A Message from Treasurer Torsella

From the home of the Eagles to Heinz Field, everyone knows Pennsylvanians are tough competitors. And that goes for our state’s 529 plans, too.

But sometimes, the rules of the game just aren't fair. That's the situation with what's called “tax parity” for our PA 529 College and Career Savings Program.

We have a stellar state 529 program. The PA 529 Investment Plan (IP) is one of just 30 plans in the country to win a Morningstar Medal, and ranks in the top 10 plans in the country. We also offer a prepaid tuition option, the PA Guaranteed Savings Plan (GSP), which very few states have been successful in sustaining. It has been more than fully funded for the past 7 years. Despite recent market turmoil, as of June 30th, 2020, it stands at 123.70% funded status. And unlike in other states, PA’s prepaid plan provides flexibility in how funds are saved and where they can be used. Both plans also offer Pennsylvanians special advantages: savings are not counted against state higher education financial aid eligibility, are protected from creditors, and are excluded from state inheritance tax. It's also more affordable than ever to save in a PA 529 plan. As of June 2020, families can now open an account in either plan with just $10, and the minimum for subsequent contributions is just $10, too.

But no matter how well our plans perform or how hard we work to market them, with unfair (and unwise) tax treatment, we will keep losing assets to other states. These assets could be lowering fees and accumulating earnings for our own state's kids. Every penny we can save counts, because Pennsylvania students have the second highest debt load in the country, with an average student debt burden of $36,000. Instead, year after year we continue to subsidize the growth of other states’ 529 plans, while gaining nothing in return for it.

The good news is: We can make the rules fairer.

The law can and should be changed to allow state income tax deductions only for contributions to Pennsylvania’s own 529 plans.

PA 529 Plans are best in class, but tax subsidies to other states are holding them back.

Pennsylvania law inequitably treats contributions made by PA residents to other states' 529 plans as deductible for state income tax purposes, even though most states do not reciprocate by giving their residents a tax break for using PA plans. This is often referred to as “tax parity,” but it's really an unfair trade: we are using state dollars to subsidize the plans of other states. This puts Pennsylvania's 529 plans at a disadvantage and means PA 529 Plan participants are losing out on $3.3 million annually in fee savings to be had through economies of scale. It also means our kids are losing out on additional incentives we could provide through programmatic growth. And the state is losing an estimated $8.5 million annually in tax revenue.

Recommendations

Pennsylvania should stop subsidizing out-of-state 529 plans and handing our competitors a winning advantage at the expense of Pennsylvania's families and taxpayers.

States are legally entitled to exclude contributions to out-of-state 529 plans from tax breaks, and most--including all of our large-state peers--do. We can't afford to wait. We should adopt this cost-saving, common-sense policy now.
What’s a 529 Plan?

529 Plans are a tax advantaged way to save for higher education. They get their name from Section 529 of the federal tax code. Assets in 529 accounts grow tax-free and withdrawals are not taxed if they are used for a qualified expense. The Pennsylvania 529 College and Career Savings Program helps families save for education expenses, allowing invested money to grow tax free and providing numerous financial benefits. Families can choose one of two plans—the PA 529 Guaranteed Savings Plan (GSP) or the PA 529 Investment Plan (IP)—depending on their preference for returns based on growth in tuition costs or the investment markets.

“Tax Parity”: The PA 529 Plan’s Achilles Heel

Subsidizing other states’ plans has been hampering the growth and appeal of PA’s 529 plans for years. Generally speaking, participant fees decrease as plan assets increase. With assets of approximately $3.5 billion, the PA 529 Investment Plan’s fees range from 0.215% to 0.315%. But plans in “tax parity” states end up charging the highest fees amongst their peers because they have lower asset bases. This is one reason that, despite vigorous fee reductions, Pennsylvania’s IP fees are still higher than the average fees of similar plans. The assets of Pennsylvanians that we lose to out-of-state plans effectively underwrite the ability of other plans to lower their fees, and thus they have the freedom to grow their plans. Pennsylvania Treasury estimates that nearly half of all the 529 savings of Pennsylvanians are located in our competitor’s plans. And while our IP did recently earn a Morningstar medal, the limited growth and higher fees brought on by “tax parity” will make it difficult to further boost the plan’s ratings in the future.

Meanwhile, states that limit tax deductions to in-state 529 contributions make their 529 plans more attractive to contract bidders. This attractiveness translates into more competitive bids, thereby driving down administrative costs and ultimately resulting in savings that are passed on to the participants.

