Florida Prepaid College Program Is Fiscally Sound; Numerous Options Exist for Mitigating Effects of Large, Sustained Long-Term Tuition Increases

at a glance

The Florida Prepaid College Program is the largest in the nation and is fiscally sound, with an actuarial reserve of $379 million at the end of Fiscal Year 2001-02. At present, no major program changes are needed. However, the program’s financial stability could be jeopardized by the proposed substantial long-term annual tuition increases. To address this problem, the Legislature and the Florida Prepaid College Board could consider several options, including adjusting some conservative actuarial assumptions, re-adjusting the investment portfolio, raising contract prices, or discontinuing future sales.

If universities are given the authority to raise tuition at their discretion, the Florida Prepaid College Program should consider pricing university tuition plans similarly to community college tuition, local fees, and dormitory plans.

The Florida Prepaid College Program appeals to families at all income levels. To expand its services to low-income families, the Florida Prepaid College Board and the Legislature could consider a variety of program modifications.

Scope

This review was conducted at the request of the Legislature and examines four issues related to the Florida Prepaid College Program:

- the program’s actuarial soundness if the Legislature authorized universities to charge differential tuition or higher rates of tuition increase;
- options for assuring that existing contracts are honored;
- various pricing structures for future contracts that would accommodate different tuition assumptions; and
- alternatives for future contracts that would establish different guarantees and matching programs for families with financial need.

Background

The Florida Prepaid College Program is one of many state and federal programs created to encourage families to save for future higher education expenses. As shown in Exhibit 1, these programs offer various tax incentives to save for education.¹

¹ In addition to these various education-specific benefits, provisions like the Uniform Gifts to Minors Act allow for additional tax-advantaged savings on a child’s behalf, though not specifically for education.
Qualified Tuition Plans, known as “529 plans” for the section of the federal tax code which authorized their creation, allow individuals to contribute to an account to pay a beneficiary’s qualified higher education expenses (tuition, fees, books, supplies, and room and board). There are two types of Qualified Tuition Plans: college savings plans and prepaid tuition plans. College savings plans offer dedicated higher education savings accounts with tax-free growth of varying risk and return. Prepaid tuition plans let families pay for future tuition based on today’s cost and guarantee a rate of return equal to tuition inflation. Contributions to both college savings plans and prepaid tuition plans are made with after-tax dollars, but earnings used to pay for “qualified higher education expenses” are exempt from federal and many states’ income taxes. At the end of 2002, all 50 states and the District of Columbia had college savings plans, and 20 states, including Florida, offered prepaid tuition plans.

Florida began offering a college savings plan, the Florida College Investment Program, in November 2002. It offers numerous investment options, including a portfolio of funds that change (reducing risk) as the beneficiary ages; a portfolio with fixed proportions of stocks and bonds; or individual funds with varying investment strategies. Portfolio value is based on the performance of the investments chosen by the contributor. As a result, college savings plans generally carry investment risk, which means the account value may increase or decrease depending on market conditions.

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### Exhibit 1

There Are Many Federal and State Government Programs to Help Families Pay Higher Education Expenses

<table>
<thead>
<tr>
<th>Program</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Coverdell Education Savings Accounts</strong>&lt;sup&gt;1&lt;/sup&gt;</td>
<td>Investment grows tax-free with $2,000 annual contribution limit. May be used for elementary, secondary, and postsecondary education.</td>
</tr>
<tr>
<td>Education savings bonds</td>
<td>Certain bond interest may be excluded from federal income tax when used for education expenses in the same calendar year the bonds are redeemed.</td>
</tr>
<tr>
<td>IRA withdrawals</td>
<td>Taxpayers may withdraw various IRA funds without penalty if used for higher education expenses of the taxpayer, spouse, child, or grandchild.</td>
</tr>
<tr>
<td>HOPE Credit</td>
<td>$1,500 credit per student in the first two years of an undergraduate or other eligible post-secondary program</td>
</tr>
<tr>
<td>Lifetime Learning Credit</td>
<td>20% tax credit for first $10,000 of tuition and fees (up to $1,000) per income tax return for postsecondary education and job skill courses</td>
</tr>
<tr>
<td>Federal education loans</td>
<td>Government-subsidized loans to parents and students to finance higher education. These loans include Stafford loans, Perkins loans, and Plus loans.</td>
</tr>
<tr>
<td>Student Loan Interest Deduction</td>
<td>Federal income tax deduction (up to $2,500) for interest on private or government-backed loans for higher education</td>
</tr>
<tr>
<td>Qualified Tuition Plan – Savings</td>
<td>Investment for higher education that grows tax-free. The total account value is limited to the qualified higher education expenses of the beneficiary.</td>
</tr>
<tr>
<td>Qualified Tuition Plan – Prepaid Tuition</td>
<td>Purchase of tuition, fees, and other higher education expenses in advance with guaranteed payment at future prices</td>
</tr>
</tbody>
</table>

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<sup>1</sup> Coverdell ESAs were called Education IRAs until 2002.

