National Center for Policy Analysis

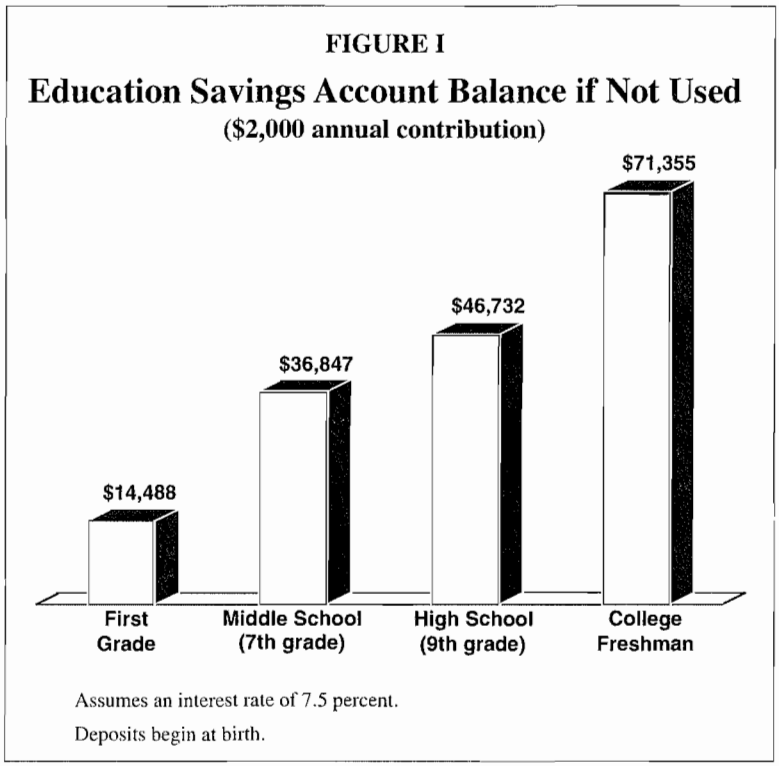
BRIEF ANALYSIS
No. 313
For immediate release:
Thursday, March 2, 2000

Expanding Education Savings Accounts

By Joe Barnett

For the third time, Congress may pass a bill to expand educational opportunities for the children of middle- and lower-income families. The Affordable Education Act (S. 1134) being considered by Congress would expand Education Savings Accounts (ESAs) in a number of ways, including allowing them to be used for expenses from kindergarten through the 12th grade. These ESA reforms would increase the educational choices open to families of modest means by encouraging them to save for their children's future and earn tax free returns on investments in stocks, bonds and other assets.

The current ESA law, enacted in 1997, allows parents or relatives to make contributions to savings accounts established to pay for education expenses incurred in connection with college or adult education. Contributions can be made until the child is 18 years old, and distributed for education expenses up to age 30. While contributions to ESAs are not tax-deductible, the interest earned accumulates tax-free and withdrawals for education expenses are not taxed.



Congress has twice passed legislation offered by Sens. Paul Coverdell (R-Ga.) and Robert Torricelli (D-N.J.), chief sponsors of the current bill, but President Clinton vetoed the measure each time. Both the president and Secretary of Education Richard Riley have expressed opposition to the new bill.

The Need for Change. There are four problems with existing law. First, current law restricts the use of ESA funds to college or adult education expenses. This means ESAs are useless in addressing problems experienced in primary and secondary schools. Yet if problems in the early years are not adequately solved, the child may never become prepared to enter college.

Second, contributions to ESAs are now limited to $500 a year. Even after investing the maximum amount in an ESA — a mere $42 per month — for 16 years, families would have saved only $15,000, assuming a 7.5 percent return. This is far less than the cost of four years of enrollment at most colleges. Increasing the amount that can be contributed to an ESA would allow parents to accumulate amounts that are closer to expected expenses.

A third problem is that most brokers or banks impose a minimum account balance much higher than $500. That is because the fixed administrative expenses and marketing costs for accounts with low balances may exceed their earnings. Allowing a higher contribution would make ESAs more widely available and allow them to earn rates of return similar to those for other tax-advantaged accounts.

Fourth, under existing law, if a family is contributing to a state prepaid college tuition plan, it cannot contribute to an ESA benefiting the same student in the same year. This means that parents are penalized under federal law if colleges in the state where they live also try to give them a financial helping hand.

