How States Use Tax Incentives to Make College More Affordable for Their Residents

College costs rose exponentially over the last three decades. While states' historical investment in direct higher education subsidies gets most of the media attention, how and why states have leveraged the tax code to improve college affordability has gone largely unnoticed. This brief examines two tax-related methods states have used to reduce the financial burden of postsecondary education: qualified tuition plans and qualified student loan bonds. After highlighting the value consumers obtain from 529 plans and nonprofit and state-based student loan programs, this brief recommends options available to federal and state policymakers to expand these offerings to residents in their states.

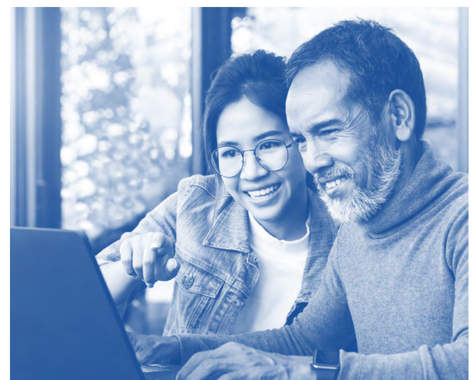
College Savings Plans

State-sponsored 529 plans, named after the part of the tax code that created them in 1996, help families save for college. As of 2023, more than $450 billion is invested in 529 plans across the country from more than 16 million open accounts.[1]

There are two types of 529 plans: college savings plans and prepaid tuition plans. College savings plans are generally available to anyone while prepaid tuition plans typically have residency requirements. Across all 529 plans, earnings grow tax-free and expenses are tax-exempt so long as they are for qualified higher education expenses. Qualified expenses include costs required for enrollment at a postsecondary institution such as tuition and fees, required books and supplies, and room and board. If money is withdrawn for non-qualified expenses, income tax will need to be paid on the earnings portion of the disbursement in addition to a ten percent penalty that is assessed on the balance. Some states also impose additional tax penalties for withdrawing funds for non-qualified expenses.

Nearly every state has a 529 plan, and many have multiple plans. Anyone can participate in most of these state plans no matter where they live, but some states have additional benefits available for state residents such as deductions to state income taxes for contributions to the account.

Many states, cities, and community groups also provide Children's Savings Accounts (CSAs), sometimes also called Children's Development Accounts (CDAs), which start with seed funding from the sponsoring government or group and may require parents to create a 529 account to access the funding. Maine was the first state to create a universal CSA with automatic enrollment at birth in 2013, and many states across the country have followed since. These seeded accounts encourage families to save for college early and inspire children to go to college.



Key Takeaways

- State-sponsored 529 plans help families of all backgrounds and income levels save for and access college.
- Affordable student loan debt is a tool some students can use to access and complete their postsecondary education.
- States that prioritize nonprofit student loan programs save the average borrower thousands of dollars compared to other higher-cost student loan programs.

Impact of Saving for College

Research has shown that low- and moderate-income children benefit from even small-dollar savings accounts that are specifically designated for higher education. A child from a low- or moderate-income family with fewer than $500 in savings was more than three times more likely to enroll in college and more than 4.5 times more likely to graduate than a similarly situated child with no savings. Low- and moderate-income children with savings of more than $500 were five times more likely to graduate from college than their peers with no savings.[2]

Pennsylvania conducted a pilot study in 2018 to examine the short-term impacts of a state-seeded CSA program. Families of new babies born in 2018 in six counties were eligible to opt-in to receive $100 set-aside for their child's future postsecondary costs, and they were encouraged to link that funding to a Pennsylvania 529 account. The study found that the seeded funding increased the diversity of families opening 529 accounts, and families in the six pilot counties were twice as likely to open a 529 account in the first year of their child's life compared to families in other counties.[3]

A large-scale longitudinal study of Oklahoma's CSA found that seeded accounts have had positive impacts. The study, which began in 2007, was the first randomized controlled trial study of CSAs in the nation. The families of children in the treatment cohort were given $1,000 deposits at birth and were provided with deposit incentives, matching funds, and educational materials. After 14 years, the original deposit had more than doubled and the average account had a total of more than $4,300 saved. The seeded accounts also dramatically increased the number of low-income families setting up 529 accounts. Among the control group, only about 500 low-income children had an Oklahoma 529 account at age 14, compared to over 36,000 low-income children in the treatment cohort who had received an automatic CSA at birth.[4]