Sources: U.S. Internal Revenue Service, Publication 970; Bureau of the Public Debt, Department of Treasury; National Association of State Treasurers.
Florida’s prepaid tuition plan, the Florida Prepaid College Program, was established in 1987 to allow Florida residents to pay the cost of higher education in advance at a fixed level and with a statutory state guarantee. OPPAGA’s predecessor, the Auditor General’s Performance Audit division, first reviewed the actuarial soundness and usage of the program in 1992, when it was called the Florida Prepaid Postsecondary Education Expense Program.

The program allows the purchaser to establish an account for a beneficiary (the future college student) and to ‘lock in’ the future cost of a two-year (community college) or four-year (university) program, or a combination of two years in each (“two plus two”). Account holders may make lump sum or periodic payments, and they may purchase local fee and dormitory plans in addition to the tuition plans. Prices are based on the beneficiary’s age and assumptions about rates of tuition, fee, and dormitory cost inflation and investment return. For example, a “two plus two” plan purchased in January 2003 for a newborn cost $6,092 in a lump sum, $129 per month for 55 months, or $49 per month until the child begins college (if on time). By comparison, the same plan for a seventh grader cost $6,709 in a lump sum, $143 per month for 55 months, or $121 per month until college.

The Florida Prepaid College Program is the largest in the nation. As shown in Exhibit 2, as of September 30, 2002, the Florida Prepaid College Program had nearly half of the beneficiaries in state-sponsored prepaid programs nationwide. As of February 2003, the Florida Prepaid College Program had 629,762 tuition contracts, 139,927 dormitory contracts, and 107,908 local fee contracts.

Exhibit 2
Florida Prepaid College Program Is Almost as Large as All Other State Prepaid Plans Combined

![Exhibit 2](image)

Source: College Savings Plan Network, as of September 30, 2002; interviews with other state prepaid program officials. (Data for Texas is from December 31, 2002. Data for Pennsylvania are from that program’s staff and differ from the College Savings Plan Network.)

The Florida Prepaid College Program is administered by the Florida Prepaid College Board, which also administers the new Florida College Investment Plan. By statute, the board consists of the Attorney General, the Chief Financial Officer, the chancellor of the Florida Board of Education Division of Colleges and Universities, the chancellor of the Florida Board of Education Division of Community Colleges, and three members appointed by the Governor and confirmed by the Senate. It is responsible for making investment decisions and otherwise administering the program’s funds.

The Florida Prepaid College Board is administratively housed in the State Board of Administration, which provides administrative and some investment services and is responsible for approving the Florida Prepaid College Board’s Comprehensive Investment Strategy. Otherwise, the Florida Prepaid College Board operates its programs independently. Florida law requires the board to submit an annual report to the Governor and the legislative leadership by March 31 of each

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1 Section 1009.97, F.S.
3 These amounts are rounded to the nearest dollar. For the enrollment period ending January 31, 2003, a newborn was defined as a child born after September 1, 2002. The price of a contract is determined by (1) multiplying the current cost of $1,983.90 for university tuition for a student taking a full-time annual course load of 30 credit hours by the 6.8% projected tuition inflation rate to the expected date of matriculation and (2) deflating the result at the 6.6% projected investment return rate back to the present.

7 Sections 1009.971(1), F.S.
The Florida Prepaid College Program uses economic and demographic assumptions to project future assets and liabilities and establish contract prices. The methods for determining the program’s financial soundness and establishing contract prices are based on assumptions regarding economic and demographic conditions from the present until the earliest point at which all contracts could have expired. Exhibit 3 identifies key assumptions used to project the liabilities and assets of the program at the end of Fiscal Year 2001-02. For example, the program assumes that it will receive an annual return on investments of 5.57% based on a conservative investment strategy that relies most on bonds rather than equities. The program also assumes that all students will finish high school on time and graduate from college (and thus need all their prepaid funds) within four years, although many students take longer to graduate, which allows the plan to invest the funds for longer periods of time.

Issues—

Financial soundness

Our analysis of the Florida Prepaid College Program’s actuarial projections determined that, based on the program’s economic and demographic assumptions,

- the Florida Prepaid College Plan is currently among the most financially sound in the country, and
- the long-term tuition increase recently proposed by the Higher Education Funding Council may pose risk to the program’s long-term viability.

Exhibit 3

Projections of the Program’s Financial Soundness Are Based on Economic and Demographic Assumptions

<table>
<thead>
<tr>
<th>Economic Assumptions</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund earnings rate</td>
<td>5.57% per year</td>
</tr>
<tr>
<td>Tuition rates</td>
<td></td>
</tr>
<tr>
<td>Universities</td>
<td>6.8% per year</td>
</tr>
<tr>
<td>Community colleges</td>
<td>6.0% per year</td>
</tr>
<tr>
<td>Local fee rates</td>
<td></td>
</tr>
<tr>
<td>Universities</td>
<td>6.0% per year</td>
</tr>
<tr>
<td>Community colleges</td>
<td>11.0% per year</td>
</tr>
<tr>
<td>Dormitory rate</td>
<td>6.0% per year</td>
</tr>
</tbody>
</table>

| Demographic Assumptions       |               |
| Early surrender of contract   | Based on historical experience |
| Matriculation rate            | 100% on time   |
| Dropout rate                  | None           |
| Beneficiary replacement       | None           |

The actuarial projections are also based on other assumptions that we did not address such as annual expenses, future program participation, and mortality and disability rates of beneficiaries.

