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GIVING FAMILIES MORE CONTROL IN EDUCATION

A State Income Tax Deduction for K-12 and College Education Savings

BY DAN LIPS

EXECUTIVE SUMMARY

MARYLAND PROVIDES TAX BENEFITS AND INCENTIVES to encourage families to save for their children's higher education.[1] The state operates two college savings vehicles: a Prepaid College Trust and a College Investment Plan. Under state law, families can claim a tax deduction worth up to $2,500 per beneficiary for contributions made into either savings plan for their children. Families with more than one child can claim a state tax deduction worth up to $2,500 for each child's contribution. Under federal law, interest earned in either account is not subject to tax if spent on eligible expenditures for higher education.

In all, Maryland's Prepaid College Trust and College Investment Plan had combined assets of nearly $2 billion for more than 110,000 beneficiaries in 2007.[2] The plans received $352 million in contributions in FY 2007.[3] The popularity of these plans demonstrates Maryland families' commitment to saving for their children's postsecondary education.

However, Maryland families should question why similar benefits and incentives are not provided for expenses related to a child's primary and secondary education. Often, during the K-12 education years many children most need, but cannot afford, the quality educational opportunities that will put them on the track to graduate high school and pursue higher education.

Maryland could become the first state in the country to offer a state tax benefit for contributions made to Coverdell Education Savings Accounts (ESAs).[4] Under federal law, families can contribute after-tax dollars to Coverdell ESA, where invested funds earn interest tax-free if they are spent on eligible K-12 or higher education savings accounts. Annual contributions are limited to $2,000 per account.

Offering Maryland taxpayers a $2,000 state income tax deduction for contributions made into a child's Coverdell ESA would give families more flexibility, helping to ensure that their children receive a quality education. To help low-income children participate, the tax benefit could be structured to encourage individuals and businesses to make charitable contributions into disadvantaged children's Coverdell ESAs.

A state tax deduction for contributions into Coverdell ESAs for K-12 and higher education saving would be a step toward giving families greater power in education. Families could use funds saved in their children's Coverdell ESAs for a range of education expenses, including: private school tuition, academic tutoring, supplemental services, transportation, books and educational supplies, special needs services, and computer technology.[5] This reform should be complemented with other educational options to give families greater ability to secure for their children a quality primary, secondary, and postsecondary education.

BACKGROUND ON K-12 AND HIGHER EDUCATION SAVINGS ACCOUNTS

Policies that give families greater ability to save for their children's educational expenses have attracted bipartisan support. In the 1980s, President Ronald Reagan called for the creation of federal benefits for education savings accounts.[6] Republicans in Congress championed expanding education savings account options for families as a part of their 1994 "Contract with America."[7]

In 1997, President Bill Clinton signed into law the Taxpayer Relief Act of 1997, a legislative package that included tax benefits for education savings known an Education IRAs.[8] Education IRAs allowed families to contribute up to $500 per year into an account that allowed for tax-free savings for higher education expenses.

After the 1997 legislation, a bipartisan coalition in Congress continued to push for expanded education savings account options. Senators Paul Coverdell (R-GA) and Robert Torricelli (D-NJ) introduced the Parent and Student Savings Account Plus Act (S. 1133), which would have increased the amount that could be invested in a child's Education IRA and expanded allowable expenses to include K-12 education costs, private school tuition, and homeschooling expenses. President Clinton vetoed the legislation.[9]

Coverdell ESAs On June 7, 2001, President George W. Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001. This tax reform package modified rules governing Education IRAs and renamed them "Coverdell ESAs" after the late Georgia senator. The tax package increased the annual contribution limit per beneficiary from $500 to $2,000 and expanded allowable uses to K-12 education costs, private school tuition, tutoring, special needs services, other school costs such as room and board or uniforms, and educational technology (such as computer equipment or internet access) if they are used by the student during his or her education.[10] The legislation also increased the income limit for married couples making contributions.[11]

Coverdell ESAs are a useful savings vehicle for education but have certain restrictions that prevent broad use.

