TD Economics

Special Report

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TIME TO RE-THINK FINANCIAL ASSISTANCE FOR POST-SECONDARY EDUCATION

A private member's bill has passed the House of Commons that would dramatically alter Registered Education Savings Plans (RESPs). In the current scheme no tax deduction is received when contributions are made, but the interest and capital gains on the funds are not taxed until withdrawn. Then the financial returns are taxed in the hands of the students. In the Liberals' bill an upfront tax deduction would be received at the time of contribution but all the proceeds, the original contributions plus any accrued return, would be taxed at the time of withdrawal. The intent of the bill is that all withdrawals would be taxed in the hands of the student. However, there appears to be a legal opinion within the Department of Finance that as written, the withdrawal of the original contributions would be taxed in the hands of the contributor and only the gains would be taxed in the hands of the student. If the funds were not used for the designated education purposes, the funds would be taxable in the hands of the contributor along with a penalty to mitigate any benefit from tax deferral. The bill is now before the Senate. The Conservatives have pledged to block the new scheme from being implemented.

Instead of viewing the piece of legislation in isolation, the Senate could perform a useful function of reviewing all programs offering financial assistance for post-secondary education. If the goal of this assistance is to facilitate access to education for children of low and modest-income families, the conclusion will be that this new bill would make the current flawed system even less efficient.

Clarification of Parliamentary Rules

Some observers have wondered how such a private member's bill could be introduced into the House of Commons. Private members cannot introduce money bills. But a money bill is one that proposes to raise taxes. Bills that reduce taxes are not prohibited. There is of course an element of tax increase within this bill. All withdrawals would become taxable rather than just the returns on the contributions. However, the Speaker ruled that this did not violate the money bill provision as the net result is a significant tax reduction.

Substantial Cost to the Treasury

Finance Canada has estimated that the proposed change would cost the treasury $900 million per year. This calculation is based upon an assumption that the flows into the new scheme would be similar to the current program. This is likely flawed. The proposal offers a lucrative form of tax deferral and splitting and we know Canadians love to find ways of reducing their household tax burden. With little potential for net penalty many more Canadians are likely to take advantage of the proposed new scheme. The cost would likely be double the Finance estimate, or around $2 billion per year.

The income re-distribution effects are wonky

Tax deductions favour higher-income participants because the value of the deduction is determined by your tax rate and that rises as you move up the income tax brackets. The deduction for someone in the highest tax bracket would be worth about double the value to someone in the lowest bracket. For example, at the federal level the deduction would be applied at a rate of 15 per cent for taxfilers up to $37,885 of income, while the deduction rate would be 29 per cent for someone with more than $123,184 of taxable income. Most provinces also have progressive tax rates, so the relative attractiveness of a deduction for higher-income taxfilers becomes even greater for total taxes.

The current RESP scheme does not contain such a bias in favour of higher-income individuals. Indeed, in a subtle way it makes it relatively more onerous at higher levels of income. As contributions must be made out of after-tax earnings, the higher the rate of taxation, the more that must be earned on a before-tax basis to make the same after-tax contribution. Yet the benefits of the existing RESP program are heavily skewed toward the well off. The program is disproportionately used by high-income, high-wealth and high-parental education families. A Statistics Canada survey released in 2001 showed that only 6.3 per cent of children from households with less than $30,000 of annual income were beneficiaries of RESPs and the figure was 12.7 per cent for families with incomes between $30,000 and $49,999. In contrast, 21.7 per cent of children in households with income between $60,000 and $79,999 and 29.9 per cent of children from households with more than $80,000 were beneficiaries (Statistics Canada Daily, April 10, 2001).

On the basis of published information available on the distribution of households with RESPs, one study concluded that roughly 70 per cent of the benefits from the RESP program and the associated Canada Education Savings Grant (CESG) go to families with incomes above the national median. (Meeting the Need: A New Architecture for Canada's Student Financial Aid System, Ross Finnie, Alex Usher and Hans Vossensteyn, IRPP, August 2004). But due to the unavailability of the data to the authors, they had to assume that regardless of income, all RESP holders had the same amount of money in their plan. This clearly is an invalid assumption, as subsequent data reveals. In 2001 the average amount saved in a RESP was $2,200 for households with less than $25,000, but 2.2 times that, or $4,880, for households with income above $85,000. (Planning and preparation: first results from the Survey of Approaches to Educational Planning (SAEP) 2002, Statistics Canada). In 2005, from unpublished data from the Survey of Financial Security, we see that while only 18.6 per cent of families had more than $75,000 of after-tax income, they held 53 per cent of all RESP assets. Families with less than $40,000 of after-tax income made up 50.6 per cent of the population but held only 15 per cent of RESP assets. In the middle, 30.8 per cent of families had between $40,000 and $74,999 of after-tax income and 32 per cent of the RESP assets. So the benefits of RESPs, and by inference CESGs, are much more skewed toward the wealthy than this study showed.

