■ VIEWPOINT ■

Roger Martin

How to Judge the Budget

Paul Martin should be spending for future prosperity. Here's what's needed

WHAT CAUSES PEOPLE TO LIVE, WORK, SAVE AND INVEST in Canada? What leads firms to locate, invest and innovate in Canada? These questions need to be considered in pondering Finance Minister Paul Martin's Feb. 28 budget. Reason: while the Liberal government has slain the federal deficit, it has presided over the worst decade in living memory for Canada's relative prosperity.

After many decades occupying third place in the world in gross domestic product per capita (if city-states and tiny countries are excluded), Canada slipped to the fifth spot in 1991. We have vacillated between fifth and seventh ever since. Ireland, which in 1987 had half our standard of living, is set to become a more prosperous country than Canada in 2000. Canadians have long consoled themselves by characterizing the U.S. as sacrificing social spending in order to create high levels of wealth. Now we must face the fact that the wealthy U.S. is spending more per capita on social programs than Canada does.

In response to this challenge, Ottawa prepares for the budget by polling ministries for wish lists of investments, which not surprisingly engulf every dollar of the emerging surplus of $62 billion over the next five years. And the government is hewing to an arbitrary rule of 50% social spending, 50% tax and debt reduction, without any logic supporting that split.

Interestingly, this is exactly how unsuccessful firms plan their investments. They determine how much they have to spend, ask each division what it would like to spend and then allocate money based on keeping the peace among warring divisions. Successful firms, on the other hand, invest on the basis of a winning vision. They decide first on their goals, determine what investment is required to achieve each goal, then invest what is needed to achieve it. If these companies don't have enough capital, they narrow their goals. But they don't spend ineffectively.

The Chrétien government's fifty-fifty split between spending and cutting is the wrong notion completely. I would argue that at least 50% of the budget should be dedicated to measures that strengthen incentives for work and investment, which in turn strengthen prosperity. That means the government needs to consider tax cuts of a particular kind.

Why so? An economy's prosperity is strongly influenced by the decisions made by citizens and firms on how much they will work and invest. In each case, the benefit is highly sensitive to the tax rate on the last dollar earned, the marginal tax rate. In a progressive tax system, the marginal rate is always the highest rate paid. So in Canada we all pay 17% in federal tax on the first $30,000 in taxable income, 26% on the next $30,000 and 29% thereafter.

The weakest tax cuts leave marginal rates constant but reduce the overall amount of taxes paid, thereby spending part of the government's surplus. An increase in the child tax credit, for example, leaked as a likely budget measure, would put more money in the hands of every Canadian with a child and thereby cost a lot. But it would not change the incentive to work or invest. Similarly, such leaked measures as increases to the GST credit and the disability credit may be worthy, but they are expensive and leave incentives unchanged.


TOM HANSON—CP

The point on Feb. 28 should be increasing prosperity

A modestly more effective scheme, also expected, is raising the thresholds at which the 26% and 29% tax brackets take effect. This would lower the marginal rate for Canadians whose income level falls between the old threshold and the new—a good thing. But it would leave the incentives for everyone else the same. It would again be expensive because all wealthy Canadians would have more income subjected to the lower 17% and 26% rates while their marginal incentives would remain unchanged.

The best measure would cut the marginal tax rate for all Canadians because that would stimulate more work and investment and strengthen the economy. It would cost nothing in terms of outlays, for instance, to raise the 17% tax bracket on the first $30,000 of taxable income to high-income Canadians while reducing their marginal rate from 29% to 26%. Everyone with taxable income of less than $150,000 would pay the same or more tax, but all would have a greater incentive to save, invest and earn more income. Measures such as the reduction of rates on each tax bracket, eliminating the current federal individual surtax, reducing capital-gains taxes, and reducing corporate income tax rates would all improve incentives to prosper.

The same applies to program spending. Increased funding of university research and specialized education to help meet the human capital needs of growing industries will make Canada more productive. Increased funding of health care or day care, while laudable, don't have that effect.

Canadians should look closely at the budget to see whether at least 50% of the surplus aims to boost prosperity. If it doesn't, then we may have squandered a historic opportunity. ■

Roger Martin is dean of the Rotman School of Management at the University of Toronto