Coverdell ESAs are managed by the private sector. As a result, government statistics or estimates are limited as to what extent participation in the Coverdell ESA program has increased since 2001. In 2001, the Joint Committee on Taxation estimated that the exclusion of earnings of the Coverdell ESA program would result in a net revenue loss for the federal government of $300 million in 2004 to $500 million in 2008.[12] But this estimate did not differentiate between higher education and K-12 education uses of funds invested in Coverdell ESAs.

One could reasonably assume that participation in the Coverdell ESA program is relatively limited. Coverdell ESAs are a useful savings vehicle for education but have certain restrictions that prevent broad use. For example, only interest earned in the account is deductible. Because deposits are not deductible, the tax advantage is very marginal. Participation in the Coverdell ESA program is probably limited to middle- and upper-income families who already have the ability to save for their children's education.

529 College Savings Plans Congress also created new College Savings Plan options to allow families to save specifically for their children's higher education expenses.[13] Named after a section of IRS code, 529 College Savings Plans allow families to invest after-tax dollars into private accounts overseen by state governments. Funds invested in these accounts accrue tax- free as long as expenditures are made for approved college education expenses.

There are two types of 529 College Savings Plans:

> **Pre-Paid Tuition Plans:** These allow savers to invest funds into an account to pay for future college costs, locking in current tuition prices for participating colleges and universities. In Maryland, this program is known as the Maryland Prepaid College Trust.
>
> **College Savings Plans:** The second is college savings plans, which allow savers to invest funds into an account that offers various investment options with funds accruing tax-free if spent on allowed higher education expenses. In Maryland, this program is known as the *Maryland College Investment Plan.*

The Popularity of College Savings Plans All 50 states and Washington, D.C. currently sponsor some form of 529 College Savings Plan.[14] These savings plans have become increasingly popular with American families. The College Savings Plan Network reports that more than $130 billion has been invested in 529 College Savings Plans across the country.[15] More than 10 million accounts have been opened.[16]

Participation in the Maryland College Savings Plans indicates the popularity of 529 accounts nationally. In 2007, the College Savings Plans of Maryland Board reported that the Maryland Prepaid College Trust and the Maryland College Investment Plan had combined assets of nearly $2 billion for more than 110,000 beneficiaries.[17] Specifically, $542 million had been invested in the Prepaid College Trust and $1.4 billion had been invested in the College Investment Savings Plan.[18] There were more than 25,000 beneficiaries participating in the Prepaid College Trust program and nearly 85,000 beneficiaries participating in the College Investment Plan.[19] The average account size per beneficiary in the latter Investment Plan was more than $13,000 per account in 2007.[20]

State Tax Benefits for College Savings Plans One reason for the high participation in College Savings Plans across the nation is the many state tax incentives to encourage participation. According the website FindAid.org, more than thirty states offer some tax incentive (either a state

TABLE 1 COMPARISON OF EDUCATION SAVINGS ACCOUNTS AND TAX BENEFITS

	529 COLLEGE SAVINGS PLANS	COVERDELL EDUCATION SAVINGS ACCOUNTS
DESCRIPTION	Named after a section of Internal Revenue Code, 529 plans allow taxpayers to contribute after-tax dollars into an account, where savings can accrue tax-free if spent on qualified higher education expenses. 529 plans fall into two categories: 1) pre-paid tuition plans, which allow people to purchase tuition years in advance at discounted rates, or 2) savings plans, which offer investment options for college savings. Under federal law, there is no income limit for who can contribute and there is no limit on how much can be contributed each year. Every state now offers at least one 529 college savings plan.	Under federal law, individuals can make after-tax contributions into Coverdell ESAs (formerly known as Education IRAs), which allow savings to accrue tax-free if it is withdrawn for qualifying K-12 or higher education expenses, including private school tuition. Taxpayers can contribute a maximum of $2,000 annually. The contribution limit is reduced if the taxpayer's adjusted gross income is above $95,000 (or $190,000 for a joint-filer).
TAX INCENTIVES (NATIONAL)	More than 30 states offer tax incentives for contributions made to state-managed 529 college savings plans.	In 2008, there is no federal tax deduction or credit for contributions made to Coverdell ESAs. No state offers a tax deduction or credit for Coverdell ESA contributions.
TAX INCENTIVES (MARYLAND)	Maryland offers a state income tax deduction worth up to $2,500 for contributions made into the state's College Savings Plans. Taxpayers can claim up to $2,500 per beneficiary for each contribution.	Maryland does not offer a tax deduction or credit for Coverdell ESA contributions. This report recommends that Maryland taxpayers be offered a tax deduction or credit for contributions made into Coverdell Education Savings Accounts.

