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IRAs FOR COLLEGE EDUCATION: BEWARE OF IMITATIONS

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INTRODUCTION

Individual retirement accounts, widely known as IRAs, have become a popular and convenient way for Americans to save for their retirement. The IRA success understandably is spawning clones. One of the potentially most important is an IRA-type plan by which parents can save money to pay for their children's costly college educations. Michigan already has such a program. Other states and Congress are considering similar programs.

Before legislatures rush to approve what they assume is a wise and beneficial proposal, they should be sure it is not a wolf in IRA clothing. The measure pending in Congress for tuition prepayment investment funds managed by the federal government, for instance, would open the door to subsidies for wealthy families, a boost in college fees, and increased government interference in the economy. A much better plan would create a true IRA clone for education, a tax-exempt savings plan, managed and invested, as are Individual Retirement Accounts, by private financial institutions. This would be a genuine and effective "Education IRA."

Losing Control. Paying into a government pool run by a bureaucracy, as envisioned by the congressional proposal, means that parents would lose control over their funds, and with that, the opportunity to pursue the highest available market returns. By contrast, Education IRAs would allow contributors to retain almost complete control over their funds and the freedom to choose the best available investment. Education IRAs also would give parents and their children real choice in school selection. The proposals pending in state legislatures, however, generally favor in-state public colleges; some explicitly restrict the choice completely to such schools. Thus the contributing parent would be locked into one type of institution, even if that were not in the student's best interests. With Education IRAs, by contrast, parents would be free to use the funds for any school, public or private, in-state or out-of-state, that they preferred.

While the sponsors of the government-run tuition prepayment plans contend that their programs would be self-financing, they likely ultimately would require substantial taxpayer subsidies. These subsidies would go mostly to higher-income families, because only they could afford to pay into the pools and thus qualify for a share of the benefits. Low-income families effectively would be excluded from receiving such subsidies. An Education IRA system, by contrast, would have no claim to taxpayer funds.

Adding to College Costs. Parents and students today face a major problem in rapidly rising college costs. But the government tuition prepayment plans would likely add to this problem, causing costs to rise even faster. This is because under the plans substantial new funds would be accumulated, which parents would have to spend on higher education within a specified time period or suffer heavy taxation penalties--in some cases losing their funds altogether. The result would be the bidding up of college costs even faster than the current rate, with parents' concern for costs diminishing as they sought to spend funds to avoid penalties.

With Education IRAs, however, parents would have the incentive to save for college fees and the incentive to conserve their funds by challenging college costs, since funds held in the accounts would not be subject to time limits and penalties pressuring them into unnecessary spending. Parents could devote unused funds to their retirement, health care, or nursing home expenses, or leave the funds to their children.

In considering methods to enable Americans to finance the cost of higher education in the future, Congress should focus on private sector plans, not highly flawed, government-sponsored programs.

GOVERNMENT TUITION PREPAYMENT PLANS

Congressional Proposals

Representative Pat Williams, the Montana Democrat, and Senator Claiborne Pell, the Rhode Island Democrat, have introduced legislation (H.R. 2509 and S. 1572) to establish a national tuition prepayment program. Their bills would create a new federal government agency to be known as the National Education Savings Trust. Parents could enter into contractual agreements to contribute into an agency pool up to $2,000 per year for each child, with a ceiling of $48,000 on total lifetime contributions per child. These payments could be made through regular voluntary withholding from paychecks, similar to the mandatory Social Security payroll tax.

The funds in the pool would be invested by the Trust in specially issued federal bonds, with interest rates indexed to the average rate on regularly issued, intermediate and long-term federal bonds. The Trust also could buy federal bonds on the open market. The funds paid into the Trust, together with the accumulated interest, would be available to pay college or graduate school tuition and costs for the child designated by the contributing parents.

The House bill provides that parents with annual joint adjusted gross incomes of up to $125,000 can take an income tax deduction equal to the amount contributed to the Trust each year. The deduction would be phased out rapidly for those with higher incomes. In the Senate bill, the same deduction is allowed for those with annual incomes up to $25,000 per year, with a deduction of 50 percent of contributions allowed for those with incomes between $25,000 and $60,000, a deduction of 25 percent of contributions allowed for those with incomes between $60,000 and $100,000, and no deduction at all allowed for contributions by individuals with incomes over $100,000.