States that encourage 529 plan savings with seed and matching programs not only increase enrollment rates, but they also help their residents more easily afford postsecondary education. Those individuals with seeded Oklahoma 529 accounts have on average enough money saved after 14 years to pay for their first year of tuition and fees at a 4-year college or university.[5]

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Qualified Student Loan Bonds

Qualified Student Loan Bonds (QSLBs) are another way that states help students and their families access higher education more affordably. Starting in the 1970's, state and local governments issued tax-exempt bonds to provide capital for nonprofit state-based student loan organizations. These entities would then buy federally guaranteed student loans from commercial lenders to provide liquidity through a secondary market.[6] Later, as inflation and the cost of college increased, a number of states established their own private student loan programs to help students fill their unmet need. These state-based, nonprofit alternative student loan programs are funded by tax-exempt bonds.

QSLB Benefits for Borrowers

This type of tax-exempt financing allows state-based, nonprofit student loan organizations to offer higher education loans at lower rates compared to typical for-profit education loans. Federal rules for QSLBs restrict the yields of state-based, nonprofit organizations making loans financed by QSLBs to no more than the yield of the bonds plus two percent, thereby ensuring any savings are passed onto borrowers.

An analysis by a northeast Education Finance Council (EFC) member organization found that their student loans funded by tax-exempt bonds for the 2024-25 school year have an interest rate that is 4.8 percentage points lower than what is offered by a large for-profit student loan company. These lower rates translate to a savings of more than $9,500 in interest payments across a 15-year repayment term.[7] For borrowers, this means their monthly student loan payments are over $50 lower with a nonprofit student loan provider than a for-profit one. Importantly, state-based nonprofit student loan providers do not charge a loan origination fee and have a broader array of benefits available to borrowers, such as income-based repayment plans and loan rehabilitation.

Obstacles to States Expanding Nonprofit Student Loan Programs

QSLBs were incorporated into the Internal Revenue Code in 1986, and were classified as Private Activity Bonds, which made them subject to annual volume cap limitations. State laws dictate how these allocations are made to different issuers in the state, meaning QSLBs compete with things like affordable housing and this limits states' ability to use tax-exempt financing for QSLBs.[8] In 2023, QSLBs accounted for less than one percent of all Private Activity Bond dollars issued. The limits on the volume of these bonds impact how much nonprofit and states can help their residents obtain lower-cost postsecondary financing.

Additionally, interest income earned by investors from the purchase of QSLBs is subject to Alternative Minimum Tax (AMT) laws, which can consequently suppress investor interest. Adding QSLBs to the list of Private Activity Bonds that are exempt from the AMT will decrease the bonds' rates by about 50 basis points, which will result in lower student loan rates for borrowers.[9]

Policy Recommendations

States can expand usage of 529 plans by creating financial incentives for families to open accounts.

Research has shown that seeded CSAs that encourage or require families to open 529 accounts have resulted in an increase in the number of families with 529 accounts.

Congress can encourage families from low-income backgrounds to open 529 savings accounts by establishing a matching grant program.

Research on seeded CSAs has demonstrated this initial investment increases participation among low-income families, particularly if the program is automatic and not opt-in.

Congress should exempt QSLBs from the Private Activity Bond volume cap.

Some types of Private Activity Bonds are not subject to volume caps, and QSLBs should be included in that group. Artificially limiting the number of QSLBs a state can issue each year limits the extent to which states can help borrowers and their families obtain lower-cost student loans.

Congress should exempt QSLBs from the Alternative Minimum Tax.

QSLBs should be added to the list of Private Activity Bonds that are exempt from the Alternative Minimum Tax. This will increase investor interest in the bonds and decrease student loan rates for borrowers.

States without a designated nonprofit or state-based student loan organization should establish one to take advantage of QSLBs.

States that do not have a designated nonprofit or state-based student loan organization are unable to receive tax-exempt QSLBs. By designating a state-based, nonprofit organization, states can use these bonds to finance student loans at lower rates to benefit its residents.

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