Sources: Pamela J. Jackson, "An Overview of Tax Benefits for Higher Education," CRS Report for Congress, January 17, 2006. In addition, more background information on 529 plans and Coverdell ESAs is available at www.savingforcollege.com.

income tax deduction or a partial income tax credit) for contributions made into 529 College Savings Plans.[21] In Maryland, families can claim a tax deduction worth up to $2,500 per beneficiary for contributions made into either savings plan for their children. Families with more than one child can claim a state tax deduction worth up to $2,500 for each child's contributions.

What is the value of Maryland's state tax deduction for 529 College Savings Plan contributions? According to the Comptroller of Maryland, the highest individual income tax rate was 4.75 percent in 2007.[22] This suggests that a taxpayer paying the highest rate who takes advantage of the maximum contribution of $2,500 per beneficiary will save about $112 on their state income taxes.[23] If a parent makes annual maximum contributions beginning when a child is born through age 18, the family could save about $2,000 (at today's current tax rates) in state income tax payments. This amount is above what is earned in the account through investment income and what is saved by avoiding taxes on investment earnings.

IMPROVING COLLEGE ACCESS: PREPARING CHILDREN FOR POSTSECONDARY EDUCATION

The growing popularity of 529 savings accounts demonstrates that millions of American families wish to save for their children's higher education costs. However, Maryland citizens should question whether the current situation—only providing a state income tax benefit for higher education savings—is equitable or efficient in improving educational opportunities for students in the Old Line State.

Most American families expect their children to graduate high school. A majority expect their children to pursue higher education after high school. A survey of American parents published by the National Center for Education Statistics found that less than one percent of American parents of students in grades 6 through 12 did not expect their children to graduate from high school.[24] 40 percent had parents who expected them to earn a four-year college degree; 13 percent expected at least two years of college, and 30 percent expected their children to earn graduate or professional degrees.[25]

While many families have high hopes for their children, many students do not fulfill their parents' expectations. Statistics show that many Americans do not access or complete higher education. The Census Bureau reports that only 28 percent of Americans over age 25 are college graduates or have a higher level of education.[26] Moreover, higher education attainment rates are lower among minority populations. Only 18 percent of African-American and 12 percent of Hispanics have a college education or higher, compared to 28 percent of whites.[27]

Estimates of high school graduation rates show that many students do not complete high school. The state of Maryland reported that 85 percent of the class of 2007 graduated from high school. The rate was lower among African American (78.6 percent) and Hispanic (79.7 percent) students.[28]

There is reason to believe that the graduation rate in Maryland could be lower than the state's estimate. The National Center for Education Statistics reported that the average freshman 4-year graduation rate in 2004 was

79.5.[29] In some communities, the graduation rate is likely well below fifty percent. A 2008 report by the America's Promise Alliance found that Baltimore City had the fourth lowest graduation rate of the nation's 50 largest cities, with only 35 percent of students graduating.[30]

College Access: A Problem of Affordability or Preparedness? Policy discussions about improving college access often focus on the problem of college affordability. Rising college costs support the belief that the affordability is the main barrier to access. In 2007, The College Board reported that the annual cost of tuition, fees, and room and board increased by 5.9 percent at private four-year colleges and public four-year colleges (in state).[31] Over the past decade, the real cost of a year at a 4-year private and public colleges increased by 29 percent and 41 percent, respectively.[32]