This 5.57% is a “nominal” rate of return, meaning it includes inflation.

Source: Ernst & Young, Florida Prepaid College Program, Analysis of Actuarial Adequacy as of June 30, 2002.

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8 Section 1009.971(2) and 1009.971(4)(l), F.S.
9 Local private partners work with school districts to identify eligible students and often require the students to apply or otherwise express interest. Project STARS scholarships, funded by state matching dollars, are most commonly “two plus two” tuition plans.
However, the investment return assumptions used to determine the program’s financial soundness (shown in Exhibit 3) differ from those used to determine the price of contracts offered by the program. For example, the fund earnings rate assumption for projecting the growth in the program’s assets was 5.57% in Fiscal Year 2002-03, but was 6.6% for the purpose of setting university tuition contract prices. The assumption used for setting this price was reduced from 6.8% in the previous year, and the Florida Prepaid College Board plans to continue to phase it down to the level used in actuarial projections.

The Florida Prepaid College Program is currently among the most financially sound in the country

A common measure of the financial soundness of a prepaid tuition program is the ratio of the present value of the program’s assets divided by the present value of its liabilities. A ratio of greater than one means that the program’s projected assets exceed all of its contracted commitments if current conditions persist throughout the remainder of the program’s existence. As of June 30, 2002, the program had a funding ratio of 111% with an actuarial reserve of $379 million. This was the highest ratio of projected assets to liabilities of the 16 state prepaid programs for which data was available.10 The Florida Prepaid College Program’s positive financial condition can be attributed to several factors, most prominently its investment return.

The program’s actuarial reserves declined in the past year, due in part to the stock market reverses and the program’s pricing of contracts. In Fiscal Year 2002-03, the program based its prices for contracts using an assumed rate of return of investments of 6.6%, although it projected a 5.57% rate of return on these funds over time. The assumption used for setting this price was reduced from 6.8% in Fiscal Year 2001-02, and the Florida Prepaid College Board plans to continue to phase it down to the level used in actuarial projections.

The long-term tuition increase recently proposed by the Higher Education Funding Council may pose risk to the program’s long-term viability

In December 2002, the Higher Education Advisory Council recommended that the state aim for an average Florida university tuition equal to the national average. The Higher Education Funding Advisory Council has estimated that tuition prices would need to increase by as much as 10% annually over the next decade to meet this target.

Exhibit 4 shows that the program would be unable to meet all of its future obligations if tuition increased by 10% a year indefinitely and all other actuarial assumptions remained unchanged. Under this scenario, the program would be unable to meet its obligations after 2018 and experience a shortfall of $390 million.11

Exhibit 4
A 10% Annual University Tuition Increase in Perpetuity Could Deplete All Assets by December 2018

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Based on current assumptions of 5.57% investment return and 6.8% tuition inflation, all contracts (as of June 2002) would be paid off in 2025, leaving a $1.5-billion fund balance ($379 million present value).</td>
<td>2025</td>
</tr>
<tr>
<td>If annual tuition inflation were 8.43% in perpetuity and all other assumptions held constant, the fund balance would hit zero in 2025 with no remaining beneficiaries to pay.</td>
<td></td>
</tr>
<tr>
<td>If annual tuition inflation were 10% in perpetuity and all other assumptions held constant, the fund balance would hit zero in December 2018, and the Prepaid College Plan would not be able to pay remaining beneficiaries.</td>
<td>2018</td>
</tr>
<tr>
<td>If annual tuition inflation were 15% in perpetuity and all other assumptions held constant, the fund balance would hit zero in November 2014, and the Prepaid College Plan would not be able to pay remaining beneficiaries.</td>
<td>2014</td>
</tr>
</tbody>
</table>

Source: OPPAGA analysis of Ernst & Young, Florida Prepaid College Program, Analysis of Actuarial Adequacy as of June 30, 2002 and other data provided by Florida Prepaid College Program staff.

10 This is based on unaudited data provided by the Florida Prepaid College Program and the Tennessee State Treasurer's Office.

11 This represents a shortfall in the projected amount of assets available to cover future liabilities in present dollars. The projection is based on data available as of June 30, 2002.
Options to address high tuition growth

The Florida Prepaid College Program and the Legislature have several alternatives to address long-term concerns if tuition is increased more than 8.43% annually over time.

There are several alternatives that the state could take to address concerns regarding the program’s long-term viability should university tuition inflation increase to the 10% per year level suggested by the Higher Education Funding Council’s recommendations. These include:

- modify the program’s actuarial assumptions to better match historical experience;
- raise contract prices;
- modify the program’s long-term investment strategy to increase the likelihood of greater future returns;
- shift the risk from the state to universities and colleges or program participants; and
- suspend or eliminate the program if tuition increases and investment performance in the future lead to “financial infeasibility.”

