

## The "529" Rip-Off

Those new college savings plans aren't so great.

By Austan Goolsbee

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In the past year, parents have been pouring money into the new "529" state college savings plans. Since the 2001 Bush tax bill exempted qualified withdrawals from taxes, the 529 plans have become one of the fastest-growing personal financial products in history. About \$25 billion is now invested in 529 plans, three times as much as two years ago, and investors are expected to add \$40 billion more by 2006.

Financial advisers and even *Consumer Reports* have been touting 529s as a miraculous way to save money for your children's college. They seem flawless. Unlike other tax-advantaged savings plans, the 529s have extremely high contribution limits and no income cutoffs. All earnings are tax-exempt if they're spent on education. The 529 plans are supposed to be an enormous federal tax subsidy for education.

But serious flaws in the 529s are being overlooked. The long-run potential of the plans has been seriously compromised by excessive "management" fees that states have added to these plans. In addition, all but a few of the plans limit investors to a single financial firm that offers only two or three investment options. The reality of 529 plans is that much of the tax subsidy is merely going to pay these higher fees to states and financial companies. Under some plans, families would actually do worse investing in 529 plans than in traditional savings instruments.

Take one of the most egregious examples, Arizona's InvestEd plan, operated by Waddell and Reed. Investing in its class "A" shares with the highest equity option, an investor must pay 92 basis points (0.92 percent of assets) per year for fund expenses and then another 91 basis points of state management fees. When you cash out, you have to fork over another 5.75 percent of total assets as a "sales load." The class "B" shares don't take the 5.75 percent final cut, but the extra management fee is 162 basis points, meaning the state and Waddell and Reed grab a whopping 2.54 percent of your savings every year.

These fees are unbelievably high, vastly more than you'd pay for any normal investment. Over the life of the fund, the fees can kill the benefits of these plans completely. Consider two parents who want to save enough money to pay tuition and room and board at Harvard for their now-infant daughter. If Harvard's costs grow 5 percent annually, the parents will need \$330,000 in 2021. Imagine the Arizona 529 plan were a low-expense S&P Index fund—the Vanguard fund that has expenses of 18 basis points, for example. With \$50,000 in the account today and the historical rate of return of 11 percent, these parents would have \$350,000 in 2021.

But woe to them if they opt for the actual Arizona plan. Assuming the same 11 percent

return, after the extra fees and the sales load, the class "A" shares would yield \$237,000 in 2021, the class "B" shares \$217,000. Here, the excessive expenses have cost these two parents more than \$110,000 dollars. This is hardly the boon to educational savings they might have hoped for. In fact, this family would do better to skip the 529 entirely. If they put the money in an index fund and then paid the capital gains taxes when they sold, they would still clear \$290,000, much more than with the Arizona 529 plan.

The excessive fees aren't limited to Arizona. Of the 45 states that have established plans, 27 of them charge expenses of more than 1 percent per year, and 10 of those take additional sales loads. Even the best 529 plans, the ones run by states that chose low-expense investment companies—notably TIAA-CREF and Vanguard—are still charging more than they would for similar, non-529 investments. Tennessee, Minnesota, and Michigan, for example, use the same TIAA-CREF equity option (a mixture of the Growth and Income fund and the International Equity Index). Investing in these funds with a regular IRA would mean expenses of about 45 basis points. But the same investment with the Minnesota and Michigan 529s costs 65 basis points in expenses. In the Tennessee 529, it costs 95 basis points. Utah has by far the cheapest 529 plan, but even it adds 25 basis points of state fees to Vanguard's tiny 7 basis points of expenses.

These state fees make it easy to understand why every state either has a 529 plan or is developing one. The maintenance fees are a regular cash stream for them. The financial companies, too, are clamoring for the exclusive 529 franchises because they provide such huge fees. In Illinois, for example, where the exclusive provider is Salomon Smith Barney, the state treasurer has appeared in a series of statewide ads promoting the 529—paid for by Salomon Smith Barney.

The federal government will forgo billions of dollars in tax revenue to subsidize 529s. The goal of this subsidy was to encourage education, not to have the federal government provide a windfall to states and financial firms in the form of high fees. An easy way to fix the 529 problem would be to bestow the benefits of the 529s on other savings plans. Congress could raise the limit on contributions to Coverdell/Education IRAs or allow penalty-free withdrawals from 401(k) accounts for educational expenses. In these other accounts, people can choose any investment from any provider, without paying extra management fees. It would cost the federal government the same amount as the current 529 system, but the benefits would go to the parents, not the providers.

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