However, a greater barrier to improved college access is preparedness—that is, the limited number of students who leave America's K-12 schools prepared for or qualified to go on to higher education. Researcher Jay Greene discusses this problem in his 2005 book *Education Myths:*

> *The racial gap in college attendance has led to the widespread adoption of the College Access Myth—that artificial barriers are preventing a significant number of academically qualified minority students from entering college. The evidence, however, shows that fewer minority students attend college because minority students are less likely to meet the bare minimum qualification to apply to college. So, while it's true that minority students are less likely to attend college, the main barrier currently preventing more minorities from attending college is not money or race but the shoddy K-12 education that many of them receive. Any attempt to address the problem of minority enrollment that does not focus on improving K-12 education will be ineffective.*[33]

By Greene's evaluation, only 16 percent of Hispanic students and 20 percent of African-American students can be defined as "college ready," compared with 37 percent of white students. These statistics cast doubt on whether further increasing taxpayer subsidies for higher education is equitable or effective in improving social mobility and opportunities for the children who have the greatest need. In fact, the real problem is actually the limited number of students who leave America's elementary and secondary schools prepared for or qualified to pursue postsecondary education. In the current American education system, additional tax subsidies for higher education are unlikely to significantly benefit minority children.

To improve college preparedness and access, Maryland policymakers should focus on reforms to improve K-12 education to increase the population of students who graduate the state's secondary schools and are prepared to attend college. Policymakers in the Old Line State should implement policies that are designed to create systemic reform.

One promising model of systemic reform is in the state of Florida, which has seen dramatic gains in students' test scores on the National Assessment of Educational Progress over the past decade.[34] Importantly, Florida's overall test score gains have been boosted by dramatic improvement by Hispanic and African-American children.

Florida's progress has occurred during a time when the state implemented aggressive, systemic education reforms, including: implementing academic standards and a testing system to measure student performance, expanding public and private school choice options for families, opening new charter schools, ending social promotion, focusing on basic skills like improving reading instruction, and improving teacher quality. Maryland policymakers would be wise to consider how these reforms could improve learning in the Old Line State.

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PROPOSAL: A TAX DEDUCTION FOR SAVINGS FOR *BOTH* K-12 AND HIGHER EDUCATION

In addition to systemic reforms, Maryland policymakers should also review current tax benefits for education to consider how to expand the pool of college applicants to improve college access. To help more families provide their children with a quality elementary and secondary education, Maryland could extend the benefits of the 529 college savings plan program to contributions made into Coverdell education savings accounts (ESAs).

Very simply, Maryland tax filers could be allowed to claim a deduction worth up to $2,000 per beneficiary for contributions made into Coverdell ESAs. (Note: the annual federal limit for contributions into a beneficiaries account is $2,000. This per-beneficiary tax deduction would thus be $500 lower than the deduction offered for 529 college savings plan contributions.) Importantly, families would only be allowed to claim one deduction per beneficiary per year.[35]

This would be a first-in-the-nation plan to offer a way to save for both K-12 schooling and college. In addition to allowing individual families to make contributions on behalf of their own children, the tax incentive could be structured to offer similar (or perhaps more generous) tax incentives for individuals or businesses that make charitable contributions into needy children's ESAs.

STATE OVERSIGHT AND RULES

Federal rules regulating the Coverdell ESA program allow individuals to open accounts with commercial entities that choose to offer Coverdell accounts. Money that is withdrawn or spent on ineligible expenses is subject to a federal tax penalty.

If Maryland offers a tax incentive for Coverdell ESA contributions, state policymakers could choose to establish some state regulations or oversight. For example, state policymakers could designate approved private savings vehicles, as is done under the 529 college savings program. Under Maryland's 529 program, the state partners with the private sector to administer government-managed savings accounts to provide a range of savings options. If state policymakers deem increased regulation necessary, the regulations should be structured to give families a range of meaningful savings options.

