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**DISCIPLINING INDUSTRIAL INCENTIVES TO
PROMOTE COMPETITIVE AND EFFICIENT CANADIAN
AND NORTH AMERICAN MARKETS**

By:

Mark Ronayne
Economics and International Affairs Directorate
Bureau of Competition Policy
Industry and Science Canada

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TABLE OF CONTENTS

I. INTRODUCTION	1
Purpose and Outline of the Report.....	4
II. COMPETITION, EFFICIENCY AND INDUSTRIAL INCENTIVES IN A SMALL OPEN ECONOMY	5
1. The Economic Costs of Industrial Incentives.....	8
(i) Industrial Incentives and the Distortion of Efficient Competition.....	8
(ii) Industrial Incentives and Rent-Seeking Behaviour.....	10
(iii) Intergovernment Competition for Investment.....	11
(iv) Financing and Administrative Costs	12
2. Potential Competition and Efficiency Enhancing Uses of Industrial Incentives.....	12
(i) Subsidies and Competitive Entry	13
(ii) Incentives and Strategic Trade Policy	15
(iii) Externalities and Industrial Incentives.....	17
(iv) Other Economic Uses of Industrial Incentives.....	20
3. Competition, Efficiency and the Design of Industrial Incentives	24
(i) The Objectives of Incentives	25
(ii) The Range of Businesses Eligible for Incentives.....	26
(iii) Determining the Types of Incentives Available.....	26
(iv) Time and Quantity Limits on Incentives.....	27
(v) Factors Considered in Relation to the Provision of Incentives	27
(vi) Conditions on the Receipt of Incentives	27
4. Summary.....	28

III. THE PROVISION OF INDUSTRIAL AID IN CANADA	30
1. Industrial Incentives in Canada	30
(i) The Amount and Nature of Industrial Incentives in Canada.....	30
(ii) The Distribution of Incentives by Level of Government	38
(iii) The Objectives of Industrial Incentives in Canada	41
2. The Legal and Institutional Framework.....	43
(i) The Federal Government.....	43
(ii) The Provincial Governments.....	48
(iii) Federal-Provincial Relations.....	54
3. Summary	56
IV. THE EC INDUSTRIAL AID FRAMEWORK.....	58
1. The EC State Aid Rules.....	59
(i) The Legal and Institutional Setting	59
(ii) The EC State Aid Provisions	62
2. The Use of Industrial Aid in the EC	66
3. The Treatment of Specific Categories of Aid Under the EEC Treaty	73
(i) Regional Economic Development.....	73
(ii) Sectoral Aid.....	76
(iii) Research and Development Aid	79
(iv) Aid to Small and Medium-Size Enterprises.....	81
(v) Aid to Public Enterprises	83
4. Summary and Discussion.....	85
V. CANADIAN INDUSTRIAL INCENTIVES IN THE 1990's.....	87
1. The Challenges.....	87
2. Approaches for Meeting the Challenges.....	91
(i) Industrial Incentives and the Canadian Economic Union	92
(ii) Amending the Current Industrial Incentives Framework.....	95

(iii) Toward a North American Industrial Incentives Framework.....	98
VI. SUMMARY	103
REFERENCES.....	108

LIST OF TABLES

Table	Contents	Page
III-1	Subsidies and Capital Assistance in Canada, 1980-89 (\$billions)	32
III-2	Government Business Enterprises in Canada, 1989	36
III-3	Canadian Direct Industrial Aid by Level of Government, 1980-89	39
III-4	Federal and Provincial Government Business Enterprise Assets, 1980-89 (\$billions)	41
III-5	Canadian Federal and Provincial Industrial Assistance Program Objectives	43
IV-1	Principle Objectives for Industrial Aid to EC Manufacturing, 1986-88	68
IV-2	Major EC Commission Economic Development Fund Payments and Commitments, 1989-90 (ECU million)	70

I. INTRODUCTION

Industrial incentives are an important feature of the Canadian economy. Their use in various forms remains a major instrument for the achievement of economic, social and other policy goals. The annual volume of industrial incentives provided in Canada is substantial. In 1991, direct federal and provincial subsidies and capital assistance to Canadian businesses alone was worth well over \$10 billion. A further uncounted amount of aid was also provided to businesses through tax incentives, the supply of products or services at favourable prices or rates and various other indirect forms of assistance.¹

The use of industrial incentives in Canada, however, is in an important period of transition. Concerns relating to their past usage combined with tight budgetary constraints are leading governments in Canada to reassess the role and use of incentives. This has already resulted in a number of major changes in the way that they are provided. For example, at the federal government level, dissatisfaction with previous regional economic development incentives has contributed to the establishment of separate regional development ministries based in the areas they serve.²

Re-evaluation of the way that industrial incentives are provided in Canada is also being forced by the increasing industrial policy role of the provinces. This development could provide significant benefits to the Canadian economy by allowing the provinces to control aspects of industrial policy that they can manage better than other levels of government. Also, greater provincial government responsibility for industrial policy could increase the pressures on provinces to develop better economic development approaches and programs.³

¹ For discussion of the provision of industrial aid by provincial and federal governments in Canada, see *infra*, chapter III, section 1.

² The roles of these departments are discussed in chapter III, section 2 below.

³ That is, provinces that develop better industrial policies are likely to be more successful at attracting and or maintaining businesses. For discussion, see, for example, R. D. Anderson

Greater provincial involvement in the industrial policy area, however, also entails certain risks. In particular, there is a danger that it will lead to wasteful or "negative sum competition" among the provinces to attract businesses.⁴ The pressure that may be placed on governments to engage in such competition was recently demonstrated by the aborted efforts of Piper Aircraft to relocate in Canada. In preparation for a possible move to the country, Piper sought the most favourable incentive package that it could obtain from no less than 9 different provinces.⁵

The potential strengthening of the Canadian common market is another important factor to consider in relation to the future use of industrial incentives in Canada. The elimination of the remaining interprovincial barriers to trade is a key element in the Prosperity Initiative *Action Plan for Canada's Prosperity*, and is the subject of ongoing federal and provincial discussions.⁶ Common market issues have also been an important matter for consideration during recent discussions on the *Canadian Constitution*. The *Charlottetown Constitutional Accord*, while not containing separate provisions on the Canadian common market, would have made strengthening the Canadian economic union a specific economic policy objective under the *Constitution*.⁷

and S. D. Khosla, "Competition Policy, the Canadian Economic Union and Renewal of the Federation," *Canadian Competition Policy Record*, volume 12, no. 4, December 1991, pp. 57-77.

⁴ The phrase "negative sum competition" is taken from the Royal Commission on the Economic Union and Development Prospects for Canada, *Report* (Ottawa: Canadian Government Publishing Centre, Supply and Services Canada, 1985), volume 2, p. 261.

⁵ See *The Globe and Mail*, "Nine Provinces trying to woo Piper Aircraft," December 10, 1991, and *The Financial Post*, "Piper Deal Show-down in Sight," March 6, 1992, p. 4.

⁶ Steering Group on Prosperity, *Inventing Our Future: An Action Plan for Canada's Prosperity* (Ottawa: October, 1992). For supporting views, also see, for example, Royal Commission on the Economic Union and Development Prospects for Canada, *supra*, note 4, volume 3, chapter 22 and Canadian Manufacturers' Association, *Canada 1995: A Plan for the Creation of a Single Economic Market in Canada*, Economic Policy Statement, November, 1990.

⁷ See *Consensus Report on the Constitution: Charlottetown Final Text*, August 28, 1992, section 4.

Industrial incentives could have important implications for efforts to further develop the Canadian common market. There is a danger that attempts to eliminate other barriers to interprovincial trade will lead to increased use of industrial aid to shelter businesses. Disciplines on these incentives may be necessary to ensure that they do not lead to a repartitioning of the Canadian internal market.

The potential importance of this issue is demonstrated by the recent efforts of the EC to complete its internal market by 1992. The 1985 EC Commission *White Paper on Completing the Internal Market*, which marked the start of the EC 1992 initiative, recognized that effective controls on industrial aid within the Community would be necessary to ensure completion of the common market. In respect of this concern, the EC has taken a number of measures to ensure that its Member States will not replace trade barriers reduced or eliminated by the EC 1992 initiative with aid-based barriers.⁸

Developments taking place in the international marketplace will also be important to consider in relation to the future use of industrial incentives in Canada. Increasing international competition is further emphasizing the need for government programs and policies that promote rather than impede the international competitiveness of domestic industries. The development of a sound industrial incentives framework in Canada will be a key requirement in this regard. In an increasingly competitive global marketplace, it will be essential for Canada to ensure that industrial incentives are used in ways that promote, rather than impede the competitiveness and efficiency of Canadian industry.

The prospective implementation of the North America Free Trade Agreement (NAFTA) is a further key issue for consideration. The NAFTA, like the Canada-U.S. Free Trade Agreement, potentially provides the opportunity to redesign the framework for managing subsidy-related trade

⁸ For a review of the development of EC state aid policy in connection with the EC 1992 initiative, see External Affairs and International Trade Canada, *Europe 1992: Working Group Report on Competition Policy* (Ottawa: January, 1991), Chapter IV.

distortions in North America. The current countervailing duties system has been a major source of concern for Canadian businesses as well as governments. For businesses, the threat of countervailing duties may be an important restraint on their access to U.S. as well as Mexican markets.⁹ For governments, the current countervailing duty system, because it does not clearly identify incentives that may later be countervailed, creates uncertainty regarding the likely impact of related programs.

The most recent NAFTA draft would not, by itself, substantially amend the current countervailing duties framework between Canada and the U.S. It would provide, however, for future discussions to be held on this framework. Under section 1907 of the NAFTA, Canada, the U.S. and Mexico would be committed to consult on:

- (a) the potential development of more effective rules and disciplines on government subsidies; and
- (b) the possible creation of a substitute system of rules for dealing with unfair transborder pricing practices and government subsidization.

The NAFTA, therefore, could allow for consideration of different approaches for disciplining industrial incentives within North America than the present countervailing duties system.

Purpose and Outline of the Report

This report examines the framework governing the use of industrial incentives as it relates to the promotion of competitive and efficient Canadian markets. The report is not intended as a critique of the previous use of industrial incentives in Canada.¹⁰ Rather, its purpose is to suggest

⁹ In this regard, see, for example, M. F. Ronayne, R. D. Anderson and S. D. Khosla, *Non-Tariff Barriers in Canada-U.S. Trade: A Case Study of the Steel Sector* (Ottawa: Bureau of Competition Policy, Economic Policy Branch, June, 1987), chapter IV.

¹⁰ A number of studies considering this issue are included in the attached references for the report.

possible framework approaches for promoting the use of industrial incentives in a manner that better promotes efficient and competitive domestic markets.

To this end, Chapter II of the report outlines the economic analysis of the competition and efficiency implications of industrial incentives. Given that incentives are likely to continue to be used for social, environmental and other such policy goals, the chapter also considers ways to minimize the competition and efficiency distorting effects of incentives in such cases.

Chapter III examines the current industrial incentives framework in Canada. The chapter discusses key trends in the use of these incentives and outlines relevant features of the legal and institutional framework underlying their use. Chapter IV examines, for comparative purposes, the treatment of industrial incentives in the EC. Chapter V discusses the use of industrial incentives in Canada and suggests possible framework approaches for their better harmonization with competitive and efficient Canadian markets. Chapter VI provides a summary.

II. COMPETITION, EFFICIENCY AND INDUSTRIAL INCENTIVES IN A SMALL OPEN ECONOMY

The economic implications of industrial incentives continues to be an area of much debate. Traditional economic analysis of industrial incentives tends to take a generally negative view of their implications for the competitive and efficient operation of the markets affected.¹¹ Economists have also recognized, however, that there are market conditions where the use of industrial incentives, at least in theory, can be welfare enhancing. Indeed, much recent economic debate has taken place on the potential use of industrial incentives as a "strategic trade policy" instrument or to mitigate economic losses associated with research and development spillovers.

¹¹ For an example of this analysis, see Stephan Lehner and Roderick Meiklejohn, "Fair competition in the internal market: Community State aid policy," *European Economy*, volume 48, September 1991, pp. 7-114, chapter 3.

This chapter discusses current thinking regarding the economic implications of industrial incentives in a relatively small open economy like Canada. Section one examines ways in which these incentives can impede the competitiveness and efficiency of markets. Section 2 discusses the potential use of industrial incentives to mitigate the economic costs of certain market imperfections or failures. Section 3 looks at the importance of the design of incentive programs for their competition and efficiency implications. Section 4 provides a summary.

1. The Economic Costs of Industrial Incentives

(i) Industrial Incentives and the Distortion of Efficient Competition

The economic implications of industrial incentives in efficiently competitive markets may depend on the type of assistance provided. An important distinction can often be drawn between the implications of incentives provided as a fixed amount independent of output (fixed or lump sum incentives), and aid provided in proportion to the quantity of a good produced (production incentives). The former class of incentive includes, for example, aid for the purchase of plant or equipment, the free supply of infrastructure, capital injections or government assumption of debt costs. Production incentives, include not only subsidies tied specifically to the amount of a good produced, but also aid based indirectly on output, such as subsidies on variable inputs.

Both of the above types of incentive can entail substantial allocative and production efficiency distortions. The nature of these distortions and how they arise, however, may depend upon the type of incentive provided. This, in turn, can have important implications for the desirability of using one type of aid or another in relation to a particular economic or social policy objective.¹²

¹² The issue of which type of aid is preferable to deal with a particular type of market distortion or economic or social policy concern is further discussed in section 3 of this chapter.

