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Tax Policy and Industrial Policy

*Robert Couzin**

INTRODUCTION

Alain Robbe-Grillet, the French film-maker, once observed, paraphrasing Aristotle, that every good story should have a beginning, a middle, and an end - although not necessarily in that order. So I shall begin with my conclusion.

I believe that the role for tax policy in forging an industrial policy is very limited, for two reasons.

The first is a matter of personal preference. This conference has, not surprisingly, been polarized by views in favor of or against industrial policy (as well as some haggling over definition). It is not within the scope of my remarks, or my expertise, to join that debate. However, it is incumbent upon me to stake out a position.

Ruskin said that government and co-operation are the laws of life, while anarchy and competition are the laws of death.¹ I believe he overreacted to the seamier side of social Darwinism. I start from the proposition that government should neither manage nor restrict competition, although active steps may be required to promote competition, and to control or balance some of its less positive side-effects. My reasons are an amalgam of those expressed by others: a philosophical view of why we have societies in the first place, a perspective on what is "fair" in the distribution of income and wealth among citizens, and a bias (albeit uninformed) towards the economic arguments which favor the market over a few smart people in a room as the best mechanism for allocating resources and creating wealth. "Free trade" is a pleonasm; "managed trade" is an oxymoron.

Whatever I may think, of course, nations (certainly Canada) will adopt bits and pieces of industrial policy. It is both unrealistic and probably wrong to be a purist. Some activities of the state, including social policy, will necessarily entail elements of industrial policy. Consider training and health care. Thus, the technical question must be posed, whether tax policy is an appropriate and useful instrument for achieving whatever may be the goals of the industrial policy.

The second reason for my conclusion is, therefore, a technical

* Société Jundique Internationale (in association with Stikeman, Elliott, Paris).

The following text was compiled from the transcript of the remarks made by Mr. Couzin at the Conference.

¹ JOHN RUSKIN, SELECTED WRITINGS 275.

judgment, more plumbing than philosophy: I doubt that tax policy is the right instrument to effect such industrial policy as the society may choose. I should, however, emphasize that this is indeed a technical matter rather than an issue of principle. I do not see any ideological bar to using tax policy to achieve other objectives. It is legitimate for government to examine all policy instruments in order to assess what works best.

DEFINITIONS

Discussion is often facilitated by a definition of terms.

Tax Policy

Taxes are collected from taxpayers and spent by governments to fulfill the textbook demands of allocating resources, stabilizing the economy and redistributing wealth. Modern tax systems do many other things. They change the cost of goods and services, either inadvertently or by design. Government intervention in the economy can be fostered or effected through the tax system. Differential prescriptions or proscriptptions can mimic regulation or spending programs.

A bottoms-up notion of tax policy would begin with the basic elements of any tax system. First and foremost is the choice and definition of the tax base (e.g. income or consumption). Second, what is the tax mix? Which bases should be used, and in what proportions. The recipe for extracting sufficient resources to accomplish government objectives, while inflicting the least damage on the economy which generates those resources, is not easy to come by. There is no accounting for tastes. Next, what is to be the taxpaying unit (e.g. the individual or the corporation), and the rate structure? Once those are determined, a number of technical provisions are likely to follow in an attempt to keep the base to what was decided, to prevent the unit from flying apart (such as through income splitting) and to protect the integrity of the rate structure.

Our hypothetical tax system can then be judged, having regard to the elements which it is supposed to contain and the objectives it is supposed to serve. Simplicity, for example, is important because complexity breeds economic inefficiency and leads to tax avoidance. Equity is another criterion for judging tax systems, reflecting a political view that all citizens are equal (in some sense) and should be so treated. Neutrality is another way of saying that the tax system should accomplish its objectives in a manner which does not reduce the overall efficiency of the economy more than is necessary.

