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529 College Savings Plans

Have Important Features that Make Them Effective Savings Platforms

But They Should be Reformed to Make Them More Inclusive

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I work in the Asset Building Program of the New America Foundation, a nonpartisan think tank in Washington, D.C. Our work is committed to identifying programs and policies that expand asset ownership in ways that help more Americans achieve economic security, which today, perhaps more than ever, requires access to both income and assets. Clearly, one of the most significant factors in generating these resources is education, particularly post-secondary education. The problem, also clearly stated, is that for many Americans high and escalating tuition costs make it increasingly difficult to afford and access a post-secondary education.

In 2007, the total cost of attending a four-year public university jumped to \$13,589—an increase that far exceeds the rate of inflation at a time when median wages were largely stagnant. As government and institutional aid fails to keep pace with increased costs, few families can expect to afford higher education expenses out of their existing resources. For families wary of taking on costly and onerous levels of debt, savings has become central to accessing education and training. Accordingly, these costs are especially challenging for families with fewer resources. More than half of academically-qualified low-income students are prevented from attending a four-year college because of cost considerations.¹ Given rising tuition costs and the value of a college degree, it is imperative to provide all Americans, and especially lower-income families, the opportunity to save for their futures.

It is hard to argue with anyone claiming to be confused by the array of tax incentives the federal government has created with the purpose of promoting education, especially when considered along with the broader set of tax expenditures intended to support savings. In general, there is much to be said for reform efforts that consolidate and simplify the tax treatment of savings in general and post-secondary educational savings in particular. This should be as part of a larger tax reform effort.

One of the fundamental problems with our current approach is that by using the tax code, including deductions and the promise of tax-free earnings, we fail to assist many families that could benefit from assistance the most. *We should be striving to realize more inclusive policies that create opportunities for all aspiring Americans, regardless of their tax liabilities.* This critique applies particularly to one of the newest policies, which has

¹ Christina Milano (2003). Hearing on “Expanding Access to College in America: How the Higher Education Act Can Put College Within Reach” Washington, D.C.: Committee on Education and the Workforce’s Subcommittee on 21st Century Competitiveness.

quickly developed into the preeminent savings vehicle for post-secondary education, 529 college savings plans.²

These 529 savings plans are established and maintained at the state level. Each state plan includes the administration of an account system, the offering of investment options, and the oversight of private-sector investment management. The federal government allows for earnings from these personal accounts to be withdrawn tax-free when used to pay for qualified higher education expenses and many states offer additional incentives, such as tax deductions on state income tax calculations.

By the end of 2006, deposits in 529 plans exceeded \$91 billion—up from just \$20 billion four years ago. More than 7.2 million individual accounts have been established, with an average account size of \$12,500. Participation in 529 plans is expected to increase rapidly, with total investments expected to exceed \$257 billion by 2011.

The advent of 529 savings plans reflects the general trend to employ an account-based approach to encourage savings. Still many higher-income families would likely send their children to college even without 529 plans and their tax benefits. For lower-income families, the ability to save for post-secondary education is certainly likely to increase access to post-secondary educational opportunities. Unfortunately, they are not expected to greatly benefit from the tax advantages of the 529 plans.

However, there are several promising features of 529 plans which make them a potentially attractive savings platform for families up and down the income scale. I would like to use this testimony to highlight these features and then identify how they could become the basis of a more inclusive savings policy that help provide more Americans, from all income levels, the opportunity to save for their future.

Using 529 Plans as a Savings Platform

Collectively, these state-run 529 plans have characteristics that make them a powerful tool to facilitate saving. While each state is responsible for constructing their own 529 plan, they all have the following beneficial features: (1) public sector oversight that allows incentives and coordination with other policy efforts; (2) centralized accounting functions; (3) a limited number of investment options; and (4) the ability to cross subsidize between large and small accounts.³

Public Sector Oversight and Policy Coordination

Because each state controls their savings plan, they have the ability to facilitate coordination with other program efforts and policy objectives. Some states are more

² Section 529 of the U.S. tax code defines the tax rules that govern qualified tuition programs for post-secondary education. These qualified tuition programs are administered by each state, and include prepaid tuition benefit contracts and savings accounts. Most of my comments focus on the accounts held in state-run 529 savings plans.