TAX DEDUCTIONS FOR INDIVIDUAL OR CORPORATE CHARITABLE CONTRIBUTIONS

If tax deductions were only allowed for parents who make contributions into their children's Coverdell ESA, the benefit would be restricted to those families who pay state income taxes and can afford to save for their children's education. This would mean that participation would likely be greatest among middle- and upper-income families. This would do little to provide better opportunities for disadvantaged children. This problem can be addressed by letting individuals and businesses receive a tax deduction or credit for charitable contributions into the Coverdell ESA of a student who is not their son or daughter.

There is precedent for such an option. For example, Louisiana offers all state taxpayers deductions for 529 college savings contributions for disadvantaged, unrelated children.[36]

Moreover, states like Arizona, Iowa, Florida, Georgia, Pennsylvania, and Rhode Island now offer various forms of corporate or individual tax credits for contributions made to fund private school scholarships for children.[37] Combined, these programs will help as many as 100,000 children attend private school this year.

Maryland could offer individuals the same tax deduction for contributions made into Coverdell ESA accounts for non-related children to encourage this type of charitable activity. Moreover, if policymakers wish to increase the likelihood of this type of charitable behavior, taxpayers could be offered a full or partial tax credit for contributions made into the accounts of low-income children. Encouraging charitable contributions could ensure that more disadvantaged children have greater access to K-12 and higher educational opportunities.

HOMESCHOOLING

The Home School Legal Defense Association (HSLDA) reports that homeschooling families can use funds saved in Coverdell ESAs only in states that identify home schools as private schools. According to HSDLA, Maryland does not define homeschooling as private schooling, and thus the Maryland homeschoolers cannot use funds saved in Coverdell ESAs for their home education expenses.[38] Maryland policymakers should pair the tax incentive reform with changes to homeschooling regulations to allow homeschooling families to benefit from this tax incentive for education saving.

THE BENEFITS OF LEVELING TAX INCENTIVES FOR EDUCATION SAVINGS OPTIONS

Leveling tax incentives for education savings options would offer a number of important benefits. The parents of a single child who earn $60,000 a year could save up to $2,000 a year for their child's K-12 and education and receive an annual tax benefit of approximately $95.[39] By the time the child is six years old, when he or she is ready for kindergarten, the family will have saved approximately $12,360.[40]

Since the average tuition cost for private elementary schools is approximately $3,300, this savings could help the family pay for nearly four years of private education.[41] Or, these funds could be saved and used to pay for tutoring expenses to help their child catch up or get ahead during later school years. Funds could also be spent on books, supplies, equipment, and special-needs services for special needs students. College students with 529 savings accounts already enjoy a wide range of higher education options. K-12 students should benefit from the same wide range of choices.

An expanded ESA program would encourage private charity, since taxpayers would be allowed to receive tax deductions for charitable contributions to savings accounts for disadvantaged students.

Greater access these education opportunities through an expanded Coverdell ESA plan would give parents the flexibility to use education savings when and where they are most needed. Moreover, an expanded ESA program would encourage private charity, since taxpayers would be allowed to receive tax deductions for charitable contributions to savings accounts for disadvantaged students. And because of the charitable contributions, disadvantaged children would have more opportunities to receive quality education services during their K-12 and postsecondary education years.

PROJECTING FISCAL IMPACT

State policymakers would likely want to consider the potential fiscal impact of offering a tax deduction for contributions to a child's K-12 and higher education savings account. The fiscal impact of this program would depend on the rate of participation and the amount of new contributions that would be made and claimed as a state income tax deduction. In all likelihood, the fiscal impact of the new tax deduction would be modest and perhaps could even result in a net revenue increase for the state.

