National Center for Policy Analysis

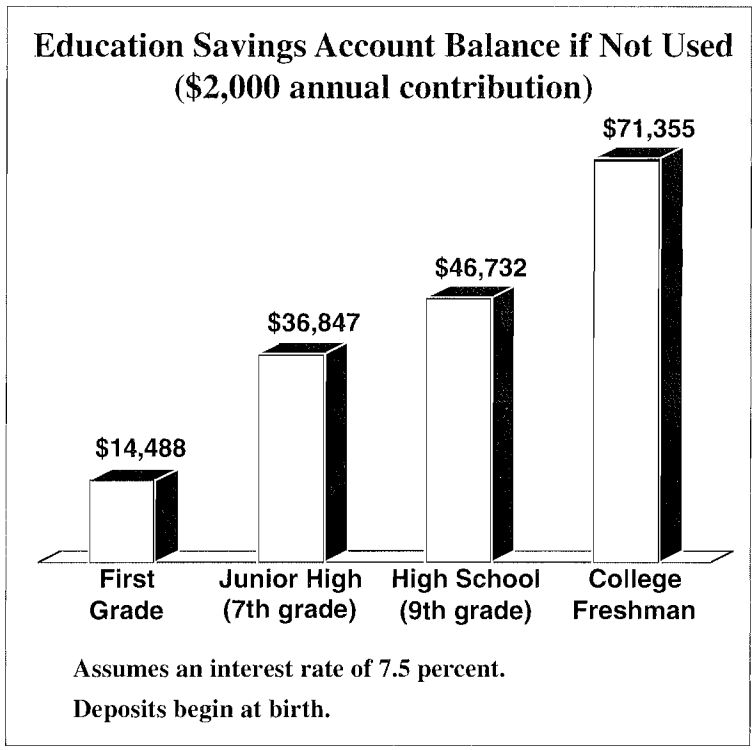
BRIEF ANALYSIS
No. 244
For immediate release:
Monday, October 27, 1997

Education Savings Accounts

The tax code has always allowed various deductions and credits for investment in physical capital. But there have been few incentives to make comparable investments in *human capital* — expanding the productive capacity of human beings.

In a step toward rectifying this discrepancy, the tax law passed last summer allows a child's parents or others to set up an education savings account (ESA) to help pay tuition and other expenses at a public or private college. While contributions to ESAs are not tax-deductible, the interest earned accumulates tax free and withdrawals for education expenses are not taxed.

Congress is now considering a proposal that would increase the amount that can be contributed to an ESA, allow corporations to contribute to such accounts and expand the uses of ESA funds to include expenses for students from kindergarten to the 12th grade. A similar measure proposed by Sen. Paul Coverdell (R-Ga.) passed the Senate last summer 59 to 41 as an amendment to the tax bill passed as a companion to the Balanced Budget Reconciliation Act. However, it was dropped when President Clinton threatened a veto.



Expanding Education Choice. The new legislation:

- Raises the annual contribution limit for Education Savings Accounts from $500 to $2,500 (the House bill) or $2,000 (Sen. Coverdell's bill).
- Expands the use of ESAs to include expenses related to elementary and secondary education at public, private or religious schools and homeschools.
- Defines qualified expenses for which the funds can be used to include tuition, fees, tutoring, special needs services, books, supplies, computer equipment (included related software and services) and other equipment, transportation and supplementary expenses.
- Allows contributions to the ESA to be made until the student is 18 years old, and distributed for the student's expenses up to age 30 (with an exception for special needs students, for whom there is no age limit on contributions or distributions).
- Allows any undistributed funds accumulated in the account to be rolled over tax-free into the account of another child.

There are limitations on ESAs. Parents may not contribute to a state prepaid tuition plan and an ESA in the same year. And since this bill simply expands the uses of ESAs set up under this summer's tax bill, contributions cannot be made by high-income taxpayers. Permissible contributions are phased out for those with modified adjusted gross income between $95,000 and $110,000 or for couples filing joint returns with incomes between $150,000 and $160,000.

Benefiting Middle-Income Families. The primary beneficiaries of ESAs should be middle- and lower-income families and public schools. According to estimates by the Joint Committee on Taxation:

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- By 2002, 14.3 million families would benefit from the bill; of this number about 10.8 million would be families with children attending public schools.
- Seventy percent of the tax savings from these accounts would go to families whose income is less than $75,000 a year.

For a child attending public school, the money could be used for carpooling or other transportation costs, a home computer or extra tutoring. Parents of special needs children could use this money for tutoring or occupational therapy. Or it could be used to pay tuition at a school in another district or a private school.

Encouraging Middle-Class Savings. The accumulated savings would provide a substantial financial benefit to families. For example, under Coverdell's Senate bill,

- If a parent places $2,000 each year in an ESA starting in a child's first year, and assuming a 7.5 percent interest rate, $14,488 would be available by the time the child reaches first grade.
- By the time the child starts junior high school $36,847 would be available and when the child starts high school, $46,732.
- If the funds are not used for elementary or secondary education, parents contributing $2,000 a year from the child's first year would have $71,355 available for their child's college tuition, room and board and other expenses.

The tax savings with ESAs would also be substantial, even for middle income families. For example:

- A couple, each of whom makes $35,000 a year, would save $3,600 by the time the child reached junior high school — just in terms of taxes they no longer had to pay.
- That tax saving would be more than $6,000 by the time the child entered high school.
- If the funds are saved until the child reaches college, a middle income family will have saved close to $10,000 in avoided taxes.

Supplementing IRA Savings. ESAs are an option available to families in addition to Individual Retirement Accounts (IRAs) under existing law. Last summer, Congress expanded the options for withdrawals from IRAs to include higher-education expenses — but did not increase the amount of tax-deductible contributions that can be made to an IRA each year ($2,000 for an individual or $4,000 per couple).

More than 75% of the children who benefit would go to public schools.

Since contributions to ESAs under this summer's tax bill were limited to $500 a year, lower- and middle-income families might be tempted to rob Peter to pay Paul — that is, dip into their IRA savings for current college tuition expenses. Even after investing the maximum amount in an ESA — a mere $42 per month — for 16 years, families would have saved only $15,000. This is not enough to pay for a college education at many schools. Increasing the amount that can be contributed to an ESA allows parents to save more.

Conclusion: Support for Education Choice. There is widespread support for giving parents more choices. According to a September 1997 poll by Public Opinion Strategies, the Tarrance Group and Voter Consumer Research, 66 percent of those surveyed favor a proposal which allows parents who have tax-free education savings accounts to withdraw their money to pay for their children's education expenses from kindergarten to 12th grade at any school — public, private or religious. Only 25 percent oppose the idea.

The bill before Congress increases parents' choices. For instance, parents may decide to use some of the funds during a child's primary and secondary school days — say, for an SAT preparation course — while saving the rest for college. Since parents would be spending their own money, it encourages parental involvement in their children's education. And because it gives them increased resources that can be used for educational enrichment at the school their child attends, it encourages parental involvement in the schools.

This Brief Analysis was prepared by NCPA Policy Analyst Joe Barnett.