The RESP bill is bad tax policy and even worse education policy

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SECTION: COMMENT COLUMN; REWARDING THE RICH; Pg. A15

LENGTH: 738 words

Last week, opposition MPs pushed through a private member's bill introducing deductibility for contributions to registered education savings plans. Yesterday, Finance Minister Jim Flaherty said he will make the RESP issue a confidence matter rather than leaving it to the Liberal-dominated Senate, because "it imperils the fiscal plan of the government."

On first pass, it may be hard to see what could be wrong with tax breaks for overburdened families with children combined with encouragement for education. On some reflection, however, it is clear that RESP deductibility is bad tax policy, and even worse education policy.

Let's review how RESPs are taxed right now. Contributions to RESPs are not deductible for the purposes of taxation, meaning the contributions come out of after-tax money. RESP contributions, however, do attract a matching grant of up to $500 a year. Income earned on the investments inside the RESP is exempt from annual taxation. And withdrawals of the income (but not the original principal) from the RESP are taxed in the hands of the student, who typically doesn't have taxable income exceeding the value of his or her credits anyway.

Under the new proposal, the RESP contributions would become deductible. This means that a typical family making a $1,000 contribution might save $400 off its current tax bill because of the new deduction, reap another $200 through the matching grant, and have none of that money taxed in the future. The new RESPs would allow contributors to avoid taxes not just on the return to saving, but on the principal itself. In contrast, traditional registered retirement savings plans and the new Tax-Free Savings Accounts exempt tax only on the return to saving, with taxes still paid on the principal either up front or later. Deductibility up front plus light taxation on the way out means RESPs provide a large tax benefit for users.

But who gets this benefit? In my research, I have shown that high-income households participate in RESPs almost 3.5 times as much as low-income households. Similarly, households with university-educated parents participate 3.8 times as much as those with less than a high-school diploma. These patterns occur because high-income and high-education families more often expect their children to attend postsecondary education, and because they are more likely to have room in their budget to put money into an RESP. There is no evidence that RESPs do anything but perpetuate the existing socio-economic mix on our campuses.

It is clear that most of the benefit of RESPs goes high up the income scale. Some might argue that middle- and high-income Canadians deserve a tax break. Those Canadians pay the bulk of the taxes, so perhaps a little relief might be justified. But an honest tax policy would make that argument up front rather than slipping it through under the guise of an education policy. If tax relief is on order, there are better ways to do it - broad-based cuts in tax rates, say.

The reported cost of RESP deductibility is $900-million annually. (This assumes RESP contributions don't grow in response to the tax change - which they will.) For the same $900-million, we could send a $1,000 cheque annually to each Canadian undergraduate, or completely fund the operations and research at a university the size of McMaster, or quadruple the size of the Canada Research Chairs program, or double the size of the Canada Student Loans program. Instead, RESP deductibility funnels that $900-million to high-income households, the children from which are likely to attend postsecondary schools without any tax incentive. Is RESP deductibility really the best way to build our education system?

I have little doubt that the RESP deductibility proposal will prove popular among RESP users. Who doesn't want a tax break?
But the right question isn't whether students should be supported or taxes lowered. It's whether the RESP deductibility proposal is the best way to achieve those goals. If we're going to hand out $900-million tax breaks, should they go primarily to high-income families with university-bound children, or to all Canadians? Similarly, if we're going to spend $900-million more on federal support for education, is RESP deductibility the best way to do so?

Canadians interested in good tax policy and smart education policy should hope that, one way or another, this ill-conceived proposal is rejected.

LOAD-DATE: March 11, 2008

LANGUAGE: ENGLISH

PUBLICATION-TYPE: Newspaper

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