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College Savings Plans: A Platform for Inclusive Saving Policy?

Perspective

February 2004

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Introduction

This Center for Social Development (CSD) Perspective addresses pros and cons of using College Savings Plans (529 plans) as a platform on which to work toward more inclusive saving policy. CSD has been studying College Savings Plans for several years (Clancy, 2001; Clancy, 2003; Clancy & Sherraden, 2003). Our interest is in finding a suitable platform on which to build a more inclusive and progressive policy for saving and asset accumulation. Recently, in a series of email exchanges, Peter Orszag has suggested that 529 plans are not suitable for this purpose. Margaret Clancy and Michael Sherraden have responded with information that may balance the discussion. This is a constructive exchange; we have all benefited from it. We felt that, in the interest of a more informed policy discussion, it might be useful to share the different viewpoints with a wider audience.

The paper is organized in two parts. The first part is CSD's assessment of the potential of 529 savings plans as a platform for inclusive saving policy, and summarizes CSD state-level research on inclusive features of 529s. This is important so the reader can see the starting point of the discussion. Clancy and Sherraden write this first part.

The second part is a debate. First, Orszag raises questions about the suitability of 529s as a platform for inclusive saving. He takes the view that 529s are in several ways financially harmful for the poor. Sherraden and Clancy then respond to the issues that Orszag raises. They take the view that 529s also have financial features that are positive for the poor, and more importantly, 529s offer the greatest potential for achieving a large-scale, inclusive policy. As in most debates, important issues are raised on each side of the discussion. Both approaches have merit, and both have shortcomings. The debate is not intended to have a winner and loser—policy issues are seldom so clear-cut—but to inform the thinking of those who are interested in this topic, and hopefully to contribute to better policy choices and more productive research in the future.

Part I:
Perspective and Research on 529s
Margaret Clancy and Michael Sherraden

Perspective on 529s

Policy goal: Inclusive asset-building policy. It would be desirable to have an inclusive asset-building policy. By inclusive we mean universal and progressive. Ultimately, we are aiming for a policy structure in which everyone has accounts from birth to death, allows contributions by third parties, and gives greater subsidies to the poor. The policy should lead to enough asset accumulation for everyone, including the poorest families, to fulfill the stated purposes of the policy, whether those are education, home ownership, retirement security, or other purposes.

The reasons for an inclusive asset-based policy are both fairness and practicality. The non-poor already receive substantial asset-building subsidies through the tax system; it would be more just to make asset-building policy universal. From a practical perspective, it is likely that asset holding enhances the well being of families and communities in many ways, including greater economic participation and citizenship involvement (Sherraden, 1991).

One potential pathway to an inclusive asset-building policy, perhaps the most likely pathway, is an inclusive children's saving account policy. There are several reasons for this: (1) public policy should seek to give everyone an even chance in life (Haveman, 1988); (2) lessons learned early in life are often more effective, and young people have more years for saving and asset building to affect their lives (Sherraden, 1991); and (3) a children and youth strategy may be the best pathway to a large and inclusive asset-building policy for the whole population (Goldberg, forthcoming).[1] Over a period of decades, as generations matured, it could become a universal policy.

The potential of 529 savings plans. There are several possible pathways toward an inclusive asset-based policy. The major options include: (1) create an entirely new policy structure, e.g., a Children's Savings Account; (2) modify Individual Retirement Accounts (IRAs), or (3) modify College Savings Plans or 529s. Of these options, we think 529s offer the greatest potential for future policy development. Regarding option number one, creating a new policy is always much harder than modifying an existing policy. Regarding option number two, as we detail below, IRAs do not have the same inclusive potential as 529s.

College Savings Plans or 529s, named after the Internal Revenue Code section, are designed so individuals can make after-tax deposits for future post-secondary educational expenses.[2] Earnings are free from federal taxes if funds are used for education expenses. 529 rules vary by state, but many states offer a tax deduction for contributions and most states do not tax qualified withdrawals. Individuals can participate in a 529 in another state, not just their state of residence.

Our main point in this discussion is that 529 savings plans have public (state government) control and a centralized accounting system, which together constitute a policy structure that has the potential to be universal and progressive, e.g., give everyone an account at birth and give greater subsidies to low income households. In contrast, there is no way to achieve this by offering a saving product in the market, e.g., an IRA, and hoping that people will sign up.[3]

[1] This section borrows from Clancy & Sherraden (2003).

[2] Expenses include tuition, fees, books, supplies, and equipment at colleges, universities, vocational schools, or other post-secondary educational institutions.

[3] The realization that a financial product by itself is not sufficient is apparent in current discussion of "opt out" vs. "opt in" strategies for retirement saving. Research shows that more people participate when 401(k) plans require an employee to decline participation (opt out). The only way to have an opt out plan is to have a central provider that puts everyone in as the default condition. A still more inclusive approach is to put everyone in a plan automatically, as occurs in Sweden's universal defined contribution retirement plan and the new Child Trust Fund in the United Kingdom (in both cases, participants choose among investment options). Social Security expert Alicia Munnell now proposes "automatic enrollment" in defined contribution retirement plans in the United States.

Public control is necessary if inclusive values, policies, and practices are to be reflected in the savings plan.[4] As we discuss in this paper, private firms in the market, left to themselves, will not seek inclusion of low-income households because the costs are too high. State governments, on the other hand, do seek greater inclusion in 529s, as we show below.

In specific ways, the current tax structure of 529s does not benefit the poor. Lower-income earners, since they have little or no tax liability, cannot receive a tax benefit. Furthermore, low to moderate income families do not have significant wealth to transfer savings balances into 529 savings plans, which means less opportunity for tax-free accumulation. In these respects, 529 savings plans are much like 401(k) plans and IRAs. All existing asset-building policies that offer tax benefits are highly regressive, i.e., those with higher incomes receive most of the financial benefits.

However, in the case of 529s, in contrast to IRAs, inclusive innovations are occurring at the state level. Typically administered by the Treasury Department through a centralized plan, states dictate rules and oversee plan participation.[5] States have a commitment to inclusion that does not occur with IRAs. These include much lower minimum deposit requirements, extensive outreach, matched savings and other features.