The potential market distortions from production incentives derive from the gap they create between the benefit that producers gain from each unit of output and the amount paid by consumers. This gap, creates an incentive for producers to oversupply the relevant goods relative to their economically efficient level.

This distortion may entail economic costs of at least two types in an open economy such as Canada's. First, the increased production of the subsidized good means that resources may be drawn away from more efficient uses elsewhere in the economy. Second, in open economies like Canada, there is also the potential for the overproduction of subsidized goods to, in effect, transfer wealth to foreign countries. This will be the case where a subsidy lowers the price of, hence the return to the domestic economy from exports.¹³

Lump sum or fixed industrial incentives, because they do not base aid on the amount of output produced or supplied, do not inherently distort efficient price and production signals from competitive markets. This is not to say, however, that this aid does not potentially entail serious economic concerns. In many cases, lump sum aid may be a threat to distort the efficient allocation of production among suppliers in the relevant market. This may occur, for example, where aid is used to prop up failing firms or encourage the entry of new businesses to a competitive market. In such cases, while subsidies may enable firms to maintain or commence production, this is likely to be at the expense of other businesses that are either more efficient, or which have already borne sunk costs to enter the relevant market.

The economic costs from such distortions may be substantial. Where subsidies are used to maintain production at inefficient sites or facilities, the total amount of the aid provided may constitute a deadweight economic loss to the economy when compared to relying on lower cost domestic or foreign suppliers. Similarly, the entire amount of a subsidy that is provided to a

¹³ A lower foreign price will occur if Canadian output is large enough to affect the foreign price, or the subsidized product is differentiated from other products such that its demand is downward sloping.

business to help it enter a market may constitute a deadweight loss if that market is already competitively and efficiently supplied.

The concerns engendered by industrial incentives are magnified when considered in the context of rapidly changing global markets. Industrial incentives have often been proposed as a means to enhance the ability of businesses to adapt to such markets. In practice, however, it has been found that they tend to have the opposite effect. Industries, such as footwear, textile, automobile and steel manufacturing have for many years received large amounts of industrial aid as well as trade protection for the intended purpose of helping them to adjust to changing international trade conditions as well as become more innovative. Related studies, however, have generally found that it slowed rather than facilitated the necessary adjustments.¹⁴

Industrial incentives can impair the adaptability and dynamism of businesses in a number of ways. Businesses that expect to receive aid if they do not successfully adapt to changing market conditions will not have the same incentives to be efficient competitors. Industrial incentives, moreover, can distort signals that are required for businesses to efficiently adapt to changing market conditions. By keeping businesses profitable in the short-term, subsidies can distort market signals indicating that the downsizing of a business or an industry is required. The conditions explicitly or implicitly attached to receipt of incentives may also create problems. For instance, requirements to maintain employment levels may lead to the adoption of less efficient methods of production.

The threat that incentives or subsidies engender for the adaptability and innovativeness of industries has recently been emphasized by the work

¹⁴ See, for example, Jaleel Ahmad, *Trade-Related, Sector-Specific Industrial Adjustment Policies in Canada: An Analysis of Textile Clothing and Footwear Industries* (Ottawa: Economic Council of Canada, Discussion Paper No. 345, 1988) and M.J. Trebilcock, M. Chandler and R. Howse, *Adjusting to Trade: A Comparative Perspective* (Ottawa: Economic Council of Canada, Discussion paper no. 358, 1988), p. 135.

of Michael Porter and others on the competitiveness of industries.¹⁵ In this regard, Porter states:

Subsidy is rarely associated with true competitive advantage...Subsidy delays adjustment and innovation rather than promoting it. Most forms of subsidy come with explicit or implicit strings attached...These limit flexibility and dampen innovation.¹⁶

Finally, in considering the implications of industrial incentives for competitive and efficient markets, another area of concern is their potential to alter the underlying competitive structure of the markets affected. The preceding discussion implicitly assumed that this structure remained competitive. While this might be appropriate for many markets, there may also be cases where industrial incentives reduce the intensity of competition. Indeed, it could be argued that this has often been an implicit goal underlying the use of industrial incentives. Subsidies have often been granted on the basis that they were needed to create "national champion" companies capable of becoming world beating competitors. A natural corollary of this goal, is the creation of a subsidized company as the dominant supplier in domestic markets for the relevant products.

Determining whether industrial incentives are likely to substantially lessen competition in any particular case requires consideration of a number of factors. It is unlikely to be a significant concern where Canadian markets can support a number of efficient competitors, or there is vigorous

¹⁵ See, in particular, Michael Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1990), chapter 12 and Michael Porter and the Monitor Company, *Canada at the Crossroads: The Reality of a New Competitive Environment* (Ottawa: Supply and Services Canada, 1991), chapter 8.

¹⁶ Michael Porter, *The Competitive Advantage of Nations*, *id.*, p. 640.

international competition. Problems may arise, however, where:

- i. there are substantial barriers to entering the domestic market;
- ii. the efficient scale of output is large relative to the size of the Canadian market; and
- iii. the potential for import competition is either weak or is restricted by barriers to international trade.

Determining where these conditions are applicable would normally require careful case by case examination of the nature of the relevant products and production, potential trade barriers and other features of the relevant markets.

(ii) Industrial Incentives and Rent-Seeking Behaviour

The encouragement of rent-seeking behaviour is another way that industrial incentives promote inefficiency. Rent-seeking refers to actions undertaken by businesses or others for the specific purpose of receiving incentives. It includes, therefore, such actions as the lobbying of government bodies or organizations for aid, committing to locate facilities in inefficient sites to obtain aid or increased usage of subsidized inputs.¹⁷

The potential economic distortions from rent-seeking behaviour have long been of concern to economists. Rent-seeking, by itself, has no underlying economic value. Accordingly, resources expended in the activity constitute a deadweight loss unless there is some underlying economic benefits to the objective being pursued.

¹⁷ For discussion of the nature and economic costs of rent-seeking see, for example, Anne O. Krueger, "The Political Economy of the Rent-Seeking Society," *American Economic Review*, vol. 64, June, 1974, pp. 291-303, Richard Posner, "The Social Costs of Monopoly and Regulation," *Journal of Political Economy*, vol. 83, August, 1975, pp. 807-27 and Gordon Tullock, "The Welfare Costs of Tariffs, Monopolies and Theft," *Western Economic Journal*, vol. 5, June, 1967, pp. 224-32.

The amount of resources that are expended in rent-seeking, in any particular case, may depend on a number of factors. At the limit, it may be as large as the entire amount of the incentive that is being sought.¹⁸ The amount may be smaller, however, where there are differences between the net benefits that the incentive are likely to provide to different potential recipients (i.e., after the conditions required to obtain the incentive are met) or some of the returns from rent-seeking behaviour are passed through to other indirect beneficiaries.¹⁹

(iii) Intergovernment Competition for Investment

Industrial incentives are frequently used by governments to compete for investment that they consider to entail social or economic policy, or political benefits. The potential economic implications of these incentives, however, are not straightforward. Depending on the relevant circumstances, they may entail significant economic benefits. For example, it has been suggested that incentives can help internalize differences between the external benefits of locating economic activity in different regions.²⁰

On the other hand it is not difficult to envision cases where competition for businesses could result in substantial economic costs. The perceived political benefits to governments of attracting businesses or investment may differ greatly from the associated economic and social policy benefits.²¹ In such cases, intergovernment competition for businesses is

¹⁸ Conditions where this may occur are described in Posner, *id.*

¹⁹ For further discussion of this issue, see, for example, Franklin M. Fisher, "The Social Costs of Monopoly and Regulation: Posner Reconsidered," *Journal of Political Economy*, vol. 93, no. 2, April, 1985, pp. 410-16.

²⁰ For further discussion of the economic implications of inter-jurisdictional competition for investment see, for example, D. G. McFetridge "The Economics of Industrial Policy: An Overview," in D. G. McFetridge (Research Coordinator), *Canadian Industrial Policy in Action* (Ottawa: Minister of Supply and Services Canada, Collected Research Studies of the Royal Commission on the Economic Union and the Development Prospects for Canada, vol. 4, 1986), pp. 1-48, at pp. 12-17.

²¹ The various pressures that may be placed on governments to join competitions for businesses and investment are well demonstrated in the Piper Aircraft case mentioned in Chapter 1 and in the Atlantic provinces. In this regard, see for example, *Winnipeg Free Press*,

likely to distort rather than enhance the efficient location of economic activity. Moreover, in a small open economy like Canada, there is a danger that the escalation of incentives, through intergovernment competition for investment, could lead to increased and unnecessary transfers of wealth outside of the country to attract foreign-owned branch plants.

(iv) Financing and Administrative Costs

The need to finance assistance is a further potentially major source of economic distortions from industrial incentives. In theory, it is possible to finance industrial incentives and other government expenditures through non-distortionary lump sum taxes. But in practice taxation and other methods of revenue generation generally used by governments tend to be highly disruptive of competitive and efficient markets.²²

In calculating the potential economic costs of industrial incentives, it is also important to account for the costs of administering related projects or programs. These costs, if they have no other purpose, constitute a net resource cost to the economy.

2. Potential Competition and Efficiency Enhancing Uses of Industrial Incentives

The negative view of industrial incentives suggested by its economic analysis in competitive and efficient markets does not necessarily apply under other market structures. It has long been recognized that subsidies may provide a remedy for various types of market imperfection or failure. This section considers this potential role for industrial incentives. Subsection (i) examines the potential use of industrial incentives to promote competitive

"Second aircraft manufacturer believed flying past province, landing elsewhere," January 21, 1992, pp. A1 and A2, *Globe and Mail*, "Rae still hopes to attract Piper Aircraft," December 6, 1991, p. B3 and *The Chronicle-Herald* (Halifax), "Development duel," September 22, 1992, p. B1.

²² The economic analysis of different taxation methods is outlined in, Simon James and Christopher Nobes, *The Economics of Taxation* (Toronto: Prentice Hall International Ltd., 4th edition, 1992).

entry to monopolistic or oligopolistic markets. Subsection (ii) examines the debate that has taken place during the past several years over the potential "strategic trade policy" role of industrial subsidies. Subsection (iii) discusses the potential use of incentives to correct market distortions associated with R&D spillovers and other types of externality. Subsection (iv) provides a summary of a number of other economic rationales that have often been put forward in support of industrial incentives.

(i) Subsidies and Competitive Entry

Competition-related market failure has long been a concern of economic policy in Canada.²³ The relatively small scale and regionally fragmented nature of many Canadian markets is widely believed to make them susceptible to monopolistic or oligopolistic control. In this regard, a 1986 study of industrial concentration in Canada found that, in over 35% of all Canadian industries, the top 4 firms accounted for more than 60% of all Canadian output.²⁴ Concentration ratios for categories of commodities manufactured in Canada tend to be even higher.²⁵

The provision of incentives to businesses to help them overcome barriers to entry potentially provides a means to mitigate the economic costs of monopolistic or oligopolistic control of markets. The benefits of using subsidies for this purpose, however, should not be overestimated. In many

²³ Competition legislation has now been in place in Canada for over 100 years. For a history of this legislation, see, for example, W. T. Stanbury, "Legislation to Control Agreements in Restraint of Trade in Canada: Review of the Historical Record and Proposals for Reform," and R. D. Anderson, S. D. Khosla and M. F. Ronayne, "The Competition Policy Treatment of Intellectual Property Rights in Canada: Retrospect and Prospect," in R. S. Khemani and W. T. Stanbury (editors), *Canadian Competition Law and Policy at the Centenary* (Halifax N. S.: Institute for Research on Public Policy, 1991), chapters 6 and 23.

²⁴ See R. S. Khemani, "The Extent and Evolution of Competition in the Canadian Economy," in D. G. McFetridge (Research Coordinator), *Canadian Industry in Transition* (Ottawa: Minister of Supply and Services Canada, Collected Research Studies of the Royal Commission on the Economic Union and Development Prospects for Canada, vol. 2, 1986), pp. 135-76, at p. 153.

²⁵ R. S. Khemani, "Merger Policy in Small v. Large Economies," in R. S. Khemani and W. T. Stanbury, *supra*, note 23, pp. 205-23, at p. 206.

Canadian markets, while the number of domestic producers may be limited, a sufficient competitive threat may already exist due to foreign competition or the threat of new entry to the domestic industry.²⁶

Attempts to use incentives to create competition in non-competitive Canadian markets may also involve substantial economic costs. In addition to rent-seeking, administrative and other such costs, there is the danger that the promotion of new entry to relatively small Canadian markets will lower the efficiency of all firms in the market. That is, a major concern that has been expressed in regard to many Canadian industries is that their scale of operations, given the relatively small size of Canadian markets, already tends to be less than optimal.²⁷ Encouraging entry to such markets, even if it is for the purpose of promoting competition, could run the threat of even further endangering the efficiency of Canadian producers.²⁸

In considering the use of industrial incentives to deal with non-competitive markets, account should also be taken of the possible existence of other less costly remedies. Depending on the relevant circumstances, it might instead be possible to enhance competition in the relevant markets through measures such as the elimination of regulatory or standards-based barriers to

26 In practice, determining whether a market is or is not competitive normally requires a detailed analysis of many factors, such as the prevalence of foreign competition, the importance of sunk costs, the degree of product differentiation, transportation costs between regions and possible regulatory restraints on entry. See, for example, Director of Investigation and Research, *Competition Act, Merger Enforcement Guidelines* (Ottawa: Minister of Supply and Services Canada, March, 1991).

