Discussion after the Speeches of Glenn White and Robert Brown

Discussion

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QUESTION, Professor King: We are talking about a level playing field in terms of equal assistance or in terms of the ability to compete effectively. We also mentioned the investment tax credit. Taking the extreme case, if the investment tax credit is too high on one side, won't that distort the level playing field? Is that a question that we ought to ask ourselves as we move into this so-called level playing field? For example, the United States had a very attractive investment tax credit. Say the tax credit was increased sizably instead of wiped out, is there some distortion from that type of tax action that needs to be anticipated in a free trade agreement or is it too soon to talk about that?

ANSWER, Mr. Brown: There are two points that could be made. One is that even in a free trade agreement, the two countries can have the flexibility to adopt their own tax policies and try out quite different things, provided that they are also prepared to bear the cost of those tax policies. If the United States wants to bring in a 20% investment tax credit and it results in a huge subsidy to investment in the United States, that might be regarded with fear in Canada. However, the United States is going to have to live with the cost of that investment tax credit and they are going to have to raise a very large amount of taxes from other sources. It's not immediately obvious that the United States winds up any better off.

The second point is the level playing field argument, and I'm very much in favor of the level playing field in taxation. I think it is the way that we should be going, but you have to be very careful measuring it. It is quite true that in some types of corporate income tax analysis, the investment tax credit and other types of investment incentives, make it look as though the effective tax rate on corporate income is very, very low. This is distorting in economic terms and leads to problems and inefficiencies.

Overall, you have to look at the total burden of taxation. Corporations pay many taxes other than income tax. There is a long list: capital taxes, franchise taxes, sales taxes on inputs, differential real estate taxes, payroll taxes. That's a very substantial burden and some of those, frankly, are the worst taxes in the system. They are more distorting, more negative, and more nonproductive than anything in the corporate income tax system. When you are looking to get a level playing field and equalized tax rates in different areas of the economy, it is important that
you look at all taxes simultaneously when you are trying to equalize the
taxes.

ANSWER, Mr. White: I certainly would echo those sentiments, but I
would add another thought. The basic problem we face when we look
at the employment of capital and a net income tax is the fact that we
deduct all the costs of labor inputs currently and we deduct the costs of
capital inputs only on a portioned or amortized basis. If you are going to
have an income tax that is not biased against the employment of capital,
you really ought to deduct capital in the first year. The only real reasons
we don't are: one, the convention in accounting is to recover the cost of
capital over a longer period; and two, it is too expensive to make the
switch. We would wipe out corporate income tax liability of capital-inten-
tensive companies for about five years if we switched to a deduction in-
stead of an amortized depreciation allowance. For that reason, we are
unwilling to bite the bullet.

The only role of an investment tax credit is to ameliorate the prob-
lem of slow capital cost recovery. A total or aggregate capital cost recov-
ery mechanism is the meaningful measure. The best way to get at the
problem is to measure cost of capital on a national basis. If you do that,
you will see very quickly why the Japanese, who have a very high tax rate
and lousy capital cost recovery system, do so well. They put a very high
premium on savings, so the cost of capital at the initial level buying the
money to put in the business—comes in at a very cheap cost.

QUESTION, Professor King: I have another question on types of
tax structures. The European Community has a consumption tax—
value-added tax (VAT)—at different levels. That's a requirement when
you get into the Community. With the situation of Canada and the
United States, if you have a consumption tax in one country, Canada,
and a tax based on income in the United States, can you really have a
level playing field as far as business is concerned? Your corporate rates
may go down as your consumption tax assumes the burden of the tax
structure.

Can you have two different systems of taxation and still have a level
playing field in the Canada/U.S. context? Is that the reason why the
European Community went to the value-added tax? Has that historically
been the approach? There must have been some reason why they went to
that.

ANSWER, Mr. White: I think the reason the Europeans went for
tax harmonization was the tax structures in Europe were very diverse at
the time they approached the economic union. First of all, we must re-
member that we are talking about a true economic union. There is no
border taxation at all. There is a free flow of goods within the union and
so they needed to adopt a system that would accommodate that. The
value-added tax, because it is rebated at the border, happens to be a very
attractive way to do that. They still have a very high corporate income
tax rate structure and very high individual income taxes in all of the
European countries. Even more importantly, they had to get away from a particularly onerous tax—the turnover tax.

The turnover tax was either a cascading tax, sales tax, or consumption tax that would be paid at every transactional level. If you start with a tax of 5% on the acquisition of raw materials, and 5% on the cost from the first manufacturer to the second manufacturer, and 5% from the second manufacturer to the third manufacturer and to the wholesaler, and finally 5% from the wholesaler to the retailer, then you can see very rapidly the tremendous tax burden. The buildup was on the full value of the goods each time, and they had to get away from that system.

Tax harmonization has not worked in Europe. The Europeans are now working on tax approximation. As a matter of fact, they are looking at the interstate taxation in the United States and how it works; particularly in relation to the sales taxes.