Can 529 savings plans be adapted to become an inclusive policy that serves the poor as well as the non-poor? This potential exists because 529 savings plans have the following characteristics: (1) Accounting functions are carried out in a centralized system, which is fundamental for achieving universality.[6] (2) There are usually only a few investment options, which makes participation relatively simple. (3) Large and small value accounts are held in the same plan, so that small, unprofitable accounts might be supported.[7] (4) There is state government control, which enables states to require inclusive features and many states do so.

Allow us clarify that we have no particular commitment to 529s as a policy. It is the policy features of 529 savings plans, compared to available alternatives, that interest us. To achieve inclusion, it is likely that government will play the leading role in defining and overseeing the policy, because the private sector does not want to hold small, unprofitable accounts. And it is likely that private financial markets will manage assets, because they are much better at this than the government. 529 savings plans already have these basic characteristics.

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[4] We view IRAs as a financial product, not a plan. This paper seeks to point out why this distinction matters. To be sure, financial products will be essential in an inclusive asset-building policy, but only in the context of a plan.

[5] This centralized system is similar to a 401(k) plan structure, though 401(k) coverage extends only to each particular employer's base. The employer is the plan administrator of a 401(k) plan. In a 529 savings plan the State Treasurer or savings plan board acts in this capacity.

[6] The reasoning here is the same as used by the designers of the U.S. Social Security retirement system. If the goal is to include everyone, only a centralized system has the potential to track everyone. In this regard, 529 plans in the states are a better model for an inclusive federal policy than is any version of IRAs.

[7] Again, this is similar to a 401(k) plan. Without the centralized 529 savings plan structure, providers would avoid unprofitable, low-balance accounts.

The direct involvement of state governments in 529 plans is beneficial for examining how a centralized system of inclusive accounts could operate in the future. Ultimately, a national savings plan may be preferable to 50 different state plans, but as in other areas of policy development in the United States, experimentation in the states can help set the stage for a national plan. Different approaches in the states can help identify the best policy features.

Research on innovations for inclusion in state 529 savings plans

State selection of 529 providers and public control of policy enables states to incorporate progressive and inclusive features. In addition to matching 529 savings deposits for low-incomes families, some states have reached out to lower income populations by excluding 529 savings plan assets from state tuition grants calculations, enrolling participants in the workplace, linking with Individual Development Accounts (IDAs), and taking other inclusive measures. Results from a CSD study of 41 states indicate that inclusion is a priority in some states (Clancy & Sherraden, 2003). Some of the results are summarized below.

Outreach. Many states are trying to reach a broad population. Outreach activities vary by state. The most often-used methods to communicate are through television, radio, and print advertisements. Efforts to reach wide segments of state residents include inserting 529 plan information with mailings for birth certificate and motor vehicle registration, and distributing information via school systems, libraries, and day care centers.

Minimum deposit requirements. A majority of plans require very low minimum contributions. In many states, accounts may be opened with a $25 check, money order, electronic funds transfer, or with as little as $10 through an automatic plan deposit.

Workplace enrollment. Extensive efforts are made for workplace enrollment. Ninety-five percent of states surveyed agree or strongly agree that efforts to introduce 529 savings plans in the workplace provide opportunities to reach participants of all incomes. Some states report that their initial workplace enrollment was to introduce the plan to state and local government employees, and then they expanded efforts to other employers.

Scholarships. Twenty-two percent of states provide scholarships through their 529 savings plan. Many of these are designed as creative outreach efforts. One state combines both scholarship and need by awarding "one hundred $10,000 4-year scholarships ($2,500 per year), to students with lowest the EFC[8] and highest SAT scores."

State financial aid. Many states (44%) exclude the value of 529 savings plan accounts from calculations for state financial aid.

Connection to college preparation program. Ten percent of respondents attempt to link their 529 savings plan with the federal GEAR UP (Gaining Early Awareness and Readiness for

[8] Defined by federal law, the EFC, or expected family contribution, is a measure of how much the student and his or her family can be expected to contribute to the cost of a student's education.

Undergraduate Programs). The mission of GEAR UP is to increase the number of low-income students who are prepared to enter and succeed in post-secondary education.

Match for low to moderate income savers. Currently, five states offer a savings match within their 529 savings plans. Rhode Island and Maine, for example, allocate user fees from national accountholders in 529s to fund a savings match for low to moderate income state-resident families. Three other states, Michigan, Minnesota and Louisiana, provide a savings match through state appropriations. Below is a summary of 529 savings plan matching provisions.

Rhode Island. Beginning in 2003, Rhode Island's 529 savings plan, CollegeBoundfund, matches contributions up to $500 per year based on family size and income. A 2:1 match ($1,000 maximum per account) is offered to state-resident families with an adjusted gross income (AGI) at or below 200% of the poverty level. Families with an AGI between 201% and 300% of the poverty line are eligible for a 1:1 match ($500 maximum per account). To be eligible for a match, the 529 savings plan account must be opened when the child is 10 years of age or younger. Matches occur annually for up to five years.

Maine. In order to qualify for a match in the NextGen College Investing Plan, the AGI of state-resident families must be $50,000 or less. Any new account with an initial contribution of at least $50 may apply to receive a NextGen Initial Matching Grant of $200. In addition, any existing account receiving contributions of at least $200 may apply to receive a NextGen Annual Matching Grant of 25% of all amounts contributed, up to an annual maximum grant of $100 for any one beneficiary.

Michigan. The Michigan Education Savings Plan provides a matching grant of $1 for each $3 contributed by state residents to their 529 savings plan. The lifetime maximum state match is $200, available during the first year of enrollment only, if the beneficiary is six years old or younger. To be eligible for the match, the beneficiary must reside in a household with a family income of $80,000 or less.

Minnesota. The Minnesota College Savings Plan provides an annual matching grant to eligible state-resident families contributing at least $200 to the 529 savings plan during a calendar year. Maximum matching grants are $300 per year. The match rate is linked to (AGI). Families with a federal AGI of $50,000 or less may receive a matching grant of up to 15% of their contributions during the year, and families earning between $50,000 and $80,000 may receive up to 5% of their contributions. Account owners must apply for the grant no later than December 31 of each year.

