions in the Legislature about a bailout for the troubled program. Because the program is not a formal guarantee of prepaid tuition (such a guarantee was determined to be unconstitutional in 1994 and the contract language was changed thereafter), any state funds to support the program or guarantee solvency must be separately approved. Both chambers had budgeted $236 million from the state's Education Trust Fund (the budget dedicated for educational expenses) to prop up PACT, but differed in a key provision to limit tuition and fee increases for PACT students. A compromise was reached in which tuition and fee increases for PACT students are capped at 2.5 percent annually at all universities and two-year colleges, except Auburn University and the University of Alabama System. In the event that the PACT Trust Fund grows by more than 5 percent for two or more consecutive years, colleges and universities are allowed to increase their tuition and fees for PACT students by 2.5 percent, plus the amount the plan grew in excess of 5 percent. The agreement did not reopen PACT to new accounts, and the program remains closed. At the end of the 2010 fiscal year, however, an annual review of the program indicated a remaining $269 million shortfall. By the end of December 2010, that deficit had grown to $338 million. Without further legislative action, the program will be forced to refund contract holders' funds by possibly as early as fiscal 2012 because after at that point it would not have the liquidity to do so. If current trends continue, the state treasurer's office has indicated that the program will run out of funds in five years.

Florida

Created in 1988, the Florida Prepaid Tuition program is the largest such program in the country, with more than 1.3 million participants (including more than 800,000 current or former recipients). The program is guaranteed by the state and allows participants to lock in tuition as well as prepay fees, housing costs and other education-related expenses, a unique component of the Florida plan. In 2007, the Legislature approved a "differential tuition" fee that could be charged by the state's top-tier research institutions to raise funds to pay for direct undergraduate instruction and services. The same legislation limited the total increase in tuition and differential fees to 15 percent annually until Florida's tuition reaches the national average. This measure is due to Florida having the third lowest average public four-year tuition rates in the country, behind Wyoming and Louisiana. Plans purchased prior to January 31, 2007, are exempt from the tuition differential fee.

The Florida Prepaid Tuition program takes this fee into consideration, adding the anticipated maximum increase to the current cost of tuition on a scale that varies by the expected year of initial enrollment. Thus, parents purchasing a plan for a kindergartner pay the average state tuition for the year plus an amount equal to 15 percent annual increases over the following 13 years before enrollment. In this way, the program is able to maintain solvency, since the combination of increased funds and investment return are anticipated to be greater than the increase in tuition. The differential tuition fee resulted in a sharp spike in program costs for individuals purchasing long-term contracts. Parents seeking to buy a contract for a child born in 2008 would have paid a lump sum of $4,614; in 2009, the lump sum cost increased to $19,776, a more than fourfold jump. Contracts are available without the differential tuition fee included, but these only guarantee base tuition, leaving the student or their family to pay the differential fee, a sum that could be substantial. The relatively recent introduction of this fee, and the inclusion of the fee in the prepaid program, makes it difficult to gauge what impact it may have on participation.

Matching Funds for investments

While the principal purpose for many state college savings plans is to increase college opportunities, particularly for lower-income families, the reality of any plan that relies on tax incentives is that they provide the greatest advantages, and thus the greatest incentive, to those families with the greatest amount of income to tax. At the same time, a lack of money is very often cited as a principle obstacle for college participation among low-income students. Providing matching contributions for lower-income participants is a tool that has been applied in a handful of states to expand participation among lower-income families. While it has a cost to the state treasury, these programs typically operate with caps on the total amount that will be matched, limiting the total fiscal impact. Moreover, providing matching funds increases the total amounts lower-income families are able to save for college, reducing to a degree, the access disparity between them and higher income families.

Recent federal legislation introduced in Congress would, if approved, provide employers tax incentives to match employees' contributions up to $600 annually. Moreover, in its budget for 2011, the Obama Administration has submitted $3.5 billion for the College Access and Completion Fund, which, if approved, states could use to establish incentive and matching grant programs for low-income Section 529 participants.

