Improving on Canada's System of College Savings Accounts

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Introduction

The US is facing a college affordability crisis, where tuition at 4 year public colleges have risen by 37% over the last 10 years and students are accumulating record levels of college debt.(1) One way to approach this problem is to provide more need based aid that targets money on students from low income families, which can be a desirable strategy since you can provide greater amounts of aid to those who need it the most. The most obvious way to do this is to expand federal Pell Grants that get administered through our current financial aid system, but even though this does target generous amounts of aid to our neediest students, it still suffers from some serious problems. Most notably, our financial aid system is extremely complicated and lacks transparency, because it requires people to fill out some very complicated forms, then applies a complex incomprehensible formula to determine how much students and their families should contribute, and then the student only figures out how much aid they will get until well after they decide to go to college, apply, and get accepted. As a result, students have no idea how much aid they will get when actually making the decision to go to college, and research has shown that this structure has no effect in getting more people to attend college.(2)

Because the current financial aid system lacks transparency, is overly complex, and ineffective at getting new students to attend college, the US needs to experiment with new approaches to providing college aid, and it would be very helpful to be able to have ways to provide need based aid that were transparent, simple, and effective. One potential new strategy would adapt an idea used by Canada, where they use a system of college savings accounts to provide grants to low income families that accumulates over their entire childhood. As soon as a child is born, parents are allowed to set up a college savings account and low income families are provided with a $500 grant from the government to get them started. Then every year until the child turns 15, the government automatically tops up the account with a $100 grant if the family continues to be low income as indicated on their tax returns. That means by the time a low income student is old enough to go to college, they could have accumulated $2,000 in government grants alone, perhaps just about enough for one year of community college. Plus, families at all income levels are also encouraged to save more for their kid's college education by providing a 20% match on the first $2,500 put into the account each year, and low income families are given an extra 10% to 20% match on the first $500 in contributions, so that kids might have even more money available for college if their parents save some money in these accounts.

This approach to need based college aid has some advantages over our current financial aid system that are described in the first part of this policy memo. The second part of this policy memo goes on to suggest improvements to Canada's system of voluntary individual college savings accounts. Unfortunately, Canada's college savings accounts suffer from many of the same problems that our own system of tax favored personal retirement accounts suffers from has as well, where both have low participation rates, allow rich families to get benefits for money they would have saved anyway, and create an incredibly complex and administratively costly system overall. If the US were to adopt a system of need based college aid based that worked more like Social Security does in the US and less like IRAs and 401(k)s, then perhaps the US could create a need based system of college aid that truly was transparent, simple, and effective that could serve as a foundation for future expansions of our system of higher education subsidies.

Advantages of Canada's College Savings Accounts Over Our Current Financial Aid System

Canada's system of college savings accounts offers four main advantages over the system the US uses to provide need based financial aid. First, Canada's college savings accounts can be created at birth, and are designed to increase aid for low income families over the course of their entire childhood. This creates expectations very early on that children will go on to attend college after graduating from high school. Creating these expectations early may motivate students to work harder in school throughout their childhood, and inspire them to take concrete steps to help them find ways to apply, get into, and pay for college that might need to be done before that last year or two in high school. This could be done simply by getting more information on the college options that are available, or making visits to college to see what they are like, or taking classes that will better prepare you for college once you get there.

The second advantage of Canada's system of college savings accounts is that it is extremely transparent. Parents set up the accounts themselves, so students will know when they have one. The financial institution that administers the account also sends them regular updates about their account balances, so the student will know exactly how much aid they get from the government each year, and how much aid will be available to them to go to college as they get older. This takes all the mystery out of the process that occurs in the US, where students have to fill out long difficult financial aid forms that somehow leads to an award right at the end of the college selection process.

The third advantage to Canada's system of college savings accounts is that the total amount of grants provided by the government depends on family income throughout a student's childhood and not on how much income a family earns one particular year when their kid applies for college. In some ways this is quite a bit fairer, since whether or not a student has faced significant hardship growing up depends not on their family's income in the year before they graduate, but on the resources available to them throughout their entire childhood. In most cases, a family's income in the year they graduate is going to be highly correlated with the income earned throughout their childhood, but it does seem fairer to provide significant aid to students who were poor growing up whose family might now suddenly be doing well, and to provide less aid to students who had families with a lot of money throughout their childhood that now finds themselves relatively poor. This also substantially reduces the disincentives to work and save, where the financial aid system in the US expects a family to devote a substantial proportion of their current income and wealth to pay for their kid's college expenses, and if a family makes more money in one particular year then they might lose out on thousands of dollars in aid as a result. If the grants are spread out across many years, then a family who makes more money in one particular year might only be expected to lose hundreds of dollars in aid as a result, making it so small that it does not even enter into a family's calculation about how much to earn.

