

Treasury's 529 Report: An Analysis of Section 529 College Savings and Prepaid Tuition Plans

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Our mission

- ◆ As part of its investigation into how to make college more affordable for middle class families, the Vice President's Middle Class Task Force asked that the Department of the Treasury study ways of making Section 529 plans more effective and reliable.

“That's why today I am asking the Treasury Department and Secretary of Education to look into 529 plans and ways to make them more effective and reliable. Their analysis will examine how people save in the 529s, whether they are taking appropriate approaches to risk, and try to identify options and best practices for helping these funds be there for families when they need them.”

--Vice President Biden

The scope of our report

- ◆ The Report investigates:
 - Extent to which Section 529 plans serve various income groups
 - Plan costs and investment choices.
 - Recommendations to make 529 plans more attractive, effective and reliable.

Treasury's Recommendations

- ◆ Give all 529 participants the option of investing in low-cost age-based index funds.
- ◆ Eliminate home-state bias to foster more competition between plans.
- ◆ Make contribution limits per beneficiary rather than per beneficiary per state.
- ◆ Further improve participant access to information enabling them to meaningfully compare plans and investment options.
- ◆ Improve monitoring and compliance.

Today's Presentation

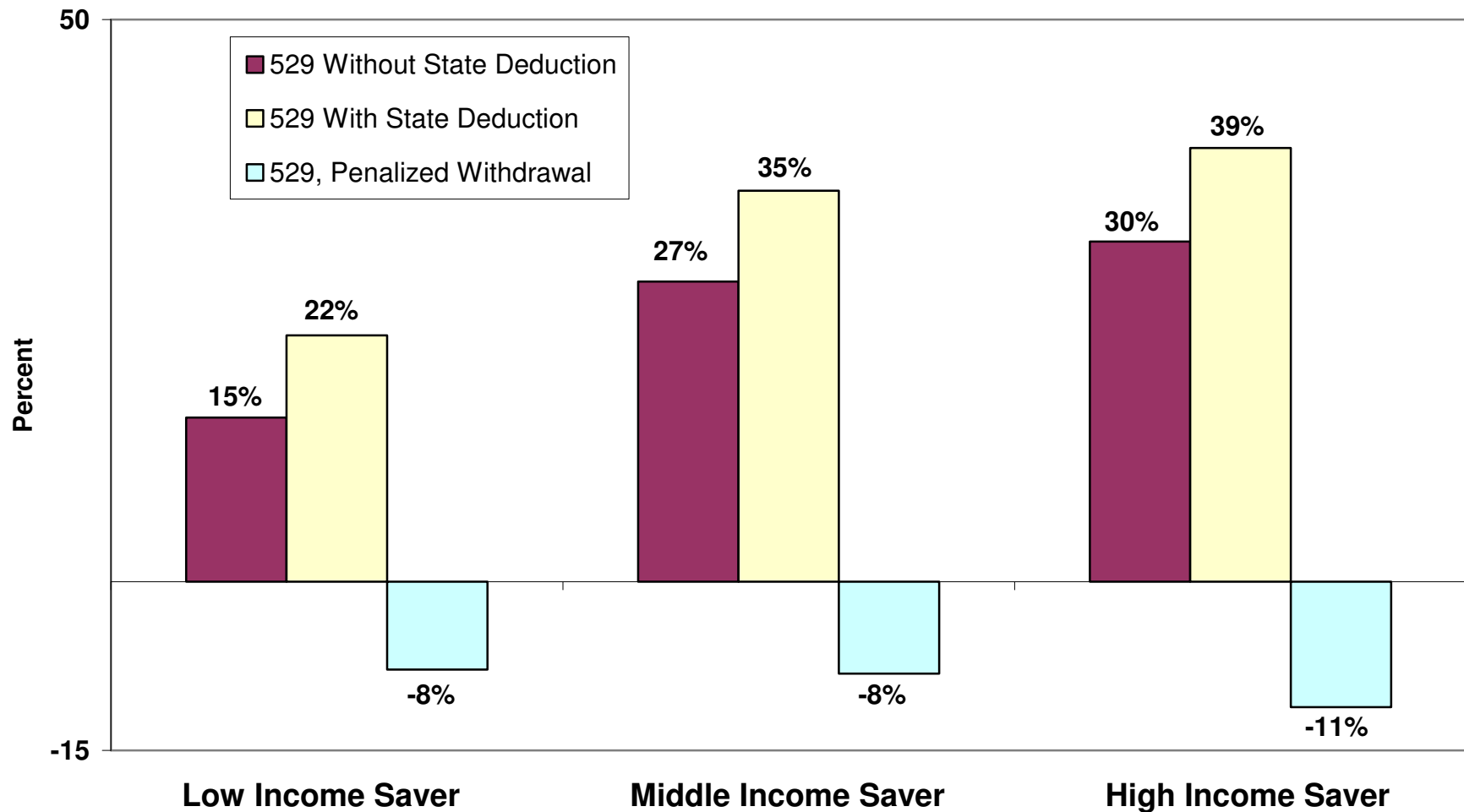
- ◆ Background on 529 plans
 - 529 account benefits and ownership by income group
 - 529 investment options
 - 529 account fees
- ◆ Treasury Recommendations