Louisiana. The Louisiana Student Tuition Assistance & Revenue Trust (START) 529 savings plan matches a portion of deposits made by all state residents, with the match rate dependent on the AGI of the account owner. The savings match rate ranges from a high of 14% of contributions for those families with an AGI up to $29,999 to a low of 2% for incomes of $100,000 and above.

Links to 529 savings plans through Individual Development Accounts (IDAs). Other states are providing links to 529 savings plans through IDAs. For example, using the 529 savings plan account as the IDA savings vehicle, Vermont offers a savings match to low-income 529 savings plan participants.

Oregon and Pennsylvania allow IDA participants to roll over participant savings and match funds into the 529 savings plan, offering more investment choices and long-term accounting after the IDA program ceases. Pursuant to state legislation, an education saver may transfer the entire IDA balance into the Oregon 529 College Savings Network and Pennsylvania's Tuition Account Program (TAP). In Pennsylvania, the matching funds are earmarked within TAP to prohibit unauthorized withdrawals of the savings match.[9]

In sum, the states are leaders in innovation for inclusion in 529 policy. Through 529s, states are in the forefront in commitment and creativity for inclusion in asset building. No other major asset-based policy is characterized by as much innovation for inclusion.[10]

Potential for inclusion

Assessing the meaning of the above research findings, the potential for greater inclusion in 529 saving may exist because plans have the following characteristics:

- Every state provides a 529 savings plan or has one in development. Most states express interest and some degree of commitment to making 529 plans more inclusive. IRA providers have no such interest or commitment because they do not want to hold small, unprofitable accounts.

- Within a state plan, all participants are in the same system and all accounting functions are carried out by the single provider. These features make it possible for states to know who has joined and who has not. There is an administrative structure that has the potential to reach all families.[11] No such structure exists for IRAs.

- The centralized 529 savings plan accounting structure offers states the ability to match contributions for low income participants.[12] Five states are doing so, and other states are considering matching contributions. This would not be possible with IRAs.[13]

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[9] Clancy, M. (2003). *College savings plans and individual development accounts: Potential for partnership,* policy report. St. Louis: Center for Social Development, Washington University. This report provides examples of state legislation connecting IDAs and college savings plans.

[10] The only asset-based policy that is in some ways more inclusive is IDAs, which are currently serving very few participants compared to large policies such as 401(k)s, IRAs, and the rapidly-growing 529s.

[11] To take an important example of a centralized system, the Federal Thrift Savings Plan (TSP) is the most successful employer-based retirement plan in reaching low-income workers (Rideout, forthcoming). Similar to the State Treasury Department or other governing body in 529s, the federal government is the central provider in TSP, offering a few simple choices, low-cost investments, and outreach and education for inclusion.

[12] In matched 529 savings plans, the financial provider typically produces a single file detailing annual contributions to facilitate match calculations by state officials. This single file, containing year-to-date contributions for all matching grant recipients, would not be possible with multiple providers.

- The centralized program with a single provider enables lower costs due to economies of scale (e.g., New York participant fees decrease as the total plan assets increase; Utah reduced plan fees this year as a result of increasing assets).

- In the 529 system, the state is in a strong position to negotiate among competing providers for a competitive fee structure and other inclusive features. This negotiating position is much stronger than that of individuals in the market.

- By state design, the majority of 529 plans have very low initial deposit requirements (Appendix A details these for every state), much lower than mutual funds offered by the same institution (see Appendix B). In comparison, high minimum deposit requirements prohibit some low-income families from choosing mutual funds as the investment vehicle for IRAs. The differences are great; in every category shown in Appendix B minimums are at least 100% higher for IRAs than for 529s. The effect of this is to have 529 accounts with much smaller balances than would be possible with IRAs, and more low income people who are able to participate.

- Related to the above, large and small value accounts are held in the same plan in 529s, so that the smallest unprofitable accounts can be supported by the largest profitable accounts. Thus, cross-subsidization to very small holders is much greater. Because the state negotiates and controls these features, the 529 is more progressive in this regard than alternatives.

- Some states have reached out to lower income populations by excluding 529 savings plan assets from state tuition grants calculations and reducing investment fees. This does not occur with IRAs.

- In 529 plans, there is simplicity of investment choice, with typically a selection of investment options emphasizing a range of risk and reward (usually a guaranteed-return fund, age-based or balanced funds, and an equity fund). This structure differs from the overwhelming process of choosing among an unlimited number of IRA providers and investment vehicles.[14] This 529 feature is more comparable to a 401(k) plan.

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[13] What about the possibility of an "effective match" or subsidy for low-income savers using other policy vehicles, such as the Small Savers Credit (SSC) or state level Earned Income Tax Credit (EITC)? The potential is more limited. The small savers credit is not currently refundable, and the state EITC does not occur in all states, so legislation would have to be enacted. Regarding outreach, 529 programming is far better than the SSC. EITC outreach has improved, but the EITC is not about saving. The EITC would be more attractive if the refund were split so that part could be transferred into a savings account. But then, what is the saving vehicle? What is the system that holds the savings accounts? What is the potential to connect to other progressive features? In our view the whole system matters. We see value in the 529 because it is a plan that seeks to reach and enroll people, may provide a match, requires small initial deposit amounts, and so on.

[14] A recent study in Sweden by Conqvist and Thaler finds that workers placed in a required defined contribution retirement system were "paralyzed" by an extremely large number of fund choices and most tended not to pick any fund.

- Having only a few simple options creates the potential for low investment costs, especially when a low-cost provider such as TIAA-CREF or Vanguard is selected.

- Many states are known for low-cost plans. These plans can be a model for future policy development. High-cost plans also exist, but even these may have progressive features. For example, some states with higher fees, such as Maine and Rhode Island, use revenue from administrative fees to fund matches and provide fee rebates to low and moderate income account holders in the state.

- Workplace enrollment is facilitated in 529 savings plans. Workplace offerings of 529 savings plans as an employee benefit creates the potential for broad participation by families of all incomes. Employers partner with state and 529 plan officials by facilitating on-site informational meetings and enrolling workers through payroll deduction. To take one state as an example, in 2003, TIAA-CREF conducted 220 employer events in Missouri alone.[15] These types of partnership do not occur with IRAs.