The fourth advantage to Canada's system of college savings accounts is that it awards the aid well before the student decides to go to college, which makes the aid twice as powerful because of loss aversion. Loss aversion is a psychological bias identified several decades ago that observes that people feel losses twice as powerfully as gains. If a student gets the aid before they decide to go to college, then they feel like they own it, so when they decide not to go to college then not getting that benefit will feel like a loss. If a student does not get the aid until after they decide to go to college, then if they decide not to go, failing to get their benefits will feel like the elimination of a future gain. Since psychology tells us that losses are twice as bad as gains are good, creating a loss will be felt twice as strongly as giving up a similarly sized future gain. In Canada, a student gets their benefit every year as balances accumulate in his account, so they feel like they own it very early on in life and not spending it will feel like a loss. In the US, financial aid awards are not handed out until after a student applies and gets admitted into college, so a student does not feel like they own the aid until after they have already made the decision, so the reduction in benefits they get by not going feels like giving up a future gain.

Ways to Improve Canada's College Savings Accounts

Even if Canada's system of college savings accounts has some advantages over our current financial aid system in the US, using individual savings accounts to provide college subsidies has its downsides as well. The US currently has a system of tax favored retirement accounts like IRAs and 401(k)s, as well as a system of tax favored college savings accounts, known as 529 plans, and these types of voluntary individual accounts face a number of problems like low take up rates, providing tax breaks for rich families who would have saved anyways, and high administrative costs due to greater amounts of choice and complexity. What the US needs to do when developing a new need based system of college subsidies is to take an approach similar to what Social Security does for retirement, rather than copying a system more like IRAs or 401(k)s.

Any new need based subsidy system should include five particular features to make them more effective. First, a new program should make people feel like they have their own individual account by sending them a letter informing of their future benefits each year that will become available to them when they go to college (with the first letter arriving just after birth), but in actuality have all the money coming into the system go to pay for current benefits rather than into an individual account set up in your name. This is basically the way Social Security worked when it was initially created, where the government gives you the impression that all the payroll taxes you pay into the Social Security system goes specifically to pay for your own benefits later in life, much like an individual account would, even though practically, the benefits you pay in now are used to pay the benefits for people currently in retirement. This has changed a bit over the years, where eventually the Social Security system saved up some of the excess it collected in payroll taxes to buy Treasury bonds they could redeem in the future, but the basic gambit was successful. People felt like they were paying for their own benefit while the government avoided being forced to wait a generation to pass out benefits as money accumulated in a system of accounts. Using a system like this instead of paying into tens of millions of individual accounts allows you to change expectations about going to college early on in life, while also allowing you to start providing benefits to new college students right away.

Second, any new system of need based college subsidies should provide universal automatic enrollment that requires no forms to be filled out in order to qualify. Just like everyone automatically qualifies for social security based on their earnings history and age without any complex application process, any new system of college subsidies should also allow students to be enrolled as soon as they are born without requiring the parents to take any action to do so. In my preferred system, the government would automatically grant a $1,000 award for every child in the year they were born, whether you were rich or poor. As the child grew up, the government would use the income reported on the forms sent to the IRS by a kid's family to determine if the kid was part of a low income household that year and increase the award by $200 for the half of the children with the lowest incomes. This would ensure broad political support since every child would get at least $1,000 they could spend on college, but would also target more money for kids from low income families (making it a need based system), where they could collect up to an additional $3,600 in college aid over the course of their entire childhood. By making it universal, this system would avoid the problem of low participation rates, and by focusing the benefits on kids from low income families the benefits would be quite progressive.

Third, any new system of college subsidies should not allow parents to make extra contributions into the program that their child could use later, so parents would therefore not get any subsidies or tax benefits for putting aside money for college that they would have saved anyway. This makes the need based subsidy system even more progressive by avoiding tax benefits for the rich, and dramatically reduces the complexity of the overall system. Figuring out which money counts as income in which years under which circumstances, and what rules, restrictions, or penalties might apply to each distribution makes any account system much more difficult to understand and administer.