Modify the program’s actuarial assumptions to better match experience

The program needs to have reasonable rate of return assumptions because they are used to project the value of the program’s assets and establish contract prices. We believe that some of the program’s assumptions may be overly conservative given historical market and investment experience. Specifically, the assumed rate of return on stocks is lower than that of other comparable funds and much lower than historical averages; the projected high school graduation rate is higher than the actual

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Exhibit 5 shows the size of the program’s actuarial balance at various levels of tuition inflation with all other current assumptions remaining constant. The exhibit shows that the program can support a tuition inflation rate of 8.43% in perpetuity without incurring a projected future funding deficit. However, sustained 10% tuition increases over this level would deplete the program’s reserves before 2025, the projected date by which all current contracts will be used. At 10% tuition inflation through 2025, the program would end with a $390-million shortfall, and a 15% tuition inflation rate through 2025 would result in a shortfall of over $2 billion.

**Exhibit 5**

Long-Term Tuition Increases Greater than 8.43% Annually Will Deplete All Program Reserves Assets Prior to Meeting All Projected Liabilities Through 2025

[Diagram showing actuarial balance in 2025 versus tuition inflation rates]

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These projections assume linear relationships between the actuarial balance and the yield and inflation rates. In reality, those relationships are not linear. However, both OPPAGA and Florida Prepaid College Program staff and actuarial consultants considered this simplification to be a reasonable approximation.

Source: OPPAGA analysis of Ernst & Young, Florida Prepaid College Program, Analysis of Actuarial Adequacy as of June 30, 2002 and other data provided by Prepaid College Program staff.
matriculation rate; and the projected dropout rate is lower than the actual dropout rate.  

Return on stocks. As shown in Exhibit 3, the assumption for the funds’ earning rate is 5.57%. This means that the program expects to receive the same 5.57% long-term return on equities (stocks) as for bonds. This assumption is overly conservative given historical experience. Despite the decline in stock values over the last few years, the long-term total return on equities has averaged over 11% per year since the 1920s. In contrast to the Florida Prepaid College Board’s assumption, the Florida Retirement System assumes a higher (8.3%) rate of return on its stock investments. If the Florida Prepaid College Program were to maintain its current portfolio balance of 4.8% equities and assume the 8.3% return used by the Florida Retirement System, it would add $30 million to the program’s actuarial balance. Further, if the program had 12% of its assets invested in equities as targeted in its strategic investment plan and used the 8.3% rate of return assumption, it would add $75 million to its balance.

Exhibit 6 shows how changes in the assumptions affect the program’s projected balance and break-even tuition inflation rate if all other current assumption remain constant. This exhibit shows that if the board assumes the same return on equities as the Florida Retirement System and that it re-balances its portfolio to meet the investment plan target of having 12% of its investments in equities, the program could support a tuition inflation rate of approximately 8.76% in perpetuity rather than 8.43%.

In addition, the university tuition growth rate assumption has been conservative since the start of the 1990s, but it is not necessarily conservative based on expectations for the next decade. The Florida Prepaid College Board projects that tuition will increase approximately 6.8% per year for universities and 6.0% for community colleges. By comparison, from Fiscal Year 1989-90 to 2002-03 the actual average annual tuition growth rate was 5.9% for universities and community colleges. (These tuition calculations include student financial aid, building, and capital improvement fees.)

Source: OPPAGA analysis of Ernst & Young, Florida Prepaid College Program, Analysis of Actuarial Adequacy as of June 30, 2002.

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1 These projections assume linear relationships between the actuarial balance and the yield and inflation rates. In reality, those relationships are not linear. However, both OPPAGA and Florida Prepaid College Program staff and actuarial consultants considered this simplification to be a reasonable approximation.

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Exhibit 6
Changing the Program’s Investment Return Assumptions Changes the Maximum Sustainable Level of Tuition Increase Projected Through 2025

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1 This estimate is based on actuarial analysis as of June 30, 2002.
High school graduation and dropout rates.
A second area where the program’s actuarial assumptions could reasonably be modified is in its high school graduation and college dropout assumptions. As shown in Exhibit 3, the program assumes 100% high school matriculation and zero dropout rates. Thus, the plan assumes that all beneficiaries will graduate from high school on time and use their prepaid plans immediately and to the fullest extent allowable.

We believe that while a prepaid account provides an added incentive for a student to graduate and go to college, the 100% matriculation and retention assumption are too conservative. General student performance data show that retention rates for first-time, first-year students at Florida four-year colleges and universities and at two-year colleges are 84% and 76%, respectively. Four-year graduation rates in Florida four-year colleges and universities for first-time-in-college students and two-year graduation rates for transfers with Associate of Arts degrees are approximately 33%.14

Further, the program also assumes that all currently unused benefits will be used by program participants. This adds an additional element of conservatism to the program’s projections of its future assets.

The program should use actual historical experience in developing all its economic and demographic assumptions. Although there is no “right” number for any of these assumptions, they should be based on the best information available. This would help ensure that the program is making reasonable determinations of its financial soundness and setting reasonable contract prices.

