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Leveraging 529 Savings Plans to Make Postsecondary Education Affordable for All

ideas42 POLICY LAB

529 savings plans allow families to save money tax-free for future education expenses—including tuition, books, fees, room and board, and some student loan repayments. When designed well, 529 savings plans can help families build savings and make postsecondary education more affordable. But these savings plans do not serve everyone equally, particularly families with low incomes and families of color. States that administer 529 savings plans should improve their programs to meet the needs of all families—thereby increasing the affordability of postsecondary education and advancing racial equity.

Postsecondary education, which includes four-year colleges and universities, two-year associate degree programs, vocational schools, trade schools, and some online programs, can provide families with a path to economic security. For example, compared to those with just a high school diploma, adults with a bachelor's degree report higher income, greater job satisfaction, and better health outcomes.[1,2] Yet almost 40% of high school seniors—about one million people each year—don't pursue higher education right out of high school.[3] While there are many reasons someone may not pursue higher education, those who haven't enrolled most often cite the prohibitive cost.[4]

The high cost of postsecondary education has implications for both racial and wealth equity. In addition to affecting families with low incomes, the prohibitively high cost of postsecondary education disproportionately affects families of color, who have been historically excluded from both institutions of higher education and wealth-building opportunities.[5] For example, students of color are less likely than their white peers to enroll in college and far less likely to graduate.[6,7] For these same reasons, students of color who graduate college are disproportionately burdened with student loan debt, which stymies their ability to build wealth in the future and perpetuates racial wealth gaps.[8]

Promoting access and equity in postsecondary education starts with making college affordable for everyone. Tax-advantaged 529 savings accounts are one way policy makers can increase the affordability of postsecondary education for families, by encouraging and incentivizing long-term savings habits. They can also help families foster a college-bound identity—the sense that college is achievable for their children.[9] But to truly work for all families, state 529 programs must be redesigned to explicitly increase affordability and close racial gaps.

Current 529 Plans Don't Work for Everyone

529 savings plans allow families to save money tax-free for future education expenses—including tuition, books, fees, room and board, and some student loan repayments.[10] These plans are provided by states and private organizations and are available to families across the country. 529 savings plans allow families to invest and grow their savings tax-free, and when families withdraw their funds for predesignated educational expenses, these withdrawals are excluded from federal income taxes (and some state taxes). Unlike other savings vehicles, like Coverdell Education Savings Accounts or Roth IRAs, 529 accounts have no limits on federal income, age, or annual contributions, and funds can be easily transferred to other family members.[11]

Because of the tax advantages and general flexibility of these accounts, 529 plans are the most popular education savings vehicle in the country: there are about 16 million 529 accounts currently open in the U.S., representing over $411 billion in assets.[12,13] On average, Americans save about $29,000 in a 529 account.[14] Yet families report only saving about half as much as they'd like for their children's college expenses.[15] In addition, 529 plans have not historically served all families equitably: people who make $150,000 or more a year, despite making up just under 20% of the U.S. population, account for 50% of all 529 savings plan owners.[16,17] Additionally, fewer than 1% of families making $75,000 or less currently save in a 529 account.[18] Families of color, who have been historically excluded from opportunities to build wealth, are also underrepresented among 529 account owners: only 17% of Black and Hispanic families use a 529 account to save for college, compared to 31% of white families.[19,20]

Redesigned 529 Plans Can Advance Equity in Education

To close wealth gaps in education, state policy makers and program administrators must redesign their 529 savings plans to specifically support families with low incomes and families of color in saving for college. At the ideas42 Policy Lab, we have leveraged our expertise in applied behavioral science to identify the two main ways states can do so: by creating slack and by removing barriers.

Create Slack for Families

One common reason families do not save in a 529 account is because they simply lack the extra room, or slack, in their budgets to make ends meet today and also save for tomorrow.[21] For many families, particularly families with low incomes and families of color historically excluded from wealth-building opportunities, saving for postsecondary education can feel less pressing than other expenses. The solution, however, is relatively simple: by increasing the resources families have, states can create slack for families and encourage longer-term planning, including 529 saving. This could be in the form of extra cash, financial rewards, or tax credits; even micro-incentives can have outsized impacts on savings behavior.[22] States should design these programs to particularly benefit families with the least slack in their budgets to advance equity. Specifically, states should consider:

- **Offering seed deposits or baby bonds** to newborn babies in the state that families automatically receive once they open a 529 account. These transfers—either as cash or direct deposits into the 529 account—not only encourage families to open an account but also have been found to improve education outcomes, increase economic security, and close racial wealth gaps.[23]
- **Providing bonus deposits** to families for completing certain saving behaviors—for example, a financial reward for making your first contribution or a matching grant for contributing a certain amount each year. Matching grants should be progressive, in that families with lower incomes get higher rewards than families with higher incomes. These bonuses benefit all families but particularly help families with lower incomes to save.
- **Creating a refundable state tax credit** for 529 savings. States should establish a state tax deduction for 529 contributions that is refundable, so that even families with the lowest or no income can benefit from 529 saving. Additionally, like matching grants, this tax credit should be progressive so that taxpayers with lower incomes don't need to contribute as much as taxpayers with higher incomes to earn the full credit. In addition to benefiting families with the lowest incomes, refundable tax credits have historically served families of color disproportionately.[24]

- **Connecting contributions to existing purchases.** States should consider partnering with organizations to automatically deposit a percentage of account owners' purchases at qualifying grocery stores and other local businesses into consumers' 529 accounts. This builds college savings into account owners' existing spending habits without requiring them to make separate contributions. These rewards could be targeted toward families with tight budgets, who might not otherwise feel they have the slack to save.

Remove Barriers for Families

Even for families with the ability to save, there are some restrictions related to 529 accounts that can make families hesitant to contribute. For example, once deposited, 529 savings are not easily accessible, causing some families to feel like they are losing financial liquidity. There are also strict rules for withdrawals, and nonqualified withdrawals face tax penalties. Finally, 529 saving can impact federal financial aid eligibility; although the benefits of saving almost always exceed any small impact on aid, families—especially those with the lowest incomes who rely the most on aid—may not want to risk it.[25] These rules do not trust families to make the best choices for themselves, and when people feel forced or coerced, they may avoid certain behaviors, even behaviors in their best interest. Families need to be trusted to save on their terms, and any rules that disempower families should be lessened or eliminated altogether. Both states and the federal government should take action to do this, including by:

- **Providing a grace period to take back deposited funds if emergencies arise.** States should consider allowing families to take back their deposited 529 funds without a tax penalty if more pressing and immediate needs arise within a certain period (e.g., 30 days after deposit). This allows families to save without sacrificing financial liquidity, and it also means families can be prepared if financial emergencies arise, both of which are meaningful ways to empower families and close racial wealth gaps.[26]
- **Allowing tax-free withdrawals during financial hardship.** The federal government should allow families to make tax-free withdrawals from their 529 account at any time after a deposit is made in instances of financial emergencies, similar to hardship distribution exceptions from retirement accounts.[27] This can function as another form of emergency savings for families beyond an initial grace period. In these cases, the federal government should not force families to provide documentation to prove their need and instead trust families that say they have met the conditions for a distribution.
- **Eliminating the impact of 529 saving on financial aid eligibility.** The federal government should also consider eliminating the impact of 529 saving on federal financial aid determinations, either for all families who save or just for families with annual incomes below a certain threshold. Currently, certain families with incomes below $50,000 can save in a 529 account without it impacting their federal financial aid eligibility, although the federal government should consider increasing this cap to ensure as many families as possible are saving.[28]

Conclusion

State-sponsored 529 college savings plans, when designed well, provide an opportunity to close educational equity gaps. Using insights from behavioral science, policy makers should design 529 programs to serve all families—particularly families with low incomes and families of color—by creating slack and removing barriers. Policies that create slack through seed deposits, bonus deposits, tax credits, and automatic saving via spending can help build families' actual savings, especially those with tight budgets. In addition, removing barriers regarding financial liquidity, withdrawals, and financial aid eligibility can increase people's willingness to save in a 529 plan in the first place, and can disproportionately benefit families of color.

Whether advocating for nationwide policy changes or implementing minor program tweaks,[i] state policy makers and 529 program administrators should continue to be thoughtful and creative about designing 529 plans to best support all families in building college savings and to advance equity in postsecondary education.

[i] Policymakers and program administrators who are excited about this work can go even further by thoughtfully designing for more subtle, often surprising behavioral barriers. See ideas42's additional work regarding intentional, behaviorally-informed program design for college savings.

Endnotes

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