First, many of the people who would be making Coverdell ESA contributions would likely have otherwise taken advantage of the 529 College Savings Plan contribution deduction. Since the Coverdell contribution deduction is limited at $2,000 per beneficiary (compared to $2,500 per beneficiary under the 529 program), the state would save a modest amount of revenue when people choose to participate in the Coverdell ESA program rather than the College Savings Plan.[42]

However, new people (including families who choose private schools for their children) would likely choose to make contributions and claim the state income tax deduction if this was made available. The net revenue loss to the state for each contribution would be approximately $95 per year per beneficiary.[43] However, policymakers should bear in mind that when students use education options outside the state education system (including private schools), they reduce the state's education expenses, limiting the program's net fiscal impact.

How This Policy Will Benefit Maryland Students To understand how this policy would benefit Maryland families, policymakers should consider the example of four hypothetical students:

Private school student (K-12): The family of this child plans to enroll him/her in a private school in first grade, where he/she will remain through high school. The family makes annual contributions worth $2,000 into the child's ESA credit, each year beginning when the child is born. Each year, the family receives a state tax benefit of approximately $95.[44] By the time the child is six years old, the family has saved approximately $12,360.[45] By this time, they have received a state income tax relief of $570.[46] This is enough to purchase roughly four years of private elementary school tuition, which is approximately $3,300.[47] The family continues to contribute $2,000 per year into the child's account, saving approximately $1,700 on state income taxes by the time the child finishes high school.[48]

Public school student who needs tutoring: A family chooses to save $2,000 per year in their child's Coverdell ESA—believing that they would like to have the flexibility of choosing a public or private school for their child. The child attends public school through elementary school and middle school. But by the time that the child reaches sixth grade, he/she is struggling in some subjects. Fortunately, by that time, the family has saved more than $24,000 into his/her Coverdell ESA. To help the child get back on track, the family chooses to enroll him/her in an after-school tutoring program, which costs $1,500 over the course of the school year. Thanks to tutoring, the child finishes a successful school year and the family still has more than $22,000 saved in his/her ESA, which, one day, they hope to spend on his/her college education.

High school student who transfers into private school: A freshman in high school has attended public schools through the elementary and middle school grades. However, the child is struggling in his/her new public high school. Fortunately, the parents have contributed $2,000 per year into the child's ESA—expecting to use it on his/her college education. But the added flexibility of the Coverdell ESA allows them to instead use that funding to enroll the child in a private high school. By the time he/she is 14 years old, they have saved nearly $29,000—more than enough to pay for four years of tuition at the average private school.[49] The family will still have some funds saved to spend on the student's college education after he/she successfully finishes high school.

Disadvantaged Student Who Receives ESA Donations: A disadvantaged student's parents are struggling to pay the bills and cannot afford to save for his or her education. Fortunately, relatives and other members of the child's community have decided that they are able to help the family save for his/her K-12 and college education. Thanks to the state tax deduction, these charitable supporters are encouraged to contribute a total of $1,000 per year into the child's Coverdell ESA. By the ESA account will receive $18,000 by the time he/she is 18 years-old. These funds can have been spent on private school tuition or tutoring, or, saved for the students' college education.

CONCLUSION

Maryland offers taxpayers the opportunity to claim a state income tax deduction for contributions made into students' College Savings Accounts. Parents and taxpayers should question why the benefits of the 529 college savings plan are only available to families who save for their children's postsecondary education. Many families and students would benefit from the opportunity to save for their children's K-12 education. To address this need, Maryland could become the first state in the nation to offer tax deductions or credits for contributions made to Coverdell Education Savings Accounts that provide tax-free savings for K-12 and higher education costs.

Offering this tax benefit would provide families with more savings options and help ensure that more children receive quality primary and secondary educations. Those savings, combined with charitable contributions for disadvantaged children, could open the door to new education opportunities for many children. A state tax incentive for Coverdell ESA contributions would help put more parents in charge of their children's education, encourages charity, and reduces dependence on government-provided education.

DAN LIPS *is a Senior Policy Analyst at the Heritage Foundation and a Senior Fellow at the Maryland Public Policy Institute.*

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45. Author calculations, assuming that the savings account earns a modest 3 percent interest rate.
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