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Issues of Equity in College Savings

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by Sandy Baum

The author reviews the equity of savings plans from a number of perspectives. This article will be published in Fall 1989 by ACE/MacMillan in a book titled, "New Ways of Paying for College," edited by Arthur M. Hauptman and Robert H. Koff.

Saving for college is clearly a good thing. The recent trend toward encouraging parents and students to think of college as an investment that must be paid for over time—rather than as a pay-as-you-go experience that lasts for one or two or four years—is long overdue. It is apparent that the higher education system as we know it cannot survive for long if this perspective does not become entrenched. Furthermore, all public or private organizations interested in promoting higher education opportunity—educational institutions, state legislatures, banks involved in the student loan industry, guarantee agencies, the federal government, and nonprofit educational organizations—can fruitfully become involved in the movement toward encouraging savings for college.

Although savings plans from many sources may have merit, not all plans deserve unconditional support. Some programs may expend public funds without encouraging significant savings. Some actually may limit the educational opportunities of the children of people who participate in them, either by generating profits for the institutions that sponsor them or by restricting the schools at which savings may be used. And some may divert public or institutional funds away from students who are most in need of them toward middle-class students whose families have been able to participate in savings plans.

Achieving Vertical and Horizontal Equity

In choosing among savings plans, an important objective should be to design or select plans that genuinely encourage savings and that embody a basic fairness in the way their benefits are distributed. It is easiest to look at the fairness of public policies through the categories of vertical and horizontal equity. Achieving vertical equity requires different treatment of people in different economic circumstances. For example, people with low incomes would be given greater subsidies to finance higher education than would people with higher incomes. Achieving horizontal equity requires equal treatment of people in similar circumstances. In other words, families with similar incomes should have access to similar subsidies, regardless of the choices they make about how to manage their personal finances.

A discussion of vertical equity in educational policy should begin with programs designed to increase educational opportunity. Such policies can be directed at different constituencies and will have different effects on each. Starting at the bottom rung of the economic ladder are many young people who do not complete high school or who do not receive adequate elementary and secondary

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educations. Although it will take a lot more than dollars to solve their problems, significant funding from the federal education budget can have great benefits for such students in the vital early levels of education. In addition, these youth also need focused assistance when they are about to enter the labor market. Many prospective young workers need further education, either formally or through on-the-job training, and most need financial support to attain that education. Here, then, is a way in which education dollars can be spent fruitfully if the intention is to help the "truly needy."

Moving up the ladder of economic and educational achievement, about 40 percent of undergraduates are enrolled in public or private institutions whose programs are two years or less. Most attend public community colleges, but some attend private, for-profit schools, and a few attend private, not-for-profit institutions. Almost half of these students finance their educations through some combination of financial aid and their own contributions—without any parental assistance.

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It is well known that students in two-year and vocational institutions tend to come from families with significantly lower incomes and with weaker educational backgrounds than do students at four-year colleges and universities. Limited economic opportunities explain why most of these students have chosen brief programs: they may have limited resources to pay for college; they may need to contribute to the support of a family; or, their lower socioeconomic backgrounds may have generated lower educational aspirations. Many two-year and vocational students would receive no postsecondary education if financial aid were not available. Such students typically are reluctant to borrow to finance their educations and frequently have the most difficulty repaying the loans they do take.

They are, then, an important constituency in need of public funds to ensure and improve their educational opportunities. And they are not likely to benefit much from family participation in the type of long-term savings plans currently being proposed and implemented.

Finally, there is the population at whom savings plans are primarily targeted—young people from middle- and upper-middle-income families who attend four-year colleges and universities. Faced with declining real federal aid to college students, with increasing diversion of federal aid dollars to students in two-year and vocational schools, and with skyrocketing college costs, this subset of the college population now bears a much heavier burden. In the last decade, tuition at public four-year colleges has risen an average of 141 percent, and at private four-year colleges it has gone up 191 percent. Median family income has risen only about 70 percent in this same period.[1]

Clearly, families are having greater difficulty in financing their children's educations. Presently, only a few of the wealthiest families can hope to do so out of current income. Thus, savings plans have become imperative.