Tax Free. Interest earned on the contributions would accumulate tax free in the Trust. Unlike existing IRAs, where the tax is merely deferred until retirement, contributions and interest withdrawn for college or graduate school tuition and costs would be exempt totally from tax. If the child did not attend college, or did not use up the accumulated contributions and interest, the contributing parents could withdraw the remaining funds from the account in a lump sum. This sum would be fully taxable as income. A 10 percent penalty on the withdrawal would be added to the tax bill (20 percent under the Senate legislation if the withdrawal is made after the child reaches 25). The Senate proposal also provides for an automatic withdrawal of all remaining funds when the child reaches 30. The House bill provides that, if the funds were not used or withdrawn within the period specified in the original contractual agreements with the parents, they would be forfeited to the Trust. Neither bill provides for any withdrawals before the child reaches 18.

The Michigan Plan

Michigan has already enacted a similar plan for state residents. Six states have followed with similar legislation, and proposals of varying kinds are under consideration in at least 38 states.

Under the Michigan plan, enacted in December 1986 and expected to be operational in 1988, a new state agency has been created to administer the program. The agency is to forecast college tuition and costs for the next three decades, and then advise parents how much they need to prepay each year into a central fund held by the agency to finance these costs. Parents who agree to participate would pay this amount into the fund each year. The agency will invest the funds for the parents and pay for tuition and costs when their children attend college. The state agency may increase the required payments into the fund each year to ensure that expected tuition will be covered. While no direct state subsidies into the fund are planned, they could become necessary if the state agency runs short of funds to pay expected tuition obligations.

Only for In-State Schools. Parents will be allowed a state income tax deduction equal to their contributions into the fund. The investment returns earned by the fund will be exempt from state tax. The state also is seeking a ruling from the Internal Revenue Service that would exempt parents from federal income taxes on their share of investment returns earned by the fund. The IRS, however, seems likely to rule that such returns must be subject to federal tax--at least when they are withdrawn for tuition and schooling costs, if not when earned. Since there would be no federal deduction for contributions paid into the state fund, these contributions would not be subject to federal tax when withdrawn.

Under the original Michigan proposal, the state agency could pay only for tuition and costs at in-state public institutions. The final legislation, however, allows the Michigan agency to pay for students attending private and out-of-state schools. Nevertheless, the plan still favors in-state public institutions by limiting the guarantee to parents that their payments will meet all college expenses to these schools only. Higher expenses at private or out-of-state schools will have to be met by the parents themselves. Similar proposals in other states would allow payment of agency funds only for in-state public schools. The Michigan plan makes no provision for withdrawals and refunds if students do not attend or complete college.

A GENUINE EDUCATION IRA

An alternative method of helping parents to meet the costs of higher education would be to allow them to establish "Education IRAs," modeled on the existing system of Individual Retirement Accounts. One means of doing so would be the Education Savings Accounts proposed by the Reagan Administration in 1984. Under this proposal, parents could contribute up to $2,000 per year for each of their children to a separate private investment account. The parents would be allowed a federal income tax deduction for the contributions. The funds would be invested by the parents directly or by a private financial institution chosen by them. The investment returns would be tax free. Unlike a regular IRA, where tax is due when the funds are withdrawn, Education IRA funds could be withdrawn tax free for the higher education expenses of the child designated for each account. Funds in the accounts not used for such expenses could be saved for the retirement of the parents, subject to the usual IRA taxation of withdrawals for retirement income.

Missouri Governor John Ashcroft is calling for a program similar to the Reagan Education IRAs. Under Ashcroft's proposal, Missouri parents could contribute up to $2,000 per child below age 18 to Family Education Accounts, investing the funds as in an IRA. State income tax deductions would be allowed for contributions, while investment returns to the accounts would be exempt from state tax. The funds could be withdrawn, free from state tax, for higher education expenses at public or private schools in Missouri or out of state.

THE IRA ADVANTAGE

Tuition prepayment plans involving payments into government-run investment pools, such as the Williams-Pell and Michigan plans, are inferior to the IRA-type alternatives. When contributions go into a government pool, managed by a government bureaucracy, the contributor loses control over his or her money as well as the flexibility to choose the best possible investment alternatives earning the highest available market returns. With Education IRAs, by contrast, the contributor retains almost complete control.

Under the Williams-Pell bill, moreover, the contributor is in effect limited to investing in low-yielding bonds. With an Education IRA, the contributor can always invest in government bonds if he wants, increasing his security but likely reducing the potential return. But the investor also can invest in any other market alternative, including corporate bonds, money market funds, diversified mutual funds, and common stocks.

A particular defect of the Michigan plan, moreover, is its tilt toward in-state public schools. Other state proposals cover expenses only at state institutions. IRA-type plans such as the Missouri proposal, however, allow complete flexibility and choice regarding the school the beneficiary student can attend.

Missouri Plan. The Michigan plan and similar proposals also are generally limited to covering expenses at a college or junior college. The states are generally unwilling to take the responsibility to try to predict tuition and costs far into the future for a wide range of institutions. But the flexible, individually held savings of an Education IRA, such as the Missouri plan, can be tailored easily to cover expenses at any kind of higher education institution--from vocational education to college to professional schools to regular graduate schools.