The formation of tax policy can be viewed by retrospective example, namely recent trends in the OECD and in Canada. To reduce economic inefficiencies, bases have generally been broadened. Special

treatment of certain industries has been reduced in the corporation income tax. Consumption tax has been broadened to include as many goods and services as possible without giving rise to unacceptable (and not correctable) regressivity. Other trends reflect not so much policy as underlying economic reality. Corporate taxation is a reducing fraction of the total tax mix. These trends reflect the growth of individual income and consumption, and the growing mobility of capital. This is no place to rekindle debates on deficit financing (although I will return to the matter below), but another trend in taxation is related to that fiscal reality. Taxes, especially in Canada, have been going up, from thirty-one percent of GDP in 1985 to thirty-seven percent of GDP in 1992. That, in itself, is a challenge to tax policy because economics can deal with low rate bad taxes more easily than they can deal with high rate bad taxes. It is surprising how preposterous and unjustifiable a tax can be if the rate is low enough.

Industrial Policy

Even the most liberal economic systems welcome an element of command economy during time of war. A Roman aqueduct or a Canadian transcontinental railway is a collectivization of the wealth of citizens for the good of all. Normally, although not always, "public" works redistribute resources from the few to the many. Once the justification for government becomes the nation state, rather than the hereditary sovereign, expenditures on such public works, and indeed war, may be justified either by a collective conception of the body of citizens, or through more mundane discussions of "externalities". Even if it is in everyone's interest to fight the war, it is not enough in any one person's interest to give rise to the construction of tanks.

These philosophical discussions would be interesting to pursue, but for present purposes it is probably sufficient to note that both threads do run through modern discussions of industrial policy. It may be that bridges and technical education are both desirable because they reflect a national will, or it may simply be a matter of providing what people clearly want but cannot get through normal market forces. What matters in this discussion is that governments do decide to spend our money on such things. It is also true that the extent of such dirigisme is relevant, and fluctuates over time.

We seem to be witnessing an upward surge. Like Zelig, suddenly we are all playing the saxophone and talking about "infrastructure". To restate my own position, I would severely limit the notion of industrial policy as applicable in a world of liberalized trade and free (or "freeish") capital flows. My proposed restriction on the role of public intervention is that it should foster the allocative miracle of market forces, rather than the reverse. Government does have a responsibility to correct market failures and prevent anti-competitive behavior. It will

probably also be necessary to offset some of the undesirable results of market allocations. I concede that such redistributive policy is "anti-market". It reflects, if you will, that root of modern society which lies in Rousseau's compassion.

TAXES AND MARKETS

Governments intervene in markets. Over the last few decades, they have discovered that virtually all types of intervention can, at least in theory, be accomplished or fostered through the tax system.

Tax Expenditures

Direct spending programs are often intended to reduce the cost of certain goods or services, either to correct for market failures, to encourage desirable behavior or to implement a social policy. Such government largesse can be delivered through what have come to be known as tax expenditures. While tax expenditures are now a well understood facet of tax systems, governments rarely aggregate them with ordinary expenditures, and the public tends not to perceive the total effect of government intervention. If the state spends money both by reducing taxes it would otherwise collect and by spending taxes it has collected, there should clearly be a composite measure of how government actually supports industries or individuals.

A related, but different, point is that if a particular tax measure is best regarded as indirect government spending, then it is inappropriate to take that measure (but not direct government spending) into account in determining an "effective tax rate". True, the marginal effective tax rate may be a useful shorthand tool for expressing both the unadjusted tax rate and the effect of tax-based incentives. However, it is analytically incorrect and sometimes practically misleading. A taxpayer who claims the benefit of a tax expenditure (or a direct expenditure) is actually subject to the full statutory tax rate, and is receiving government assistance. We do not normally calculate the effective tax rate of individuals taking into account welfare payments, or of corporations taking into account defense contracts. If used without caution, marginal effective tax rate analysis denies the robust character of tax expenditure analysis by allowing the distinction between direct and indirect government expenditure to creep back in. As programs shift into or out of the tax system (such as health insurance premiums) the calculated tax rate appears, almost magically, to change.