Savings Plans and the Middle Class

Given the increasing relative and absolute burdens on middle-income families, the question is not whether we should encourage middle-income families to save but *how* we should encourage their saving, and, in particular, whether we should use public funds to encourage their saving. Plans or proposals for savings have been developed already at the state and federal levels. For example, several states have implemented college savings plans that depend on tax-free bonds and that sometimes involve the payment of bonuses to families that use the bonds to finance higher education at an in-state institution. Tuition guarantee plans such as the one developed in Michigan also are essentially efforts to encourage parents to save for college.[2]

At the federal level, recent legislation has exempted from taxation interest earned on government savings bonds by families with incomes of $60,000 or less if the proceeds are used to finance higher education.[3] Another proposal for a federal role in educational savings is for a plan resembling an Individual Retirement Account (IRA). This plan would allow families to save pretax income, thus deferring, diminishing, or eliminating tax obligations on the money saved and used to finance college education.

All of these proposed and legislated savings plans involve a public subsidy of savings. This means that they will increase the effective rate of return to savings for participants by increasing the government budget deficit.

A critical question concerns the effectiveness of such plans. Will they really increase the level of savings of the families involved or will they merely divert funds from other forms of saving? Economists disagree on how sensitive savings patterns are to changes in the rate of return. Until recently, the consensus was that small changes in the rate of return made virtually no difference in how much people saved. The belief was that although a higher rate of return makes saving a dollar more lucrative, it also makes it possible to accumulate a given amount of wealth by saving fewer dollars. Empirical evidence seemed to suggest that in practice these effects pretty much canceled each other out, leaving no measurable change in the savings rate. For example, economists found that the insertion of the IRA provision in the federal tax code led many people to change the form in which they saved, but not to save more.

Recently, new evidence has undermined the consensus that small changes in rates of return make no difference in savings rates.[4] A 1987 study by the National Bureau of Economic Research, for example, suggested that the vast majority of IRA saving does represent new saving and is not accompanied by a reduction in the growth of other financial assets.[5] The study indicated that as many as 14 percent of families with incomes between $20,000 and $30,000, and 20 percent of those with incomes between $30,000 and $40,000, contributed to IRAs in 1983.[6] The new evidence on IRAs clearly implies that middle-income families can be encouraged to increase their net saving for retirement through public subsidies. But the evidence also shows that half of the IRA contributors had incomes over $40,000 a year, and that almost 30 percent had incomes over $50,000. In other words, at least half of the subsidy went to high-income families, which are likely to have other assets as well.

By analogy with the IRA studies, we can conclude that public subsidies for educational savings might well encourage net increases in middle- and upper-income saving for college. But we must recognize as well that much of the public subsidy in such a program probably would go to families that could hardly be defined as needy. Perhaps, however, a well-publicized but unsubsidized program—involving payroll deductions or other regular payments, for example—would boost saving for education just as much as a subsidized program. If subsidies were not disbursed to the middle and upper classes, public funds could be spent on closing the gap in educational opportunity for the truly needy (although we have no guarantee they won't be spent on tax cuts, Star Wars, or pork-barrel projects).

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It is also important to recognize the regressive nature of subsidies accomplished through tax exemptions. Because of the progressive income tax structure, families in higher tax brackets receive a larger dollar subsidy for any given amount of tax-exempt income. That is, if a family with an income of $55,000 a year buys the same tax exempt-bond as a family with an income of $15,000 a year, the tax exemption will cut the higher-income family's tax bill by a larger amount than it will cut the lower-income family's bill.

This distributional aspect of subsidized savings plans is critical. Families that will be able to participate in these savings programs may well save more than they otherwise would. Of course, some savings plans have been carefully designed to encourage lower-income families to participate. A plan discussed in Massachusetts, for example, proposes the sale of college bonds in $50 denominations, to allow small savers to participate. Still, the benefit clearly will go primarily to families that are not "truly needy."