**QUESTION, Mr. Aretz:** I want to address a question to Mr. Brown. First, I think a sales tax effectively is a consumption tax because a consumer pays tax when goods are consumed. The rates are almost as high, or in some cases higher, then the VAT taxes in Europe.

Second, the VAT tax is extremely unpopular almost everywhere in the world. Would you care to comment further?

**ANSWER, Mr. Brown:** First of all, with respect to a value-added tax, it does tend to be an unpopular tax. The value-added tax has been adopted in almost forty countries in the world and it is being adopted by two or three more countries each year. Whatever you may call a value-added tax, it has proved to be an effective revenue raiser and it doesn’t ruin the domestic economy. You may or may not like it. The VAT is a well-demonstrated, well-thought-out tax that is raising hundreds of billions of dollars of revenue around the world.

In terms of whether Canada will get to it, there are problems which are essentially political. If you put a value-added tax on a broad base, the way that makes sense, you will find that you are asking an additional million Canadian businesses to register and to collect this tax. You are imposing a tax on food, and children’s clothing, and feminine hygiene products, and all of the things that just cause the people in the state to go berserk. I don’t think that the Mulroney government is capable of bringing in such a tax before the next election. Furthermore, I suspect that may mean that its implementation in Canada is indefinitely postponed.

We will have to come back to the issue, because you have to start where you are. Canada now has a federal sales tax that is an absolute abomination. It discriminates against domestic producers; it raises domestic costs; it distorts final demand and economic efficiency. It is hard to find a worse tax around the world. It would rank with the old turnover tax in Germany as an absolutely atrocious tax. Efficiency is causing us to look at that tax. The tax only has one merit in Canada and that is most people don’t know they are paying it, so it’s politically costless. It
is very costly from an economic point of view, and ultimately we will need to address that. We will have to address it with some alternative type of consumption tax because of the tax composition in Canada. We can’t get the money out of income tax; so if it’s not a value-added tax this year, then it is going to be a broad-based retail sales tax three years down the pike.

COMMENT, Professor King: One other point should be emphasized: Glenn White has alluded to it. In Canada, you not only have an income tax at the federal level, but you have a substantial provincial tax, so the total income tax rate is relatively high. At the same time, as Glenn pointed out, many U.S. companies are unable to use all of their tax credits. Perhaps the thrust of the new U.S. tax law could be not to translocate facilities to Canada, but to go to other countries where the tax structure would be more favorable. The facilities could go to Canada, but because of the new tax credit system and the differential between the U.S. and Canadian rates, companies wouldn’t be able to use the tax credits. The only way to use the tax credit is to offset income that comes from other countries where the rates are lower. The ability to transfer those credits has been limited under the new U.S. law.

COMMENT, Mr. White: There’s just no question that countries with low long-term effective rates of taxation are really going to prosper. Ireland is going to make out well under this law. The new U.S. law is the best thing to happen to Ireland in a long, long time. This is a bonanza for them, because U.S. multinationals—multibased multinationals, companies like Dow—have got to find locations which have relatively low effective tax rates. Canada presents that opportunity because of the capital cost recovery system. Ireland presents the opportunity because it will give tax holidays. France is giving tax holidays now. Those countries are ultimately going to be the beneficiaries of the new U.S. tax laws.

QUESTION, Professor King: Is it because of this tax credit situation?

ANSWER, Mr. White: No it’s because you get a low effective rate.

QUESTION, Mr. Erdilek: Suppose that trade barriers were eliminated or made much less serious than they are now, then the location of business on either side of the border, on a state-by-state or province-by-province basis, might become much more sensitive to local subsidies. Do you think that such issues might be important in terms of counteractivity as opposed to taxes? Do you think such an issue might become a hot one? In fact, presently we do have it to some extent in terms of the Autopact with the GM case in Quebec. The plant is now being offered an interest-free loan and that’s causing a lot of concern on this side of the border.

ANSWER, Mr. Brown: Yes, the issue is raised both with subsidies and tax incentives. There are a number of ways to deliver money; you can deliver it through the tax system or you can deliver it directly.
Clearly, as business becomes more competitive, more global, the issue of subsidization becomes larger, whether through the tax system or otherwise. It is a major issue now and it will get worse in the future. The limitation on ridiculous subsidies is that the country that gives them has got to bear them; and if you really analyze the effect on its competitiveness in other areas, it's not always clear that they truly benefit. The interest-free loan to GM in Montreal is an example of a government policy that probably will cost Canada dearly in the long run. These issues have got to be put on the table, because they get specific to a micro-point. This will have to be addressed in the Free Trade negotiations. We will need some mechanism for settling and distinguishing what is legitimate and not legitimate. We will also need a remedy for people who get too far over the line.

COMMENT, Professor King: I would like to thank our speakers for a wonderful session. They have covered a very complex subject with great humor and also have given us an excellent understanding of the two tax systems. We thank them for it.