Fast Facts:

- 42 states have an income tax
- 31 states provide tax deductions for contributions to their own 529 plans
- Only 6 states besides PA—representing just 7.88% of US population—subsidize other states’ plans by allowing tax deductions for contributions to other states’ 529 plans, not just their own
- PA is the only high-population state in that group, and offers by far the largest deduction.
- PA’s state tax deduction is more than 3 times higher than the national average state tax deduction of $4,991

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1 Based on June 2019 data.
2 Does not include four states which have no cap on the amount of the deduction.
Table 1: States that Allow Deductions for Contributions to Other State Plans

<table>
<thead>
<tr>
<th>State</th>
<th>Population</th>
<th>Annual Deduction</th>
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</thead>
<tbody>
<tr>
<td>Minnesota</td>
<td>5,639,632</td>
<td>$1,500</td>
</tr>
<tr>
<td>Arizona</td>
<td>7,278,717</td>
<td>$2,000</td>
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<td>Montana</td>
<td>1,068,778</td>
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<tr>
<td>Kansas</td>
<td>2,913,314</td>
<td>$3,000</td>
</tr>
<tr>
<td>Arkansas</td>
<td>3,017,804</td>
<td>$5,000/$3,000³</td>
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<tr>
<td>Missouri</td>
<td>6,137,428</td>
<td>$8,000</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>12,801,989</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

A Win for the PA 529 Means Multiple Wins for the State

Now more than ever, as COVID-19 wreaks havoc on the finances of families and on those of the state, we need an educated workforce that is not held back by outsized debt. By encouraging state residents to participate in PA 529 plans, we could build asset balances by at least **$500 million in just 5 years** and reduce participant fees for PA residents by 59%, saving IP account owners **$3.3 million annually**. And because our Keystone Scholars Program is funded from surplus earnings on the GSP, greater earnings mean more funds with which to sustain and build new features onto the program; we could, for example, target additional deposits or incentive programs to low-income families as some other states do. We would also be keeping an estimated **$8.5 million in tax revenue annually** for the state’s General Fund by restricting our generous state tax deduction to those who are investing in the PA 529 plans. Overall, ending the tax subsidy for other state plans would allow more money to stay in PA, leading to more savings for education and less debt for all PA residents.

Keystone Scholars

Pennsylvania Treasury provides $100 for every baby born to a PA family after December 31, 2018 to be used for their future post-secondary education expenses (including babies born after December 31, 2018 subsequently adopted by a PA resident). The $100 is invested by Pennsylvania Treasury and will grow over time. Research has found that a low- or moderate-income child with school savings of less than $500 is over three times more likely to enroll in college and four times more likely to graduate than a child with no savings account.

An evaluation of Pennsylvania Treasury’s pilot Keystone Scholars program found that the program was successful in getting families to start saving early for college: families in pilot counties were twice as likely to open a PA 529 as families in non-pilot counties within the first year of their child’s life.

Pennsylvania Treasury has the unique ability to fund this program through our excellent investment management of the GSP Fund. With even more growth and continued strong actuarial reserve, we can provide targeted benefits and incentives for low-income children, to ensure all Pennsylvania’s kids get a strong start in saving for their future.

³ Arkansas single taxpayers may deduct $5,000 per year for contributions to an Arkansas 529 plan and $3,000 per year for contributions to another state’s 529 plan. For joint taxpayers, the deductions are $10,000 and $6,000 respectively.
Competitor Plans in Non-Parity States Can Invest More in their Students

We estimate that PA assets generate **$3.5 million in revenue annually** for other states, which they may use towards program administration expenses. This could include benefits like:

- **Louisiana’s Earnings Enhancement:** A progressive incentive program that matches up to a certain percentage of 529 account owners’ contributions, with the lowest-income account owners earning the largest matches.
- **Nevada’s Silver State Matching Program:** A program that matches 529 contributions up to $300 per year for five years (maximum of $1,500 per beneficiary) for families with income under $75k.
- **SOAR Virginia:** A partnership between VA 529 and community organizations with the goal of preparing high school students for post-secondary education through individual advising and up to $2,000 in a VA 529 account.

But until “tax parity” is repealed, PA will continue to lose out, as the graphic below illustrates:

**Impact of 529 Tax Subsidy to Other States**

Finally, **Pennsylvanians who invest in other states’ 529 plans miss out on the benefits unique to the PA 529 Program:**

- Exclusion from state higher education financial aid eligibility.
- Exclusion from state inheritance tax
- Protection from creditors

The PA 529 Plans also offer the chance to earn rewards through various programs, such as SAGE Tuition Rewards and Upromise Shopping Rewards.

**Conclusion**

Thirty-one states have put the protections in place to incentivize residents to invest in their own 529 plans, but Pennsylvania is not one of them. Pennsylvania is the only densely populated state with an income tax and tax incentive for 529 contributions that effectively subsidize other states’ plans. We already have two winning plans. By making one simple change to the Tuition Account Program (TAP) Act, we can stop underwriting the success of other states’ students and step up the investment for our own.