The difficulty in identifying and measuring tax expenditures is certainly relevant to our theme. For example, one type of government intervention commonly justified by the externality argument is support for research and development. Society contributes to private R&D through direct government grants, government contracting with a sub-

sidy element, government funded research organizations, government funding through universities, procurement policies, regulated rates of return in utility and other monopolies and, of course, tax incentives. Any assessment of government policy towards reducing the cost of research and development by reallocation of public resources must begin with an examination of all of these measures. Until we determine how all government programs, taken as a whole, support (or impede) an economic activity, we do not know what the industrial policy actually is.

The effective tax rate issue is equally important. If research and development incentives are tax expenditures, conscious attempts to reduce the cost of research at public expense, then it makes no sense to describe the tax rate applicable to corporations which perform such research as being reduced by the incentive. The public perception that tax incentives are a rip-off is persistent and resilient to information. That perception is often promoted by governments, when it suits their purposes.²

Effective tax rates are often cited in the comparison shopping (actual or intellectual) among tax systems. "High tax" jurisdictions such as Canada sometimes respond to unflattering depictions of their tax systems by pointing out, usually in a very crude way, the need for aggregation of tax and ordinary expenditures, and the misleading nature of effective tax rates. More fundamentally, these problems of measurement prevent any serious examination of the extent and effect of industrial policy. That is not surprising. Cynics have long noted that one of the reasons for having tax expenditures is to make such examination more difficult.

Redistribution

Tax systems redistribute income and wealth among citizens in two main ways: progressive rate structures, and differential exemptions or deductions, in effect different tax bases for different people. Such measures may be promoted, and justified, on grounds other than redistribution. For example, progressive taxation has been defended on the basis of a declining utility function of money. Medical expense credits may be an attempt to achieve horizontal equity, based upon a "similar circumstances" test which takes health into account. In some cases there is a redistributive provision which is not really an element of the tax system at all. Sophisticated attempts to prevent high marginal tax rates

² The recent proposals for a corporate minimum tax in Ontario are a good example. The government finds it "unfair" that certain corporations have a low effective tax rate on book earnings, while recognizing that the low rate is the direct effect of the receipt by the corporation of tax expenditures. There is no suggestion that the minimum tax should apply to a corporation receiving government grants for the same expenditures.

on working poor, for example, reflect a quite proper attempt to integrate taxation and social assistance. The social assistance is, obviously, redistributive. The tax system is altered merely to accommodate social policy.

It is important, although not fashionable, to distinguish between redistribution and other reasons for progressive taxation and differential exemptions and deductions. It may well be that progressive income taxes, wealth taxes on only a small proportion of the population, personal exemptions and integration of social and tax policy all make sense, and are efficient, fair and democratic ways of achieving the desired redistributive justice. However, they are not the only methods now adopted to that end. Just as it is misleading to describe the corporation receiving research and development tax credits as paying a low rate of tax, and ignoring the other assistance that same corporation receives outside the tax system, so the picture of the individual taxpayer is misleading and incomplete if limited to effective tax rates and tax based redistributive measures. Why does a tax credit for medical expenses differentially affect effective tax rates, while free hospital care does not? Is it correct to consider the effect of a sales tax as regressive with respect to welfare recipients if welfare payments are fully indexed? The wealthy in Canada may "get away with" reducing family taxation by university tuition credits, but they do not seem to get away with anything by receiving public support through subsidized university tuition.

What does this have to do with industrial policy? The border between industrial and social policy is often unclear. Investments in human capital (education, retraining), workfare schemes and similar measures could be either. It is worth thinking about the aggregation and effective tax rate issues here as well.

Taxation and Regulation

The garden variety tax expenditure reduces the relative cost of something as determined by market forces (research, manufacturing plant, Canadian advertising). Taxation can also be used to increase the cost.