Kentucky

The Kentucky Affordable Prepaid Tuition (KAPT) program was established by the General Assembly in 2000 by House Bill 180. The program has three tuition plans: one for community and technical colleges; one that guarantees tuition at the highest-cost public university in the state; and a third that provides tuition benefits based on the average cost of tuition at private four-year institutions in the state, with growth guaranteed at the same rate as that of the University of Kentucky. The KAPT program included a provision to use 75 percent of the states abandoned property fund to support any unfunded liability in the Commonwealth Postsecondary Prepaid Tuition Trust Fund, which is the fund established to house and manage contributions to the program. While a KAPT contract constituted an irrevocable pledge to pay tuition, the program was not backed by the full faith and credit of the state. The use of the abandoned property fund to offset any unfunded liabilities was allowed, but not required, leaving the program in the situation of having potentially large unfunded liabilities.

The timing for the KAPT program could not have been much worse, initiated roughly at the time of the dot-com bust.* In part because of this, liabilities for the program quickly outpaced the potential of market gains to surpass tuition increases and in 2004, an actuarial analysis of the fund showed a deficit, the closing of which required an in-

* In March of 2000, the month the bill was signed into law, the NASDAQ index peaked at 5,048, the Dow Jones Industrials index reached 11,750, and the S&P 500 reached a high of 1,553—all high points that the indexes would not return to until the six to seven years later following the crash in equities that soon occurred.

jection of nearly $14 million from the abandoned property fund to the KAPT fund, a move the KAPT board approved. In 2005, the General Assembly passed legislation requiring the KAPT fund repay the abandoned property fund transfer and also repealed the alternative funding mechanism. The KAPT board successfully sued to block the repayment of the transfer, but also closed the program to new enrollees, a situation which remains unchanged. The program was 66 percent funded in June 2009, with an actuarial deficit of $59.3 million, a result of the difficult investment environment and high tuition increases.

Mississippi

Established in 1997, the Mississippi Prepaid Affordable College Tuition Program (MPACT) allows state residents to prepay tuition at current rates for schools in Mississippi. Participants have several options, including a university plan for one to five years, a junior or community college plan for one or two years, and a combination plan which allows participants to mix years between the two (two years at a junior college and two at a university, for example). Enrollment in either of the plans is limited to a four-month period beginning in September of each year. Contract prices range in cost depending upon projected enrollment date (higher costs closer to enrollment) and the plan selected.

The program is backed by the full faith and credit of the state, with a statutory requirement for the Legislature to appropriate any amount necessary to pay obligations. Should the board which governs MPACT determine that the program is financially infeasible and opt to discontinue operation, any beneficiary who has been accepted and enrolled, or is within five years of enrollment in an eligible institution, is entitled to exercise the complete benefits of the program. Other contract holders are to receive a refund of their total payments plus an interest rate that corresponds, at a minimum, to the prevailing rate for savings accounts in the state. The state has never had to provide funds to keep the program solvent.

South Carolina

Created in 1997, the South Carolina Tuition Prepayment Program (SCTPP) allowed parents and others to lock in tuition and fees for four- and two-year public colleges and universities in the state. Participants are guaranteed tuition at a state institution or the weighted average tuition rate in effect for state public universities (whichever is lower). The program began to falter in 2005-2006 as investment returns were below expectations even as tuition increased and, by 2007, it was facing a nearly $41 million actuarial shortfall. While the program was not backed by the full faith and credit of the state, it was viewed as important for the state to step in to ensure solvency.

The program stopped accepting enrollments in 2006, and was statutorily restricted from reopening to new participants in 2008, the same year the state injected $20 million to stabilize the plan. The same legislation that closed the program capped tuition increases for participants at 7 percent annually, based upon the 2006-2007 academic year. Institutions charging more than this increase must grant a waiver to the student for the difference and are prohibited from passing the additional costs to participants. Roughly 6,500 South Carolina families had invested $124 million in the plan before it was closed to new applicants by the General Assembly. The current actuarial deficit is now roughly $64 million with more than 6,000 participants still enrolled. For the program to meet all its obligations without another intervention, the state treasurer's office anticipants it would need to realize a 15 percent annual rate of return with tuition held to 1 percent—neither of these probable outcomes. Otherwise, the funds in the program likely will run out in 2017, before the final contract is honored. The program does not anticipate reopening enrollment.