529 Benefits and Use Both Increase with Family Income

- ◆ The benefit of 529 plans equals the taxes you would otherwise pay on investment earnings in a taxed account. Therefore the benefit is larger the higher is the saver's tax rates.
- ◆ However, there is a risk of having to take non-qualified withdrawals. The earnings portion of such withdrawals is taxed at the ordinary income tax rate plus a 10 percentage point penalty.
- ◆ High income families get the largest benefit for 529 accounts and are the most likely to have accounts. The benefits to middle income families are also large, but only a small minority of middle class families have 529 accounts.

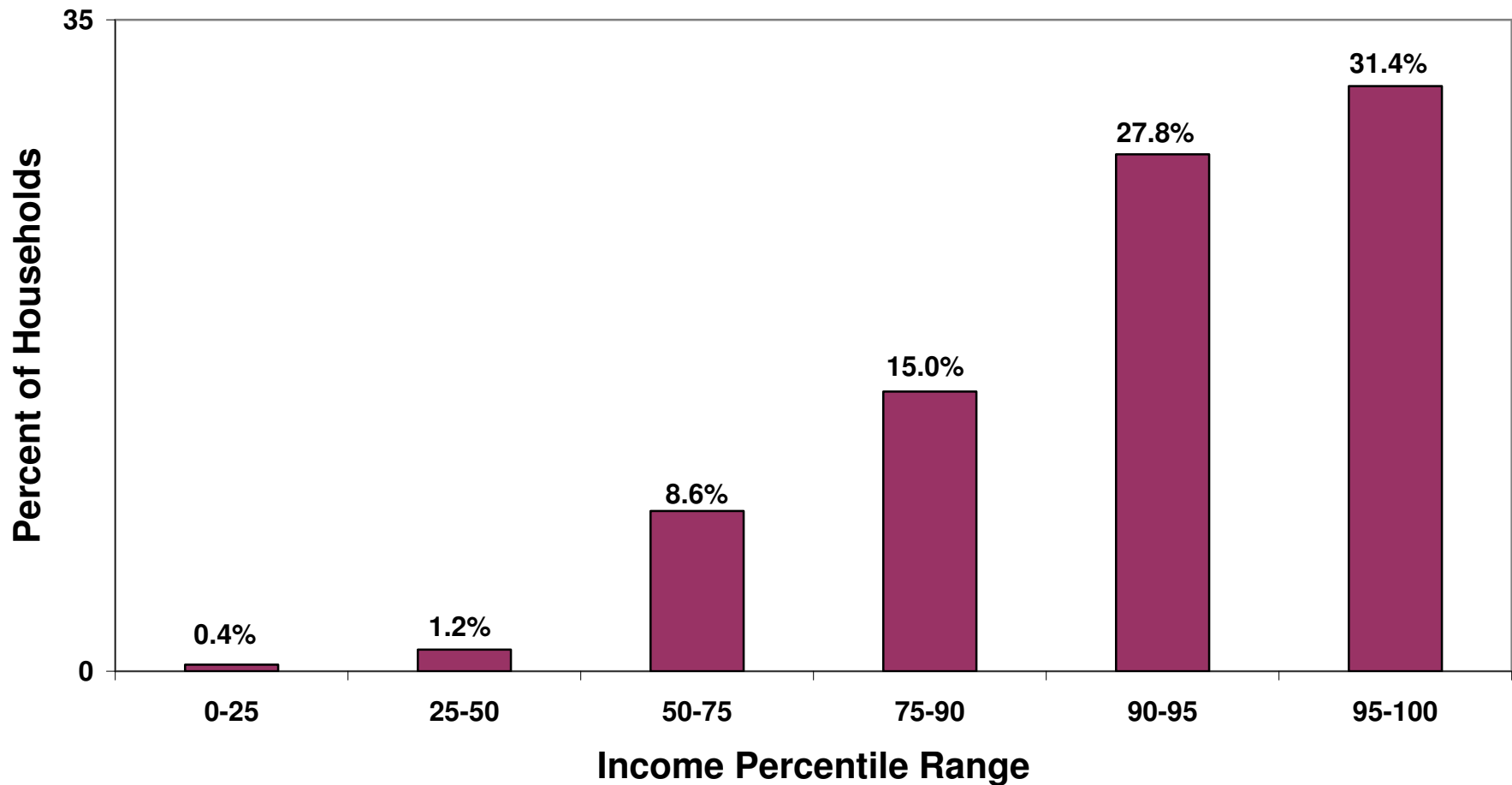
529 Tax Benefits: Size and Relation to Income

**Real Expenditures Financed with \$1,000 Invested for 15 Years:
Percent Change From an Ordinary Taxed Account**



529 Account Ownership by Income Group

Percent of Households with Children Owning a 529/Coverdell Account in 2007 by Income Percentile Group



Source: 2007 Survey of Consumer Finances.