- 529 providers and state officials work with community groups to increase plan enrollment. Again, this does not occur with IRAs. IRA providers want only high savers and can contact them as individuals. To reach low savers, 529 providers market through different strategies, such as partnerships with community-based organizations.

In sum, the states are leaders in innovation for inclusion in 529 policy. Through 529s, states are in the forefront in commitment and creativity for inclusion of the poor in asset building. No other major asset-based policy is characterized by as much innovation for inclusion.[16]

Challenges

Also there are significant challenges to overcome in existing 529 policy:

- Not all 529 plans have low investment fees and low-cost 529 plans should be promoted as a model. Federal and state policy should do more to support and promote low-cost plans.

- Related to costs, in the current policy arrangement, the expenses of inclusive features of 529 plans are borne primarily by the plan provider, and these costs are then passed along to consumers in the fee structure. Compare this to income support policies for the poor, where government provides all of the subsidy and all of the administrative costs. A good case can be made for greater federal and state subsidy of inclusive features in 529s. Some state governments have taken steps in this direction.

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[15] The Missouri Treasury Department lists on their website relationships with approximately 700 employers. Those employers interact with the Missouri MO$T plan in different ways. For example, BJC HealthCare, a hospital employing over 20,000 people, has incorporated the Missouri MO$T plan into their formal employee benefit offerings and publications. Other employers distribute information and allow on-site meetings during work hours, while others simply facilitate payroll deductions.

[16] The only asset-based policy that is in some ways more inclusive is IDAs, which are currently serving very few participants compared to large policies such as 401(k)s, IRAs, and the rapidly-growing 529s.

- Ideally, 529 savings plans could be used for more than educational purposes. Additional possible uses in the future might include homeownership, business start-up, and retirement. From this perspective, 529 savings plans would be transformed into a universal, lifelong asset-based policy that serves different purposes along the life course. This was the original proposal for IDAs (Sherraden, 1991).

Part II: Debate

529 Plans and Progressive Savings Policies
Peter R. Orszag

This section summarizes my views from the useful debate with Michael Sherraden and Margaret Clancy regarding the merits of 529 college savings plans as progressive savings accounts. We all agree that progressive reforms to increase saving among low-income families would be desirable.

In general, Sherraden and Clancy view 529s as offering a structure with inclusive features that can be built upon in the future. I am concerned that, largely reflecting their design as a structure for tax-preferred college saving by higher-income families, 529s often have high investment fees, carry penalties for non-educational use, and can in some circumstances have negative interactions with college aid. Basing a progressive savings policy on 529 plans thus carries the significant risk of locking low-income families into an account structure that is inappropriate for them and was not designed with their needs in mind.

In large part, our differences result from different perspectives. Sherraden and Clancy focus on the theoretical potential for a large inclusive policy system, while I am focused on whether 529s currently impose excessive costs on low-income savers. Furthermore, it is unclear to me that even over the longer term, it is realistic to assume that 529 plans can be transformed into an appropriate savings platform for low-income households. In any case, any such possibility must be weighed against the costs imposed on low-income participants in the meanwhile.

Saving purposes

A progressive savings policy presumably should expand savings and asset accumulation for a variety of purposes. It would therefore be desirable for low-income households to save in an account structure that is not limited to educational uses. In my view, the "college savings" part of 529 accounts is a substantial limitation from this perspective.

Furthermore, from a financial planning perspective, most low-income families should generally contribute any tax-preferred savings into a Roth IRA.[17] One of the reasons is that the rules governing withdrawals from IRAs, even prior to retirement, are significantly more generous than those governing withdrawals from 529 accounts. It would therefore seem particularly worthwhile to explore whether large, national financial services firms would be willing to

[17] This is especially the case if the family is not living in a state offering a match for contributions to a 529 plan, and if the family has positive tax liability against which the federal saver's credit could be applied.

develop and provide a low-cost Roth IRA with restricted investment and trading options. Such a low-cost Roth IRA, coupled with the federal saver's credit, provides one possible alternative to a 529-based approach to progressive savings policies.

Penalties and fees

Under existing 529 rules, households that do not use their 529 funds for higher education expenses face a 10 percent penalty on accumulated earnings and must also generally pay income tax on the withdrawal. Research has suggested that for families with incomes below $57,000, the probability of college attendance is too low to justify saving through a 529 plan because of the penalty.[18]

To accumulate assets over time, it is also important for low-income households to save in accounts with low fees. Most observers view the current 529 market as characterized by excessively high fees. As one example, Professor Austan Goolsbee of the University of Chicago has written, "The long-run potential of the plans has been seriously compromised by excessive 'management' fees that states have added to these plans."[19] Sherraden and Clancy correctly note that *some* state 529 plans have low fees; even those low-cost 529 accounts, however, are typically more expensive than other accounts (including IRAs) offered by the same provider. As an article in *Money Magazine* recently argued, "as revenue-hungry states compete for 529 assets -- more than $20 billion is stashed in these plans -- they're layering on marketing gimmicks, restrictive tax rules, and higher fees. As a result, many 529 plans are beginning to resemble high-priced insurance products rather than 401(k)s."[20]

Interactions with college aid

Additional penalties on 529 assets may in some cases result from current college financial aid rules. Those rules can impose steep implicit taxes on some forms of savings, because financial aid may be reduced by some proportion of the value of the account.[21] For the low-income families to whom the financial aid rules fully apply, the reduction in aid over four years of

[18] Susan Dynarski, "Who Benefits from the Education Savings Incentives? Income, Educational Expectations, and the Value of the 529 and Coverdell," July 2003. It is worth noting that the penalties apply only to 529 plan earnings, not the individual's basis from making contributions to the account. They can also be avoided by using 529 balances for higher education expenses of other members of the nuclear or extended family. Despite these important caveats, the penalty is a significant downside to saving through 529s for low-income families.

[19] Austan Goolsbee, "The 529 Rip-Off," *Slate*, August 2002.