Simplification and standardization

State Section 529 plans are complicated investment vehicles that pool funds of funds, are managed by third parties and generally offer participants a range of choices from which to select, perhaps even allowing for (or making automatically) adjustments for an anticipated approaching enrollment. Such complexity is not unexpected, insofar as these plans are designed to manage risks and returns for a host of clients. This aspect of college savings plans serves to create barriers to entry for many potential participants, most especially low- to middle-income families who might be less financially savvy than higher-income investors. Moreover, the complexity of state Section 529 plans makes comparison of plans across state lines very difficult, as reporting requirements and performance data can vary. In part, this is a function of state policy decisions that are established in the programs. Nonetheless, efforts are underway to standardize reporting methods for state Section 529 plans across jurisdictions and providers and to allow for improved transparency on costs, fees, and performance. The College Savings Plan Network, an affiliate of the National Association of State Treasurers, has developed disclosure principles that have been adopted by every state to varying degrees.

Additionally, for less sophisticated investors in particular, creating a simple gateway for enrollment and participation would serve to expand utilization and, consequently, college-going. Another step to easing enrollment would be to eliminate or reduce fees for moderate- and low-income families where possible, and to lower or eliminate minimum deposit requirements that are in place in many accounts. A more dramatic move would be to automatically open accounts for dependent children for all employees (unless they opt out), with a requirement to direct a percentage of the salary to that account.

Tennessee

Tennessee's Baccalaureate Education System Trust (BEST) program allows parents to purchase "tuition units" for a child based on current weighted average tuition costs at public universities in the state. Each unit is equal to 1 percent of one year's tuition at a normal course load (15 credit hours a semester). Thus, 400 units are equivalent to four years of college or university in the state. The units can be applied by the beneficiary toward the costs of college in or outside the state, with each unit carrying a value equivalent to the weighted average for Tennessee. The program is not backed by the full faith and credit of the state, but over the previous four years, the General Assembly allocated $40 million in state funds to offset the gap between investment revenues and tuition increases. On November 20, 2010, the program trustees closed the program to the purchase of new units following a determination that the program could not be self-sustaining given tuition increases and a depressed investment climate.

Texas

The Texas Tomorrow Fund, also known as the Texas Guaranteed Tuition Plan, originally was established in 1997 to provide a mechanism for Texans to prepay tuition at current rates for Texas colleges or universities. The Fund featured four plan options—senior college, junior college, junior-senior college, and private college—with varying costs and payment schedules. The program was created by the Legislature in 1996, and Texas voters approved a constitutional amendment the following year to back the fund by the full faith and credit of the state. Texas is one of the few programs to have a constitutional (and not statutory) backing.

The program was very popular, with more than 158,000 contract holders investing in the first seven years, 119,000 of whom were still active in 2008. In 2003, the Legislature deregulated tuition for four-year institutions. (Previously, the Legislature set tuition, which was typically relatively uniform across the state.) Deregulation removed both the predictability of tuition costs for the prepaid tuition program and introduced generally higher (and potentially unlimited) annual increases in tuition. Following the passage of the 2003 statute, the Texas Tomorrow Fund was closed to new investors, although the program remained open.

Since the passage of the 2003 law, the statewide average academic charges (which include tuition, mandatory and course fees) have risen by 72 percent, with the greatest increases (at the University of Texas campuses at Austin and Arlington) in excess of 115 percent. Given this rapid growth, it is not surprising that the cost of the program quickly began to outstrip its ability to meet its obligations. Rising tuition and declining investment revenues eventually lead to a widening gap between assets and obligations, an unfunded liability that was $605.6 million in 2009, up from $206.3 million reported for 2008, and a long-time shortfall of as much as $3.3 billion over the next 20 years, with the fund projected to be depleted by as early as 2015.