27 For a classic treatment of this issue, see H.C. Eastman and S. Stykolt, *The Tariff and Competition in Canada* (Toronto: The MacMillan Company of Canada, 1967). For a more recent analysis, see Paul K. Gorecki, *Economies of Plant Scale and Efficient Plant Size in Canadian Manufacturing Industries* (Ottawa: Minister of Supply and Services Canada, 1978).

28 The potential trade-off between the attainment of the efficient scale or scope of production and competition is explicitly recognized in the terms of the *Competition Act* itself. Article 96 of the *Act* provides that an anti-competitive merger may, nevertheless, be permitted if it "is likely to bring about gains in efficiency that will be greater than, and will offset, the effects of any prevention or lessening of competition..." Moreover, the *Merger Enforcement Guidelines* (*supra*, note 26, Appendix 2) specifically state that "gains in efficiency" may include increased economies of either scale or scope.

entry, the removal of barriers to foreign trade or the initiation of related cases under the *Canadian Competition Act*.²⁹

(ii) Incentives and Strategic Trade Policy

Considerable interest has been generated over the past several years regarding the potential use of subsidies for strategic trade policy purposes. This possible use of subsidies relies on the existence of international markets in which excess profits are being made due to high barriers to entry and constant or decreasing returns to scale. In such cases, subsidies might be used to strategically position domestic firms to capture a larger share of the world market, hence the available profits.³⁰

Strategic trade policy considerations are an important factor underlying the many countries' renewed interest in more interventionist industrial policies. This use of subsidies, however, is constrained by a number of factors. The basic market conditions that are required to effectively use subsidies for strategic trade policy purposes (i.e., high barriers to entry, widespread international trade and declining average costs) are not observed in many industries. Furthermore, even in markets where such conditions might be observed, they may be difficult to detect early enough to allow for the profitable use of strategic trade policy.³¹

²⁹ This might be accomplished, for example, through actions under Article 79 of the *Competition Act* which is designed to prevent businesses in a dominant position in a market from engaging in "anti-competitive acts" designed to eliminate or keep out competitors.

³⁰ The potential use of subsidies for strategic trade policy is developed in James Brander and Barbara Spencer, "International R&D Rivalry and Industrial Strategy," *Review of Economic Studies*, 1983, pp. 707-722, and Barbara Spencer and James Brander, "Export Subsidies and International Market Share Rivalry," *Journal of International Economics*, vol. 18, 1985, pp. 83-100.

³¹ It may not be sufficient to know that the type of market under consideration will eventually emerge. Rather, it may also be necessary to develop this information before other countries. If more than one country is aware of the potential for future rents in a market, they may engage in rent dissipating activities, such as early entry to the market, that can erode these rents.

Also, there is a danger that the strategic use of subsidies by one country will result in retaliatory action being taken by other countries that are affected. Strategic trade policy, while it may increase the welfare of the subsidizing country, generally reduces the welfare of other countries. As a result, these countries may have incentive to retaliate particularly if they believe that subsidies may be repeatedly used for strategic trade policy purposes. The end result may be a decrease in the economic welfare of both the subsidizing and retaliating countries.³²

From a Canadian perspective it is also important to consider that the types of industries in which strategic trade policy might be effective (i.e., those having a large minimum efficient scale and high barriers to entry), are likely to be costly to enter and to involve highly complex products and production methods.³³ The effective use of incentives for strategic trade policy purposes, accordingly, may require the provision of large amounts of aid to domestic suppliers with highly uncertain returns. The ability and willingness of governments and taxpayers to finance such aid may be especially low in relatively small countries like Canada.³⁴

³² In this regard, see, for example, Avanish Dixit and Albert S. Kyle, "The Use of Protection and Subsidies for Entry Promotion and Deterrence," *The American Economic Review*, vol. 75, no. 1, 1985, pp. 139-152. As indicated in Aslam Anis and Thomas Ross, "Imperfect competition and Pareto-improving strategic trade policy," *Journal of International Economics*, vol. 33, 1992, pp. 363-71, however, there may also be cases where strategic trade policy does not invite retaliation.

³³ Some industries that have been noted as potentially being open to strategic trade policy considerations include wide-bodied aircraft manufacturing, semi-conductor chip manufacturing, certain aerospace activities and advanced consumer electronics manufacturing. See, for example, see Robert Baldwin and Paul Krugman, "Industrial Policy and International Competition in Wide-Bodied Aircraft," in Robert Baldwin (editor), *Trade Policy Issues and Empirical Analysis* (Chicago: University of Chicago Press, 1988), pp. 45-78.

³⁴ It should be noted that these are not the only potential limitations on the strategic trade policy use of subsidies that have so far been developed. For a more comprehensive discussion of this issue see, for example, Paul Krugman, *Rethinking International Trade* (Cambridge Mass.: The MIT Press, 1990), pp. 248-54, Richard Harris, "The New Protectionism Revisited," *Canadian Journal of Economics*, vol. XXII, no. 4, 1989, pp. 751-78 and Elhanan Helpman and Paul Krugman, *Trade policy and Market Structure* (Cambridge Mass.: The MIT Press, 1989), chapter 5.

(iii) Externalities and Industrial Incentives

Subsidies have long been accepted as a possible means to mitigate market distortions relating to activities having positive externalities (i.e., economic benefits that are not reflected in market prices). It is well recognized that markets will tend to underprice, hence, undersupply such activities. Subsidies can mitigate this tendency by bringing their private rate of return more into line with their benefit to the economy as a whole.

Externality considerations are frequently cited in support of industrial incentives for research and development (R&D). Many believe that the private return on R&D normally does not fully reflect its "spillover" benefits for research and product development activity by other businesses. Such spillovers can occur, for example, when some firms can either copy or adopt the technologies developed by other firms without having to compensate the inventing or innovating firms.³⁵

R&D spillovers have long been a concern of Canadian policy-makers. The belief that they tend to be high underlies the widespread view that insufficient R&D activity takes place in Canada as compared to other developed economies.³⁶ This view has contributed to the establishment of a vast array of provincial and federal programs designed to promote R&D in Canada.

The use of incentives to correct for R&D spillovers, however, is complicated by a number of considerations. Determining the nature and

³⁵ For a discussion of R&D spillovers, see, for example, Michael Spence, "Cost Reduction, Competition, and Industry Performance," *Econometrica*, vol. 52, no. 1, 1984, pp. 101-121 and Jeffrey Bernstein, "Research and Development, Patents, and Grant and Tax Policies in Canada," in D. G. McFetridge (Research Coordinator), *Technological Change in Canadian Industry* (Ottawa: Minister of Supply and Services Canada, Collected Research Studies of the Royal Commission on the Economic Union and Development Prospects for Canada, vol. 3, 1985), pp. 1-42.

³⁶ In this regard, R&D in Canada during 1989 was equal to about 1.26% of the country's GDP. In contrast, R&D in the U.S., Japan and Germany for the same year was 2.1%, 2.8% and 2.73%, respectively, of these countries' GDP. See Michael Porter and the Monitor Company, *supra*, note 15, p. 189.

value of spillover effects is highly difficult.³⁷ Moreover, even in cases where these effects can be measured, it does not necessarily follow that offsetting them will improve overall economic welfare. Rather, achieving the optimal amount of R&D also requires consideration of a number of other factors, such as the incentive for R&D activity created by patents and other intellectual property rights, and the nature of rivalry between companies to develop inventions.³⁸ Another factor that complicates the effective use of subsidies to promote high spillover R&D is the potential for the associated benefits to be dissipated to other countries. This will occur where the benefits from spillovers cannot be geographically confined to domestic industries.³⁹

These and other aspects of R&D do not rule out the potential use for industrial incentives to deal with spillovers. They do suggest, however, that this use of incentives may generate significant economic benefits only in certain circumstances. This may be the case, for example, where incentives are used to promote more basic lines of research that have potentially high spillover effects but are not well protected by intellectual property legislation.⁴⁰

37 For a discussion of recent developments in this area, see Jeffrey Bernstein, "R&D Capital, Spillovers and Foreign Affiliates in Canada," in D. G. McFetridge (general editor), *Foreign Investment, Technology and Economic Growth* (Calgary, Alta.: University of Calgary Press, 1991), chapter 5.

38 For example, patent or other intellectual property protection, depending on the relevant circumstances, may already provide more than enough incentive for firms to engage in efficient amounts of innovative or inventive activity even if this activity has some beneficial external effects. R&D subsidies based on the presence of spillovers, in such cases, would tend to exacerbate rather than mitigate the problem. The use of R&D subsidies to improve economic efficiency in the presence of these and other relevant factors is examined in, among others, Avanish Dixit, "A General Model of R&D Competition and Policy," *Rand Journal of Economics*, vol. 19, no. 3, 1988, pp. 317-26, Gene Grossman and Elhanan Helpman, "Comparative Advantage and Long-Run Growth," *American Economic Review*, vol. 80, no. 4, 1990, pp. 796-815, Jennifer F. Reinganum, "The Timing of Innovation: Research, Development, and Diffusion," in R. Schmalensee and R. D. Willig (editors), *Handbook of Industrial Organization* (New York, N. Y.: Elsevier Science Publishers B.V., 1989), chapter 14 and Spence, *supra*, note 35.

39 This point is made in Paul Krugman, "Strategic Sectors and International Competition," in Robert M. Stern editor, *U.S. Trade Policies in a Changing World Economy* (Cambridge, Mass.: The MIT Press, 1987), pp. 220-25.

40 In this regard, see, Spence, *supra*, note 35.

R&D spillovers constitute only one of a number of types of externality that have been used to justify industrial incentives. In addition, incentives have often been advanced as a means to promote activities:

- i. leading to the development of a pool of skilled workers that lowers the costs of other suppliers in an industry;
- ii. involving the construction of infrastructure that provides benefits to other companies; or
- iii. reducing the costs or increasing the variety of inputs used by a final industry.⁴¹

Such external effects may also justify the use of industrial incentives in specific circumstances.

The use of subsidies to deal with these other types of external effects may also require consideration of other complicating factors. As in the case of R&D spillovers, the potential benefits to any single country of subsidizing the relevant activity may be dissipated by international trade in related products. As noted by Helpman and Krugman, with international trade, the location of externality-generating sectors, depending on the relevant circumstances, may have little impact on the distribution of their external benefits. Rather, competition among producers, terms of trade effects, and other considerations may allow all countries to share in these benefits.⁴²

Finally, the use of industrial incentives in relation to externalities should also take account of other possibly more efficient methods for dealing with the problem. For example, a better way of dealing with externalities may be to internalize their effects. That is, efficient supply of the relevant goods

⁴¹ This latter form of externality is referred to as a "linkage externality," in Krugman, *supra*, note 34, p. 224.

⁴² In this regard, see Elhanan Helpman and Paul Krugman, *Market Structure and Foreign Trade: Increasing Returns, Imperfect Competition, and the International Economy* (Cambridge, Mass.: The MIT Press, 1985), section II(3).

might instead be accomplished through the development of legislation requiring the parties benefiting from externalities to compensate the suppliers of the relevant products.⁴³

(iv) Other Economic Uses of Industrial Incentives

Numerous other economic concerns have also been used to justify industrial incentives. In Canada, prominence has been given to perceived capital market imperfections as a reason for aiding businesses. This use of incentives is often based on the view that the risk involved in the relevant business activity, in some way, "is disproportional and is non-insurable" such that "in the absence of direct government aid the activity would not take place at an optimal level."⁴⁴ Capital market imperfections are alleged by many to be particularly relevant to Canada based on the conventional wisdom that the country's financial institutions are "markedly" averse to investing in risky projects.⁴⁵

The view that capital markets tend to underfinance certain activities explicitly or implicitly underlies government support for a wide range of activities in Canada, including exporting, the establishment of infant industries, small and medium-sized enterprise development, high-technology investment, the development of mega-projects and others. These activities are widely viewed in Canada as entailing degrees of risk, knowledge requirements, and other characteristics that prevent them from receiving adequate private financing. Government assistance for these activities has often been given in the form of below market rates of finance and forgivable

⁴³ For example, inefficiencies relating to R&D spillovers might be mitigated by altering intellectual property protection so that those benefitting from the relevant R&D will be required to more fully compensate the inventor or innovator.

⁴⁴ Gordon Ritchie, "Government Aid to Industry: A Public Sector Perspective," in K. J. Rea and N. Wiseman (editors), *Government and Enterprise in Canada* (Agincourt, Ont.: Methuen Publications, 1985), p. 104.

⁴⁵ *Id.*

loans as well as direct grants, government investment in the relevant project and other forms of aid.⁴⁶

The economic analysis of capital markets supports that there are certain situations where incentives may help to mitigate related market imperfections. For example, it has been shown that asymmetries between the information available to lenders and borrowers on the risk and return of activities can lead to them being underfinanced. In such cases, subsidies may provide a means to more closely align the private and social rates of return for the relevant activity.⁴⁷

Private lending institutions may also underfinance certain activities due to the presence of externalities, public good properties, or other considerations referred to above. In such cases, the source of the problem may not lie in the capital market. Nevertheless, preferential loans or other finance-related incentives may provide a means to mitigate the relevant market distortion.

Industrial incentives, in certain circumstances, may also be used to mitigate inefficiencies generated by other government policies or programs. This use of incentives has been suggested, for example, as a means to mitigate losses relating to programs restricting the mobility of workers. These programs can increase the economic costs of business failures or lay-offs by prolonging the period that dislocated workers remain unemployed.