It is certainly possible to argue that it is worth some public expenditure to encourage middle-income families to save, because these families will then be less dependent on financial aid, and financial aid dollars can be focused on less privileged families. On the other hand, the amount of savings that would have to be generated (and the level of subsidy that would be required to generate that new savings), to make the middle class comfortable about their ability to finance high-cost educations without assistance is probably far above any reasonable expectations for the types of programs currently envisioned. Moreover, as long as college costs put a strain on middle- and upper-middle-class pocketbooks, these groups will continue to exert their considerable political pressure to gain relief.

Those for whom paying for college is most difficult are least likely to be aware of savings plans and least likely to participate. Their financial resources are so limited that even if they do participate in the proposed plans, they will be able to save only nominal amounts. These people are also significantly less politically vocal than the middle class. But they are the groups who should be the main focus of public programs for increasing educational opportunity, and for whom paying for college seems most out of reach. Thus, if public subsidies for savers divert funds from aid for these people, then they are hard to justify.

In light of these considerations, it would seem logical that every effort should be made to encourage all families who can possibly save for college to do so, but that this encouragement must be provided with the lowest possible expenditure of public and institutional funds. Although the discussion here has focused on public money, institutional funds should be included in this statement because of concern about savings plans that would guarantee tuition costs at participating institutions. Although a plan that promises a family that if they save a certain number of dollars a year they will definitely have what they need to pay for college has obvious appeal, it also has potentially serious side-effects. If colleges are forced to accept lower tuition payments from students whose families have participated in savings plans, they may be forced to raise tuitions for those who don't have the privilege of such a guarantee. And although some students who have not participated in plans will be wealthy enough to have no need for the plans and no real vulnerability to increased tuitions, most nonparticipants will be those who lacked the foresight or the financial wherewithal to get involved. The problem is that someone has to pay. If participating parents are guaranteed that their burden will be limited, then the government and the taxpayers—or the schools and the other tuition-payers—must bear the burden.

Recommendations

Despite the problems with subsidized savings plans, developing programs to help families save for college should remain high on the policy agenda. Encouraging saving reinforces the important social values of planning ahead, of parental responsibility for children, and of the priority of education. But it is also vital to the fairness of our financial aid system. The strongest arguments in this direction are based on considerations of horizontal equity.

Two major types of horizontal inequity exist in our current financial aid system. Both discourage families from saving for college. One horizontal inequity stems from the historical premise of the need analysis system that families should be accepted as they are. In other words, if two families with equal incomes come to the need analysis with different asset levels, the family with lower assets is eligible for more financial aid. There is some logic to this system, because people who have inherited money or benefited from housing booms obviously have greater capacity to pay than do those who have not been so fortunate. The problem is that families that have limited their consumption to save for college are expected to make greater contributions than those that have had exactly the same opportunities but have chosen to live more extravagantly.

The College Scholarship Service (CSS), through its Committee on Standards of Ability to Pay, is currently attempting to revise its guidelines for need analysis to incorporate savings expectations and to minimize this horizontal inequity. The main idea of the Sustained Annual Family Effort (SAFE) program that CSS is devising is to convince families that they can and should save and that they have to expect to pay for college over, say, a twelve-year period rather than out of current income. Their family contribution will be based on *expected* savings rather than on actual savings. In other words, families with similar long-term incomes would have the same family contribution, whether they had lived extravagantly or frugally.

A second major horizontal inequity in the current aid system is the imbalance in the way it treats saving and borrowing. Families that choose to borrow to finance college educations are currently subsidized—but only if they transfer the burden to their children—through the Guaranteed Student Loan (now the Stafford Student Loan) program. If society is indifferent about whether families save or borrow, subsidies should be equal. If we prefer that families save, as seems implicit in the current rash of savings plans, then certainly the existing system is ill-conceived, and either the subsidy for borrowing should be reduced or a national plan for subsidizing savings should be implemented.