³ Marget Clancey, Reid Cramer, and Leslie Parrish (2005). *Section 529 Savings Plans, Access to Post-Secondary Education, and Universal Asset Building*. Washington, D.C.: New America Foundation.

active than others in reaching out to lower-income families. These states' actions include broad outreach efforts, small minimum deposit requirements, scholarships for accountholders, and other incentives. A number of states offer a savings match to low- and moderate-income families who are state residents. With these targeted incentives, 529 plans are a preferred route for many families to save for post-secondary education compared to other tax-advantaged vehicles such as Coverdells or IRAs. Also, partnerships with public and non-profit entities allow states to market their 529 savings plans in non-traditional venues, such as in schools, public libraries and other social service systems.

Centralized System of Accounting

As each state is responsible for overseeing plan participation, they create a centralized system of account management. This means that all participants are in the same system, and a single provider carries out all accounting functions. With this centralized system, it becomes easier and less expensive to service the accounts. This is similar to how a 401(k) plan works. These systems are capable of tracking contributions, investments, and earnings for all plan participants. It also creates the opportunity to match deposits for low- and moderate-income state resident families.

Limited Investment Options

In most 529 plans there is a prevailing simplicity in investment options. Usually only a limited number of funds are offered that capture a range of risk and return characteristics. Professionally-managed mutual funds generate a degree of diversification. Most states generally offer a conservative guaranteed-return fund based on government bonds, balanced funds based on the beneficiary's age, and a small set of funds that track different aspects of the securities market. The notion is that a limited set of investment options provides account holders adequate investment choice in pursuing their investment strategies and is preferable to the information overload that may be experienced if choosing among an unlimited number of investment options. Recent studies focusing on 401(k) plans have found that too many investment choices can lead to financial inertia, paralysis, and low participation—qualities to avoid in long-term investing.

Small Accounts Viability

Centralizing administrative functions also creates economies of scale that can help lower costs. With such a large asset pool, states are in a strong position to negotiate a more competitive fee structure with their private sector investment managers than would be offered to individual investors. In many states, these advantages have been realized and investment companies have departed from their normal business practices to offer pricing and minimum contribution concessions. As a result, many 529 plans have relatively low initial deposit requirements compared to the mutual fund industry. There is the potential to lower fees further as assets under management rise. Because large- and small-value accounts are held in the same plan, there is a natural cross-subsidy where the smaller accounts (which may be unprofitable) can be supported by the larger accounts (with higher profit margins). As the state negotiates and controls the fee structure, there is an opportunity to support small accounts within the 529 college savings plan structure.

Several potential drawbacks should also be recognized that potentially undermine the appropriateness of using 529 plans as a savings vehicle for lower-income families. These include consideration of how these savings will interact with eligibility for financial aid and public assistance programs, high administrative costs which some state plans charge that erode earnings, and penalties for non-qualified uses if a recipient opts not to choose post-secondary education. Each of these issues should be addressed directly as part of a reform effort to make 529 plans more effective and inclusive savings vehicles.

Policy Options to Make 529 Plans More Effective and Inclusive Savings Vehicles

Over the last thirty years, the number of specialized savings accounts has expanded significantly, extending well beyond 529 savings plans.⁴ While this policy trend represents a shift toward asset-based policy, the implementation of these efforts has been considerably more regressive than the preceding social insurance and means-tested transfer programs developed since the New Deal. Furthermore, the need to save for college is an extension of the underlying importance of savings as the basis for more extensive asset building. As such, there is a case to be made for government to support a more inclusive asset-building policy, which could include a reformed 529 Savings Plan program.

The involvement of state governments in 529 savings plans has provided a laboratory of innovation and led to a series of insights. First, it is clear that the public sector can play a leading role in defining and overseeing policy. Second, private financial firms can build upon their expertise to effectively manage assets and keep administrative costs down with high account volumes, limited transactions, and a small set of investment choices. Third, incentives must be crafted for each target population. Fourth, consumers must have access to timely and transparent information to make informed investment decisions that are right for them.

While the structure of most state-run 529 plans offers an effective savings platform, the federal tax incentives associated with these accounts primarily restrict benefits to middle- and upper-income families. Accordingly, it is unlikely that this federal policy, if left unchanged, will significantly increase access to post-secondary education opportunities.

Building on these insights, there are a series of policy options that would improve the effectiveness and inclusiveness of this policy effort. These proposals built on the guiding principles of *transparency, inclusiveness*, and offering *saving incentives* for those who need them most, will enable families to evaluate and make informed choices as to how best to save for college.