In August 2009, the state announced changes to the refund policy for plan purchasers, reducing the refunded sum to the amount of contributions, less administrative fees, a shift from the previous policy which refunded the current value of tuition. This change was amended in late September 2009 to provide refunds with earnings to individuals cancelling matured contracts (less fees), and those with unmatured accounts a refund equal to the actuarial value of the contract. Following objections from participants, in early November 2009 the board governing the plan reversed this policy and reverted to the guidelines in place prior to the August changes. In this time period, 7,000 account holders cancelled contracts valued at $110 million, slightly more than 7 percent of the fund's value.

In 2008, the state introduced a new prepaid tuition plan, the Texas Tuition Promise Fund, which provides three options for parents and others to prepay college tuition. Depending on the plan, tuition units will pay for in-state undergraduate tuition and fees at any Texas public college or university, regardless of cost; the weighted average costs of in-state undergraduate tuition and fees across Texas four-year institutions; or the weighted average cost of undergraduate tuition and fees for in-state students at Texas public two-year colleges. The plans differ in their costs depending on the plan type and payment option selected. The all-Texas plan, which covers the costs at any institution (public or private) regardless of cost, is roughly 44 percent more expensive per unit than the weighted average plan, a variation designed to insulate the plan from skyrocketing tuition increases.

Virginia

The Virginia Prepaid Education Program (VPEP) was created in 1996 to provide a means for parents and others to lock in current tuition rates at a state school. Contracts are available for up to five years at the university level or up to three years for community college, or a combination of the two, up to a maximum of eight years (three at the community college and five at the university level). The program does not have the backing of the full faith and credit of the state, and the enabling statute stipulates that the actions of the governing board of the program do not constitute a public debt for the Commonwealth. However, the statute also obligates the governor to include in the budget sufficient funding to ensure the plan can meet its current obligations should the program be unable to do so from its funds. To date, the program has not experienced a shortfall that would require an appropriation.

However, VPEP has experienced the dual pressures of rising tuition and shrinking returns. In 2005, the General Assembly extended to some institutions of higher education some degree of autonomy in setting tuition, which has resulted in tuition increases in excess of the national average. Virginia

Commonwealth University, one of four universities in the state to have the highest level of autonomy, increased its tuition and fees by 24 percent between the 2010 and 2011 school years; the University of Virginia increased tuition and fees by nearly 10 percent. The board overseeing the plan increased the costs for a contract by just over 10 percent in December 2006, considerably more than the 7 percent increase in contract prices from the year prior. At the same time, VPEP investments shrank by 1 percent ($13.35 million) in fiscal 2008, and by 15 percent ($202.3 million) in fiscal 2009. The 2008 losses were in spite of new investments of approximately $112 million. The result was an actuarial deficit of $284 million (an increase from a deficit of $51.8 million the previous year). In response, the VPEP board reallocated investments in June 2009, resulting in a $7.7 million positive effect on reserves.

West Virginia

In 1997, the West Virginia Legislature created the Smart529 Prepaid Tuition Plan. The plan allowed parents and others to lock in tuition rates and prepay for a child's education at a West Virginia college or university. The prepaid program in West Virginia provided for the tuition and mandatory fees at state institutions of higher education. The program proved very popular, selling more than 25,000 contracts in its first year of operation, and more than 10,000 in the next year. In all, West Virginia sold 49,518 contracts for tuition over the life of the program.

In March 2003, the Legislature passed House Bill 2953, which closed the program to new enrollments, allowing the plan to remain in effect only for those already enrolled. The same legislation established an escrow account to guarantee payment for contract holders, authorizing annual transfers of up to $1 million from the state's Unclaimed Property Trust Fund should there be an actuarially determined unfunded liability in the Prepaid Tuition Trust Fund. The escrow account is then authorized to support unfunded liabilities within the Prepaid Tuition Trust Fund. Such transfers have been made following audits of the Prepaid Tuition Trust Fund by a private accountant, with the most recent report (2009) indicating a total deficit in the plan of $27 million and a funding ratio of 74.2 percent of the amount required to meet all obligations. Under current projections, the plan anticipates reaching a negative cash flow point (when obligated funds will exceed available investments) in 2018, several years before the final contract is honored.

