**College Savings Plans: A Key Tool for College Financing**

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Families raising a child who plays basketball like the next Lebron James have little to worry about in terms of college financing. The next superstar will most likely receive full scholarships to the college of their choice. However, the rest of us aren't so lucky; most families are forced to finance college entirely on their own. It is estimated that it will cost a child born this year nearly $225,000 to attend a four-year public college when they turn 18. The cost at a private college will be more than double that: $475,000.

As the cost of post-secondary education continues to rise and state budgets constrict, financing college for students in lower-income families will become an increasing challenge. Investments that parents make when their children are young may be a critical component of the decision to attend college when that child turns 18. And yet the opportunities for lower income families to save and prepare for a child's education are few and far between.

College savings plans, named 529 plans after the section of the IRS code that created them, are one of the best ways to save money for a child's education. All the earnings on the investment are free from federal and state tax as long as you use your investment proceeds to pay for a college education. On top of that, many states, including those in the Washington, DC metropolitan area, offer residents generous annual tax deductions on their state income taxes for funds invested in their state's college savings plan.

529 plans come in two basic flavors: prepaid plans and investment plans. With a prepaid 529, parents are purchasing tuition credits at today's prices in return for the promise of an equal amount of free credits when the child turns 18 and attends an in-state college (and out-of-state or private colleges for those purchased in the DC metro area). By reimbursing the parents for the value of the current college credits they've purchased (or allowing the child to attend a local college using the credits), the prepaid 529 plan maintains the value of the saver's purchase against the rapidly increasing cost of higher education.

In an investment plan, parents invest in mutual funds or other financial instruments that have been designated by a state as part of the state's 529 plan. Generally speaking, parents may only invest in their own state prepaid plan but may invest in any state's investment plan.

Yet, despite the increasing need for assistance in college financing, 529 plans may not be the best option for lower-income families. While a college savings plan may provide an important psychological boost and security for the children in low-income families, it has a number of disadvantages for the parents. 529 plans usually cost more than an investment made in the same mutual funds that aren't a part of a state college savings plan. The tax savings that middle and high-income families experience from tax-free earnings and state tax deductions often handsomely offset this disadvantage. However, families in lower tax brackets will not receive as much tax savings as middle and high-income families simply because they pay at a lower marginal tax rate. A low-income family does not receive the same, or, in the worst case any, subsidy that a middle or high-income family receives for the same size investment.

Imagine two families, the Smiths and the Jones', each living in the District of Columbia. The Smiths are a low-income family in the 15% federal tax bracket and the 4% D.C. state tax bracket. The Smiths invests $1,000 into a 529 plan when their child is 10 years old, receiving a $1,000 tax deduction on their D.C. income taxes, saving them $40 in taxes. The savings grows to $2,000 by the time the child is ready for college, and when they withdraw the funds, the Smiths save $190 in taxes.

The Jones are a wealthy family in the 28% federal bracket and have a marginal D.C. tax rate of 8.5%. The Jones copy the Smiths investment exactly. Except that same $1,000 tax deduction saves them $85 in taxes. And they save $365 in taxes when they withdraw the funds – their total tax savings were nearly twice that of the Smiths.

If we look at a third family, the Johnsons, who pay no income taxes because of their low income, the situation is even worse. The Johnsons receive absolutely no incentive to invest in the DC College Savings Plan because it is impossible for them to lower their taxes at all. They already pay $0. Because the DC College Savings Plan deduction is non-refundable, the Johnsons have no tax incentive to invest in the Plan.

***Policy Recommendations***

One policy proposal to help families like the Smiths and the Johnsons would be to change the 529 tax deduction into a refundable credit. With a refundable credit, all families that save for their children's college education would receive the same benefit per dollar saved. In the example above, the District could adjust the credit so that families that invested $1,000 in a single year all received a tax credit of $85, regardless of their income. By offering a tax credit of 8.5% of all money invested in the DC College Savings Plan, up to an annual maximum of $4,000 ($8,000 for married couples), the District could ensure that the wealthy Jones' still received the same tax reduction they had previously while providing fairer incentives for low income families like the Smiths and Johnsons to invest.

On the federal level, the current Saver's Credit could be adjusted to include college savings. Currently, low-and-moderate income families who contribute to a retirement plan can get a tax credit of up to $1,000 ($2,000 for married couples) for contributions they make to a retirement account. The credit ranges from 10% to 50% of the contribution the family makes to a retirement account. Including college savings in the credit would be an easy way to give families like the Smiths and Johnsons more incentive to save for their children's future education.

As a college education becomes increasingly essential for job and income security, creating pathways and reducing barriers for everyone to attend post-secondary education is critical. Systemic changes are key in order to create equal opportunities for financing college; these policy recommendations will allow for lower income families to make investments in their children's futures.

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