Use 529 Plans as a Platform for Lifetime Education Savings

529 plans have qualified uses that include a range of post-secondary educational expenses. These uses should be clarified and expanded to cover more asset-building activities. While commonly associated with saving for a child's higher education expenses, these accounts can work just as well for working adults looking to save for

⁴ The list includes traditional Individual Retirement Accounts (IRAs) in 1974, Coverdell Education Savings Accounts in 1997, 401(k) plans in 1978, and Health Savings Accounts first created in 1996, and Roth IRAs in 1997.

their own higher education and skills training needs. For workers looking to command a higher wage in their current field, or switch fields altogether, higher education and training is essential. For individuals who cannot pay for tuition, books and fees out of pocket—and are wary of taking on onerous debt—saving is the answer. Instead of creating new workforce training accounts, the Federal government should use the existing infrastructure available through 529 accounts and work with states to promote and incentivize the use of these accounts by working adults.

Add 529 Plans to the List of Products Eligible for the Saver's Credit

The Saver's Credit currently provides a 50 percent match—in the form of a non-refundable tax credit—to low- and moderate-income people who contribute to a retirement account such as a 401(k) or IRA. To further promote savings in general, a range of savings products, including 529s, could be added to the list of products that trigger this credit; the administration proposed such a change as part of the FY 2008 Budget. Certainly one could argue that pre-retirement assets—especially a post-secondary education—is a critical element of retirement security, and it should be noted that all IRAs already permit tax- and penalty-free withdrawals for post-secondary education.

Support Matching Grants to Low-Income Savers

Currently 529 plans are largely underutilized by low- and middle-income families. A number of states have dedicated funds to match savings in 529 plans as an additional incentive for low-income families. These incentives appear to be successful in encouraging families to contribute to 529 plans. Seven states—Colorado, Louisiana, Maine, Michigan, Minnesota, Rhode Island, and Utah—already provide matching funds to low-income savers, and Arkansas will begin providing targeted matches in 2008. Additional resources could be devoted to helping states develop matching grant programs.

Create a State Innovation Fund

A variety of state and private sector actors have enacted innovative programs within their 529 plans to primarily help low-income children pay for college. For example, a few non-profit organizations have offered matches to families saving for college through parallel 529 scholarship accounts. In SEED for Oklahoma Kids, 1,000 newborns will receive a 529 plan with a starter deposit of \$1,000. Financial information and matching deposits will be provided as incentives for families to continue to save for a post-secondary education. Coalitions are being formed in states such as Kentucky and Michigan to look into the possibilities of universal 529s for every child in the state with progressive savings incentives incorporated to help low-income families. The federal government could encourage these types of innovative activities by sponsoring a competitive grant process where states could receive awards to help seed these initiatives.

Facilitate Better Disclosure and Comparison of 529 Plans

Because they are created by state governments, 529 plan investments are not subject to federal security laws such as those covering most mutual funds. In addition, research shows that individuals saving in broker-sold plans were frequently doing so in out-of-state plans, even if they would potentially benefit more from saving in their in-state plans

because of state tax incentives. This raises the question of whether brokers recommend plans that benefit themselves rather than seeking the best plan for their client. At a minimum, brokers should be required to inform clients about any benefits that exist from utilizing their own state's 529 plan. In addition, the federal government should support efforts to allow the easy comparison of all plans in a particular state and among states. Websites, such as savingforcollege.com, provide a simple comparison of 529 plans which could be promoted or serve as a model. Finally, states should be encouraged to market their direct-sold plans to their residents, which are usually a less expensive alternative to the broker-sold options.

Collect Better Data on Who Saves and Benefits from 529 Plans

Because data is generally not collected about 529 plan accountholders' socioeconomic details, we do not know how plan ownership varies by income and which segments of the population benefit from these tax incentive the most. If this data were collected, it could help shape improvements to 529 plan policies in the future, helping to ensure that tax breaks and other incentives are serving their intended purpose. Useful data about the saving habits of low-income families in 529 plans could be gained from those states offering matching grants, since an application disclosing income must be provided.

Require Employers to Offer Payroll Deduction into 529 Plans

One of the most effective ways to encourage families to save is to make the process automatic. Millions of Americans have already opted to direct a portion of their paycheck into a restricted account such as an IRA or 401(k), allowing them to save for retirement with minimal effort. Payroll deduction has enabled workers to build retirement security by making one, initial decision to divert a portion of their income; the same process should be used to facilitate saving for higher education. Employers should be required to offer payroll deduction into Section 529 higher education savings accounts if requested by their employee. Small- and medium-sized employers that do not already offer payroll deduction can be offered a small tax credit to cover the costs associated with implementing the change.