Volume 26, January 2006

Policy Points

A publication of the Southern Good Faith Fund Public Policy program

Expanding Access To College in Arkansas:

A 529 College Savings Plan Match Policy

In a recent study, Arkansas ranked next to last in the nation in attainment of both two-year and four-year college degrees. Arkansas households also varied greatly in degree attainment by income levels. Among the wealthiest one-fifth of Arkansas households, 40 percent have a college degree. Among the poorest one-fifth of Arkansas households, the figure is strikingly smaller—**just 3 percent**.[1]

There is a great need in Arkansas to improve higher education attainment, particularly among lower-income households. The social and economic benefits of doing so are immense. State policy should support this goal at every opportunity, and a 529 college savings plan match policy presents such an opportunity.

The social and economic benefits of increasing higher education attainment are well known. In 2003, the median earnings for a high school graduate were $30,766, while college graduates had median earnings of $49,889.[2] This disparity in earnings among workers with different levels of education has grown over the past 25 years. Over their working lives, individuals with bachelor's degrees will earn $2.1 million on average, nearly twice as much as high school-educated individuals.[3]

Furthermore, a 2002 report by the Arkansas Department of Higher Education estimated that the fiscal impact from increasing the attainment of college in Arkansas to the national average would generate an additional $2 billion to $7 billion in state revenues—revenues that could be invested in further economic development infrastructure improvements including K-12 and higher education improvements.[4] Finally, states with a better educated workforce are best positioned to benefit from the increasing global economy in terms of developing and attracting business growth.

Access to Financial Aid

The most basic way to improve higher education attainment is to provide greater access to financial aid so that more individuals can afford to pay college tuition. As the table below indicates, college tuition costs are climbing rapidly, pricing college out of reach for more and more families every year. Since 1980, the cost of higher education has been rising more rapidly than the Consumer Price Index, according to the College Board.

Average Annual Higher Education Costs 2004-2005

School Type	Cost	Percent change from 2003-04
Two-year public	$2,076	8.7%
Four-year public	$11,354	7.8%
Four-year private	$27,516	5.6%

Source: Trends in College Pricing, 2004, The College Board. (Costs include in-state tuition, fees, room and board.)

Compounding this trend of rising tuition, especially for lower income families, is the fact that recent financial aid increases have been in the form of loans, not grants or scholarships.[5] Loans have to be repaid; grants and scholarships do not.

Additionally, need-based grants and scholarships are becoming less available compared to merit-based grants and scholarships. Between 1993-94 and 2002-03, state merit-based aid grew from $304 million to $1.2 billion—an increase of approximately 300 percent. Comparatively, stated need-based aid grew from $2.75 billion to $3.97 billion, an increase of only 44 percent.[6]

Given these dynamics, increases in need-based aid, especially in the form of grants or scholarships, is a national need, and particularly a need in high poverty states like Arkansas.

Section 529 College Savings Plan

Recognizing the economic and social benefits of increasing educational attainment, as well as the continually rising cost of college tuition, federal and state lawmakers have developed a number of innovative programs to make higher education financially accessible to more Americans. In recent years, qualified tuition programs have become a popular program for financing higher education expenses. These programs, known as "529 plans" for the section of the tax code that authorizes them, are investment plans designed to pay for future qualified higher education expenses.

In 1996, Congress authorized 529 college savings plans to allow individuals to contribute to an account to pay a beneficiary's qualified education expenses including tuition, fees, books, supplies, and room and board. The value of 529 college savings plans is based on the money contributed by the account holder and the performance of the investments or investment strategy chosen.

Contributions to 529 college savings plans have been growing as the public has become more aware of their value as savings vehicles. A survey of state 529 college savings plans indicates that assets held in such plans grew from $200,000 in 1998 to $52.2 billion at the end of 2004. The number of accounts rose to more than one million, and the average savings amount was $9,700.[7]

Broader Participation

In their current form, the benefits of 529 college savings plans flow largely to middle and upper income households—those families with the ability to save enough to make participation in the plan a useful savings tool. This same trend is apparent in many tax-preferred savings accounts including IRAs, where households with higher incomes and larger income tax liabilities are most able to take advantage of these savings incentives.[8]

To broaden the scope of families that can benefit from 529 college savings plans, particularly to encourage and enable lower income families to benefit, some states offer an incentive in the form of a savings match. A savings match matches, within limits, the contributions families are able to make on their own, thus making 529 college savings plan participation more attractive and worthwhile as a savings tool for families with limited capacity to save significant amounts on their own.

