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Using Cash Rebates for Tax Relief Without Risk

by Herbert Grubel and Michael A. Walker

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Using Cash Rebates for Tax Relief without Risk

Since 1994, Paul Martin's fiscal policies have eliminated the budget deficit which had threatened Canada with serious financial instability. His prudent budget forecasts and the use of a contingency reserve have restored public faith in the budget process. He can justly be proud of these achievements, but his job is not yet complete.

Martin's incomplete job and risk

Large fiscal surpluses have developed and will continue to develop in Canada if spending is held constant (see table 1). (For a discussion of the assumption underlying this projection, see Grubel, 1998, chp. 1.) These projections, made in the summer of 1997, have turned out to be slightly too conservative for 1998/99. In January 1999 it is widely believed that the surplus for the current fiscal year will be about $7.5 billion. Most important for our analysis is that the annual *increases* in the surplus rise gradually from about $7 billion to $10 billion. There is a clear need to use this surplus to cut taxes because Canadians' tax burdens are too high and keep the economy from reaching its full potential. A recent study of taxation in major countries worldwide showed Canada with a rating of only four on a scale of 10.[1] There is also a clear need to reduce the level of Canada's debt, which is still the third highest among industrial nations.[2] A lower debt is necessary to reduce the risk that future recessions and higher interest rates will again result in deficits.

Paul Martin is hampered in his efforts to enact tax reductions by the following legitimate and fully understandable concern. If, in his forthcoming budgets, he announces plans for tax cuts equal to the *expected* year's surplus, an unexpected recession or increase in interest on the debt will create a deficit. His commitment to balanced budgets would be questioned, and he would lose the public credibility he has worked so hard to develop.

Retrospective cuts and cash rebates

To eliminate the risk of deficits, we propose that fiscal surpluses be returned to taxpayers as cash rebates at the end of the year they are realized. These same surpluses should lead to permanent tax cuts at the end of the following year, but only

Table 1: Potential Fiscal Supluses

Year	Projections of the federal surpluses ($ billion)	Increase due to that year's growth, inflation, and bracket creep ($ billion)
1998/99	$4.4	N/A
1999/00	11.1	$6.7
2000/01	18.7	7.6
2001/02	27.1	8.4
2002/03	36.5	9.4
2003/04	46.9	10.4

Source: Herbert Grubel, "Canada's Fiscal Imbalances," in *How to Use the Fiscal Surplus: What is the Optimal Size of Government?* ed. Herbert Grubel (Vancouver: The Fraser Institute, 1998), fig 13, p. 22.

1 The information is for 1995 and is from Gwartney and Lawson, 1997, p. 70.

2 Among the OECD countries, only Belgium and Italy have higher debt-to-GDP ratios. For details, see Alexander and Emes, p. 61.

if economic conditions are favourable. Here is how we envision this strategy working.

Assume that at the end of the 1998/99 fiscal year the surplus is $10 billion. Under these conditions, in May 1999, Canadians would be sent tax refund checks summing to that amount.

The 1999/00 budget would retain the taxation structure and levels of the preceding fiscal year. If the economy stays on its normal growth path and interest rates remain unchanged, that year's fiscal surplus would equal $10 billion, plus another surplus of, say, $5 billion. The 2000/01 budget would again provide for a cash rebate to taxpayers a month or so after the budget is tabled. In that year, the rebates would sum to $15 billion. However, importantly, the 2000/01 budget would also lower tax rates permanently to levels which would wipe out the surplus of $10 billion first realized in 1998/99.

If the economy remains on its normal growth path and interest rates are unchanged, the permanent reductions in tax rates would create a surplus during 2000/01 of $5 billion, which is equal to the surplus of the preceding year ($15 billion) minus the effect of the permanent tax cut ($10 billion). The effect of economic growth and bracket creep in that fiscal year would add to the surplus another, $7 billion, say. Therefore, the 2001/02 budget would provide for a cash rebate of $12 billion, and a permanent tax cut of $5 billion (the surplus of 2000/01 due to inflation, growth and bracket creep).

The proposed process would continue until the optimum level of spending and taxation at 15 percent of GDP is reached.

Reducing the debt

At the proposed optimum level of taxation equal to total federal spending, a large proportion of that spending goes to servicing the debt. We recommend that these debt servicing payments be reduced through a program of debt reduction. Program spending can then rise, within the 15 percent limit, to replace the debt payments which will no longer be required. Thus, if at the target level of taxation, increases in revenue continue to accrue at rates greater than necessary to maintain balanced budgets and total federal spending at 15 percent, the surpluses should be used to pay down the debt. Through time, this process would permit program spending to rise as a fraction of total spending. If the debt were eliminated completely, taxation and program spending would equal 15 percent of GDP. In other words, under our proposed strategy, the government would return to taxpayers current services exactly equal in value to the amount they paid in taxes. As a result, there would be no more inequitable inter-generational transfers of resources through debt creation and servicing.