[20] Penelope Wang, "The trouble with 529 plans," *Money Magazine*, October 7, 2003.

[21] Current federal financial aid tests exclude assets for families who are not required to file a tax return, or who have incomes below $50,000 and are eligible to file IRS Forms 1040A or 1040EZ. Many factors, however, can prevent families from being eligible to file a 1040A or 1040EZ. For example, families who either pay or receive alimony and have dependent children must file the regular 1040, rather than either the 1040A or 1040EZ. Results from the Urban-Brookings Tax Policy Center model suggest that a substantial share of tax filers with adjusted gross income below $50,000 are not eligible to file the 1040A or 1040EZ, and therefore do not qualify from the exclusion of all assets from financial aid tests.

college can theoretically amount to 20 percent or more of the value in 529 accounts, although in practice it is unlikely that many low-income families will be subjected to an implicit tax rate this high. Other assets, including home equity and ordinary and Roth IRA accounts, are fully exempted from any implicit taxes.[22]

Potential for inclusion and progressivity

Sherraden and Clancy correctly note that some 529 plans require low minimum contributions, which makes the accounts more attractive to low-income families.[23] Many other 529 plans, however, require more significant minimum investments. For example, the plans managed by TIAA-CREF allow accounts to be opened with as little as $25 in contributions; the plans managed by Fidelity require a minimum contribution of $1,000.[24]

Sherraden and Clancy also underscore that five states provide a savings match for low to moderate income families to save through their 529 plans. On the other hand, contributions to 529s do not qualify for the progressive saver's tax credit through the federal income tax code.[25] It is not clear that it will be easier to expand the state matches to 529 plans than to expand the saver's tax credit in the federal income tax.[26] Making the federal saver's credit refundable is currently being actively discussed by policy-makers on a bipartisan basis, and may be included in a forthcoming proposal by Representatives Rob Portman and Ben Cardin (who are widely seen as the leading policy-makers on pensions and retirement saving in the House of Representatives).

Sherraden and Clancy put substantial weight on the centralized accounting that each state provides in a 529 plan. To avoid the excessively high costs imposed on 529 plans in many states, however, individuals would have to hold their funds in a 529 plan from *another* state. The

[22] In evaluating these interactions with college aid, the scale of the costs that low-income parents currently bear, given existing financial assistance, when their children attend college may be relevant. According to a recent Congressional Budget Office, the average parental cost of college attendance (excluding the "cost" of providing a room at home) for students from families with incomes below $30,000 was about $1,500 for all students in 1999-2000, and less than $1,000 for students attending a public four-year university. See Congressional Budget Office, "Private and Public Contributions to Financing College Education," January 2004, Table 10.

[23] Sherraden and Clancy also note that electronic participation is encouraged in 529 plans, although that is also the case with other accounts such as IRAs. Workers can contribute every pay period to either 529 plans or IRAs using payroll deduction and automatic transfers.

[24] IRAs often have minimum investment requirements in the $500 to $1,000 range, although some financial firms waive such requirements for workers making contributions to an IRA through regular payroll deductions.

[25] Since the saver's credit is not currently refundable, it is of little or no use to most low-income families. See Peter R. Orszag and Matthew G. Hall, "The Saver's Credit," *Tax Notes,* June 9, 2003.

[26] Note also that centralized accounting within a state is not necessary in order for a state government to provide some form of progressive matching contribution for saving. It would be theoretically possible, for example, for a state government to "piggy-back" off the federal saver's credit, much like many states provide their own EITCs. In this scenario, the state would provide a tax credit equal to some percentage of the federal credit, which would increase the implicit match rate from the federal credit.

benefits from the centralized accounting within a particular state are thus dissipated as the desire to avoid extremely high fees causes account holders to invest in other state plans. Finally, any negotiating power that states could theoretically enjoy by accumulating large 529 assets does not, in general, appear to have been put to good use, as the high fees typical of 529 plans suggest.

I agree with Sherraden and Clancy that workplace enrollment is an important feature of progressive savings policies. Payroll deduction IRAs, however, can and do serve this function. I am unaware of evidence that firms are more willing to adopt one form of payroll deduction relative to the other.

Conclusion

My conclusion is that substantial changes would be needed to make 529 plans an appropriate vehicle for saving by low-income families. In part, the problems arise because 529 accounts were designed as a mechanism for higher-income families to save specifically for college on a tax-preferred basis, not as a mechanism for broader saving purposes among lower-income families. The penalties imposed on 529 accounts if the funds are not used for higher education expenditures, along with the typically high administrative costs on the accounts, are particular sources of concern.

Sherraden and Clancy are confident that changes could be enacted in the near future to attenuate these problems. I am more skeptical that the high-income orientation of 529 plans (and the rules surrounding them) could be changed in the next few years. In any case, I remain concerned that in the meanwhile, 529 accounts do not seem well-designed to meet the savings needs of low-income families. At the very least, alternative paths should be explored – including the possibility of a low-cost Roth IRA offered by national financial services firms.

On Structure and Financial Issues
Michael Sherraden and Margaret Clancy

The first priority should be to build an inclusive policy structure with the potential to create an account for everyone and provide progressive funding. While 529s are not perfect in this regard (no policy is), 529s have many desirable features on which to build. We return to this theme at the end, but first let us turn to financial points raised above. These points can benefit from clarification.

Saving purposes

As we stated at the beginning, it would be desirable for low income households to save in an account structure that is not limited to educational use, though we do not think this is a major issue.

There is also merit in a saving policy that focuses on post-secondary education. This policy can serve to focus parents and children toward educational goals.[27] Given the huge economic importance of post-secondary education on earnings potential, this would be desirable.

Available aid for college does not cover costs for most (or even many) low-income families. The College Board states that "financial barriers to college enrollment remain a particular issue for low-income families and students" (The College Board, 2003b).

> After accounting for the average grant aid per enrolled student, net tuition and fees at public four-year institutions averaged about $1,700 in 2002-03, compared to the published price of $4,115. At private four-year colleges and universities, grant aid from all sources reduced the tuition and fees paid by the average student from the published level of $18,596 to about $11,300. However, these averages conceal the reality that the distribution of grant aid has changed in recent years, with a declining share of grants being awarded to the lowest-income students (The College Board, 2003a).