⁴⁶ Determining the the subsidy element in government loans and other measures used to correct for alleged capital market imperfections is often highly difficult. Nevertheless, these measures can provide their beneficiaries with a substantial competitive advantage over companies that are internally financed or that are required to obtain financing through financial institutions. In addition, loan programs operated by provincial and federal governments in Canada often subsidize businesses by assuming much of the risk that would be otherwise be borne by borrowers. Such loan provisions, in effect, transfer risks entailed in investments to taxpayers.

⁴⁷ For an overview of this issue, and related limitations on the use of industrial aids in such situations, see Gene M. Grossman, "Promoting New Industrial Activities: A Survey of Recent Arguments and Evidence," *OECD Economic Studies*, no. 14, Spring, 1990, pp. 85-125, at pp. 111-15.

Industrial incentives encouraging the location or expansion of businesses in depressed regions may be one means to mitigate these costs.

Government policies or programs that directly distort factor prices are another form of intervention that may provide an economic rationale for industrial incentives. Such policies and programs include, for example, import restrictions, regulatory interventions and certain environmental or other standards that increase the price of manufacturing inputs. Subsidizing purchases of the affected inputs may help to mitigate the market distorting effects of the relevant policies or programs by better equating the social and private rates of return on the inputs.

This use of industrial incentives, however, is also subject to some important qualifications. Depending on the situation, subsidies may actually be a relatively inefficient way to deal with the type of distortion under consideration. For example, rather than using incentives to relieve regional unemployment, it may be better to develop policies that increase the ability of workers to seek employment in other regions. Similarly, factor price distortions generated by import barriers, regulatory restraints and other policies might be more effectively remedied by amending these policies rather than attempting to offset their effects through the use of incentives.

The policies of foreign governments have been widely used to justify industrial incentives in Canada and other countries.⁴⁸ The express purpose of these incentives is frequently to match subsidies provided by other countries or to help domestic businesses overcome tariffs and other trade barriers erected by other countries. In addition they may be given to industries to help them overcome foreign labor or environmental policies, that are considered to give foreign producers an undue or unfair competitive advantage.

⁴⁸ For example, matching foreign assistance to exporters has been a major concern underlying the granting of favorable loans and insurance to Canadian exporters since at least 1944. In this regard, see A. Raynaud, J.-M. Dufour and D. Racette, *Government Assistance to Export Financing* (Ottawa: Minister of Supply and Services, 1983), pp. 8-9.

The use of industrial incentives to counter foreign government policies can improve the competitive and efficient operation of markets under certain conditions. For example, in certain circumstances, the use of subsidies in retaliation against "strategic" foreign subsidies may provide net benefits if it creates incentive for the foreign countries to abandon these subsidies.⁴⁹ The use of domestic subsidies to offset foreign subsidies may also be justifiable in certain cases to prevent costly temporary shut-downs of domestic plants and temporary unemployment.

Substantial interest has recently been generated in the potential use of subsidies to promote welfare enhancing entry in certain monopolistically competitive markets. These markets are characterized by differentiated products, low entry barriers, substantial international trade, relatively high transportation costs and declining average costs for each differentiated product.⁵⁰

The potential economic benefits from industrial incentives in such markets derives from their ability to affect the location as well as the scale of production. That is, where industrial aid induces the relocation of production to a country, that country avoids the transportation costs entailed in acquiring the product from a foreign source. Moreover, the increase in output generated by industrial incentives can close the gap between the price and marginal cost of products where there are constant or increasing returns to scale. It has been shown that for some level of subsidy, the combination of these benefits, may outweigh the economic costs of the subsidy.⁵¹

⁴⁹ This might be the case, for example, in a repeated game strategic trade policy setting. In such cases, an aggressive response to foreign subsidies might be used, depending on the relevant circumstances, to provide incentive for the country first applying the subsidies to abandon its policy.

⁵⁰ See Anthony Venables, "Trade and Trade Policy with Differentiated Products: A Chamberlinian-Ricardian Model," *The Economic Journal*, vol. 97, 1987, pp. 700-717. A less technical discussion of this paper is provided in Helpman and Krugman, *supra*, note 34, pp. 145-49.

⁵¹ This effect can be obtained through subsidies for fixed costs, marginal costs or exports costs. In this regard, see Venables, *id.*, p. 714.

The potential benefits of industrial subsidies in monopolistically competitive markets, however, has the potential to provide significant benefits to a country only in cases where average costs of production are declining rapidly, there is a large amount of international trade and transportation costs between countries are high in relation to the value of the relevant products. Such conditions are unlikely to coexist for many products or industries.⁵² Also, as in the case of strategic trade policy, there is the danger that the use of subsidies to encourage the location of manufacturing in one country will lead to retaliation by other countries. In this case as well, the benefits that a country achieves from subsidies may be at the expense of other countries' economic welfare. Accordingly, these other countries may have incentive to retaliate causing, in the end, a net welfare loss for both countries.⁵³

3. Competition, Efficiency and the Design of Industrial Incentives

The competition and efficiency implications of industrial incentives, whether they are provided in relation to one of the above economic rationales or for other economic or social policy objectives, are likely to depend to a large extent on the design of related programs or projects. In many cases, careful consideration of various aspects of incentives programs or projects might reduce the threat they engender for the competitiveness and

⁵² Helpman and Krugman, *supra*, note 34, p. 149.

⁵³ It should be noted that these are not the only possible cases in which subsidies, at least in theory, might be used in imperfectly competitive markets to improve a country's economic welfare. For example, it has been shown that subsidies may be used in limited cases for this purpose where a single product is produced with increasing returns to scale in two countries, and the markets in these two countries can be segmented. In this regard, see Anthony Venables, "Trade and Trade Policy with Imperfect Competition," *Journal of International Economics*, vol. 19, 1985, pp. 1-20. Limitations on this use of industrial aids are discussed in Ignatius Horstmann and James Markusen, "Up the Average Cost Curve," *Journal of International Economics*, vol. 20, 1986, pp. 225-47 and Shmuel Ben Zvi and Elhanan Helpman, *Oligopoly in Segmented Markets* (Cambridge, Mass.: National Bureau of Economic Research, Working Paper no. 2665, 1988). Finally, a case has been made that governments, in certain cases, may be able to increase their country's overall economic welfare by subsidizing entry by domestic firms into emerging oligopoly or monopoly markets. For discussion of this case and its limitations, see Wilfred J. Ethier, "Decreasing Costs in International Trade and Frank Graham's Argument for Protection," *Econometrica*, vol. 50, pp. 1243-68, and Dixit and Kyle, *supra*, note 32.

efficiency of markets while still allowing them to achieve their objectives. This section considers this issue in regard to:

- i. the specified objectives of incentives;
- ii. the range of businesses eligible for incentives;
- iii. the specific nature of the incentives provided;
- iv. possible limits on the amount and timing of incentives;
- v. factors used to determine eligibility for and the amount of incentives; and
- vi. conditions attached to the receipt of incentives.

(i) The Objectives of Incentives

Ensuring that the objectives of incentives are no broader than required to achieve valid economic, social or other policy objectives can have important implications for their economic costs. As indicated in the preceding sections, economic analysis supports the use of industrial incentives to promote activities such as small and medium-sized enterprise development, exports or R&D only in certain circumstances. It follows that programs that broadly target these activities will result in the provision of incentives in many cases where they are unwarranted and may distort the competitiveness and efficiency of related markets.

It may also be important to ensure that the objectives of incentives are not too narrowly defined. This may be an issue, for example, where there is a threat of industrial aid helping to entrench a firm in a dominant position in a product or geographic market. In such a case, some broadening of the objectives of related programs might be considered to account for valid competition related concerns.⁵⁴

⁵⁴ Overly narrow specification of the objectives of industrial incentives programs could also engender unnecessary competition and efficiency costs in other ways. It may be important to ensure that the manner in which a program's objectives are specified does not unnecessarily limit the ways in which its fundamental goals can be achieved by, for example, confining its application to a particular size or class of business or method of production.

(ii) The Range of Businesses Eligible for Incentives

Careful definition of the range of businesses eligible for incentives may also help to avoid unnecessary disruptions of the competitive and efficient operation of related markets. On one hand, making assistance available to more businesses than is required can unnecessarily increase the amount of aid provided hence the associated competition and efficiency distortions. On the other hand, the potential competitive implications of incentives might support extending their availability to a broader range of businesses. This may be a concern where, for example, planned aid would unduly favor some suppliers in a market at the expense of other, possibly more efficient suppliers, or help one or a small number of businesses to achieve a dominant position in a market.

It may be noted that the methods that have been developed by competition authorities in Canada and other countries for defining antitrust markets might be useful for designing the coverage, as well as other aspects of industrial incentives programs.⁵⁵ These methods provide a systematic approach for identifying products and suppliers that compete in the same market as the businesses under investigation. Applied to industrial incentives programs, they might be used to identify businesses that should be made eligible for help in order to avoid the threat of some businesses receiving an undue or excessive competitive advantage.

(iii) Determining the Types of Incentives Available

The type of incentive provided in a particular set of circumstances, as indicated in section I of this chapter, can have important competition and efficiency implications. As noted, fixed or lump sum aid should generally be less of a threat for the competitive and efficient operation of markets than is production aid. The potential use of production aid, however, should not be ruled out in certain circumstances. It may be particularly effective for dealing

⁵⁵ For a description of this process as it is applied under the Canadian *Competition Act*, see, for example, *Merger Enforcement Guidelines*, *supra*, note 26.

with market imperfections that directly distort prices. These might include, for example, import restraints that directly affect the price of a factor of production.

(iv) Time and Quantity Limits on Incentives

Firm limits on the amount of, or time that incentives will be provided may be necessary to avoid the threat, noted above, of aid impeding, rather than enhancing adjustment to changing market conditions. Businesses that believe that aid will not extend beyond a certain amount or point in time should have a much stronger incentive to make the kinds of adjustments needed to become effective competitors.

(v) Factors Considered in Relation to the Provision of Incentives

The factors determining the incentives received by individual businesses may require careful consideration in order to avoid unnecessarily distorting efficient production, supply and other decisions. For example, the provision of assistance to an industry through a subsidy on one of its inputs may be a threat not only to distort the price and quantity of the final product, but also, the efficient choice of inputs.⁵⁶ In such cases, simply subsidizing the final product may be less distortionary.

(vi) Conditions on the Receipt of Incentives

Close scrutiny of the conditions attached to industrial incentives can also have important competition and efficiency benefits. A major concern in

⁵⁶ This problem has been recognized as far back as the 1700's. Adam Smith stated in the *Wealth of Nations* (Canaan edition, vol. II, book IV, chapter V, p. 21):

The bounty to the white-herring fishery is a tonnage bounty; and is proportioned to the burden of the ship, not to her diligence or success in the fishery; and it has, I am afraid, been too common for vessels to fit out for the sole purpose of catching, not the fish, but the bounty.

(Canaan edition, vol. II, book IV, chapter V, p. 21, quoted in Simon James (compiler), *A Dictionary of Economic Quotations* (Totowa, N. J.: Barnes & Noble Books, 2nd edition, 1984), p. 170.

this regard should be ensuring that these conditions do not unnecessarily restrict the ability of businesses to efficiently respond to changing market conditions. For example, requirements to employ a given amount of labour or other factor, or use a certain technology in order to receive aid can create incentives to adopt inefficient production methods. Similarly, requirements to export goods in order to receive incentives may result in the inefficient diversion of output away from domestic markets as well as promote overproduction of the relevant goods.

4. Summary

The potential competition and efficiency implications of industrial incentives may depend largely on the nature of the underlying market. Industrial incentives, especially in markets that are already reasonably competitive and efficient, are likely to involve major costs. These may include, for example, excess production and consumption of the relevant goods, the selection of inefficient sites for production, the choice of inefficient production methods, the promotion of wasteful rent-seeking behaviour, and the establishment of dominant firms or businesses.

Industrial incentives can provide an instrument for mitigating competition and efficiency distortions associated with various types of market failure or imperfection. Related uses of industrial incentives potentially include the promotion of competition in oligopolistic or monopolistic markets, the correction externalities, mitigation of the economic costs of other government policies, and the promotion of activities that are underfunded by capital markets. The economic analysis of the market imperfections associated with these uses of industrial incentives, however, suggests that they are likely to be of major concern only under limited circumstances. Moreover, in these circumstances, incentives may be only one of a number of possible ways to remedy the problem. This, combined with the potential market distortions and economic costs of incentives, support the adoption of a highly cautious approach toward their use for economic, social or other policy purposes.

In cases where the use of industrial incentives are considered to be warranted, it may be possible to mitigate their potential costs through the careful design of related programs. Close attention to the competitive implications of key elements of incentive programs may be helpful in this regard. For example, production aid generally constitutes a greater threat to the competitiveness and efficiency of markets than aid that is provided as a lump sum. Other elements of industrial incentives programs having potentially important competition and efficiency implications include:

- i. the specification of the objectives to be achieved;
- ii the range of potential recipients;
- iii. the use of quantity and time constraints;
- iv. the factors used to determine the availability and amount of incentives; and
- v. the conditions attached to the receipt of incentives.

III. THE PROVISION OF INDUSTRIAL INCENTIVES IN CANADA

The provision of industrial incentives in Canada, is subject to few basic framework rules or guidelines. Rather, the Canadian *Constitution Act*, outside of certain limitations, has not greatly restrained their use by either provincial or federal governments.⁵⁷ As a consequence, the provision of industrial incentives in Canada, at any point in time, may be shaped by a range of forces. These may include, the fiscal strength of different levels of government, provincial views regarding the adequacy of federal policies, conflict among the provinces, government views on the efficacy of industrial policy and others. This chapter examines the current use of industrial incentives in Canada and its underlying legal and institutional framework

1. Industrial Incentives in Canada

(i) The Amount and Nature of Industrial Incentives in Canada

Provincial and federal governments in Canada are highly active in the provision of industrial incentives to businesses. Both levels of government operate a vast array of ongoing programs providing various forms of assistance to businesses.⁵⁸ These programs are supplemented by aid that is provided on a more case specific basis often because it pertains to situations that are not covered by ongoing programs or involves a particularly large quantity of aid.