There are at least 3 reasons why RESPs and CESGs are concentrated among the well off. First, the higher the income, the easier it is to put aside savings. Second, children from higher income families are more likely to attend post-secondary education. Third, many people only become aware of RESPs and CESGs through the advice of professional financial planners and lower-income households are less likely to access such services.

For 2008, Finance Canada estimates the total cost of tax-driven education assistance to be $1.8 billion. This total support is only slightly less tilted toward the wealthy than RESPs and CESGs, with families above the national median receiving roughly 60 per cent of all education and tuition tax credits. The cost of the CESGs, at more than $500 million per year, should be added to this total because they are a sister program to the tax-driven RESPs. That brings the total to $2.3 billion. Under the Finance Canada estimate for the cost of the RESP bill now before the Senate, the total cost would be $3.2 billion. A more realistic total, taking into account the likely greater popularity of the new RESP scheme, would be $4.3 billion. To put this massive figure into some context, consider that it is sixty per cent of total tuition revenue from all Canadian universities and colleges (Statistics Canada estimates total tuition at $7.1 billion for 2007). The tax assistance works out to almost $10,000 for each of the half a million students current holding a Canada student loan.

If a substantial further amount of funds is going to go into supporting access to post-secondary education then it is important to ensure the best bang-for-the-buck. The whole education financial support system is already inefficient with one program layered on top of another. The February 26th Budget set out some promising principles to clean this up a bit. The proposed new RESP scheme does not fit into that clean up. It is a dandy income deferral and splitting mechanism, although it only covers a limit portion of the population. No doubt it would prove very popular, especially with higher-income households. For a great sum of money, however, it would likely do little to improve access to post-secondary education for children of lower-income families. It is interesting to go back to the document "Canadian Opportunities Strategy" which accompanied the 1998 federal budget and introduced the CESGs and enhancements to other aspects of financial assistant for students. The stated goal was to focus government

assistance on those with "low and middle incomes." If that remains the goal then a complete re-think of the system is in order. Straight grants, based upon the income of the household, would be much more effective in achieving this goal.

A chance for the Senate to shine

If the private member's bill passes through the Senate, the Conservatives would need to put an amendment on another bill, or introduce a new bill, with the express purpose of cancelling the Liberals' private member's bill. But as the Conservatives couldn't muster the votes to defeat the private member's bill in the House the first time, they would not likely be able to pass such an attempt to cancel it. They would then need to put the issue forward as a Confidence Motion. It is highly unlikely that post-secondary education financing would be a centerpiece of an election. More likely is a sad situation in which such an important policy issue becomes a political pawn.

The Senate has a track record of producing some excellent non-partisan studies of critical policy areas. It should rise to the challenge of studying the myriad of programs to assist students to finance post-secondary education. This should include not only the proposed new scheme for RESPs, but existing programs including education and tuition credits and the CESG. As well, it should address whether the RESP is still a viable policy instrument in light of the introduction in this year's budget of Tax Free Savings Accounts (TFSAs). They offer many of the advantages of RESPs with fewer restrictions. The review should also examine the proposals in the Budget to re-vamp student financial assistance. The new Canada Student Grant Program appears to go in the direction advised here.

If the new, proposed RESP scheme does proceed, one detail will have to be addressed. It appears that as written, taxes will apply when contributions made from the end of 2005 are withdrawn. But contributions made in 2006 and 2007 did not receive a tax deduction. So unless corrected, this would amount to double taxation. And the apparent confusion over who is to pay the taxes on withdrawal will have to be straightened out.

Hopefully rational thought will rule the day and all parties will see the value of stepping back from political strategies and put their talents toward thinking of the best post-secondary education financing plan. If improving access to education of children of lower-income families is the goal, then we are not on the right path.

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