This problem is considerably complicated by intergenerational considerations. We want to encourage parents to save, but we do not want to penalize the children of parents who fail to do so. We provide financial aid based on the economic circumstances of the family at the time just before college, but the subsidies involved in borrowing go largely to students after they finish college, when their incomes are not always closely related to their parents' incomes.

Another phenomenon to guard against is exaggerating the benefits of saving over borrowing. We can get a clearer view of the choice between the two by understanding borrowing as postponed saving. Different family circumstances will result in different optimal choices about the timing of saving to pay for higher education. The current financial aid system is too heavily weighted toward borrowing. But we need not end up with a system that carries heavy penalties for postponing savings until after college, when many families may be at the peak of their earnings profiles, may have paid off their mortgages, and no longer have dependent children to support.

Efforts toward encouraging saving are in the right direction and should be increased. The ideas of trying to make contact with families several years before the children are ready to start college and of keeping them informed of how much they will need to save each year to pay for college (or to meet their family contribution levels) are vital. It is reasonable to believe that many families will be encouraged to save if they have these guidelines and incentives. A specific savings plan that involves payroll deductions or some other form of required monthly contribution could be an important component of a plan to encourage savings. It is not at all clear that adding a subsidy to the plan is necessary.

Summary

In sum, everyone involved in the college financing issue should work toward providing more information to families with young children about how they can save for college and about what will be expected of them in the coming years. Setting up savings plans is also very important. We should be wary, however, of plans that involve significant funding. The difficulties of middle-class families should not divert our attention from the plight of those less well off, who can't even think of saving for college. Every effort should be made to help middle- and upper-middle-income families without diminishing the funds available for the people who need them most. A variety of savings plans will be required to solve the growing problem of college financing for middle- and upper-middle-income families. Public and private educational and financial institutions all have a role to play. But that role should be a cautious one, limiting the losses of low-income families with children aspiring to college and protecting the savings and the educational opportunities of more privileged families that participate in the plans and of those that choose to save through independent channels.

In one sense, the savings programs now being proposed and implemented are a step in the right direction, because the current policies for subsidizing postsecondary students are too heavily weighted toward subsidized borrowing. Focusing some of our attention on encouraging saving before college—and perhaps diminishing the subsidy associated with providing access to funds for those who need to borrow—has the potential to redress the horizontal inequity of subsidizing those who do not save.

But without minimizing the seriousness of existing horizontal inequities and of the financial squeeze on the middle class, it is important to understand that savings programs do have the potential for creating substantial vertical inequity. Federal policy toward higher education traditionally has been directed toward assuring access to postsecondary education for students from families with low incomes. Future efforts must continue in this direction at the same time that they ease the burden imposed on the middle class by rapidly rising college costs. ◆

Notes

[1]Based on a 1988 report of The College Board cited in Gary Putka, "Benefit of B.A. is Greater than Ever," *Wall Street Journal,* August 17, 1988, p. 23

[2]A detailed discussion of state-sponsored college savings plans appears in Courtney Leatherman, "States' Interest in Tuition Plans Grows; Focus Shifts Towards Savings Programs," *The Chronicle of Higher Education,* September 14, 1988. See also chapter 13 of this volume, "The States' Role in Financing Higher Education: A Perspective."

[3]This law was a provision of the 1988 technical changes to the 1986 Tax Code (H.R. 4333 and S. 2238).

[4]See Lawrence H. Summers, "Issues in National Savings Policy," in *Savings and Capital Formation,* ed. Martin Feldstein (Chicago: University of Chicago Press, 1988), for an accessible discussion of economists' views on the subject of the interest sensitivity of savings rates.

[5]Steven F. Venti and David A. Wise, "Have IRA's Increased U.S. Saving? Evidence from Consumer Expenditure Surveys," NBER Working Paper no. 2217 (Cambridge, Mass.: National Bureau of Economic Research, April 1987).

[6]This can be compared with 7 percent of those with incomes between $10,000 and $20,000, and with 58 percent of those with incomes over $100,000.