The actual amount of direct and indirect industrial incentives that are provided in Canada is highly difficult to estimate.⁵⁹ Some indication of the

⁵⁷ For discussion, see, for example, Peter M. Leslie, *Federal State, National Economy* (Toronto: University of Toronto Press, 1987), chapter 9 and Peter Hogg, *Constitution Law of Canada* (Toronto: The Carswell Company Limited, 2nd edition, 1985), chapter 6.

⁵⁸ A sample of these programs is provided in CCH Canadian Limited, *Industrial Assistance Programs in Canada* (Don Mills Ont.: Tax and Business Law Publishers, annual).

⁵⁹ There have been many studies of industrial aid in Canada including, among others, Jean-François Bence and Murray Smith, "Subsidies and the Trade Laws: The Canada-U.S.

potential significance of these incentives, however, can be obtained from a number of related measures. The Canadian National Income and Expenditures Accounts include two types of government expenditure that may be used to obtain a rough indication of direct government aid to industry. They are subsidies to businesses (i.e., government transfers to businesses toward current costs of production), and capital assistance (i.e., government transfers to businesses to encourage investment in fixed capital and the improvement of existing assets).⁶⁰

The following table examines the magnitude of these expenditures by all levels of government during the 1980's. It indicates that total direct government aid to businesses has been in excess of \$13 billion per year since 1983, mostly outside of the agricultural sector. The majority of this aid, has been provided in the form of operating subsidies rather than capital assistance.

Dimension," *International Economic Perspectives* (Halifax, N. S.: Institute for Research on Public Policy, April-May 1989), Andrew Moroz and Stephen Brown, *Grant Support and Trade Protection for Canadian Industries* (Halifax, N. S.: Institute for Research on Public Policy, April, 1987), and G. E. Salembrier, Andrew Moroz and Frank Stone, *The Canadian Import File: Trade, Protection and Adjustment* (Halifax, N. S.: Institute for Research on Public Policy, 1987), pp. 55 ff. These studies, however, have tended to be restricted to certain classes of incentives, incentives provided by one level of government, specific aid cases or aid to specific sectors. No comprehensive study on industrial incentives in Canada has been conducted similar to the state aid surveys in the European Community discussed in the following chapter.

⁶⁰ See Statistics Canada, *Guide to the National Income and Expenditure Accounts* (Ottawa: 1990), catalogue no. 13-603E, Appendix II. As noted in André Blais, *A Political Sociology of Public Aid to Industry* (Ottawa: Minister of Supply and Services Canada, the Collected Research Studies of the Royal Commission on the Economic Union and Development Prospects for Canada, vol. 45, 1986), at p. 29, however, these figures may tend to overestimate the amount of direct industrial aid that is provided since they include some disbursements that may not normally be considered to constitute industrial aid.

TABLE III-1

**Subsidies and Capital Assistance in Canada,
1980-89 (\$billions)**

	Operating Subsidies (\$millions)		Capital Assistance (\$millions)	Total Direct Aid to Businesses	
Year	Total	Agriculture*	Total	All Sectors	Excluding Agriculture
1980	8.0	1.0	1.1	9.1	8.1
1981	10.4	1.4	1.2	11.6	10.2
1982	9.6	1.3	3.2	12.7	11.4
1983	10.1	1.4	4.7	14.8	13.4
1984	12.1	2.0	4.1	16.2	14.3
1985	12.0	2.8	3.8	15.7	12.9
1986	10.4	2.9	3.6	14.0	11.1
1987	11.6	4.2	2.8	14.4	10.2
1988	11.5	4.4	2.4	13.9	9.5
1989	11.3	4.0	2.4	13.6	9.6

Sources: Statistics Canada, *National Income and Expenditure Accounts: Annual Estimates 1980-91*, (Ottawa: Statistics Canada catalogue no. 13-201, 1992), tables 49 and 50. and the Public Institutions Division of Statistics Canada.

*Includes provincial and federal subsidies to the agricultural sector.

Direct government aid to non-agricultural businesses increased substantially during the early 1980's. As indicated by the table, it rose from \$8.1 billion in 1980 to \$14.3 in 1984 or about 77% in nominal terms or just under 30% in real terms.

A substantial decrease in direct aid occurred during the latter half of the 1980's, almost 50% in real terms. Caution should be taken, however, in interpreting this as a strong shift away from the use of direct aid as an economic and social policy instrument. Rather, the fall in direct non-

agricultural aid during this period was caused primarily by declining federal government payments under three programs in the petroleum sector: compensation for importers of crude oil and petroleum products, the Petroleum Compensation Fund and the Petroleum Incentives Program. When these subsidies are removed, direct industrial aid actually increased in nominal terms from 1984 to 1989, although it declined by about 18% in real terms. Overall, in 1989, the level of industrial aid provided outside of the agricultural sector and the above programs actually remained well above the level in 1980, about 34% higher in real terms.⁶¹

More recent figures suggest that direct industrial aid may be resuming an upward trend. Total direct aid for all sectors was just over \$16.5 billion during 1991 as compared to \$13.3 billion in 1989. This increase has occurred primarily outside of the agricultural sector. Indeed, federal government subsidies for agriculture in 1991, about \$1.2 billion, were actually well below the 1989 total of just over \$2.3 billion. Also, no significant aid was provided under the any of the three above-mentioned programs in the petroleum sector.⁶²

Aid covered by the above table is a significant aspect of the Canadian economy. Overall, it was equal to about 1.7% of Canadian GNP in 1989, and about 2.1% of GNP in 1991.⁶³ During 1987, operating subsidies alone accounted for more than 1% of GDP for 9 of 50 major commodity groups in Canada.⁶⁴ Direct aid provided in the form of capital assistance, while it tends to be considerably less than aid provided as operating subsidies, is significant when compared to overall investment in the Canadian economy. In 1989,

⁶¹ Estimated direct aid outside of the agricultural sector and the relevant sectors was about \$4.2 billion in 1980 as compared to about \$9.3 billion in 1984, and about \$9.5 billion in 1989.

⁶² A similar break-down of provincial aid during 1991 is not yet available. It is possible, therefore, that the decline in federal aid to the agricultural sector from 1989 to 1991 has been somewhat offset by increased provincial aid in the sector.

⁶³ Statistics Canada, *National Income and Expenditure Accounts: Annual Estimates 1980-91*, (Ottawa: Statistics Canada, 1992), catalogue no. 13-201, table 11.

⁶⁴ See Statistics Canada, *The Input/Output Structure of the Canadian Economy 1987* (Ottawa: 1991), Table 14.

this assistance was equal to about 2.7% of all fixed capital investment in Canada.⁶⁵

Indirect industrial incentives tends to be much more difficult to detect and measure than direct incentives. Their potential importance, however, should not be underestimated. A recent study of government support in the Canadian pulp and paper industry found that over 45% of all aid to the industry during the 1980's was provided in forms other than direct grants. This indirect aid accounted for about 2.4% of all investment in the sector during the period under consideration.⁶⁶

One source of indirect industrial incentives in Canada that is relatively well studied is the provision of loans at below market rates and loan guarantees. Provincial and federal governments in Canada have become increasingly involved in the provision of loans to the private sector since WWII. From 1950 to 1980, the value of federal and provincial government loans and investments, loan guarantees and credit insurance extended to the private sector increased from about 4.3% of Canadian GDP to about 18.5%.⁶⁷ Government involvement in the Canadian financial sector continued to increase during the 1980's. From 1980 to 1989, government assets in the Canadian financial sector increased from about \$63.1 billion to about \$121.0 billion. In real terms, this represented an increase of just over 8%.⁶⁸

The subsidy portion of government loans to businesses normally must be determined on a case by case basis and may be highly sensitive to the

⁶⁵ Statistics Canada, *supra*, note 63, tables 25 and 26.

⁶⁶ See, Industry, Science and Technology Canada, *Subsidies in the North American Pulp and Paper Industry: Effects on Canada-U.S. Competitiveness* (Ottawa: Special Projects Branch, August 1992).

⁶⁷ W. T. Stanbury, *Business-Government Relations in Canada* (Scarborough, Ont.: Nelson Canada, 1988), pp. 66-68.

⁶⁸ Based on data provided by the Public Institutions Division of the Department of Statistics Canada.

method of estimation chosen.⁶⁹ There is no doubt, however, that it can be substantial. A 1982 Economic Council of Canada study of 25 federal and provincial government loan programs concluded that they provided as much as \$905 million in indirect subsidies to businesses during 1979. The rate of subsidy for individual programs, taking into account the costs of providing the loans and losses due to bad loans, was estimated to be as high as 45.6% of the value of the loans provided.⁷⁰

Government owned business enterprises (GBE's) are another potentially important source of indirect industrial aid in Canada. In the electricity sector, for example, the supply of power by GBE's at favorable rates has often been used by provincial governments to promote their economic objectives.⁷¹ In addition, both provincial and federal governments in Canada have established GBE's to provide preferential loans, loan guarantees and other financial assistance to promote small businesses, encourage exports and achieve other objectives.⁷²

GBE's are also of concern as potential recipients of indirect industrial aid, such as uneconomic capital injections. This aid may threaten the competitiveness and efficiency of Canadian markets where it is provided to GBE's that compete with private businesses. Moreover, the relationships that exist between GBE's and their owner governments, as indicated by the EC's experience discussed in chapter section 3(v) following, can facilitate the

⁶⁹ The focus of this paper on the competitive implications of subsidies suggests as an appropriate method of estimation a comparison between the actual rate of interest paid by the recipient and the rate that normally would be required to obtain a similar loan from the private sector. This approach, however, is difficult to use over a broad range of loans since it requires that risk of these loans estimated on a case by case basis.

⁷⁰ See Economic Council of Canada, *Intervention and Efficiency* (Ottawa: 1982), Appendix A.

⁷¹ See, for example, Phillipe Faucher and Johanne Bergeron, "Hydro-Quebec," in Allan Tupper and Bruce Doern (editors), *Privatization, Public Policy and Public Corporations in Canada* (Halifax, N. S.: Institute for Research on Public Policy, 1988), pp. 265-362.

⁷² Many of the organizations examined in the Economic Council study *Intervention and Efficiency*, *supra*, note 70, Appendix A, were in fact GBE's.

provision of industrial incentive in ways that are difficult both to detect and discipline.

The provision of industrial incentives to or by GBE's has not been systematically studied in Canada.⁷³ However, the extent of government ownership of businesses in Canada, examined in the following table, suggests that it is potentially a major area for concern.

TABLE III-2

Government Business Enterprises in Canada, 1989

Sector	Assets (\$ billions)	Percent of all Government Business Assets	Percent of All Assets in the Sector (1985)
Transportation	18.6	6.8	33.1
Communications	9.3	3.4	30.0
Electricity	98.2	36.2	94.8
Manufacturing	3.0	1.1	2.6
Mining	10.7	4.0	10.1
Finance	121.0	44.6	7.3
Trade	6.1	2.3	5.8
Other	4.3	1.6	2.9
Total All Sectors	271.3	100.0	14.7

Source: Statistics Canada, Public Institutions Division and Statistics Canada, *Corporation Financial Statistics*, catalogue no. 61-207, 1985.

As indicated by the table, GBE's in Canada had total assets in 1989 of about \$271 billion. These assets were concentrated in finance, electricity and transportation. Substantial assets were also held, however, in each of the other sectors denoted in the table.

⁷³ There have been, however, some studies, such as Faucher and Bergeron, *supra*, note 71, of aid provided by certain GBE's.

Certain trends in government ownership of business enterprises during the 1980's are worth noting. Despite privatization efforts during the 1980's, the real value of all GBE's during the decade actually increased by about 10%.⁷⁴ Privatization efforts appear to have been the most successful in the manufacturing sector where the total assets of GBE's decreased significantly in both real and nominal terms. Whereas these enterprises accounted for 4% of the total assets of GBE's in 1980, by 1989, their share had declined to just over 1%.⁷⁵

GBE's are an important factor in a number of sectors of the Canadian economy. In 1985, they accounted for over 30% of all Canadian assets in the transportation, communications and electricity sectors. They also represented a significant share of all assets in the mining, financial and trade sectors of the economy. Overall, GBE's made up over 14% of all assets in the Canadian economy in 1985, and included 5 of the 25 largest Canadian enterprises.⁷⁶

Governments in Canada can also provide indirect incentives to industries in a number of other ways. These include, in particular:

- i. the granting of special tax credits or rebates;
- ii. the use of preferential procurement or contracting practices (i.e., the purchase of goods at more than their market value or the assignment of intellectual property rights to businesses performing contract research); and
- iii. the provision of low-cost or free goods and services to businesses.

⁷⁴ This estimate is based on figures provided by the Public Institutions Division of Statistics Canada.

⁷⁵ *Id.*

⁷⁶ James A. Brander, *Government Policy Toward Business* (Toronto: Butterworths Canada Ltd., 1988), chapter 13.