Expanding Educational Choice. The new bill, which was favorably reported by the Senate Finance Committee to the full Senate for approval, would:

- Increase the limit on contributions from $500 to $2,000 a year.
- Allow contributions to both a prepaid state college tuition plan and an ESA benefiting the same student.
- Let corporations or nonprofit organizations use ESAs to set up scholarship funds for low-income children.

Dallas Headquarters: 12655 N. Central Expy., Suite 720 • Dallas, TX 75243-1739 • 972-386-6272 • Fax: 972-386-0924 • E-Mail: ncpa@public-policy.org
Washington Office: Metropolitan Square • 655 15th Street N.W., Suite 375 • Washington, D.C. 20005 • 202-628-6671 • Fax 202-628-6474 • E-Mail: ncpa@his.com
For more information: Julie Hillrichs in Dallas at 972/386-6272 or Joan Kirby in Washington at 202/628-6671

- Expand the use of ESAs to include expenses related to elementary and secondary education at public, private or religious schools and homeschools, in addition to college.

Benefits for Middle- and Lower-income Families. President Clinton's main criticism of ESAs has been that they give tax breaks to wealthy families that don't need them to do what they could and would do anyway — pay to send their children to private schools. However, most families of private school students are far from wealthy:

- Half of the parents of students attending private schools earn annual incomes of $50,000 or less, and a quarter earn less than $35,000.
- Almost 70 percent of families of students in parochial schools have incomes below $35,000 and almost 90 percent have incomes below $50,000.

In any event, the primary beneficiaries would be children from middle- and lower-income families, since permissible contributions would be phased out for individuals with modified adjusted gross incomes between $95,000 and $110,000 and for couples with incomes between $150,000 and $160,000. Higher-income families would not be allowed to make contributions to ESAs for the benefit of their children. According to estimates by Congress's Joint Committee on Taxation:

- By 2002, 14.3 million families would benefit from the bill; with about 10.8 million of them 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.
- More than 75 percent of the children who benefit would go to public schools.

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 the money for tutoring or occupational therapy. Or it could be used to pay tuition at a school in another district or at a private school.

Encouraging Middle-Class Savings. The accumulated savings would provide a substantial financial benefit to families. As Figure I shows:

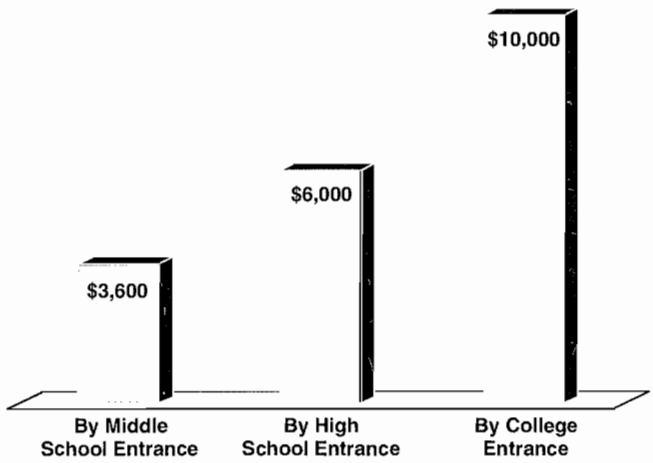
- If a family deposits $2,000 a year in an ESA starting in a child's year of birth, $14,488 would be available by the time the child reaches first grade.
- By the time the child starts middle school $36,847 would be available and when the child starts high school, $46,732.
- If the funds were not used for elementary or secondary education, at the time of admission to college $71,355 would be available for the child to use for 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 in taxes by the time the child reached middle school. [See Figure II.]
- The 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.

FIGURE II

Expected Tax Savings on ESAs



Note: Assumes $2,000 annual contribution from year of birth; two-earner family, each earning $35,000 per year; and balance in account not withdrawn until the time period indicated.

Conclusion. Traditional Individual Retirement Accounts (IRAs) and Roth IRAs have become popular vehicles for middle-class retirement investments (and may be used in addition to ESAs by savers who meet IRA income requirements). Without the limitations imposed by current law, Education Savings Accounts could become as widely accepted, and benefit millions of American children.

Joe Barnett is a policy analyst with the National Center for Policy Analysis.