Such increase may be appropriate to counterbalance market inefficiencies or failures. If public funds are used to clean up a lake, and not all taxpayers (or all taxpayers but not in the same proportions as they pay taxes) benefitted from the activity which polluted it, price adjustment is appropriate. Carried to the extreme, were it not for technical difficulties in designing and administering the appropriate taxes, one might contend that almost all activities which are not regulated should, instead, be subject to the pure price adjustment mechanism. Regulation should be applied only to things that are "priceless". One would not wish to tax criminal offenses instead of prohibiting them. Practically,

regulation will still reappear where price mechanisms are simply too complicated.

Just as it is important to aggregate tax expenditures and other government expenditures on related programs, so should excise taxes or negative tax expenditures be considered in the same analysis. If the R&D company does not really have a low effective tax rate because of the proper costing of research expenditures, given the public benefit from those expenditures, nor does the pulp and paper company have a very high effective tax rate when it is required to pay what would be the market cost for its use of the environment.

THE INTERNATIONAL ELEMENT

A third dimension which must be considered before tax policy and industrial policy meet is the implications of borders.

Neutrality

Canada and the United States are both federal states. We should understand better than most the conflict between sovereignty and economic efficiency. Within each country we find something approximating the free movement of goods, capital and people across borders. There remain significant interprovincial barriers to trade in Canada, but significant is a relative term. There are also, and always will be, barriers to the movement of people, but at least at the sub-national level these are not (generally) exacerbated by the law. The reason we can achieve the degree of harmony and openness we do is because there are values and identities shared at a higher (national) level. There is a positive (although probably not linear) correlation between political sovereignty and national identity, on the one hand, and economic efficiency, on the other.

So called free trade (the old term) or globalization (the new term) are important elements in both tax and industrial policy. Americans, naturally enough, have a different perspective than do Canadians. When Robert Reich talks about capturing value from international business undertakings, rather than head offices, he can only be talking to Americans. The United States is so big that free trade within it already produces a large proportion of what would be achieved from world free trade. This is especially true if one adds in the cultural and language factors which will prevent completely free movement of goods, services, capital and labor on a global basis for the foreseeable future. For Canada, regional or multi-lateral trade liberalization is an important element in enhancing economic efficiency.

The "freer", if not free, movement of goods and services has made certain demands on tax policy. The movement of people is not at all free, due not only to legal barriers, but cultural, linguistic and practical

ones as well. Taxation is usually overwhelmed by other factors in the context of labor mobility. The barriers to the free movement of capital are much lower, and in this context, there is some consensus that tax policy is a subtle but important element.

Broadly speaking, source taxation promotes capital import neutrality, while residence taxation (coupled with full foreign tax credit) promotes capital export neutrality. Ideally, one would have both, but this is not an ideal world.

The largest unit within which export and import neutrality may reasonably co-exist is generally seen as the national state. It is appropriate to ask whether regional free trade zones may not subtly extend the scope of efficiency.

Harmonization

Harmonization is a method of creeping towards export and import neutrality at the same time. The best-known current practitioner of the art is the European Community. North Americans love to watch their travails. We delight in noting the difficulties they have in achieving some types of harmonization which we already have. We point out the obstacles they face, and underscore the time it takes them to move forward. However, their experience is somewhat different from what ours has been or will be. Indeed, it is remarkable that a group of relatively similar-sized economies, with diverse cultural, linguistic and historical background can harmonize at all.

It is also worth watching how differences between EC members can be maintained, within certain limits, through the harmonization process.

DEBT AND DEFICIT: THE FISCAL IMPERATIVES

It is no longer possible to talk about tax or industrial policy without saying the "D" words. Our North American political emperors have only just discovered their nakedness and, this being the twentieth century, they cannot stop talking about it. Canadian public debt may, in some respects represent a more serious problem than American public debt. The foreign debt proportion is higher, and the contribution of the provinces is greater. There is also a practical dimension. The U.S. represents a quarter of the world economy. Foreigners are unlikely to stop lending to the U.S., although they may try to extract a higher return. It is by no means impossible that foreigners could decide not to lend to Canada. Indeed, to the extent foreigners view North America as one place (and we, after all, encourage them to do that in some respects), they may be loath to lend to the northern part, just as we worry they would rather lend to Ontario than Saskatchewan.