Home State Bias

All state Section 529 plans are eligible for equal tax treatment under federal law but, in general, only investments state residents make in their home state plan earn them state tax advantages. This creates a bias toward home state plans that discourages parents from investing in plans offered either by other states or private entities that may perform better or better suit their needs. On the other hand, home state bias exists in part because, as instrumentalities of the state, state Section 529 plans were created to advance specific public purposes. As then-Pennsylvania state treasurer Barbara Hafer testified before Congress in 2004 during hearings on this matter, states' establishment and maintenance of these plans follows from the "overarching state public policy driving these programs... To make higher education affordable and accessible for its citizens of all socio-economic levels." Moreover, because states extend benefits that have at least some cost to the state treasury, it is unlikely that they would be willing to, or find advantage in, extending identical benefits to programs that are not under the control of the state.

While there are calls for action at the Congressional level to eliminate home state bias, this would intrude upon states' ability to determine their own tax policy, something Congress is wisely hesitant to do. Moreover, college savings plans (unlike most prepaid tuition plans) do not have residency requirements, and families are free to invest in whichever plan fits their needs the best regardless of where they live. The only residency restrictions these plans feature is a limitation on specific state tax advantages. Most states (including all in the South except Arkansas and Mississippi) have chosen to conform their state income tax rules to the federal government, meaning that those tax advantages the federal government extends (deferred tax status on contributions and tax exemption for distributions from the fund for qualified expenses) are conveyed upon state taxes as well. States may vary on the other benefits they offer, which may include exemptions from state income tax when the funds are used for a qualified educational expense and income tax deductions for contributions made to the state plans.

To the extent that home state bias exists, then it is a function of incentives for state residents to invest in state-managed programs to increase college-going rates. The likely outcome of any federally initiated requirement that states treat out-of-state and private Section 529 plans equally would be the reduction or elimination of these incentives. Nonetheless, the benefits of open competition among plans, including the reduction in fees and the ability to choose the best investment vehicle to use, would indicate an opportunity for states to create reciprocity arrangements that would extend tax benefits among consortia state plans as well as pool the funds, expertise, and participants in order to maximize program efficiencies.

Looking Ahead

529s, Prepaid Tuition Programs and the Access Puzzle

College savings plans tend to be more heavily utilized by high-income investors. This likely occurs for a variety of reasons, including the higher overall savings rate among top earners, the greater proportionate tax advantages these programs afford high-income investors, and the higher college enrollment rates among this population. The extent to which these programs are most heavily subscribed by savvier, high-income investors serves, in part, to blunt their utility in advancing overall access to higher education.

Recognizing this imbalance in utilization, 10 states offer matching grants for low- and middle-income families who make investments into college savings plans, including two in the Southern region (Arkansas and Louisiana). In general, states match family contributions at an established rate depending on family income, with some limitations. In Arkansas, the state provides a matching grant of up to 200 percent for families with an adjusted gross income (AGI) of $30,000 or less, and a 100 percent match for families with an AGI between $30,000 and $60,000, both capped at $500 per year. Louisiana provides matching grants beginning at 2 percent for families with an AGI of $100,000 or more, 4 percent for those with an AGI between $75,000 and $99,999, with the match increasing by increments of 2 percent for each $15,000 drop in AGI thereafter, eventually capping at 14 percent for families with an AGI of less than $30,000. While Louisiana's match is the lowest in the country percentagewise, it is the only state that does not set a cap on the match amount.

Whether such matching grants are effective at spurring college savings among low- and middle-income earners is an open question. Below a certain income threshold, program participation is extremely low, and college savings programs may provide insufficient incentive to save. Moreover, to the extent they are available to those middle- and high-income families who would participate regardless of the matching grant, the funds dedicated to these activities can be seen as offsetting money for need-based aid.