Fourth, by banning any parental contributions, this strategy would allow the system to become entirely government run, much like Social Security, where the government identifies the kids, calculates their benefits using tax forms, tells them the amount they were awarded each year, and then distributes the award directly to the colleges. Doing it this way would drive down the administrative costs dramatically, since the system could basically become completely automated. There would be no need for private financial institutions to sign up beneficiaries, take individual contributions, allow parents to choose specific investments, or have these companies take a cut of the profits, which would all raise the administrative costs for each student. Even if there would be no opportunity to earn returns on any investment, awards could be indexed for inflation each year, which is actually more generous than allowing future benefits to go up by the interest earned by investors on long term government bonds.

Fifth, any new system should use the data collected by the IRS over the last two decades to calculate what award the student would have gotten if the subsidies had been in place the year they were born. The IRS has data on every tax return filed over a very long period time that they have already collected into a massive database that is currently being used by researchers on a variety of topics. If the IRS had this data going back 18 years, then they would know which students belonged to low income families in each year and what benefit they would have qualified for if the system had already been in place, and with a little computer programming could calculate the total award completely automatically. This would allow full benefits to go out right away in the year the program was enacted, rather than forcing students to accumulate balances in their individual accounts every year that would take almost two decades to ramp up.

Conclusion

Making these changes to Canada's college savings accounts would then provide significant advantages over both our current system of financial aid and over Canada's system as well. Kids would still have their expectations about college changed early in life, much like Canada's system, due in part to a system that is extremely transparent. The benefits would be based on income over the length of a student's entire childhood, rather than the year before they went to college, which is fairer and reduces the disincentive to work and save more. Plus, students would feel like they were given the award before they decide to go to college rather than after, which make the impact twice as powerful due to loss aversion.

The program proposed here would improve on Canada's system of individual accounts as well. Low participation rates would be avoided by creating a system with universal automatic enrollment that required no forms to be filled out. By banning parental contributions, the system could become entirely government run, which would dramatically lower administrative costs, create a much simpler system, and make the benefits more progressive since it would avoid any tax shelters for the rich. By awarding grants rather than contributing to individual accounts, this allows the full amount of benefits to go out right away to students going to college, rather than have them accumulate gradually over decades, and given the wealth of data currently available to the IRS, the system could provide benefits as if it were in place from the year a student was born.

Then the question becomes how do you actually get this program enacted and funded. Ideally, this program would be passed at the federal level in order to avoid a fractured system of individual state programs, as has happened with the 529 plans, though perhaps individual states could create their own program before the federal government does their own, or add on additional benefits using the same basic federal structure if they do. As far as costs go, the plan proposed here would cost about $11 billion a year, assuming every student got at least $1,000 and students from low income families were allowed to earn up to $3,600 on top of that. There is currently a big push to make college more affordable and if more money were to become available for that purpose, then some of it could be spent on this particular proposal as I discuss in a different policy memo on providing free tuition at public colleges (Sly 2020a). In another policy memo (Sly 2020b), I identify how funds could be diverted from ineffective programs like Pell Grants and tax credits to the states, and in theory, some of those funds could be used to pay for this federal system of need based grants. In a third policy memo (Sly 2020c), I propose an overarching tax deal that could free up $100 billion in investments for young children funded through a new Value Added Tax, and $11 billion could be set aside from that revenue source to pay for this plan.

Clearly, students need more help paying for college, and providing more need based aid is one potential strategy that policymakers would like to draw upon. Unfortunately, our current need based financial aid system is complex and ineffective, so building upon Canada's approach to aid targeted on students from low income families offers one promising new strategy that would be worth doing in the US. The US, however, should create a system more like Social Security and less like individual retirement accounts, and if done well, then this new need based system could provide a foundation for future reforms to our system of higher education subsidies.

End Notes

#1 - According to the Center on Budget and Policy Priorities (Mitchell et al 2019), tuition at 4 year public colleges and universities is up 37% from 2008 to 2018. Student debt in 2020 reached a record $1.6 trillion.

#2 – A summary of the literature on the effects of different higher education subsidies can be found in Dynarski and Scott-Clayton (2013) and also in Sly (2018).

References

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