These types of incentives are also used widely by governments in Canada for such purposes as the promotion of R&D and exports, and regional economic development.⁷⁷

The significance of these other sources of industrial aid also has not been systematically examined. The high degree of government involvement in related aspects of the Canadian economy, nevertheless, suggests that they too may be a major source of indirect aid to businesses. For example, corporate taxes collected by governments in Canada were almost \$15 billion in 1991. In the same year, government purchases of goods and services amounted to more than \$140 billion.⁷⁸

(ii) The Distribution of Incentives by Level of Government

Federal and provincial governments are the main suppliers of industrial incentives in Canada.⁷⁹ The federal government, however, is widely considered to be the dominant provider. Among other considerations, this view is generally based on the belief that the provinces provide much less aid, overall, than the federal government.⁸⁰

⁷⁷ See generally, CCH Canadian Limited, *supra*, note 58, ¶180,000.

⁷⁸ Statistics Canada, *supra*, note 63, table 36.

⁷⁹ Business subsidies provided by local governments in Canada between 1986 and 1991 averaged just below 15% per annum of the amount provided by either federal or provincial governments. It may be noted that this is an important difference between the industrial aid framework in Canada as compared to the U.S. where local governments are major providers of industrial aid. In this regard, see section 1 of chapter V below.

⁸⁰ For typical examples of this thinking, see André Blais, *Industrial Policy* (Ottawa: Minister of Supply and Services Canada, Collected Research Studies of the Royal Commission on the Economic Union and Development Prospects for Canada. vol. 44, 1986), p. 8 and Wyn Grant, "Government and Industry in Canada," in Wyn Grant (editor), *Government and Industry: A Comparative Analysis of the US, Canada and the UK* (Brookfield Vermont: Gower Publishing Company, 1989), chapter 6, p. 170.

TABLE III-3

Canadian Direct Industrial Aid by Level of Government, 1980-89

Provincial (\$billions)

Year	Agriculture	Housing	Other	Total
1980/81	.43	.79	1.06	2.27
1981/82	.66	.79	1.23	2.69
1982/83	.80	1.04	2.26	4.10
1983/84	.72	1.30	2.88	4.90
1984/85	1.01	1.16	2.73	4.89
1985/86	1.65	1.19	3.21	6.05
1986/87	1.17	1.31	3.55	6.04
1987/88	.97	1.36	2.88	5.21
1988/89	1.68	1.33	2.91	5.93
1989/90	1.76	1.54	2.92	6.21

Federal (\$billions)

Year	Agriculture*	Housing	Other	Total**
1980	.59	.45	5.47	6.42
1981	.74	.44	6.36	7.53
1982	.57	.94	6.82	8.33
1983	.65	1.74	6.87	9.26
1984	1.00	1.18	8.67	10.84
1985	1.16	1.08	7.11	9.35
1986	1.72	1.12	4.49	7.32
1987	3.29	1.21	4.61	9.11
1988	2.79	1.10	3.92	7.80
1989	2.32	1.14	3.94	7.40

Sources: Statistics Canada, *National Income and Expenditure Accounts: Annual Estimates 1980-1991*, catalogue no. 13-201 and Public Institutions Division.

*This amount does not include federal capital assistance in the agriculture sector which was not available.

**The Total figures provided are not accrual adjusted for the years 1987-1991.

Table III-3, however, suggests that the relative importance of the federal government as a provider of industrial incentives in Canada declined

substantially during the 1980's. Direct federal aid to businesses outside of the agricultural sector actually declined from \$5.9 billion in 1980 to \$5.1 billion in 1989. In real terms, this amounted to a 49% decrease in this aid. In contrast, provincial direct industrial aid increased from \$1.8 billion in 1980 to about \$4.5 billion in 1989, or by about 43% in real terms.⁸¹ Overall, the ratio of federal to provincial non-agricultural direct aid declined from 3.22 to 1.14 from 1980 to 1989.⁸²

A number of other measures suggest that provincial governments in Canada are becoming increasingly important providers of indirect industrial incentives relative to the federal government. The provinces, relative to the federal government, appear to have significantly increased their capacity to provide financial aid to businesses. Table IV-4 below indicates that provincial business enterprise assets in the financial sector more than doubled from 1980 to 1989. Federal government assets in the sector, while they remained greater than provincial government assets, increased by less than 70% over the same period.

Overall, the total assets of provincial GBE's, even in 1980, was significantly greater than federal GBE assets. This gap actually increased substantially during the 1980's. Whereas the ratio of provincial to federal GBE assets was under 1.4 in 1980, by 1989, this ratio had risen to about 1.8.

⁸¹ The constant dollar values use 1986 as the base year with corresponding values for 1980 and 1989 dollars of .672 and 1.14, respectively. The ratio of total federal to provincial direct industrial aid fell from 2.8 to 1.2 over the same period. A slight increase in this ratio, to 1.36, occurred during the early 1990's (see Statistics Canada, *supra*, note 63, tables 49 and 50).

⁸² Due to data limitations, this figure does not take account of possible changes in federal capital assistance to the agricultural sector.

TABLE III-4

**Federal and Provincial Government Business
Enterprise Assets, 1980-89 (\$billions)**

Sector	1980		1985		1989	
	Fed	Prov	Fed	Prov	Fed	Prov
Finance	43.5	20.9	53.1	37.9	66.1	55.0
Transportation	9.1	2.4	13.4	4.4	13.4	5.2
Communications	.9	3.3	3.7	4.5	3.5	5.8
Electricity	.2	53.3	.3	84.2	0.0	98.2
Manufacturing	3.7	2.2	2.1	3.5	.5	2.5
Mining	4.1	1.7	8.8	3.4	6.8	3.9
Trade	2.6	.6	5.5	1.1	5.0	1.1
Other	.2	1.5	.4	2.4	.8	3.5
Total	64.3	85.9	87.3	141.5	96.1	175.2

Source: Statistics Canada, Public Institutions Division.

The provinces are also major purchasers of goods and services when measured against the federal government. Overall, provincial expenditures during 1991, outside of debt servicing, were \$140.7 billion with current expenditures on goods and services of \$46.2 billion. Federal expenditures other than debt servicing were about \$119 billion for the same year, with current expenditures on goods and services of about \$30.6 billion.⁸³

(iii) The Objectives of Industrial Incentives in Canada

Regional economic development has long been a major goal of industrial incentives in Canada. While not specifically recognized in Canada until the 1960's, it has been a motivating factor behind economic policies throughout Canada's history.⁸⁴ That regional development continues to be a

⁸³ Statistics Canada, *supra*, note 63, tables 37 and 38. It may be noted that local government current expenditures on goods and services were also substantial at \$42.8 billion.

⁸⁴ Royal Commission on the Economic Union and Development Prospects for Canada, *supra*, note 4, vol. 3, p. 207.

major policy objective in the country is evident from the existence of federal government departments such as the Atlantic Canada Opportunities Agency, Western Economic Diversification Canada and the Federal Office of Regional Development (Québec) having specific regional economic development priorities.

Regional development, however, is not the only widely used objective for industrial incentives in Canada. Others are indicated by Table III-5 which lists the principle objectives of 129 federal and provincial ongoing incentive programs.

TABLE III-5

**Canadian Federal and Provincial Industrial
Assistance Program Objectives**

Principle Objective*	Provincial Programs	Federal Programs
Innovation, R&D	19	9
SME Development	23	4
Trade and Export	7	5
Energy Economization	3	5
General Investment	11	1
Industry/Sector Specific	9	3
Employment/Training	15	5
Regional Aid	7	4
Other Objectives	4	3
Total	88	39

Source: CCH Canadian Ltd., *Industrial Assistance Programs in Canada* (Don Mills, Ont.: Tax and Business Law Publishers, 1991)

The table indicates that numerous provincial as well as federal programs exist in Canada for such objectives as the promotion of R&D, employment and training, exporting, small and medium size enterprise development and investment.

2. The Legal and Institutional Framework for Incentives

The legal and institutional framework underlying the provision of industrial incentives in Canada involves a complex interplay between provincial and federal governments. The federal government, as the principle provider of industrial incentives in Canada, has traditionally been at the center of this framework. Increasing provincial dissatisfaction with related federal policies however, has led them to adopt a much more active industrial assistance and policy role over the past several years. Understanding the provision of industrial incentives in Canada, therefore, requires that due consideration be given to the roles of the provinces, as well as the federal government and the nature of the relations between the two levels of government.

(i) The Federal Government

Decision-making at the federal government level on matters relating to industrial incentives and policy potentially involves many cabinet committees, departments and agencies. Final decision-making authority on major issues, including those directly or indirectly relating to industrial aid, rests within the federal cabinet. Under changes recently made to the cabinet decision-making system, the full cabinet, in addition to having certain specific policy responsibilities, will be responsible for determining the Government's overall agenda and major policies.⁸⁵

An important role on industrial aid related matters may also be played by the Operations Committee. This committee, along with other responsibilities, has been given the tasks of reviewing the Government's weekly agenda and coordinating the development of new policies. Other

⁸⁵ The current cabinet committee system is outlined in Office of the Prime Minister, *Release*, June 25, 1993. This system represents a substantial downsizing and reorganization from the previous cabinet committee framework outlined in Katherine A. Graham, "Discretion and the Governance of Canada: The Buck Stops Where?," in Katherine A. Graham (editor), *How Ottawa Spends 1989-90: The Buck Stops Where?* (Ottawa: Carleton University Press, 1989), chapter 1 and G. Bruce Doern and Richard Phidd, *Canadian Public Policy: Ideas, Structure, Process* (2nd edition) (Scarborough, Ontario: Nelson Canada, 1992), chapters 4 and 11.

relevant cabinet committees include Economic and Environment Policy which focuses on government policies and programs to promote Canadian competitiveness, Social Policy which is responsible for the development of social policies and programs, and Treasury Board which has legal responsibility for the authorization of expenditures and is generally responsible for the allocation of resources to support government policies and programs.⁸⁶

Input on the provision of federal industrial incentives may also come from a number of departments and agencies. While still evolving as a government department, a key role is likely to be played Industrial and Science Canada (ISC). ISC, established in June 1993, has been given the role, formerly held by Industry Science and Technology Canada (ISTC), of flagship federal government department on microeconomic policy matters. It carries over the industrial and science policy roles that were assumed by ISTC at its formation in 1987.⁸⁷ In addition, it has been given various new responsibilities relating to market and business framework policies and investment policy.⁸⁸

Other federal government organizations that may have an important role include three regional departments created to manage federal economic development policy outside of Ontario. The Atlantic Canada Opportunities Agency (ACOA) was established in 1986 to oversee federal regional development policies in New Brunswick, Prince Edward Island, Nova Scotia and Newfoundland. The objective of this agency, as set forth in its founding

⁸⁶ See Office of the Prime Minister, *id.*

⁸⁷ The formation and intended role of ISTC is examined in Bruce Doern, "The Department of Industry Science and Technology," in Katherine A. Graham (editor), *How Ottawa Spends 1990-91: Tracking the Second Agenda*, (Ottawa: Carleton University Press, 1990), pp. 49-71 and Donald J. Savoie, "Atlantic Canada Opportunities Agency (ACOA): Something Old, Something New, Something Borrowed, Something Blue," in Katherine A. Graham (editor), *How Ottawa Spends 1989-90: The Buck Stops Where?* (Ottawa: Carleton University Press, 1989), pp. 107-30.

⁸⁸ The roles and responsibilities of ISC are outlined in Office of the Prime Minister, *supra*, note 86.

legislation, is:

to support and promote opportunity for economic development of Atlantic Canada, with particular emphasis on small and medium-sized enterprises, through policy, program and project development and implementation and through advocacy of the interests of Atlantic Canada in national economic policy, program and project development and implementation.⁸⁹

ACOA, therefore is intended to play a major role in the development of federal government regional economic policy in Atlantic Canada both through related program development and by representing the region's concerns within the federal government.⁹⁰

To accomplish this objective the Minister of ACOA "may exercise powers and perform duties and functions that affect economic opportunity and development in Atlantic Canada over which Parliament has jurisdiction and that are not by or pursuant to law assigned to any other member of the Queen's Privy Council for Canada or to any department board or agency of the government of Canada."⁹¹ In addition, the Agency manages funds provided by the federal government specifically for the economic development of the Atlantic provinces. Specifically, it oversees the \$2.1 billion "Atlantic Allotment" set up by the federal government to promote the development of Atlantic Canada over the 1989-94 period.⁹² ACOA is also involved in the development and management of programs negotiated under the Economic and Regional Development Agreements (ERDA's)

⁸⁹ *Government Organization Act, Atlantic Canada, 1987 (Atlantic Canada Opportunities Act)*, s. 12.

⁹⁰ For discussion, see Savoie, *supra*, note 87.

⁹¹ *Government Organization Act, supra*, note 89, s. 5. More specific powers of the Minister for ACOA are outlined in section 13 of the *Act*.

⁹² Atlantic Canada Opportunities Agency, *ACOA Facts and Figures* (August 1992).

between the federal government and the separate provincial governments in Atlantic Canada.⁹³

Management of federal regional development programs and policy for Western Canada is the responsibility of the Department of Western Economic Diversification Canada (WED) also established in 1986. This department has responsibilities similar to ACOA's but for the provinces of Manitoba, Saskatchewan, Alberta and B.C. WED advocates Western Canada's interests with respect to the development and implementation of national economic policy and programs.⁹⁴ In addition, the department manages federal regional development initiatives in Western Canada through management of a \$1.2 billion fund set aside for this purpose.⁹⁵ WED also plays an important role in managing programs developed under the ERDA's between the federal government and the individual Western provinces.