529 Investment Options

- ◆ Most plans offer funds accommodating most tastes for risk and expected return.
- ◆ Age Based Funds.
 - The single most popular option.
 - Equity share starts out high when the beneficiary is young and automatically declines as the beneficiary approaches college age.
- ◆ Index Funds
 - Not universally available in 529s. For example, only 23 of the 48 states with direct-sold plans offer age-based index funds.
 - Because of their low fees, they perform well relative to actively managed funds and have a large following.
 - Well suited to investors who do not wish to spend time acquiring information and evaluating the investment philosophy and track records of the various actively managed funds that are offered.

529 Account Fees

- ◆ There is a lot of variation in fees across plans, even for funds that are similar.
- ◆ This variation in fees for essentially the same products suggests limited inter-plan competition.

Section 529 Account Fees for Direct Sold Moderate Risk Age-Based Fund for Current 5-Year-Old			
Item	Asset-Based Fees Levied* (Percent at Annual Rate)		
	57 Funds	24 Index Funds	33 Managed Funds
Minimum	0.24	0.24	0.25
25th Percentile	0.53	0.50	0.75
50th Percentile	0.76	0.55	0.92
75th Percentile	0.95	0.75	1.06
100th Percentile	1.30	1.03	1.30
Average	0.78	0.61	0.90

529 Account Fees

Section 529 Account Fees for Direct Sold Moderate Risk Age-Based Fund for Current 5-Year-Old						
Item	Front Load Fee Equivalent to Asset-Based Fees Levied** (Percent)			Percent of Real Returns Absorbed by Fees**		
	57 Funds	24 Index Funds	33 Managed Funds	57 Funds	24 Index Funds	33 Managed Funds
Minimum	2.2	2.2	2.3	6.9	6.9	7.2
25th Percentile	4.8	4.5	6.7	14.9	14.1	20.9
50th Percentile	6.8	5.0	8.1	21.2	15.5	25.4
75th Percentile	8.4	6.7	9.3	26.2	20.9	29.1
100th Percentile	11.2	9.0	11.2	35.2	28.3	35.2
Average	6.9	5.4	8.0	21.6	17.0	24.9

Treasury's Recommendations

- ◆ Give all 529 participants the option of investing in low-cost age-based index funds.
- ◆ Eliminate home-state bias to foster competition between plans
- ◆ Make contribution limits per beneficiary rather than per beneficiary per state.
- ◆ Further improve participant access to information enabling them to meaningfully compare plans and investment options.
- ◆ Improve monitoring and compliance.

Access to Low-Cost Index Funds

- ◆ Index funds have been found to have major advantages over actively managed funds: they have lower fees, they perform well on average, and they are easy for consumers to understand.
- ◆ However, only 23 of the 48 states with direct-sold plans offer age-based index funds.
- ◆ Having each state offer this “plain vanilla” option would provide families with greater choice. Of course, if families still preferred to invest in the other options, they could continue to do so.

Home State Bias and Fees

- ◆ The substantial variation in fees across the 24 age-based index funds likely reflects limited inter-plan competition.
- ◆ Home-state bias limits competition, thereby contributing to higher fees.
 - Only five of the 34 states that offer a tax deduction or credit for contributions to their own 529 plans also offer these tax benefits for contributions to out-of-state plans.
 - 13 states exclude all or some in-state 529 account balances when calculating state financial aid, but none offer a similar exclusion for out-of-state 529 balances.
 - As a result of this “home-state bias,” families have strong incentives to choose their home state plan even if other plans offer preferable investment choices.

Better Limiting 529 Tax Benefits at the Top

- ◆ Putting a true limit on Section 529 contributions requires making the limits per beneficiary, rather than per beneficiary per state.
 - All states have per-beneficiary caps on investments in their plan, usually between \$250,000 and \$350,000.
 - Because 43 states offer plans open to residents in other states, a beneficiary can have accounts in as many as 44 states, each with about \$300,000.
- ◆ More effective 529 contribution limits would free up federal resources for education aid targeted to low and middle income families.

Facilitating consumer comparison shopping

- ◆ The variation in fees, even if justified by variation in fund performance, makes choosing the right option more complicated for families.
- ◆ The College Savings Plan Network (CSPN) has done a valuable service by collecting information on Section 529 savings plans and making it available in a convenient form on the internet.
- ◆ However, because there is no established format for reporting historical investment returns for the various investment options, CSPN can only offer links to historical return data for the various plans.
- ◆ It would be a great help to investors if a standard reporting format were developed and the information was available directly on the CSPN web site.

Improving monitoring and compliance

- ◆ The ball is in our court on this recommendation.
- ◆ Limiting the tax breaks we give investors who are improperly using 529 accounts means we will have more resources for students and families seeking to invest in post-secondary education.