The documented success of matched savings accounts in the form of Individual Development Accounts (IDAs) has proven that given the right incentives low-income individuals can and will save for the purchase of a major asset including a college education.[9]

Currently, there are several states that offer a savings match within their college savings plans. Match rates, match caps, and other features vary by state. For example, some states offer matches only in the first year of participation, and others impose an age requirement for match eligibility. The following is a summary of savings match plans of three states:

"In their current form, the benefits of 529 college savings plans flow largely to middle and upper income households."

Rhode Island. Established in 2003, Rhode Island's college 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 percent of the poverty level, and families with an AGI between 201 percent and 300 percent of the poverty line are eligible for a 1:1 match ($500 maximum per account) annually for five years. To be eligible for a match, the college savings plan account must be opened when the child is 10 years of age or younger.

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 percent of all amounts contributed, up to an annual maximum grant of $100 for any one beneficiary.

Louisiana. Louisiana Student Tuition Assistance & Revenue Trust (START) college 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 percent of contributions for those families with an AGI up to $29,999 to a low of 2 percent for incomes of $100,000 and above.

Policy Recommendation

The Future Scholars Grant Program

Arkansas should establish a progressive 529 college savings plan match policy. A proposed name for the match plan is the *Future Scholars Grant Program*. A progressive savings match based on family income will enable a broad range of families to benefit from the plan, while focusing most of the help on those families who need it most.

The following is a proposed design for the *Future Scholars Grant Program*. Under the program, savings matches will only be available to individuals who are Arkansas residents and whose family income is below 300 percent of poverty. The savings matches will be distributed on an annual basis, based only on the participant's yearly savings and not on earnings on investments. The match rates will vary depending upon the adjusted gross income of the family of the accountholder. As shown in the table below, families with incomes at or below 100 percent of poverty will get a 3:1 match. Families with incomes between 101 percent and 200 percent of poverty will get a 2:1 match. Families between 201 percent and 300 percent will get a 1:1 match.

Family Income Eligibility Criteria

Adjusted Gross Income (family of four*)	Minimum Deposit	Match Ratio	Maximum Annual Match
$19,350- and below	$25	3:1	$1,500
$19,351-$38,700	$50	2:1	$1,000
$38,701-$58,050	$100	1:1	$500

* 2005 U.S. Department of Health and Human Services Poverty Guidelines, accessed at www.aspe.hhs.gov/poverty/05poverty.shtml

Matching savings or grants will only be made on the first $500 saved per year in the plan by the accountholder or participant. Participants who qualify for the 3:1 and 2:1 savings match will have the minimum deposit of $250 reduced to $25 and $50, respectively. Current minimum deposits of $250 are a significant barrier to participation for low-income individuals. But some minimum deposit is beneficial for purposes of establishing accountholder commitment to making future contributions.

The Potential Value of a Savings Match

The next table provides a comparison between the balance of an account with a 3:1 match and the balance of an account with no match. Both balances assume a $100 yearly contribution by the account holder and an annual return of 6 percent. The balance of the account without a match will not cover tuition for two years at a state two-year college, which is the minimum amount of time in which an associate's degree can be earned. In contrast, the balance of the matched account, even with a very modest $100 annual accountholder contribution, is enough to pay for three years of tuition and fees, excluding room and board, at a four-year public college.[10]

Account Comparison With and Without Match

Yearly Contribution	Years	Avg. Return	Account Value
Without Match $100	18	6%	$3,276
With 3:1 Match $100+$300= $400	18	6%	$13,104

Estimated Cost

In Rhode Island, 1.3 percent of all the state's 529 college savings plan accountholders currently are receiving the state's savings match. In Minnesota, 1.5 percent are receiving the match.

These participation rates from states that have a 529 college savings plan match policy for low-income families provide a reasonable starting point for estimating how many Arkansans may be eligible for a similar savings match if the state adopts one. However, since Arkansas has about twice as many families in poverty as these two states on average, a higher estimate, such as 3 percent, is a better estimate for Arkansas.

The Gift Plan, Arkansas' 529 college savings plan, currently has 10,965 open accounts. 7,855 of these accounts are owned by Arkansas residents, which again are the only participants eligible for the *Future Scholars Grant Program*. Three percent of 7,855 equals 235 potentially eligible account holders.