Raise contract prices
Another way the Florida Prepaid College Board could address concerns regarding the program’s long-term viability would be to raise contract prices to build a reserve sufficient to insure against unexpected tuition increases and other risks. The increase necessary to assure the program’s long-term viability would depend on the number of new program participants as well as the policy objectives guiding the price increase.

However, increasing contract prices would have several disadvantages. While a price increase may bolster the long-term financial viability with regard to existing contracts, it might also reduce the number of new participants in the program. This is because higher prices would make other investment programs relatively more attractive, or they may make the program less affordable for potential low-income participants. Lower demand for prepaid plans would, to some degree, limit the effectiveness of a price increase on building a reserve. Moreover, because the premium would be insurance against the impact of higher-than-expected tuition increases on existing contracts, it could be viewed as a premium on new contracts to safeguard existing ones. As such, potential new purchasers may perceive an inequity in the contract prices.

Next year’s sales volume will be a poor indicator of the effect of rising prices on prepaid plan demand. As the Legislature and the Florida Prepaid College Board consider options including prepaid plan price increases, it will be important to consider future demand in response to price changes. However, Fiscal Year 2002-03 obscures that response. In this year, the Florida Prepaid College Program has nearly doubled its previous year’s record sales level. (See Exhibit 7.) This sharp rise in contract purchases appears to be largely a response to media reports regarding the uncertain future of the program and expected tuition hikes.

14 The most recent data available on all Florida students are for those who initially entered a higher education institution in 1995. Florida Prepaid College Program staff report that high school graduation and dropout data are presently unavailable.
Purchasers expected a high return on their investment because of prices based on lower-than-expected tuition growth rates. Therefore, as a result of the exceptionally high sales volume in 2002-03, as well as the opening of Florida’s College Investment Program, prepaid contract sales are most likely to decline in the next fiscal year, perhaps below the previous 2001-02 record level. This change will likely occur irrespective of tuition increases.

**Modify long-term investment portfolio to increase likelihood of greater future returns**

The Florida Prepaid College Board invests conservatively to meet projected future obligations. The program’s investment goals are prioritized as follows in its Comprehensive Investment program: Safety, Liquidity, and Yield. The program maximizes the safety goal by investing primarily in government securities and high-quality corporate bonds. The safety and liquidity goals are met by matching the cash flows resulting from fixed investments of differing maturities to projected contract payments. After meeting the first two goals, the program strives to maximize the return from its investments.

The Florida Prepaid College Program’s Comprehensive Investment Plan specifies that the program’s target allocation of assets is 88% fixed income assets (bonds) and 12% domestic equities (stocks), and it allows a range of 0% to 15% on equities. As a result of recent declines in stock values, the actual allocation of assets was 95.2% bonds and 4.8% domestic equities as of September 30, 2002.

We believe that the actual allocation of the program’s investments should be re-balanced to conform to the targets in its Comprehensive Investment Program. We recognize that while equities have a higher long-term expected return than bonds they are also more risky. However, the Florida Retirement System and other states’ prepaid tuition programs invest more heavily in equities than Florida’s program. Although dropping stock values have contributed to many states’ projected actuarial deficits, higher risk may be acceptable over the long-term given the trade-off in higher

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1 “Tuition” refers to the combination of matriculation, financial aid, building, and capital improvement fees. Local fee plans have only been offered since 1999. Dormitory plans were not offered in 1998.

Source: OPPAGA analysis of Florida Prepaid College Program data.
expected investment returns. The Florida Prepaid College Board’s investment advisors recommended the development of a rebalancing strategy as part of their 1998 study of the program’s asset allocation.

We believe that the board should conduct an asset allocation study to determine whether it would be advantageous to modify the program’s current investment strategy. The program has not conducted such a study since 1998, although a recommendation of its investment advisors at the conclusion of that study was to annually review its asset allocation and conduct a more in-depth study every three years.

**Shift risk from the state to universities and colleges or program participants**

Currently, the state bears the investment risk in the Florida Prepaid College Program. As an alternative, the Legislature could cap the state’s liability and require either higher education institutions or program participants to make up the difference between the maximum allowable benefits and actual costs. This could be accomplished in several ways. One approach would be for the state to set maximum allowable benefits under the program to equal to a specified return on the contract price, such as 9%. Another alternative would be for universities to accept the program contract and provide either a scholarship or waiver for the difference between the funding provided by the program contracts and the universities’ actual cost. These alternatives would have the benefit of sustaining the program and fiscally protecting the state. However, they would place more of the risk on beneficiaries and would likely reduce demand for the program because of the lack of state guarantee. Moreover, shifting more of the risk to the universities would address only changes for program beneficiaries choosing to attend Florida institutions, and provisions would have to be made for those persons wanting to apply prepaid benefits to out-of-state institutions.