Equally, prepaid tuition programs often are promoted as a tool to increase college participation rates, since it eliminates what is understood as a significant barrier to participation—tuition uncertainty. State support of these programs in this case would seem to be a component of a policy supporting post-secondary success. But as with college savings plans, prepaid tuition programs are most heavily used by high-income investors. The focus for state policy then becomes the appropriateness of using state funds to bolster prepaid tuition programs' solvency at the possible expense of other funds for higher education, including institutional support and need-based aid, with the end result being a shrinkage in the funds available to promote equitable access to higher education.

The Future for Section 529 Plans

There has been considerable focus in the past several years on the need for the United States to increase the number of college graduates in the workforce or face a decline in our global competitiveness. Achieving any expansion in post-secondary completion depends on a vast and complex array of factors, including elementary and secondary preparation, secondary and post-secondary alignment, and educational infrastructure. But preparation for post-secondary education is of little benefit if college is financially out of reach to students.

In light of this, there has been increased interest among states in helping families plan financially for post-secondary education. Section 529 plans represent one of a number of tools families are encouraged to use, and state actions in the coming years may make these more attractive. Recommended improvements to state Section 529 plans include: matching grants for low- and middle-income investors; ending home-state bias; improving marketing; and increasing the transparency of plans to improve cross-comparison.

As has been demonstrated, matching grants are used in a handful of states to augment the investments made by low- and middle-income families and to create an incentive for families to prepare financially for college. By matching contributions for these investors, states compensate for the overall tax advantage that high-income families enjoy with Section 529 plans. By capping the matching amount or the income level at which families are eligible, plans are able to limit the cost to the state treasury.

Another step that has the potential to improve college savings options for families is to eliminate what is known as the "home state bias." While all state Section 529 plans enjoy similar tax advantages at the federal level, states vary in the preferences they extend to their programs, generally extending or amplifying the preferential treatment for in-state college attendance, creating a disincentive for families to compare investment programs that are most well-suited to their needs. A handful of states have opted to provide their residents the opportunity to enjoy state tax benefits for Section 529 programs offered by other states, including Tennessee. In so doing, states essentially get out of the business of operating college savings plans, allowing participants to select from the full range of providers. Doing so creates opportunities for programs that operate with lower fees and provide greater benefits and further extends portability to college savings, but essentially severs the ability of the state to use these programs to effect public policy objectives.

While this portability would seem to be highly advantageous, leading to competition among programs and improving benefits for participants, state Section 529 programs have a limited amount of transparency and consistency. Reporting of historical returns by Section 529 plans varies greatly, which makes comparisons among programs difficult. If states act to remove home state bias, competition among programs could be improved by the disclosure of performance information and program priorities in a consistent manner that would provide for realistic comparisons across plans.

Moreover, while state Section 529 plans have been in existence since the mid 1990s, participation in programs lags, in part, because of awareness. Families who invest for college are more often using less advantageous vehicles, such as conventional passbook savings plans or certificates of deposit, likely because state Section 529 plans remain unfamiliar to many families. While this may be due to perceived complications related to these plans, including the tax reporting requirements of the plans, there also is a clear need to communicate to families the benefits of these plans as part of an overall college-readiness program for children. Historically, states have borne the greatest burden in marketing and promoting these programs, but should home state bias be reduced and plans begin to compete for customers across jurisdictions, it is reasonable that plan providers will take up more of the burden for this activity. Even absent any growth in competition among programs, states would be well-served by promoting plans and communicating their benefits and how they operate.

Prepaid Tuition programs face a rockier future. Changes in most state programs, both in the region and outside it, point to these investments being pricier for families and riskier for states to support. The near-term economic prospects do not indicate much opportunity for these programs to open (or reopen) where they are not operating, although it would seem reasonable that those that are still enrolling participants have adapted to current conditions and are likely to remain in operation. For those that do remain open, changes in terms, especially the costs per unit of tuition, are likely to make these investments less attractive as the programs recalibrate their structure to meet projected costs and more limited returns on investments.