Low-income families with children face considerable challenges in paying for their own and their children's education. Also, the low-income population is made up disproportionately of people of color, who also have much lower asset holdings (Oliver and Shapiro, 1995, discuss wealth of African Americans), and lower college attendance rates. Any policy that would increase savings for college among low-income people would have the effect of reducing both class and racial inequality.

We also think that, over time, it may be possible to expand the 529 policy structure to include saving for other purposes. This has already occurred, for example, with IRAs, which have evolved into Roth IRAs.[28] Policy is always fluid. The most useful perspective is to think about what policies can become.

Penalties

As noted, under existing 529 rules, households that do not use the funds for higher education pay ordinary income taxes and face a 10 percent penalty on accumulated earnings.

However, to keep this in perspective, *all* existing structured, tax-benefited savings policies have penalties. For a balanced view, two additional points are important: (1) 529 savings can be transferred for use by other members of the nuclear or extended family, and (2) the potential ordinary taxation and penalty is on 529 plan *earnings*, not the savings balance. Thus, the financial impact of these potential penalties will be non-existent or small for the vast majority of families.

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[27] In CSD's qualitative research on IDAs, one of the strong themes is that IDA savings for a particular purpose creates a goal or "road map" (one participant's words) that focuses attention and improves saving and other behaviors toward that goal. See Margaret Sherraden et al. (2004).

[28] President Bush now proposes changing the pre-paid taxation principles of Roth IRAs further into programs of Retirement Savings Accounts and Lifetime Saving Accounts. The latter would have no restrictions on use.

Roth IRAs have a greater range of allowed uses, but have identical penalties for nonqualified use. If a low-income individual needs to use Roth IRA funds for an emergency such as job loss, car repair, or a family member's funeral, the penalty would be the same as with a 529 nonqualified withdrawal.[29]

Plan expenses and net financial returns in 529s

To accumulate assets over time, it is important to save in accounts with low expenses. However, we should not lose site of the fact that it is net returns that matter, and also keep in mind that low-income families currently have limited saving options.

We turn first to expenses. Many states have 529 plans with low fees. TIAA-CREF and Vanguard offer total 529 fees as low as 0.65% annually with no additional charges. In comparison, industry average fees for mutual funds are 1.24% for stocks, 1.13% for bonds, and 0.46% for money market funds (Ma and Fore, 2002). TIAA-CREF is program manager in twelve states, and Vanguard administers plans in three states. In other words, there are at least 15 states with 529 fees that are about *half* those of the average stock mutual fund. Other states also offer low-cost plans.

Even among low-cost 529 providers, plan expenses may be somewhat higher than investment in a similar fund outside the 529 plan.[30] One reason for higher fees is the added costs of outreach to families of all income levels and other inclusive features required by state governments. Outreach is fundamental to a primary goal of inclusion. In contrast, no similar outreach occurs by IRA providers. IRA providers have shown little interest and invested very few resources in trying to reach low-income families.

In the current system of 529s, these inclusive features are borne by the provider or the state and then incorporated in the fee structure. As a possible alternative in the future, it would be desirable for the costs of inclusion in 529s—outreach to employers and community-based organizations, special mailings, telephone hotlines, matching deposits and scholarships for the poor, low-minimum deposits, and holding very small account balances—to be supported by federal and state subsidy.

In other ways, state control in 529s lowers fees. In some cases, the centralized asset management with a single provider enables participants to pay lower fees due to economies of scale (e.g., New York participant fees decrease as the total plan assets increase; Utah reduced plan fees this year as a result of increasing assets).[31] Also, there are precedents for

[29] If the family were eligible for a state income tax deduction for the original contribution, they may have to report additional state "recapture" income.

[30] This point is somewhat more complicated than Orszag puts it. In many 529 plans, states charge one fee for a selection of funds; some fees could be higher and some lower than regular investment fees, depending on the specific fund investment.

[31] In New York's 529 College Savings Program, Direct Plan participants' total fees are 0.60% when total assets are below $2 billion; 0.58% when assets are $2 billion to $4 billion; 0.56% when assets are $4 billion to $5 billion; and 0.55% when assets exceed $5 billion (at 12/31/03 assets totaled 1.9 billion). Due to increased total assets, Utah

administrative fee rebates in 529 plans. Many states assessing administrative fees reimburse these amounts to state-residents, and Rhode Island reimburses account maintenance fees to 529 Matching Grant Program (low-income) participants.

What is the overall picture? In one assessment, out of a total 72 plans (some states have more than one plan), *Money Magazine* recommends 12 low-fee plans for "state residents buying direct" and four low-fee plans for "residents and national shoppers," while issuing warnings on 23 plans with high fees (Wang, 2003). Thus, 22 percent are called low-fee, and 32 percent are called high-fee. Our point is not that all state 529 plans have low costs, but that many states have low-cost plans. [32] We are interested in the low-cost plans as policy models.

At the household level, an option for low-income families, who may not qualify for a state tax benefit anyway, is to invest in a low-fee 529 in another state. *No low-income family has to be stuck with a high-cost 529 plan*.[33] The best strategy for protecting the poor from high cost 529 plans is to inform and assist them in investing in state plans where costs are lower. In the larger picture, if demand for high cost plans decline enough, market forces will eventually push them out.

In this discussion, it is also useful to note that the costs of 401(k) plans are far greater than the costs of similar investments outside the 401(k) plan. Legal, record keeping, and trustee fees in 401(k) plans are "hidden" because the employer pays them as part of the benefit structure for employees or they are charged against fund earnings.[34] This may illustrate two things: (1) outreach and inclusion has costs, and (2) most middle and upper income households are benefiting from such outreach, and someone is paying the costs.[35]

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switched from Vanguard Admiral to Institutional shares, reducing participants' expense ratio from .18% to .10% for certain funds.