The Williams-Pell and Michigan plans in fact offer parents no benefit or advantage they would not have with a genuine Education IRA. The IRAs offer parents the opportunity to save for future tuition costs with equivalent tax advantages, but without the above flaws. Recognizing this, Robert Atwell, President of the American Council on Education, the umbrella organization for higher education associations, recently expressed concern regarding the growing state government interest in Michigan-style plans. He noted that such plans appear to be "a bad idea whose time has come."[1]

THE PERILS OF POLITICIZATION

Putting Taxpayers at Risk

The Williams-Pell legislation also would create a system subject to heavy political pressures. Disappointed parents who found that the Trust could not pay enough to cover college expenses in full no doubt would lobby Congress to subsidize the Trust. These parents would argue that they had paid for the benefits and had a right to them. Indeed, the language of the Williams-Pell bills makes this almost certain, by stating that contributing parents will enter into agreements with the Trust, providing that the Trust has a "contractual obligation" to the parents, "on its own behalf and on behalf of the federal government" to provide for college costs as specified in the agreement. States the Williams-Pell legislation: "The Trust shall offer a purchaser a plan that will, on the basis of actuarial projections, attempt to

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1. Bill Reinhard, "Criticism of State Tuition Savings Grows in Education Community, Capital," *Education Daily*, July 15, 1987.

achieve sufficient return to pay tuition and fees and other costs...related to attendance at a postsecondary education institution."[2]

The legislation thus fosters the impression that the Trust will take care of all college expenses for those who pay into it, and that the federal government has a contractual obligation to make good on this promise. But the bills contain no language indicating that the benefits for contributing parents would be limited to what they pay in plus interest, despite the claims by the legislation's sponsors that the program is to be self-financing.

Taxpayer Subsidies for Wealthy Families. Indeed, the legislation provides authorization for the appropriation of such federal funds as may be necessary "to provide sufficient funds to continue operations" of the Trust. These continued operations presumably would involve the payment of the contractual obligations of the Trust, which would mean the payment of full college costs for parents paying into the Trust. Consequently, the language of the legislation already provides a basis for subsidizing the Trust with government funds on a regular basis.

The beneficiaries of this would be mostly higher-income families, because low-income families would be unlikely to pay into the Trust. So if the Trust became federally subsidized, taxpayer funds drawn from all income groups could end up subsidizing higher-income families. A government-sponsored education program thus almost certainly would become a subsidy to middle- and upper-income Americans. In a private sector Education IRA system, on the other hand, there would be no politically viable justification for the government providing subsidy payments to the accounts of individual investors.

Funny Money

Another serious problem with the proposed Trust is that its "investments" would be placed in the same kind of "assets" as the Social Security "trust funds"--that is, not real savings but simply a right to future federal revenues. The parents' savings flowing into the Trust immediately would be loaned to the federal government and spent. All the Trust would have would be an IOU from the federal government. Just as the Social Security trust fund is a chimera, so the Education Trust would be a chimera. As such, the Trust's investments would make no real contribution to American industrial activity producing income for future obligations. Instead, when benefits were due to be paid, the federal government would have to pay off the IOUs out of additional taxes or increased borrowing.

The Michigan plan creates a system that is even more likely than the Williams-Pell scheme to be taxpayer-subsidized. Residents paying into the system

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2. This section of the legislation refers the reader to Section 104(d)(3) of the bill for further definition of the benefits. That section provides no greater clarification, however, stating only that the Trust shall pay funds

> "directly into postsecondary education institutions, upon receipt of appropriate documentation, to contribute to the payment of tuition and fees, and other costs directly associated with attendance at the postsecondary education institution, as provided for in the advance tuition prepayment plan agreement of an eligible beneficiary enrolled in the institution."

are promised explicitly that certain levels of tuition and expenses will be paid for their children by the fund. The system's actuaries are supposed to calculate the payments necessary over time to finance such tuition and expenses. But if the actuaries miscalculated, the state would have to turn to the taxpayer to bail out the system or else face collapse of the system or the cancellation of promised benefits.

The Michigan actuaries also are supposed to increase the required payments into the system over time as necessary to finance the promised benefits. But as actuaries for Social Security have come to appreciate, there is always stiff political resistance to such increases. This resistance will be all the more powerful in Michigan as increasing numbers of parents contribute to the system. If increases are held down in response to the political pressure, however, the general taxpayer will have to subsidize the system to make up the difference.