Federal regional development policy in Quebec is managed by the Federal Office of Regional Development for Quebec (FORD-Q). This department was created in July 1991 from a division of ISTC.⁹⁶ FORD-Q is responsible for coordinating federal regional development policies and programs in Quebec and acts as the federal government's primary regional development representative for the province. Ford-Q's grants and contributions to businesses in Quebec under its various programs for 1992-93 have been estimated at about \$167 million.⁹⁷

The creation of separate federal government departments to deal with regional and economic development policy and programs in the Atlantic

93 These programs are discussed in subsection (iii) below.

94 *Western Economic Diversification Act*, 1988, s. 5.

95 Western Economic Diversification Canada, *Working with western Canadian business to develop* (Edmonton).

96 See *Canada Gazette, Part II*, vol. 125. no. 4, pp. 2258-68.

97 See 1992-93 *Estimates Part III: Federal Office of Regional Development* (Ottawa: Minister of Supply and Services Canada, 1992), pp. 23-26.

provinces, the West and Quebec represents an important turning point in the federal government's regional policy approach. It reflects a deliberate attempt by the federal government to adopt a more decentralized regional economic development framework. Each of the above departments is based in the region it serves. Previously, federal regional economic development policy had been largely the responsibility of the Department of Regional Industrial Expansion headquartered in Ottawa.⁹⁸

Another department affecting federal industrial incentives is Finance. The Department is the central policy agency of the government for economic and financial matters. Its responsibilities include overseeing and harmonizing government actions affecting the economy, including economic actions taken by other departments and agencies.⁹⁹

Other government agencies or departments may also influence federal industrial aid relating to their specific areas of expertise or mandates. These agencies and departments include, for example, Transport Canada, External Affairs and International Trade Canada, the Cape Breton Development Corporation, the recently reorganized Department of Agriculture and Agri-Food, and the recently formed Departments of Human Resources and Labour, Government Services and Natural Resources.¹⁰⁰

The large number of departments and agencies that are involved in industrial policy at the federal level implies a need for effective coordinating

⁹⁸ Various approaches for managing federal regional economic development policy have been tried in the past. For an outline of the system existing prior to the establishment of ACOA, see for example, Herman Bakvis, "Regional Politics and Policy in the Mulroney Cabinet, 1984-88: Towards a Theory of the Regional Minister System in Canada," *Canadian Public Policy*, vol. XV:2, 1989, pp. 121-34.

⁹⁹ For a description of the areas of responsibility of the Department of Finance as well as other departments, see *The Estimates of the Government of Canada* (Ottawa: Ministers of Supply and Services Canada, annual).

¹⁰⁰ A number of the federal government departments that had previously had a significant role in regard to the development or operation of industrial aid related programs have had their mandates substantially changed, or handed over to other departments as a consequence of the reduction of the number of federal government departments from 32 to 23 in June 1993. In this regard, see Office of the Prime Minister, *supra*, note 86.

mechanisms to avoid overlapping or conflicting policies or programs. Since the 1970's, a number of measures have been taken at the cabinet level to achieve greater coordination of economic policy.¹⁰¹ Nevertheless, the view that federal industrial and economic policy initiatives require greater coordination continues to be widely held. Among other considerations, this view is based on the perceived lack of a stable department having a specific role and strong mandate to oversee the vast array of related policies and programs of all departments and agencies of the federal government.¹⁰²

Unlike the EC situation outlined in the following chapter, there is no broad set of basic guidelines or policies on the use of industrial aid to achieve various economic and social policy objectives. Such guidelines or policies have been developed in isolated cases. For example, the Industrial Regional Development Program implemented in 1983 included a formal system for classifying census districts for regional aid based on their levels of unemployment and income, and the fiscal capacity of the relevant provincial government.¹⁰³ Such efforts, however, have tended either to be temporary in nature, or to be limited to specific programs.

(ii) The Provincial Governments

The provinces have traditionally had broad scope under the *Constitution Act* to use industrial incentives in support of their economic and other objectives, even in regard to matters outside of their areas of exclusive jurisdiction.¹⁰⁴ Moreover, the provisions of the *Charlottetown*

¹⁰¹ Grant, *supra*, note 80, pp. 159-68.

¹⁰² For examples of this view, see *id.*, Michael Atkinson and William Coleman, *The State, Business, and Industrial Change in Canada* (Toronto: University of Toronto Press, 1989) and Allan Tupper, "Federalism and the Politics of Industrial Policy," in Blais, *supra*, note 80, chapter 10. It remains to be seen whether this role will now be undertaken by the expanded and strengthened industry department.

¹⁰³ For discussion, see Michael Atkinson and Richard Powers, "Inside the Industrial Policy Garbage Can: Selective Subsidies to Business in Canada," *Canadian Public Policy*, vol. XIII:2, 1987, pp. 208-17.

¹⁰⁴ As stated by Hogg, *supra*, note 57, at p. 127:

Constitutional Accord suggest that provincial jurisdiction over industrial policy, may be substantially increased. In this regard, section 25 of the August 28, 1992 *Consensus Report on the Constitution*, would have specifically required that a framework be established to "ensure that when the federal spending power is used in areas of exclusive provincial jurisdiction, it should...not distort and should respect provincial priorities..." Also, the *Consensus Report* would have affirmed the provinces' exclusive jurisdiction in a number of areas, including forestry, mining, recreation, certain aspects of labor market development and training, and others. In these areas, the provinces would have been given the authority to restrain federal spending within their boundaries. In addition, section 36 of the *Consensus Report* would have required the federal government to negotiate agreements with the provinces on regional development when requested to do so by the relevant province.

The provinces have shown an increasing willingness since the 1950's to use the various levers available to them to promote their own economic policies. This trend has been ascribed to a number of political as well as economic factors. In Ontario, for example, increasing provincial government involvement in the industrial policy area during the 1980's has been attributed to deteriorating economic performance particularly in the province's traditional manufacturing sectors.¹⁰⁵ In the Western provinces, increasing industrial policy activism has been attributed largely to dissatisfaction with federal policies that they consider to favour the more industrialized central regions of the country. In Quebec, industrial policy has been motivated by, among other considerations, the desire to increase the role of indigenous Francophone businesses in the province's economy.¹⁰⁶

the provinces have never recognized any limits on their spending power and have often spent money for purposes outside of their legislative competence.

¹⁰⁵ See, for example, Tupper, *supra*, note 102 at p. 355. The current industrial strategy of the province of Ontario was recently outlined in Ministry of Industry Trade and Technology, *An Industrial Policy Framework for Ontario* (Toronto: July, 1992).

¹⁰⁶ For a brief summary of considerations that have lead to the development of provincial industrial policies, see Royal Commission on the Economic Union and Development Prospects for Canada, *supra*, note 4, vol. 3, pp. 142-45.

No general approach to industrial policy has emerged among the provinces.¹⁰⁷ For instance, Quebec is currently using a targeted approach to industrial strategy focusing "on the strengthening of sectors in which Quebec is already competitive and on the support and eventually the development of a limited number of other industrial sectors that are deemed to be strategic."¹⁰⁸ Specific instruments that may be used to pursue this strategy include: (i) the provision of inexpensive hydroelectric power; (ii) financial incentives provided through loans, partnerships and other means involving the Société de développement du Québec, Caisse de Dépôt, SGF, SDI and other government organizations and businesses; (iii) tax incentives and aid for R&D; and (iv) training assistance.¹⁰⁹

The industrial strategy of Alberta, in contrast, is intended to promote diversification of the province's economy away from the supply of basic resources. In addition to the longstanding goal of promoting further processing of resources within the province, Alberta's current industrial policy is aimed at increasing advanced manufacturing and certain strategic business services.¹¹⁰ Instruments that the province has used to achieve its objectives include the establishment of mixed private and government enterprises especially in the resource sector, the restriction of resource exports, the provision of grants, preferred loans, loan guarantees and other measures.¹¹¹

¹⁰⁷ In this regard, see *id.*, Grant, *supra*, note 80 p. 262 and Tupper, *supra*, note 102.

¹⁰⁸ Gouvernement du Québec, *Québec's Development Industrial Strategy for the 1990's: The Industrial Clusters* (Montréal, Québec: Direction du soutien promotionnel et administratif, July 1992), p. 12.

¹⁰⁹ *Id.*, pp. 10-12.

¹¹⁰ See Government of Alberta, *Toward 2000 Together: A Discussion Paper on Alberta's Economic Options and Choices*, 1991.

¹¹¹ For further discussion, see Robert L. Mansell and Michael B. Percy, *Strength in Adversity: A Study of the Alberta Economy* (Calgary: University of Alberta Press, Western Studies in Economic Policy, publication no. 1).

There are, however, various similarities as well as differences between provincial industrial strategies. It is possible, for instance, to isolate a number of industrial policy objectives that are shared among all or most of the provinces. These include:

- (i) the promotion of small and medium-size enterprises;
- (ii) the reduction or sharing of risk for certain private sector firms, especially start-ups;
- (iii) the enhancement of R&D;
- (iv) increased high-technology or high value-added manufacturing activity; and
- (v) export promotion.

Programs relating to each of these objectives are now operated independently by all or most of the provinces.

The industrial strategies of the provinces, moreover, appear to be converging. The resource bases of individual provinces that often provided the foundation for their earlier industrial development strategies, while still considered important, are being supplanted by policies, like R&D incentives, designed to promote high technology or advanced manufacturing. The promotion of such industries is now a central focus of all provinces' industrial strategies.

This convergence, combined with the expanding industrial policy roles of the provinces should be expected to increase the potential for conflicting or competing provincial policies and programs. Such conflict has already arisen in a number of well known cases. The efforts by Piper Aircraft, noted in chapter I above, to obtain the most favorable package of concessions available from provincial governments across the country is one such case. Other instances have arisen in such sectors of the Canadian economy as

petrochemicals, pharmaceuticals, iron and steel, automobile manufacturing and forestry products.¹¹²

Interprovincial competition and conflict in the industrial incentives and policy area has been a concern of many commentators and provincial authorities for a number of years. In this regard, Alan Tupper states:

As provinces have expanded their economic roles, they have engaged in fairly frequent and intense competition for industry. Provincial governments are now attempting to offer concessions to industry that are comparable to those of their neighbours.¹¹³

Recent calls for restraints on interprovincial rivalry to attract businesses have also been made, in Western Canada, in a joint statement by the premiers of Manitoba, Saskatchewan, Alberta and British Columbia, and, in the Atlantic provinces, by the Premier of Nova Scotia.¹¹⁴

While there is general concern over the competitive use of incentives to attract businesses, progress on this issue has been limited. The creation of a Canada-wide approach for mitigating this competition and coordinating industrial incentives has had various proponents over the years.¹¹⁵ However, efforts to achieve this goal have been ineffective.¹¹⁶

¹¹² For discussion, see, for example, Tupper, *supra*, note 102, pp. 359-70 and Ritchie, *supra*, note 44, pp. 101-12.

¹¹³ Tupper, *id.* p. 365. Also see, for example, Michael Jenkin, *The Challenge of Diversity: Industrial Policy in the Canadian Federation* (Ottawa: Supply and Services Canada, Science Council of Canada Background Study No. 51, 1983), pp. 101-47, Mansell and Percy, *supra*, 111, p. 122 and Savoie, *supra*, note 87, pp. 121-22.

¹¹⁴ See Western Premiers' Conference, *Communiqué #3: Economic Cooperation*, British Columbia May 14-15, 1992 and *The Chronicle-Herald*, *supra*, note 21.

¹¹⁵ See, for example, Larry Grossman (Ontario Minister of Industry and Tourism), *Interprovincial Economic Co-operation: Towards the Development of a Canadian Common Market* (Toronto: Ontario Ministry of Industry and Tourism, January 1981).

¹¹⁶ In this regard, see, for example, see Jenkin, *supra*, note 113, chapter VII.

Regional efforts at coordinating industrial incentives have also been largely ineffective. In a related development, Nova Scotia, P.E.I. and New Brunswick, in 1971, established the Council of Maritime Premiers to develop mechanisms and procedures for regional cooperation. The specific functions of the Council include:

- (i) the initiation of studies on economic, social and cultural programs and policies in the member provinces;
- (ii) the coordination of public policies affecting the Maritime provinces;
- (iii) the initiation of joint programs; and
- (iv) the approval of joint submissions from the Maritime provinces to the federal government.

The creation of the Maritime Premiers' Council has facilitated the establishment of a number of arrangements and mechanisms among the Member provinces on economic matters of mutual concern. As stated by one commentator, however, "the Council has had very limited policy success across a range of key strategic policy fields...(including)...economic development..."¹¹⁷ Although a recent call has been made for the creation of limits on the industrial incentives that may be provided by the individual Maritime provinces, provincial industrial policy remains under the control of the individual provinces.¹¹⁸

In the West, limited attempts at coordinating provincial industrial and other policy have been made through the Western Premiers' Conference, established in 1973 among the governments of British Columbia, Alberta Saskatchewan and Manitoba. This organization is also responsible for a

¹¹⁷ Charles J. MacMillan, *Standing Up to the Future: The Maritimes in the 1990's* (The Council of Maritime Premiers, December, 1989), p. 3.

¹¹⁸ See, *The Chronicle-Herald*, *supra*, note 21.

number of agreements among the member provinces. As in the Maritimes, however, limited progress has been made on issues relating to broader industrial incentives matters.¹¹⁹

(iii) Federal-Provincial Relations

Despite some major conflicts, there has been an impressive degree of cooperation between provincial and federal governments in Canada in the area of industrial policy. This cooperation is demonstrated by the wide range of related programs that are jointly operated by federal and provincial governments in Canada. There are hundreds of these programs covering a wide range of industries and objectives.¹²⁰

Central to federal and provincial cooperation on industrial incentives are the Economic and Regional Development Agreements (ERDAs) established between the two levels of government in the mid 1980's. These agreements provide a framework for negotiations between individual provinces and the federal government on joint economic development programs. In addition, they set forth instruments for achieving the development objectives negotiated between the relevant province and the federal government.¹²¹

The basic elements of the approach to federal provincial relations under the ERDA's is as follows:

- i. a development strategy, or statement of development objectives or priorities is co-determined by the federal government and the relevant province;

¹¹⁹ Jenkin, *supra*, note 113, pp. 115-18.