Assuming the 235 participants receive the maximum amount of yearly savings match allowed under the *Future Scholars Grant Program*, and the participants are evenly distributed among the three categories of match rates (3:1, 2:1, and 1:1), an average yearly savings match amount can be estimated to be $1,000 per participant. (Participants in the 3:1 match rate category will receive a $1,500 maximum savings match, participants in the 2:1 category will receive a $1,000 maximum savings match, and participants in the 1:1 category will receive a $500 maximum savings match).

Multiplying the estimated average yearly match of $1,000 times the 235 estimated number of potentially eligible participants, yields a generous estimated total annual cost for the *Future Scholars Grant Program* of $235,000.

This estimated cost is likely generous or high for several reasons. First, it is very unlikely that all participants will receive the maximum savings match amount per year. This is still true for mature plans such as Minnesota and Rhode Island. Furthermore, most participants will be in the 1:1 and 2:1 match category. In both Minnesota and Rhode Island there are many more matches made at the lowest match rate than the higher rates. In 2003, the average match contribution for Minnesota was $422 [11]; for Rhode Island it was $553 in 2004.[12] In Rhode Island, the total cost in the first several years of their 529 college savings plan match policy was $50,000 in year one, and $80,000 in year two. In Minnesota in year one, the total cost was about $42,000.

> **"A progressive savings match will enable a broad range of families to benefit, focusing on the families who need it most."**

Potential Sources of Match Funds

The source of match funds for those states with a 529 college savings plan match policy varies from state to state. Some states, like Michigan, receive an annual state appropriation. Other states such as Rhode Island are able to fund their match through a combination of out of state fees and state administrative fees.

As of July 31, 2005, *The Gift Plan* had 10,965 open accounts with assets of $129,757,744. Each account is charged an annual fee of 0.85 percent. This fee consists of a 0.25 percent investment services fee, a 0.45 percent management fee, and a 0.15 percent state administrative fee. For fiscal year 2005 the state administrative fee generated $202,500.The state has budgeted $70,000 of the revenues from the administrative fee for auditing and legal fees. $132,500 of the fee is currently unobligated.

These annual unobligated administrative fee revenues are the most obvious funding source for the *Future Scholars Grant Program*. Based on the generous $235,000 annual cost estimate provided above, the annual revenue from these fees would provide well over half of the needed funding for the *Future Scholars Grant Program*.

The Section 529 Review Committee, which makes decisions about administrative matters related to *The Gift Plan*, reports a surplus of unobligated administrative fee revenues of $900,000 which have been building since 1999. This surplus revenue is another obvious source of funding for the *Future Scholars Grant Program*. This $900,000 could be placed in a trust to generate annual interest revenues to make up any yearly shortfalls in funding that the annual administrative fee revenues are not able to cover.

In the event that not all of the earned interest from the trust is spent, which will likely be the case in the early years of the *Future Scholars Grant Program*, the unspent interest can be returned to the trust to build the capacity to yield higher interest revenues when they are needed. Any administrative fee surpluses in future years, which also are likely in the first few years of the *Future Scholars Grant Program*, can be deposited in the trust to build the trust principal.

As participation in *The Gift Plan* grows, so too do the revenues from the administrative fee. A savings match, by encouraging additional participants to join *The Gift Plan*, in part self-funds its growth by increasing the administrative fee revenues.

In the event that the state administrative fee revenues and the interest from the trust are not enough to cover the costs of the *Future Scholars Grant Program*, the principal of the trust may be drawn down to cover additional costs.

Any amount of the principal removed from the trust could then be replenished by a state appropriation. Alternatively, a state appropriation could be used to make up for any shortfall, leaving the principal in the trust untouched.

Another funding scenario is to provide an annual appropriation to fund the *Future Scholars Grant Program*. Yet another scenario is to establish a trust with a one-time $1 million appropriation from the state, which could be added to the $900,000 in surplus administrative fees. The interest earned from such a large fund could fund the *Future Scholars Grant Program* for many years. The annual surplus administrative fee revenues could then be added to the trust principal yearly for as long as is needed to build the principal to a level that provides all the revenue needed to fund the *Future Scholars Grant Program*.

Finally, an advertising and outreach campaign would be needed to promote awareness of the *Future Scholars Grant Program*. Such a campaign will need to be fit into any funding scheme.

Conclusion

The *Future Scholars Grant Program* is an excellent policy opportunity for Arkansas. It is a low-cost and potentially revenue-neutral policy that can be funded largely by putting existing state revenue resources to better use.

It would also fill an important void in the kinds of financial aid available to Arkansas students.