The fiscal crunch is very relevant to Canadian tax policy. To the

extent industrial policy costs money, it is also relevant to that.

WHITHER TAX POLICY

The real question is probably political and social: to what extent can Canada retain the society its citizens (or the unelected spokespeople for those citizens) say they want, while harmonizing in a positive manner to enhance economic efficiency and create wealth and income for the people? My more mundane topic is the role of tax policy. I will briefly advert to issues which are relevant in deciding whether tax policy can or should be brought to bear in the implementation of industrial policy.

(i) Administrative Issues

There are many well-known and well-worn arguments against the use of tax expenditures to achieve government policy objectives. It is unnecessary to round up the usual suspects. I have sympathy with the problems of lack of scrutiny, lack of accountability (although that can be solved, if politicians want to solve it), difficulties in measuring and controlling expenditure, fraud, public perception, etc. Proponents of a tax-based incentive system are quick to concede the problems and failures of the past, but argue, often persuasively, that those errors need not be repeated. Of course, their predecessors made the same arguments equally persuasively.

(ii) The "Micro" Problem

It is hardly novel to suggest that corporate decision-making is not exclusively a reflection of the invisible hand of economic forces. Corporations are run by people. In theory, those people should be rewarded by their constituencies (boards of directors and shareholders) solely according to the simplest measures of economic performance. However, this is not the case. Problems relating to short and long term profitability, the relationship between accounting earnings and economic performance, stock market perceptions, inter-personal rivalries, bureaucratic or organizational processes and other factors all weigh in the balance. Government is not the only institution where personal advancement may reflect factors other than productivity.

Tax-based incentives can have an effect on business decisions. For example, taxes affect the cost of capital. But more finely-targeted measures will not necessarily achieve the behavioral response imagined by the policy-makers. The fact that industry is unresponsive, or responds in unpredictable ways, to tax measures, is certainly a reason to be wary of spending substantial public funds on achieving industrial policy through such measures.

(iii) Competition

The proposition that tax policy may have some impact on competition is not novel either. The treatment of financing charges, loss trading, reorganization rules, etc. are potentially relevant. It would be worthwhile to look at rather more subtle uses of tax policy to support the regulatory apparatus of competition legislation. Anti-competitive behavior may impose a cost on society; tax policy can, in some cases, recoup such costs. The other side of this coin, of course, is that tax systems should not foster restraint of trade. Particularly in the inter-jurisdictional context, this remains a problem.

(iv) Loss Offsets

It does not require a sophisticated econometric analysis to conclude that if I have a partner who skims off a share of profits, but does not participate to the same extent in losses, this will alter my perception of the risk/reward ratio of the venture. Tax systems provide only moderate loss relief. Carryback and carryforward rules help, but they are limited in time, and restricted in scope due to "loss-trading" prohibitions. No one suggests government should not collect taxes on profits after a change of corporate control.

It is difficult to believe that the increased cost of risk created by the tax system has no effect on risk-taking behavior. As we struggle with the tax base in the name of neutrality, nothing is done about loss offsets. If industrial policy favors entrepreneurial risk, then loss relief requires re-examination.

(v) Neutrality

The level playing field is a worn metaphor. The trite is not necessarily trivial. The type of industrial policy I fear is the hubris of bureaucrats who will try to allocate resources better than the market. Distinguishing between a policy which counter-acts market failures and one which tries to "pick winners" is not always easy (except with hindsight, as the chosen winners rarely win). There are economic and political reasons for letting the market work, where it can work.

The economic reason is simple enough. There is a cost to intervening. The political reason is less obvious. There appear to be goods which the market is not providing in the manner which society demands (health care, education). But we must remain vigilant as to the limits on intervention, to preserve personal choice. It may be that the state can provide certain goods at a competitive price; it does not follow that it should. In some areas, government must act to provide sufficient access to a particularly important good or service. But the modern equivalent of the "government that governs least" is the government that leaves the maximum of personal choice within the matrix of public

goods and services that are necessary to the society as we define it.