**Suspend or eliminate the program**

A final option would be to terminate the program. If investment returns or tuition hikes jeopardize the program in the coming years, the Legislature could consider closing the Florida Prepaid College Program to new contracts or eliminating it altogether. Florida law provides that beneficiaries within five years of postsecondary enrollment shall be entitled to the complete benefits for which the purchaser has contracted. All other contract holders are entitled to a refund of the amount paid plus prevailing savings account interest.

Program staff report that information on the minimum statutory liability to Florida taxpayers are presently unavailable. However, considering that the program projects that it will be able to meet all contract requirements for more than a decade even with substantial and sustained tuition increases, there is little need to consider eliminating the program at this time.

A long-term concern with the option of ending the Florida Prepaid College Program, in addition to its popularity, is the public benefit it may provide by increasing this participation. This would depend in part on the use of other higher education savings options, such as Florida’s new College Savings Plan, by would-be program participants. The extent to which plan participation raises postsecondary education participation by those who otherwise would not have attended is unclear.

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16 This approach has been suggested by the Boards of Trustees of Florida State Universities.

17 Section 1009.98(8), F.S., provides that the Legislature may terminate the plan if it becomes “financially infeasible.”
Options to address variable tuition rate increases

Different rates of university tuition increase across Florida universities would require program changes

The Governor’s Fiscal Year 2003-04 budget recommendations include a proposal to increase university tuition by 7.5%, with universities authorized to increase tuition by an additional 5% at their discretion. If this proposal is adopted by the Legislature, the program may need to change future contract pricing to accommodate variable tuition levels among the universities. This is because the program currently assumes the same rate of tuition increase for all state universities.

The program’s options for accommodating variable university tuition rates include:

- Pricing university tuition plans similarly to community college tuition, local fee, and dormitory plans;
- Restructuring future prepaid plans to shift some risk to participants; and
- Placing limits on university tuition variations.

Pricing university tuition plans similarly to community college tuition, local fee, and dormitory plans

Because community college tuitions, local fees, and dormitory rates vary across the state, the Florida Prepaid College Program establishes prices for these contracts that are based on a projected weighted average. If university tuition levels become variable, the program could similarly price new university tuition contracts on weighted average tuition. For participants attending out-of-state qualifying institutions, the amount reimbursed would equal the average Florida university tuition. This approach should not affect existing contracts, which would be guaranteed tuition at any of Florida’s public universities regardless of the university the beneficiary chose.

This approach continues to place the risk of the program’s fiscal soundness on the state, but it also entails some risk to participants. Beneficiaries choosing universities with lower tuition would effectively receive a lower return on their investment than those choosing universities with higher tuitions.

The degree of predictability of average tuition growth also would affect the soundness of the program’s actuarial projections. Errors in these projections would increase the financial risk to the state. As it currently does with local fee and dormitory contracts, the Florida Prepaid College Program could reduce risk by placing limits on the age of the beneficiary for which plans may be purchased. For those types of contracts, purchases may only be made prior to the beneficiaries’ ninth-grade year. This is done to avoid participants “gaming” the system by purchasing an average cost plan when they are relatively confident that the beneficiary will attend a high-cost university.

Restructuring future prepaid plans to shift some risk to participants

The program also could reduce the state’s risk by establishing future contracts that require customers to choose from among different guarantee levels, such as the average, highest, or lowest tuition, or some percentage thereof. This approach would require some beneficiaries to pay a portion of their tuition. For example, the state of Washington’s prepaid tuition program has one unit price based on tuition at the highest-cost universities, and participants may apply those units to any state university, all of which are priced on a scale in which the most expensive universities cost 100 units per year. Participants with units in excess of tuition costs may apply the remainder to other education-related expenses, and participants with too few units to attend the university of their choice must make up the difference from other financial resources, such as other investments, loans, or scholarships.
However, this approach might still entail additional state financial risk as well, depending on the ability of the Florida Prepaid College Program to accurately forecast tuition variability and growth among state universities. As with other approaches, this risk may be reduced by age limits and other restrictions on plan purchases.

**Placing limits on university tuition variation**

Another option would be for the Legislature to limit the variability in university tuition increases, such as is currently done with community college tuition. State law places upper and lower limits on community college tuition and out-of-state fees, restricting them to 10% below and 15% above the combined total of the fee schedule adopted by the State Board of Education and the technology fee approved by the community college board of trustees. A similar approach could be used to limit the variability in tuition or combined tuition and fees among state universities.

**Affordability**

One of the public policy goals of the Florida Prepaid College Program is to promote higher education affordability. We found that

- the Florida Prepaid College Program is affordable and appeals to families at all income levels, and
- there are several approaches the Florida Prepaid College Board may take to focus more on low-income families.

The Florida Prepaid College Program is affordable and appeals to families at all income levels

Participants may “finance” their prepaid contracts over a 55-month period or over the entire period from purchase to the beneficiary’s expected attendance date. For example, in January 2003, a contract purchased for a newborn infant could be spread out to 18 years with payments of $16.95 per month for a 2-year community college contract or $63.88 per month for a 4-year university contract.