Although Arkansas has several notable state financial aid programs for high school students, including the Academic Challenge and the Governor's Distinguished Scholars, these programs are merit-based to some degree. As such, these programs are not as accessible as a strictly need-based program to low-income students, many of whom are still in under performing public schools. Furthermore, Arkansas' primary exclusively need-based program, the Workforce Improvement Grant (WIG), only targets adult students.

Arkansas simply must do everything it can to improve the educational attainment of its residents, especially those most in need of opportunities to improve their education and that of their children. The economic and social benefits of doing so are immense and have eluded Arkansas for too many generations. The *Future Scholars Grant Program* offers one more policy Arkansas can employ to help realize this critical state need.

Endnotes

[1] CFED, *2005 Assets and Opportunity Scorecard*, May 2005.

[2] Postsecondary Education Opportunity, Education and Training Pay. See www.postsecondary.org/archives/Posters/EducTrain04.pdf.

[3] U.S. Census Bureau, *The Big Payoff: Educational Attainment and Synthetic Estimates of Work-Life Earnings*.

[4] Johnston, Robert and Hardin, Lu. *Student Success: Graduation and Retention in Arkansas*. Arkansas Department of Higher Education, July 2001.

[5] The College Board. Trends in College Pricing, 2004.

[6] 35th Annual Survey Report on State-Sponsored Student Financial Aid, 2003-04 Academic Year. See www.NASSGAP.org.

[7] Investment Company Institute, see www.ici.org/issues/edu/529s_3-05.html

[8] Dynarski, Susan. *High-Income Families Benefit Most from New Education Savings Incentives*, Urban-Brookings Tax Policy Center, No. 9 February 2005.

[9] CFED, *2005 Assets and Opportunity Scorecard*, May 2005.

[10] Annual Survey of Colleges, The College Board, New York, N.Y.

[11] *Minnesota College Savings Plan*, www.mhesto.state.mn.us/mPg.cfm?PageID=110.

[12] Mike Joyce, Administrator, *CollegeBoundfund* Matching Grant Program, Rhode Island.

APPENDIX A: Section 529 Savings Plan Details

Eligibility

Generally, any U.S. citizen or resident alien can establish a 529 savings plan for themselves or for another beneficiary, regardless of income level.

Contributions

Up to $10,000 per year ($20,000 if filing jointly) can be contributed into a 529 Plan without incurring a gift tax. Alternatively, a lump sum of $50,000 ($100,000 if filing jointly) can be contributed in one year if the contribution is counted for five years. In addition, states may impose caps on the total amount that can be saved in a 529 Plan; Arkansas' is currently $245,000.

Tax Benefits

529 savings plan earnings are exempt from federal income tax. However, this federal income tax exemption is scheduled to sunset unless Congress acts before December 31, 2010. In addition to the federal tax benefit, most states exempt earnings from state income tax and many states offer a full or partial state income tax deduction for contributions. When savings are withdrawn for an eligible use, they are exempt from federal income tax and most state income taxes.

Eligible Uses

Savings can be used for a variety of educational expenses, including tuition, fees, books, supplies, and required equipment. For students attending school at least half time, savings can also be used for room and board costs. If withdrawals are made for a non-eligible use, the account owner would then have to pay income taxes on account earnings plus a 10 percent penalty. Alternatively, to avoid a tax penalty if the beneficiary decides not to attend college, the savings can be rolled into another family member's account or the beneficiary of the account can be changed. The 10 percent penalty is not assessed if the beneficiary does not use the account for an eligible use due to their death, disability, or receipt of a scholarship.

Eligible Institutions

Beneficiaries can use their 529 savings plans at any institution that is eligible to participate in federal financial aid programs administered by the Department of Education.

Interactions with Other Student Aid

Education tax credits—such as the Hope and Lifetime Learning credits—can be claimed in the same year that savings are withdrawn from a 529 plan. However, each must be targeted towards separate educational expenses. This principle is also applied to withdrawing money from both a Coverdell Education Savings Account and a 529 Plan—total withdrawals cannot exceed total educational expenses in a given year without incurring a tax penalty. Assets such as 529 savings plans are generally taken into account when assessing the extent to which a student should receive financial aid. Some states do not count 529 Plans as an asset when calculating state financial aid.

Prepared by Matt Price
Policy Analyst
Public Policy Program
1400 West Markham, Suite 302
Little Rock, AR 72201
Phone 501.372.1141
E-mail
mprice@southerngoodfaithfund.org

www.southerngoodfaithfund.org

Southern Good Faith Fund

Building communities. Changing lives.