[32] Broker-sold plans potentially add another type of fee, and additional broker-sold plans are on the rise. Broker commissions can substantially increase fees, sometimes increasing costs by 100% over direct-sold plans. However, the CSD state survey responses indicate that no state 529 savings plan sells funds exclusively through brokers (Clancy & Sherraden, 2003). States offer both a direct-sold and a broker-sold option, though it is clear that brokers do not target low-income clients. This is another middle and upper class issue. Low-income people are not likely to be working through brokers.

[33] In this regard, concerns about 529 plan expenses apply more to high and middle income families than to low income families. Families who have an income tax liability typically give up 529 state tax benefits when using a plan from another state, while low income families with no tax liability do not.

[34] Using 401(k) Provider Directory data, the Profit Sharing/401(k) Council of America (PSCA) estimates that 401(k) plan average expenses range between 1.15% and 1.30%, depending on plan size. These figures do not include the additional cost of information, seminars, and other outreach in the workplace. Compare these fees to total costs of 529 plan investments offered by TIAA-CREF and Vanguard at 0.65% to 0.80%.

[35] In the case of 401(k) plans, a labor economist would say that account holders are effectively paying all of the plan costs, which are calculated into total compensation.

Finally, what ultimately matters is *not fees, but net return.* 529 savings plans, by getting people to focus on college saving and by allowing access to higher yielding investments than bank savings accounts, may increase net return. For example, net of fees, TIAA-CREF's guaranteed investment product in 529s returned between 3.5% and 4.1%,[36] much higher than a typical bank savings account return of much less than 1%. Higher net returns are also possible with stock and bond investments in 529s, which are available to low-income families because of the very low initial deposit requirements that are not available outside of 529s.

Interactions with college aid

The facts strongly indicate that low to moderate income families saving for college in 529 savings plans will not be penalized in college aid calculations. We turn first to federal financial aid, which makes up the largest portion of financial aid. Two important asset exclusion policies are essential to take into consideration. First, federal financial aid tests exclude all assets (including 529 savings) from consideration if (1) the family is not required to file an IRS 1040 (i.e., meets the requirements to file a 1040A or 1040 EZ) and (2) income is less than $50,000 (U.S. Department of Education, 2003). Since assets for these families are not included in the aid calculation, 529 saving does not affect the amount of financial aid (Ma & Fore, 2002). Estimates indicate that this exclusion of all assets from financial aid tests would apply to more than half of tax filers of families with children in the $50,000 income range.[37]

Second, based on the parents' ages at the time financial aid is requested, an asset protection allowance exempts a specific value of parental assets from financial aid calculations. For example, if the oldest parent of a married couple is 36 years old when the child starts college and has $27,300 in a 529 savings plan and no other investments (other than a home and retirement assets, which are already excluded), the financial-aid package would not be reduced by the 529 savings. Exemptions are higher with age (see Appendix C). Since most low-income Americans hold few financial assets outside of retirement accounts, their 529 savings plan assets, and all other financial assets, would be excluded from aid calculations.

Taken together, *these two asset exclusion policies make 529 savings plan interaction with college aid a non-issue for the vast majority of low-income families*.

With very few exceptions, 529 savings impact on financial aid is an upper-middle and upper class issue. Ma (2003) points out that "the commonly referred to 5.64 percent marginal rate for parental assets in the EFC calculation is overstated for the majority of families in that only families with very high incomes are subject to the maximum 5.64 percent rate for all assets above the asset protection allowance."

The "20% or above" implicit tax rate mentioned in the preceding section assumes 1) savings amounts sufficient to last for four years of college and thus "taxed" for four years, which is much

[36] Returns represent twelve-month trailing figures for the period ended September 30, 2003; performance varied by state.

[37] These figures are based on Urban-Brookings Tax Policy Center estimates, for which we thank Orszag.

less likely for those with lower incomes; and 2) participants who do not qualify for the two extensive asset exclusion policies noted above. Similarly, Dynarski (2003), using contribution levels and withdrawal estimates consistent with middle and upper-middle income households, warns of negative implications for financial aid from college savings, but her reasoning does not apply to families with low to moderate incomes.

Turning to college aid at the state level, in our survey of state 529 programs, 44% of states report that 529 savings are excluded from calculations of state financial aid for college (Clancy and Sherraden, 2003). Thus, there are constructive policy precedents at the state level as well. Again, it is the policy models we are interested in.

Potential for inclusion, climate of innovation

The first priority should be to aim for a policy that can give everyone an account. As we have shown, states have reached out to lower income populations, creating low minimum deposits, matching 529 savings accounts, and taking other inclusive measures. The potential for expansion of these inclusive features is promising.

529 savings plans are in the early stages of implementation at both the federal and state levels. These early, formative conditions make 529 savings plans open to influence and policy development.

It is clear in our research on state 529 plans that state officials are still developing policies and are interested in inclusive features. In conducting the survey, several State Treasurers and other officials asked for more information on inclusive measures in other states and eighty-six percent of respondents agreed or strongly agree that plans should include more low-income participants. There is a climate of 529 innovation in the states.

In contrast, no such climate exists with IRAs. No provider of IRAs is seeking to bring in more low income people, nor is there a plan administrator, such as the State Treasurer or savings plan board, to direct them to do so.

Conclusion

Creating a universal and progressive asset building policy will require an understanding of policy systems. It will not happen simply as a result of financial incentives in the market. For example, financial incentives in the market is not the way we, Orszag, and millions of other Americans hold our retirement savings. We participate in structured plans that are heavily institutionalized and paternalistic. We have organization in the workplace, abundant information, and automatic deposits. It is likely that an eventual inclusive asset-based policy will be also fully institutionalized, perhaps even automatic for everyone, as in the Child Trust Fund in the United Kingdom (see H.M. Treasury, 2003).

In order to achieve a universal, progressive policy, it will be necessary to think beyond a financial planning perspective of what might be good for a single individual or family. A suggestion that, for example, some people will be better off in a particular circumstance with a

Roth IRAs does not take into consideration policy features that might bring in the whole population, and is unlikely ever to lead to an inclusive policy.

Orszag plays the devil's advocate in raising the negative financial issues. This serves a valuable purpose. Drawing up a list of negatives can help us note potential pitfalls, and our thinking has benefited from this exchange. But ultimately, this is not what matters most. What matters in policy development are positive features that can be built upon.