Although the Florida Prepaid College Program has sold contracts to families at all income levels, its use by low-income families is unclear. The program has estimated participation by low-income families. However, this estimate probably overstates the percentage of low-income families receiving benefits. As Exhibit 8 shows, contract data indicate that 42% of contract purchasers have annual family incomes below $50,000. However, this is an estimate based on a 60% response rate to an optional question on the Florida Prepaid College Program application form. For a variety of reasons, those responses do not reflect the family incomes of students receiving prepaid benefits.

Moreover, late payment and default policies are relatively lenient. If the account is not brought current within 30 days of the payment due date, the account will be considered in default. If the account is not brought current within 120 days of the first payment due date or a subsequent payment is not received within 210 days of any subsequent payment due date, it is “involuntarily terminated.” The account owner may reinstate the account within 180 days of cancellation by paying the amount needed to bring the account current plus a $50 reinstatement fee.

Performance Audit of the Florida Prepaid Postsecondary Education Expense Program, Auditor General Report No. 11825, March 25, 1992. The report found that more than half of program participants did not invest in other college savings mechanisms prior to purchasing prepaid plans. The audit also found numerous former participants cancelled because of the expense of the plans, and overall the data was not enough to support statements about the effects of the program on low-income families.

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18 Section 1009.23(4), F.S. This section also limits any amount from 10% to 15% above the fee schedule to be used for safety and security.
There are several approaches the Florida Prepaid College Board may take to reach more low-income families.

These include selling partial college tuition contracts, limiting participation to low-income families, and subsidizing contracts for these families.

**Smaller investment increments.** Additional tuition packages could guarantee, for example, tuition for the first one or two years of student’s four-year university degree. This would offer participants lower payments that would provide some assistance with the cost of higher education. It would allow more flexibility to less risk-averse families who might choose to split college planning among risk-free and risky (but higher return) investments. These would presumably include families expecting Bright Futures scholarships or those that already own non-guaranteed education investments. However, the lack of a four-year guarantee might also reduce college completion rates among low-income participants unable to fund the latter part of their higher educations.

**Limit participation.** This option would allow only low-income families to purchase contracts. However, as in the difficulty in determining the family incomes of current plan beneficiaries, this and similar approaches would face the challenge of defining “low-income.” Because grandparents and non-family members purchase plans, the Legislature would need to establish guidelines for how the program determines family income of potential purchasers. One way to make that determination would be to require plan purchasers to complete the free application for federal student aid (FAFSA) required to receive subsidized student loans for higher education.

**Provide higher benefits to families with lower incomes.** Under this option, the program would subsidize contracts for low-income families. Numerous variations on this approach could be considered. The program could set an upper limit on the tuition inflation guarantee for families above a certain income level. Low-income families would qualify for the current, guaranteed tuition plan, but other families would only qualify for benefits up to a certain

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*Exhibit 8*

42% of Prepaid Contract Purchasers Report Family Incomes Below $50,000

<table>
<thead>
<tr>
<th>Income Range</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under $20,000</td>
<td>4%</td>
</tr>
<tr>
<td>$20,000-$29,999</td>
<td>10%</td>
</tr>
<tr>
<td>$30,000-$39,999</td>
<td>13%</td>
</tr>
<tr>
<td>$40,000-$49,999</td>
<td>15%</td>
</tr>
<tr>
<td>$50,000 and Above</td>
<td>58%</td>
</tr>
</tbody>
</table>

1 This analysis excludes Prepaid College Foundation scholarship recipients, all of whom qualify for free and reduced price lunch but for whom family income data is not available. Income data are only available for 60% of contracts.

Source: OPPAGA analysis of Florida Prepaid College Program data.

Family incomes also change from the time of purchase, when the income data is collected, to the time at which the child uses the benefits. Parents with small children are likely to achieve a higher income level at the time their children graduate from high school than when they are infants and toddlers, and nearly 50% of purchases are made for beneficiaries when they are kindergarten age or younger. In addition, plan purchasers include grandparents and family friends whose incomes do not reflect that of the beneficiary’s immediate family. In particular, grandparents are more likely than the beneficiary’s parents to be on relatively low fixed incomes but have relatively greater wealth from which to pay for prepaid contracts.21

Finally, contract purchasers may change beneficiaries, changing the recipient’s family income as a result.

Of note, the Prepaid College Foundation, which receives a 100% state match of private funds, has purchased nearly 17,000 prepaid contracts that will be awarded to low-income students.

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21 Economists distinguish between income (recurring cash flow such as salary and stock dividends) and wealth (non-recurring assets such as real estate and stock value). U.S. Census Bureau data from the 2000 population census show that median family income for individuals 65 years old and over was less than half that of those under 65.
level of tuition inflation (e.g., 8.5% per year). Such a limit could be applied based on income either at the time of purchase or at the time of entry into college. Alternatively, the Florida Prepaid College Board could discount the price schedule for low-income purchasers. This latter approach implies a subsidy from high-income purchasers to low-income purchasers. In either case, the Legislature would face policy considerations with regard to defining family income.