Finally, state Section 529 plans are a component of an overall higher education strategy that works to increase the number of college graduates in a state. Because of their structure, they are most well-suited to support the financial needs of middle- and high-income families. As a vehicle for supporting low-income student participation in higher education, however, section 529 plans are insufficient to overcome the considerable barriers to entry. Targeted incentives for low- and middle-income families, such as matching grants for plan contributions, will help overcome some of the barriers to investment, but individuals in this economic strata generally have less money to invest or save. Moreover, because low-income earners are taxed at a lower rate, the benefits of state Section 529 programs accrue to high-income earners at a greater rate and thus become much more attractive. Scaling back the tax advantages for high-income earners, possibly through a means test for benefits or caps on the tax benefits based on income, would allow states to apply more resources to grant aid for low-income students.

As states grapple with the demands for an increased number of skilled workers in fields that will require post-secondary training, state incentives for preparing for college will continue to be a concern for state governments. College savings plans provide parents with a tool to plan for the expense of post-secondary education. While the tax savings do not likely constitute an incentive to accrue substantial new savings, the structure of these plans provides parents with a mechanism to maximize their savings for their children's education and inculcates an expectation of higher educational pursuit. In so doing, states can foster expanded participation in post-secondary education. Because college savings plans operate at relatively low cost to state treasuries, it is reasonable to expect changes in the programs to expand their appeal and eliminate barriers to participation across state borders.

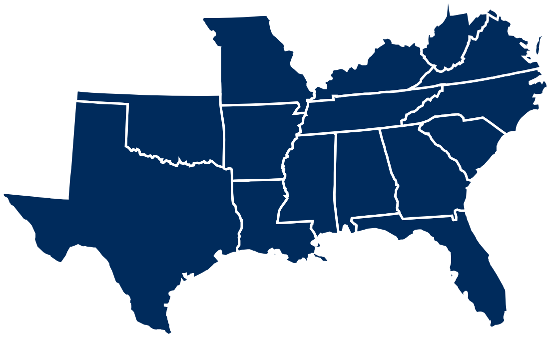
Prepaid tuition plans face a less clear future. As tuition costs have risen and investment markets have sputtered, the returns on investments made in prepaid programs are uncertain, leading to either unacceptable shortfalls or exceptionally high entry points relative to other college savings vehicles. As the few states that continue to operate these programs recalibrate their costs to expected future tuition, their cost advantage for families is certain to decline, as has been the case in Florida and Texas. For states that have been forced to close their prepaid tuition programs, the remaining accounts constitute a significant financial burden with the potential to siphon off higher education funds that otherwise would be directed toward programs to improve access. Should this be the case, the end result of these obligations would, ironically, be a reduction in the very kinds of increased participation in higher education that these programs were intended to provide.

The Southern Legislative Conference

THE SOUTHERN OFFICE OF THE COUNCIL OF STATE GOVERNMENTS

Founded in 1947, the Southern Legislative Conference (SLC) is the largest of four regional legislative groups operating under The Council of State Governments and comprises the states of Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, Missouri, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia and West Virginia.

The mission of the Southern Office/Southern Legislative Conference is to foster and encourage intergovernmental cooperation among its 15-member states. In large measure this is achieved through the meetings, publications and policy positions of the Conference's six standing Committees. Committee members are appointed by their chamber's legislative leadership and each committee elects its own officers. Through the deliberations of committee members, an array of issues facing all Southern state legislatures is considered.



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The Council of State Governments was founded during the Great Depression and, for more than 75 years, CSG has worked hard to provide state leaders with what they need to succeed in difficult times. The members of CSG include every elected and appointed state and territorial official in the United States. Through our committees and task forces, supported by our exceptional team of policy and research specialists, we consider and make recommendations on promising approaches to public policy.

This report was prepared by Jonathan Watts Hull, senior policy analyst, for the Education Committee of the Southern Legislative Conference of The Council of State Governments, under the chairmanship of Representative Tommy Benton, Georgia.

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