The fate of the contingency reserve

One of Martin's budget innovations has been the use of $3 billion annual contingency reserves. This sum enters the budget as a spending category. The reserve results in a balanced budget even if projections of revenues are overestimated and spending is underestimated by a maximum of $3 billion. Any portion of the reserve not needed to balance the budget has been used to reduce the debt, not to increase spending.

We recommend that the government retain the use of the contingency spending reserve. It offers additional protection against deficits, but importantly also institutionalizes the process of paying down the debt.

A simple method for making cash rebates

The proposed cash rebates equal to annual fiscal surpluses would be tax-free windfalls for con-

sumers. They should stimulate the economy and create jobs. A number of issues surround the payment of these rebates.

First, economic studies suggest that windfall income is used by many consumers to retire debt or add to savings, since they tend to be reluctant to spend what may only be a temporary increase in disposable income. The resultant increases in earnings on savings or lower interest payments on debt would ultimately result in permanently higher spending. Therefore, the tax rebates do not add as much to aggregate demand as would permanent tax reductions of equal size. However, if the proposed rebate system increases public confidence in the government's determination to avoid deficits, it might stimulate aggregate spending.

Second, the procedure for determining the size of the tax rebate cheques going to every taxpayer can be simple or quite complicated. We recommend that the procedure be kept as simple and transparent as possible. Only under these conditions can the rebate system be protected from the drawn-out political process of using it to create a more equitable distribution of income or favouring certain interest groups.

For this reason, we suggest that rebates be sent only to filers of personal income taxes, and in proportion to the amount of tax they paid. In 1998/99, personal federal income tax revenues were expected to be about $71 billion, which implies that the assumed $10 billion surplus would bring an average rebate of 14 percent on federal taxes paid. A surplus of $7.5 billion would result in a rebate equal to only 10.6 percent.

However, even under this simple system it is necessary to take into account that many low income Canadians pay no income tax. They do, however, pay GST, and receive a GST rebate to relieve them of the burden of paying that tax. To enable these individuals to share in the rebate process, and to account for the fact that the GST rebate does not fully compensate them for the GST they have paid, bonuses on the GST checks should be paid at the same time as tax rebates are paid out to those who receive them. Under this procedure, the $10 billion surplus would provide a lower average rebate for all taxpayers than the 14 percent (or 10.6 percent) noted in the preceding paragraph.

Basing rebates strictly on the amount of taxes paid and GST rebates is transparent, administratively simple, and devoid of political influences. In addition, since most people know or can readily find out what taxes they paid in the preceding year, they could make financial plans well in advance of the receipt of the rebate cheque after the official announcements about the likely size of the rebate have been made. As a result, the impact of the rebate on taxpayer behaviour would be evened out during the year. Finally, this approach has the advantage that taxpayers who pay low taxes because they take advantage of tax-shelters receive correspondingly lower rebates.

Rebates and social policy

We anticipate that possible fiscal surpluses and cash rebates would lead to demands that they be used to pursue social objectives. For example, there might be demands to use the rebate system for reshaping the distribution of after-tax income, favouring those with low incomes. If the average rebate were 14 percent, the recipients of GST rebates and those in the lowest earnings quintile might be targeted to get rebates of 17 percent, while those in the top quintile received only 10 percent, with correspondingly graduated percentages applied to those in the other income quintiles.

We advise against this approach since it makes for greater progressivity of the income tax system. Any changes in progressivity should be un-

dertaken only after lengthy debate and in the framework of a comprehensive review of the structure of taxation. In addition, the use of rebates for income redistribution would open a Pandora's box of political lobbying, which would absorb an inordinate amount of the government's and legislature's resources.

We anticipate that there would also be demands to pay cash rebates to business. We recommend that corporate tax rebates be based only on retained earnings, i.e., the portion not paid out as dividends. The reason is that the owners of shares of corporations would have reported dividend income and would receive a rebate on that portion of the taxes they paid.

Keep on using old budget strategies

We believe that Finance Minister Martin should assure continued public confidence in the budget-making process. To do so, for the period of tax-reductions he should adapt the innovative policies of clarity, and firm targets and their achievement which he used during the period of deficit reduction.

First, he needs to set out an ultimate target for taxation equivalent to his initial deficit target.[3] We propose setting this target for federal taxation at a level of 15 percent of GDP. (As explained below in Appendix A, at this level, Canada's economic growth rate would be maximized.) Under some reasonable assumptions about economic growth, this target could be reached by the year 2008 if spending is held constant in nominal terms. This means that the target can be reached in less than 10 years without any further deliberate spending cuts in budgets.