These and other similar options likely would reduce the program’s broad popularity. Without the absolute guarantee the plans currently carry, many would-be purchasers would find other alternatives relatively more attractive and would choose not to purchase prepaid plans. In the case of the latter option, higher prices would reduce demand among higher income families, and the idea of subsidizing other purchases might add a perception of unfairness as well.

Recommendations

To help ensure the long-term viability of Florida’s Prepaid College Program, we recommend that the actions below be taken.

- The Florida Prepaid College Board should consider revising its actuarial assumptions regarding return on equities, high school graduation rate, and dropout rate based on historical data.
- The Florida Prepaid College Board should conduct an asset allocation study to determine whether it would be advantageous to modify the program’s current investment strategy. The program has not conducted such a study since 1998. The board should then adjust its investment portfolio as needed to conform to its approved investment strategy.
- The Legislature should amend s. 1009.971, Florida Statutes, to require the Florida Prepaid College Board to submit its an annual analysis of the Florida Prepaid College Program’s financial soundness to the Speaker of the House of Representatives and the President of the Senate. The Legislature should require this analysis to include sensitivity tests that project the effects of a reasonably broad range of tuition inflation rates, portfolio returns, and demographic assumptions (e.g., matriculation, dropout rates, payment timing). In addition, the Legislature should require that the Florida Prepaid College Program actuarial analysis include estimates of the contract prices necessary to continue funding the program (with sufficient reserves) under various short- and long-term scenarios.

The February 1992 performance audit of the program similarly concluded that the annual report on fund adequacy could include additional information to enable a more thorough assessment of the reasonableness of projections of financial soundness. That report also recommended that analysis of factors affecting financial soundness projections be included in the annual report to the Legislature.

Appendix A presents options for the Legislature and the Florida Prepaid College Board to consider to address high tuition growth, variable tuition rate increases, and to promote higher education affordability.

Agency Response

Pursuant to s. 11.51(5), Florida Statutes, the Florida Prepaid College Board was provided the opportunity to comment on a draft copy of our report. The Executive Director advised that a response would not be forthcoming at this time. However, they may choose to respond at a future date. When we receive a response it will be appended to the electronic report document and can be viewed on our website.
### Appendix A

The Legislature and Florida Prepaid College Board Should Consider the Issues and Options Presented Below

<table>
<thead>
<tr>
<th>Issue</th>
<th>Options</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>High tuition growth</strong></td>
<td>Modify assumptions supporting projections</td>
<td>This should be done regardless of tuition expectations to give a more accurate and still conservative understanding of financial soundness.</td>
</tr>
<tr>
<td></td>
<td>Raise contract prices</td>
<td>Prices can be used to build larger actuarial reserve and insure against risk. Higher prices will reduce demand.</td>
</tr>
<tr>
<td></td>
<td>Modify investment portfolio</td>
<td>Get higher long-term return but more risk.</td>
</tr>
<tr>
<td></td>
<td>Shift risk from state to universities or program participants</td>
<td>The state can cap its liability and increase predictability by requiring universities or participants to pay for growth above the cap. Higher risk and lack of state guarantee will reduce demand.</td>
</tr>
<tr>
<td></td>
<td>Suspend or eliminate the program</td>
<td>Statute defines minimum state responsibility. The Legislature could consider compensation to program participants above the minimum required by law. It may also close the program to limit the state’s risk to existing contracts and also may reduce postsecondary education participation.</td>
</tr>
<tr>
<td><strong>Variable tuition rate increases</strong></td>
<td>Price university tuition plans similarly to other prepaid plans</td>
<td>This approach adds some investment “risk” by charging the average but giving benefits that vary by institution. Depending on the predictability of tuition variation, this poses additional financial risk to the state by complicating tuition projections. Some of this risk may be avoided by limiting the age of beneficiaries for whom plans are purchased, though that may also reduce demand.</td>
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<tr>
<td></td>
<td>Shift some risk to program participants</td>
<td>The program could sell guarantees for lowest, average, or highest tuition. Participants might be required to pay additional expenses if, for example, they purchase the low-tuition package but choose a higher-tuition institution. Because of the additional uncertainty and the potential for falling short of tuition expenses, this might reduce demand or college completion rates among beneficiaries.</td>
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<tr>
<td></td>
<td>Place limits on university tuition variation</td>
<td>As is the case with community college tuition, the Legislature could define the allowable range of university tuition variation.</td>
</tr>
<tr>
<td><strong>Affordability</strong></td>
<td>Smaller investment increments</td>
<td>The program could allow participants to purchase less than the full multi-year tuition, such as one year of a four-year university plan. For some potential participants, this would provide investment flexibility. For others, it may reduce demand or college completion rates.</td>
</tr>
<tr>
<td></td>
<td>Limit participation</td>
<td>This is similar to canceling the program for all but families with low incomes. It is administratively difficult because non-family members may purchase contracts, and it would require a definition of “low-income” on which to base the limit.</td>
</tr>
<tr>
<td></td>
<td>Higher benefits to low-income families</td>
<td>There are a number of ways this concept could be implemented. It would reduce demand among potential participants not qualifying for the higher benefits. It would require a definition of “low-income.”</td>
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</tbody>
</table>
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