So tax policy has a function is preserving, fostering and “improving” (a dangerous word) the operation of markets. It supplants them at a cost, both economic and political.

(vi) Savings

This is an area in which tax and industrial policy often meet. The tax system invariably presents either (or both) incentives or disincentives to saving, and differentiates between different kinds of saving. Direct incentives for, say, acquisition of domestic equities, are of questionable value, if one believes there is a global cost of capital. In that case, the incentive may promote domestic ownership, but will not reduce the cost of equity capital to the issuing corporation. However, clearly, attention is required to ensure that the tax system does not discourage saving behavior.

(vii) Harmonization

I referred above to the evident benefits of tax harmonization in achieving economic efficiency, an industrial policy few would quarrel with. However, harmonization poses an evident political problem, since it entails either an overt or covert relinquishment of sovereignty. The very announcement of an intention to harmonize effectively limits future policy choice. This has been a difficulty in achieving inter-provincial harmonization in Canada.

On a North American scale, the tax harmonization issue has raised concerns over Canadian sovereignty in general, and particularly over social and cultural values. Canada can use its resources to promote the Canadian novel, through differential tax policies or otherwise; however, the public must understand that there is a cost of doing so. The debate usually centers on social policy: can Canada maintain its distinctive social value system while harmonizing tax policy? In part, the question is mis-directed. Much of the value system has nothing to do with spending money, and therefore is unrelated to taxation. But there is certainly a valid underpinning to this widely-held concern. It relates, I believe, to redistribution.

(viii) Redistribution

The major task which confronts Canadians is to take stock of our redistributive policies. I do not mean we should necessarily redistribute less (although perhaps we should). But we must understand how much is redistributed now, to whom, and at what cost. Canadians can be asked (and are asked) to pay more in order to redistribute more. The ultimate test of our views regarding the redistributive policies of our society is whether we stay to pay for it. Consider the following

"thought experiment" (as physicists call it). Suppose that legal immigration restrictions into the U.S. were to disappear. Some cultural and practical barriers to full labor mobility would remain. However, those barriers are much lower than in Europe. How many Canadians would not respect the categorical imperative, and vote with their feet?

Thus, we commonly say that a small, open economy must support the incremental cost of its industrial and social policy, as compared to its neighbors, by taxing immobile factors. Unfortunately for Canada, the ability to extract economic rents from natural resources seems to be declining. No factors are completely immobile. We are seeing increasing focus on consumption tax and personal income tax. Free movement of goods takes a toll on the one. Consider what increased labor mobility would do to the other.

This suggests that only the preservation of immobile factors will allow a small, open economy to have significantly different redistributive policies in the long term. Consumption will surely become more mobile if trade liberalization continues. Free trade in goods and services without free movement of labor and capital is unstable. The example of the European Community suggests that the immobility of labor will also be reduced, if not eliminated.

(ix) Human Capital

Immigration raises another difficulty. It is popular to consider that an industrial policy which maximizes human capital is a virtuous circle. Society will pay more for better education, and that better education will end up producing more value for the society. Has this been true for Ireland, or for developing countries?

(x) Debt

All of the foregoing is subject to this ultimate external restraint, particularly in the case of Canada. An industrial policy limited to freeing up markets and correcting market failures may coincidentally (or not coincidentally) be the only one which can co-exist with fiscal crunch.

CONCLUSION

Where we go from here is not, paradoxically, somewhere else. We must stay where we are, and understand what we are doing. Without a carefully considered understanding of the current government role in the economy, and the costs and goals of redistribution, future tax and industrial policy will be aimless, or worse.

Yet, the process is intensely political. The electoral process seems to overwhelm any serious attempts to discuss the tangible benefits of harmonization, the necessity of Canadians (or Americans) paying for

what they want over and above what their neighbors have, and the real meaning of effective tax rates and tax expenditures. The optimist in me suggests that public education is the only answer. The pessimist suggests there is no answer.

