New Agenda Series™

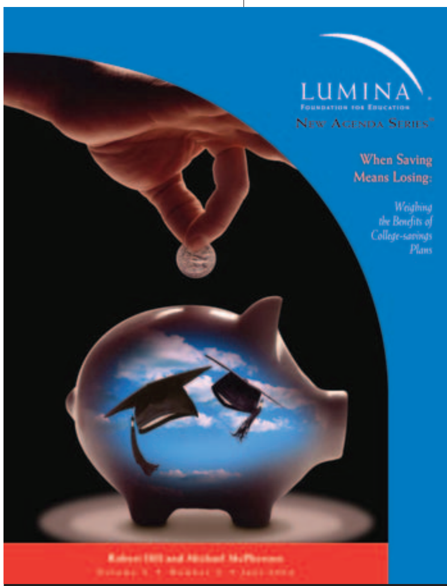
ILLUMINATIONS℠

Highlighting important research in postsecondary education access

The issue:

Postsecondary education is becoming more and more costly, but virtually everyone agrees that it remains an immensely valuable personal and social investment. For that reason, government programs that encourage families to save for college have grown and proliferated — particularly since the early 1980s, when college costs began their steady climb.

Since that time, the federal government has created the Hope Scholarship and Lifetime Learning tax credit programs. State governments also have instituted prepaid tuition plans and savings-incentive programs known as "529 plans" (in reference to the section of the Internal Revenue Service Code under which they were created). In fact, all 50 states have established college-savings programs or plan to do so soon, and in 2001, Congress passed a package of tax cuts that enhanced the tax benefits of these 529 plans.



College-savings plans seldom aid — and may even penalize — low-income families.

In short, policy-makers are doing all they can to encourage families to save for college. Yet, according to a recent study by economists Roberto M. Ifill and Michael S. McPherson, these savings-incentive efforts, however well intended, sometimes work to the detriment of lower-income families. Funds invested in a 529 plan can reduce a family's eligibility for need-based aid. In fact, depending on the formula used by a college in determining a student's financial aid eligibility, an increase in savings in a 529 plan may result in a dollar-for-dollar decrease in eligibility for scholarships, grants and loans.

The study, funded by Lumina Foundation for Education and titled *When Saving Means Losing: Weighing the Benefits of College-savings Plans*, systematically examines the interactions between college-savings plans and the need-based financial aid system.

The research:

The researchers analyzed how need-based awards are affected by an increase in assets held in various forms, including family income, a prepaid tuition plan, a 529 plan and a student savings account. Focusing on families with dependent students, they considered families in four separate income groups (less than $30,000; $50,000-$60,000; $80,000; $125,000 or more). The researchers also looked at colleges in three different price ranges: low (community colleges), medium (in-state "flagship" public universities), and high (private colleges and some out-of-state public institutions).

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The report's authors examined how a $100 increase in assets by a family in each of the income groups would affect the results of needs assessment at a college in each of the three price ranges.

THE FINDINGS:

- Federally subsidized college-savings programs often interact awkwardly with the need-based student aid system, sometimes inadvertently undermining the goal of encouraging families to save.
- Unlike wealthy families, low-income families have a financial disincentive to save for college: By saving, poorer families may reduce their eligibility for need-based aid as determined by the need-analysis system.
- The need-analysis system can reduce demonstrated need by widely varying amounts, depending on which savings instrument a family chooses.
- Families expecting to receive need-based aid would do better to invest in savings plans than in prepaid tuition plans. (The financial aid need-analysis system treats money in prepaid tuition plans as being readily available for college payment; these funds thus reduce need on a dollar-for-dollar basis.)
- The highest-income families — those with sufficient assets to be outside the need-based aid system altogether — are least likely to be influenced in their savings decisions by tax subsidies.
- If the government's intent is to use federal tax subsidies to encourage Americans to save more for college, it would be wise to direct those subsidies to lower-income families.

"If the goal is to use federal tax subsidies to increase the amount of college savings among families, focusing those subsidies on families of limited means is consistent with that goal."

— Michael S. McPherson, Spencer Foundation president and co-author of the report

WHAT'S NEXT:

Whether a parent invests in a 529 plan, a prepaid tuition plan or a savings account in a son's or daughter's name, the intent is the same: to put aside money for college. Likewise, there is little relevant difference among these programs from the standpoint of the federal interest in subsidizing higher education saving. Yet, a family choosing one of these plans over another may find their son's or daughter's need-based aid reduced modestly, substantially or dramatically, depending on which instrument they choose.

Clearly, there is good reason to better align the outcomes of college-savings plans with the intentions of those who created and support them. More research is needed on this issue – research that will inform a reasonable and productive conversation among policymakers and higher education officials as they work to encourage more citizens to enter and succeed in postsecondary education.

READ THE REPORT:

A copy of the report, *When Saving Means Losing: Weighing the Benefits of College-savings Plans*, is available in the Publications section of the Lumina Foundation Web site (**http://www.luminafoundation.org**). Free, printed copies of the full report also are available. To obtain a copy, or to request any of our printed material, please send an e-mail request to **aschramm@luminafoundation.org**.