Manipulating the Private Economy

If the funds in a state system were to be invested in private bonds or stocks, additional problems would be created. Very likely, the investment strategy for such funds would be subject to political pressures. Investment funds consequently would likely be allocated as preferred by those with the greatest political clout, rather than in accord with market forces. Corporations with operations inside the state might receive favored treatment, as might firms whose labor practices pleased politically powerful unions. Investment also could be part of bureaucratically determined industrial policy. This would be bad not only for taxpayers, who would have to foot the bill for inefficient investments, but also for the whole state economy.

A state government would be tempted to use its control over an education investment fund to impose onerous regulatory burdens on private economic activity. Example: allowing the fund to invest only in companies that complied with state wage and price guidelines. Such regulations would damage the economy, while contributors to the fund would suffer because its assets would be invested not to earn the best return, but to further a political agenda. These problems of politicized investment would be magnified many times by a giant monotholic federal trust fund investing in the private economy.

The political dangers of potential taxpayer subsidization and politicized investment would be avoided by an Education IRA system. Those investing on their own through private accounts would have no claim to the contributions of taxpayer funds to their investment pools. And investment through the private accounts would be determined by the market rather than political pressure.

GOVERNMENT PLANS WOULD BOOST EDUCATION COSTS

Along with the sharp increase in student aid beginning in the 1970s has come a dramatic increase in the costs of attending college. Over the past ten years, college tuition and expenses have increased 150 percent, more than twice the accumulated rate of inflation. A year at one of the nation's elite colleges today can cost over $17,000 for tuition, room and board.

The pattern is strikingly similar to what has happened with health costs. A massive expansion in government subsidies for health care over the past two decades has made the costs soar. Similarly, the massive student aid increases since the early 1970s have helped spur a rapid rise in the cost of higher education. Such increases are self-defeating, since aid that results in higher costs does not help the students or their parents who must pay the bills.

Forcing Parents to Spend. As policy makers examine possible new education assistance, therefore, they must be sure that the programs not add to education's cost. Indeed, the new programs should aim at reducing the cost. It is unlikely that the Williams-Pell proposal will do so. To the contrary, it will stimulate even more rapid cost increases as parents are increasingly able to pay higher tuition fees with government subsidized funds. Under the proposal, substantial new funds would be accumulated which parents must spend on higher education within a specified time period or be subject to major tax penalties. This is likely to bid up college costs. Schools would be able to raise their fees, knowing that parents had substantial new funds to spend under conditions that minimized their concern for costs.

Systems modeled after the Michigan plan could ignite even worse tuition inflation. That plan requires parents to spend the accumulated funds on college or lose the money altogether. Parents consequently would be even more anxious to spend the funds and even less concerned with costs. And knowing that a substantial pool of education-designated funds had been accumulated, schools would raise fees sufficiently to soak up the funds.

With Education IRAs, by contrast, the accumulated funds would belong to the parents directly and be under their control. Parents obviously would not want to spend their funds unnecessarily or deposit more in the accounts than they felt would cover college costs. Nor would parents be under any time limit to spend the money or be subject to a penalty if they did not use it entirely on education. Instead, they could devote surplus money to their retirement, using it for income, medical care, nursing home care, or other expenses at that time. They also could give the money to their children after retirement or leave it to them in bequests at death.

Parents thus would be far more cost conscious with Education IRA funds than with a government-sponsored education fund. They would seek the most cost-effective education deal they could find. Schools in turn would have to respond to cost-conscious consumer attitudes. This would limit increases in costs. Education IRAs consequently would be much more effective in restraining the major problem in higher education finance: rapidly soaring tuition and other costs.

CONCLUSION

Government-sponsored tuition prepayment plans, such as the Williams-Pell proposal and the Michigan plan, have no sound policy rationale. These schemes offer parents no benefit or advantage not available in an Education IRA--except the prospect of being subsidized by the taxpayer. The government plans would require investments to be made by bureaucrats through a government pool, rather than by parents through their own private accounts.

Genuine IRAs. Genuine Education IRAs are a far superior method of enabling parents to finance college fees. They allow parents to retain control over their own funds and to choose the highest yielding investment alternatives. They give parents and students the freedom to choose the education institution at which to spend the funds. While the tuition prepayment plans are likely to fuel even more rapid college cost increases, the Education IRAs provide new incentives to counter increases. While the tuition prepayment plans face the prospect of being transformed into taxpayer subsidies for higher-income families, the Education IRAs would be free from such political pressures.

A federal Education IRA would be better for parents, their children, and the U.S. economy than the Williams-Pell proposal. At the state level, Governor John Ashcroft's Missouri Education IRA plan is far better than the Michigan tuition prepayment plan. Keeping education costs down, while enabling parents to finance the cost of college, requires a system that promotes genuine saving while maintaining incentives for parents to monitor and challenge college fees. The Education IRA idea contains these essential components. Plans for a new government trust fund do not.