529 savings plans also have positive financial features. Many 529 plans are low cost, and net returns are potentially higher than would otherwise be available. The vast majority of 529 plans have very low initial deposit requirements, far lower than for IRA investments offered by the same investment companies. Some states match funds for low income participants. Some states provide scholarships for low income participants.

In America, where future federal policy is often hammered out first in the states, state level innovations in 529s are not irrelevant or inconsequential. They are a resource for future federal policy development. In contrast, nowhere near this level of innovation for inclusion is occurring in IRAs.

Overall, the financial issues raised in the preceding section are more about investment decisions by middle and upper income families than about creating an asset building system that includes those with lower incomes. In fact, 529 savings plans as they exist have many financial features that are desirable for low and moderate income households, especially in certain states. And the potential to use the 529 platform for policy change toward a universal, inclusive policy is considerable.

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Appendix A

State 529 Savings Plan Lowest Minimum Contribution Levels for New Account Holders		
State	**Initial Investment**	**Monthly Commitment***
Nebraska	$0.00	$0.00
North Carolina	$5.00	$5.00
Louisiana	$10.00	$10.00
Hawaii	$15.00	$15.00
Ohio	$15.00	$15.00
California	$25.00	$15.00
Colorado	$25.00	$15.00
Connecticut	$25.00	$15.00
District of Columbia	$25.00	$25.00
Florida	$25.00	$15.00
Georgia	$25.00	$25.00
Idaho	$25.00	$15.00
Illinois	$25.00	$25.00
Kentucky	$25.00	$15.00
Michigan	$25.00	$15.00
Minnesota	$25.00	$15.00
Mississippi	$25.00	$15.00
Missouri	$25.00	$15.00
New York	$25.00	$15.00
North Dakota	$25.00	$25.00
Oklahoma	$25.00	$15.00
Pennsylvania	$25.00	$25.00
Tennessee	$25.00	$15.00
Texas	$25.00	$15.00
Utah	$25.00	$25.00
Vermont	$25.00	$15.00
Indiana	$50.00	$25.00
Iowa	$50.00	$25.00
West Virginia	$100.00	$15.00
Alabama	$250.00	$25.00
Alaska	$250.00	$50.00
Arizona	$250.00	$25.00
Arkansas	$250.00	$50.00
Maine	$250.00	$50.00
Maryland	$250.00	$25.00
Montana	$250.00	$25.00
Nevada	$250.00	$50.00
New Jersey	$250.00	$50.00
New Mexico	$250.00	$25.00
Oregon	$250.00	$25.00
Rhode Island (state residents)	$250.00	$50.00
South Carolina	$250.00	$50.00
South Dakota	$250.00	$50.00
Virginia	$250.00	$25.00
Wisconsin	$250.00	$25.00
Delaware	$500.00	$50.00
Kansas	$500.00	$25.00
Massachusetts	$1,000.00	$50.00
New Hampshire	$1,000.00	$50.00

**Initial investment is waived if commitment is made to monthly investment through automatic contributions.

Appendix B

Access for Low-Income Families: Comparison of 529 and IRA Minimum Contribution Levels for New Account Holders				
	529 Savings Plan*		**IRA**	
	Initial Investment	**Monthly Commitment****	**Initial Investment**	**Monthly Commitment****
TIAA-CREF	$25	$15	$2,000	$50
Vanguard	$25	$25	$1,000	Not allowed***
Fidelity	$1000	$50	$2,500	$200

*We select these three providers for comparison because 1) they serve as 529 savings plan managers for the largest number of states and 2) rank nationally among the top providers of mutual funds.[38] The TIAA-CREF data apply to California, Connecticut, Georgia, Idaho, Kentucky, Michigan, Minnesota, Mississippi, Missouri, Oklahoma, Tennessee and Vermont. Vanguard 529 savings plan information applies to Utah, yet Vanguard is also the state manager for New York and Iowa (New York's minimums are slightly lower, Iowa's minimums are slightly higher. See Appendix A for investment minimums). The Fidelity data apply to Massachusetts and New Hampshire. Delaware, with a substantially lower 529 savings plan minimum investment, also uses Fidelity as the state's provider.

**Initial investment is waived if commitment is made to monthly investment through automatic contributions.

***Vanguard does not allow new account holders to contribute via an automatic investment without an initial investment of $1,000.

[38] The Investment Company Institute ranks all mutual fund companies by total mutual fund assets under management. Fidelity Investments ranks first, Vanguard Group second, and TIAA-CREF ranks ninth.

Appendix C

Education Savings and Asset Protection Allowance* Amount of Assets Exempt from Federal Financial Aid Calculations Based on Age of Oldest Parent					
Age of older parent as of 12/31/2004	Allowance if there are two parents	Allowance if there is only one parent	Age of older parent as of 12/31/2004	Allowance if there are two parents	Allowance if there is only one parent
25 or less	0	0	45	42,100	19,700
26	2,500	1,200	46	43,200	20,100
27	5,000	2,300	47	44,200	20,500
28	7,400	3,500	48	45,300	21,000
29	9,900	4,700	49	46,500	21,500
30	12,400	5,900	50	47,900	22,000
31	14,900	7,000	51	49,100	22,600
32	17,400	8,200	52	50,300	23,100
33	19,800	9,400	53	51,800	23,700
34	22,300	10,600	54	53,100	24,200
35	24,800	11,700	55	54,700	24,800
36	27,300	12,900	56	56,000	25,400
37	29,800	14,100	57	57,700	26,100
38	32,200	15,300	58	59,400	26,700
39	34,700	16,400	59	61,200	27,500
40	37,200	17,600	60	63,000	28,100
41	38,100	18,100	61	65,200	28,900
42	39,100	18,400	62	67,100	29,800
43	40,100	18,900	63	69,000	30,600
44	41,100	19,200	64	71,300	31,400
			65 or over	73,700	32,300

*The ESAPA is the amount of the parent's savings and investments that the government protects in the Federal Methodology (FM) for financial aid. The assets protected under ESAPA are in addition to a family's home equity and retirement funds.

Source: US Department of Education EFC Formula, 2004-2005