Second, annual budget projections should cover only 3 years, much as they did during the deficit-fighting phase. This strategy permits the government to adjust figures in the light of evolving and unexpected developments without threatening the credibility of the entire fiscal plan.

Third, the plan for constant spending needs to be flexible, to a limited degree, to accommodate legal requirements like increased spending on pensions and native affairs due to larger numbers of eligible persons. The gradual reduction of interest payments on the national debt occasioned by reductions in the size of the debt would provide room in the budgetary framework for these required increases in spending.

3 In his first three budgets, Paul Martin aimed for a deficit equal to three percent of GDP. This target did not have an economic rationale and was chosen on political grounds. It met the requirements of the European Community for membership in the euro-currency area and what was good enough for these industrial countries was considered to be good enough for Canada.

Appendix A: Deriving the Optimum Level of Spending and Taxation

Research has shown that government spending in Canada has been most conducive to economic growth when it equalled 34 percent of national income. Spending at lower or higher levels has historically been associated with lower growth rates in Canada.[4]

The figure of 34 percent of GDP refers to *total* government spending, while the preceding analysis focused on federal spending alone. To estimate what the share of federal spending is when total spending is at 34 percent, we use table A1.

The 1997 spending data are actual. The other figures are simulated under the assumption that total and federal spending remains unchanged at these 1997 levels. GDP is assumed to grow at 2.5 percent annually.

Table A1: Simulation of Spending as a Percent of GDP (Assuming constant nominal spending and nominal GDP growth of 2.5 percent)

Year	Nominal Total Government Spending	Nominal Federal Spending	Nominal GDP	Percent of GDP	
				Total Spending	Federal Spending
1997	385	164	855	45.0	19.2
1998	385	164	876	43.9	18.7
1999	385	164	898	42.9	18.3
2000	385	164	921	41.8	17.8
2001	385	164	944	40.8	17.4
2002	385	164	967	39.8	17.0
2003	385	164	992	38.8	16.5
2004	385	164	1,016	37.9	16.1
2005	385	164	1,042	37.0	15.7
2006	385	164	1,068	36.1	15.4
2007	385	164	1,094	35.2	15.0
2008	385	164	1,122	34.3	14.6
2009	385	164	1,150	33.5	14.3
2010	385	164	1,179	32.7	13.9

Source: Calculations by authors.

4 See Grubel and Chao, 1998; Tanzi and Schuknecht, 1998.

As table A1 shows, under these assumptions, total spending equals 34 percent of GDP in 2008. At that time, federal spending would be 14.6 percent of GDP (rounded to 15 percent in the discussion above).

Note that the assumed annual growth rate of 2.5 percent in nominal terms is likely to be exceeded, the more so the higher the inflation rate. Higher nominal growth rates have two implications. First, if nominal spending remains constant, the target of 14 percent of GDP will be reached much more quickly than the 8 years implied in the above simulation. Second, if inflation produces strong pressures to increase spending in certain areas by the amount of inflation, such spending can be increased to match the inflation rate. The target rate of 14 percent would still be reached in 8 years. If spending is increased to match inflation, we recommend that it not be universal for all programs. Instead, selective spending increases can be used to rationalize the relative size of programs without the political cost accompanying selective cuts in nominal spending.

Appendix B: Implications for Provincial Budgets

The analysis and simulation above imply that both the provincial and the federal government hold spending constant in nominal terms in order to reach the critical 34 percent level of total spending.

The effect of cash tax rebates by the federal government would be to leave provincial revenues unchanged, since in all provinces except Quebec, provincial taxes are specified as a percent of federal taxes owed. Provincial revenues would decrease if provinces kept their rate of taxation unchanged whenever the federal government reduced its tax rates. However, these revenue losses would not create provincial deficits if total spending is held constant.

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About the Authors

Herbert Grubel has been Professor of Economics at Simon Fraser University since 1971, and has a B.A. from Rutgers University and a Ph.D. in economics from Yale University. He is also the David Somerville Fellow in Taxation and Finance at The Fraser Institute. He has taught full-time at Stanford University, the University of Chicago, and the University of Pennsylvania; he has had temporary appointments at universities in Berlin, Singapore, Cape Town, Nairobi, Oxford, and Canberra. Herbert Grubel was the Reform Party Member of Parliament for Capliano-Howe Sound from 1993 to 1997, serving as the Finance Critic from 1995 to 1997. He has published 16 books and 180 professional articles on economics dealing with international trade and finance and a wide range of economic policy issues.

Michael Walker is an economist, journalist, broadcaster, consultant, university lecturer, and public speaker. Since 1974, he has directed the activities of the Fraser Institute. Before that, he taught at the University of Western Ontario and Carleton University and was employed at the Bank of Canada and the Federal Department of Finance. He received his Ph.D. at the University of Western Ontario and his B.A. at St. Francis Xavier University.

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