¹²⁰ For a listing of these programs, see Federal-Provincial Relations Office, *Federal-Provincial Programs and Activities* (Ottawa: Annual).

¹²¹ For an account of the evolution of the ERDA's, see Bakvis, *supra*, note 98.

- ii. related subsidiary agreements are negotiated between the province and the federal government for the establishment of shared cost programs and projects; and
- iii. regular consultation takes place between the responsible provincial and federal government ministers to review progress and priorities under each agreement and to set a future course of action ¹²²

Programs that are developed under the ERDA's may be managed by the relevant provincial ministry, federal regional department or agency or, in some cases, a department or agency of the federal government having direct responsibilities in the relevant sector or policy area.

The amount of funding covered by the ERDA's is substantial. Related programs for the Atlantic provinces were recently estimated at over \$1.5 billion.¹²³ These agreements, depending upon the relevant province, may cover a wide range of industries and objectives. Over 60 separate ERDA related programs were in place in the Atlantic provinces during 1992.

Federal-provincial cooperation on industrial incentives also extends well beyond the ERDA's. Numerous joint incentive programs or policies between specific departments or agencies of the federal government and the provinces operate outside of this framework.¹²⁴ In addition, the provinces and the federal government may work together on individual cases involving the provision aid to specific projects or businesses.

A key consideration from the perspective of this report is the role that the above-noted federal and provincial cooperation has had in coordinating

¹²² These elements are set forth in the basic agreements negotiated between the federal government and the individual provinces during the 1980's.

¹²³ The Atlantic Canada amount is from the Atlantic Canada Opportunities Agency, listing of Cooperation Agreements in place October 9, 1992.

¹²⁴ For a listing of joint provincial and federal economic and other programs, see, generally, Federal-Provincial Relations Office, *supra*, note 120.

and harmonizing industrial aid. Perspectives on this matter are mixed. On one hand, it is generally recognized that there have been cases where federal and provincial cooperation has played a key role in avoiding more open conflict over the use of incentives. On the other hand, there is a view that it has often had little impact on this matter. In this regard, Savoie states;

interprovincial competition in the (Atlantic) region under federal-provincial programming has been as intense as when provincial governments pursue economic development objectives with their own programs and their own resources.¹²⁵

3. Summary

The overall significance and effects of industrial incentives in Canada are difficult to establish. Nevertheless, a number of related measures indicate that they are an important feature of the Canadian economy. Direct aid to businesses in Canada provided in the form of operating and capital subsidies has accounted for over 2% of Canadian GNP. In addition, provincial and federal governments in Canada may provide a substantial amount of indirect incentives to businesses through preferential loans or loan guarantees, tax write-offs, the supply of goods or services at below market prices, capital injections to GBE's, preferential procurement practices and other means.

The make-up of industrial incentives in Canada has changed considerably over the past several years. A trend has developed toward greater use of incentives by provincial governments relative to the federal government. During the 1980's, the ratio of federal to provincial government direct industrial declined from over three to just over one. In addition, there was an apparent increase in the potential for the provinces, relative to the federal government, to provide various types of indirect industrial incentives to businesses.

The objectives of provincial and federal industrial incentives in Canada are diverse. However, there is a definable set of objectives that are

¹²⁵ Savoie, *supra*, note 87, p. 121.

shared by many of the provinces as well as the federal government. Key shared objectives include the economic development of disadvantaged regions, small and medium enterprise development, export promotion, R&D enhancement, employment creation and general investment promotion.

The legal and institutional framework underlying industrial incentives in Canada encompasses numerous departments, agencies and other organizations at the provincial and federal levels of government. The framework is, in many respects, highly decentralized. The increasing willingness of the provinces to assume greater responsibility for their economic development has been a highly important development in this regard. Many now have well articulated industrial strategies with supporting programs. These strategies, moreover, are an important determinant of the objectives and nature of joint federal and provincial economic and industrial programs and policies.

The increasing role of provincial governments in the industrial policy and incentives area was reflected in certain provisions of the *Charlottetown Constitutional Accord*. These provisions would have given the provinces authority to limit the federal government's spending power in areas designated to be under the jurisdiction of the provinces. In addition, they would have given individual provinces the authority to compel the federal government to enter into joint development agreements.

A high degree of decentralization is also evident within the federal government industrial incentives framework. The development and management of regional economic policies is now largely the responsibility of separate regional departments within the federal government, including the Atlantic Canada Opportunities Agency, the Federal Office of Regional Development for Québec and Western Economic Diversification Canada. These departments are based in the regions that they represent and act as advocates for these regions' economic interests within the federal government.

The large number of provincial and federal government organizations that are involved in the industrial policy and incentives field in Canada

suggests the need for effective coordinating mechanisms to prevent overlapping or conflicting policies or programs. Various commentators, however, have lamented the lack of such mechanisms. At the federal level, while attempts have been made to more closely coordinate industrial policy at the cabinet level, no single department or set of guidelines has yet emerged to direct or manage federal government incentives as a whole. Mechanisms for coordinating the economic and regional development policies and programs of the provinces have been particularly difficult to establish. While frequently suggested, attempts at enhancing interprovincial coordination of industrial incentives have been largely unsuccessful even at the regional level.

Federal provincial cooperation in the area of industrial policy and incentives appears to have been somewhat more successful. There are many examples of joint incentive programs between the two levels of government. The principle framework for developing these programs, the ERDA's, however, does not appear to include specific mechanisms for coordinating and disciplining the provision of incentives across provinces.

IV. THE EC INDUSTRIAL AID FRAMEWORK

The EC, since its creation, has faced the formidable task of balancing the Community's desire to establish an open and competitive common market against the demands of individual Member States for autonomy to deal with issues of national concern. The potential conflict involved in reconciling these goals is well demonstrated in the case of industrial incentives. The developers of the *EEC Treaty* clearly recognized that Community disciplines over Member State use of industrial aid would be necessary to prevent it from fragmenting the common market. At the same, the Member States wished to retain the right to use industrial incentives in relation to specific economic and social policy objectives.

This chapter examines the competition-based rules developed by the EC to reconcile the concerns of the Community and the Member States with respect to industrial incentives. Section 1 outlines the legal and institutional

setting in which these rules were developed as well as their basic provisions. Section 2 discusses the amount and nature of industrial aid in the EC. Section 3 examines the treatment of specific categories of industrial aid under the Community rules. Section 4 provides a summary and discussion of the EC state aid framework.

1. The EC State Aid Rules

(i) The Legal and Institutional Setting

The legal and institutional setting in which the EC state aid rules were developed is a key consideration for understanding their nature and purpose. The competition-based approach of these rules and their role within the EC derives from the basic objectives and instruments of the Community. The objectives of the Community, set forth in Article 2 of the *EEC Treaty*, are "to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability, an accelerated raising of the standard of living and closer relations between the States belonging to it." The common market, therefore, is viewed not only as a means to promote economic development, but also, to achieve other social and economic objectives.

The promotion of competition, since the establishment of the common market, has been viewed as one of the Community's main instruments for achieving these objectives. Article 3 of the *EEC Treaty* includes among the Community's principle activities to achieve its objectives, "the establishment of a system which ensures that competition is not distorted." In support of this activity, Articles 85 to 94 of the *Treaty* set forth framework rules for enhancing and protecting competition in the Community.

The EC competition rules are seen as promoting the Community's economic and social policy objectives in a number of ways. They play a central role in promoting the technological development and economic efficiency of the European economy, "the *sine qua non* for a steady improvement in living standards and employment prospects within the

countries of the Community."¹²⁶ Effective competition policy is also considered essential for the creation of an open EC internal market. This traditional role of EC competition policy has been re-emphasized by efforts to complete the EC internal market by the end of 1992. As stated in the 1985 EC Commission *White Paper on Completing the Internal Market*, states:

A strong competition policy will play a fundamental role in maintaining and strengthening the internal market ... As the Community moves to complete the Internal Market, it will be necessary to ensure that anti-competitive practices do not engender new forms of local protectionism which would only lead to a re-partitioning of the market.¹²⁷

EC competition policy embodies two distinct types of rules. First, Articles 85 and 86 of the *EEC Treaty* prohibit private agreements or arrangements that restrict competition as well as anticompetitive abuses by businesses in a dominant position in a market. They are similar in nature to the rules on competition in Canada contained in the *Canadian Competition Act*.¹²⁸

¹²⁶ EC Commission, *First Report on Competition Policy* (Brussels: 1972), p. 11. In this regard, the EC Commission, also stated:

Competition is the best stimulant of economic activity since it guarantees the widest freedom of action to all. An active competition policy ... makes it easier for the supply and demand structures continually to adjust to technological development. Through the interplay of decentralized decision-making machinery, competition enables enterprises continuously to improve their efficiency...

¹²⁷ EC Commission, *Completing the Internal Market: White Paper from the Commission to the European Council*. (Luxembourg: Office for Official Publications of the European Communities, 1985), p. 39.

¹²⁸ R.S., 1985, c. C-34. It should be noted, however, that there are important differences between the Canadian and EC competition policy treatment of specific practices. In particular, the EC competition policy treatment of territorial restraints tends to be much stricter than the treatment of these restraints within Canada. For discussion, see, for example, R. D. Anderson, P. Hughes, S. D. Khosla and M. F. Ronayne, *Working Paper on Intellectual Property Rights and International Market Segmentation: Implications of the Exhaustion Principle* (Ottawa: Consumer and Corporate Affairs Canada, Bureau of Competition Policy, 1990), chapter III.

EC competition legislation, however, unlike Canada's, also embodies rules designed specifically to limit competition distorting government practices. These rules include, most importantly, the state aid disciplines in the *EEC Treaty*. In addition, they include provisions limiting the ability of the EC Member States to compel state-owned enterprises, or enterprises to which the States have given special or exclusive rights to undertake actions that would otherwise contravene the Community rules on competition.¹²⁹ The EC, therefore, has traditionally viewed a comprehensive competition policy framework as dealing with anti-competitive practices by both governments and private enterprises.

It may be noted that it is competition distorting state aids that have been of particular concern for the EC Commission in relation to the completion of the EC internal market. On this matter, the *White Paper on Completing the Internal Market* states:

...it will be particularly important that the Community discipline on state aids be rigorously enforced...(state aids)...not only distort competition but also in the long run undermine efforts to increase European competitiveness. They represent a drain on scarce resources and they threaten to defeat efforts to build the internal market. As the physical and technical barriers inside the Community are removed, the Commission will see to it that a rigorous policy is pursued in regard to state aids...¹³⁰

¹²⁹ Article 90(1) of the *EEC Treaty* provides:

In the case of public undertakings and undertakings to which Member States grant special or exclusive rights, Member States shall neither enact nor maintain in force any measure contrary to the rules contained in this Treaty, in particular to those rules provided for in Article 7 and Articles 85 to 94.

A related provision is contained in the Canadian *Competition Act* (R.S., 1985, c. C-34, section 125). This provision, however, only allows the Canadian Director of Investigation and Research, *Competition Act*, to make representations in respect of competition to certain federal regulatory or other boards, commissions or tribunals.

¹³⁰ EC Commission, *supra*, note 127, p. 39.

The emphasis placed on the rules on state aids in connection with the EC 1992 initiative has led to the adoption of a number of measures designed to promote stricter Member State adherence to these rules. These measures have included, among others, the completion of detailed studies of the amounts and nature of industrial aid provided by the Member States, the initiation of a review of all major existing aid programs in the Community to ensure their compatibility with the common market, and the development or amendment of guidelines regarding the application of the state aid rules to different classes of aid.¹³¹

(ii) The EC State Aid Provisions

The EC competition rules on state aids are contained in Articles 92 to 94 of the *EEC Treaty*. Article 92 of the *Treaty*, in essence, establishes a norm that the governments of the Member States should not provide industrial aid in a manner that is harmful to competition within the Community. Specifically, the Article declares industrial aid that "distorts or threatens to distort competition..., in so far as it affects trade between Member States," to be "incompatible with the common market." Aid that is found to be incompatible with the common market, unless it is specifically permitted elsewhere under the *EEC Treaty*, is prohibited.

Government assistance to businesses subject to the EC rules on state aids is broadly defined. Article 92(1) is applicable to "any aid granted by a Member State or through State resources in any form whatsoever..." It covers, therefore, not only direct grants of aid to businesses, but also, less direct forms of aid such as loan guarantees, the provision of loans at below market rates, capital injections to state-owned enterprises and other forms of assistance.¹³²

¹³¹ These guidelines deal with, among other classes of aid, aid to motor vehicle manufacturing, assistance to state-owned enterprises, research and development aid and regional assistance. For further discussion of these and other state aid measures adopted in relation to the EC 1992 initiative, see *External Affairs and International Trade Canada*, *supra*, note 8, chapter IV.

¹³² For discussion of the types of assistance that are potentially subject to the EC state aid rules, see the Common Market Reporter (CCH), ¶ 2922.10.

The requirement that industrial aids affect trade between the Member States in order to come under Article 92, is an important limitation on the scope of the provision. This requirement prevents the application of Article 92 to export assistance and other kinds of industrial aid that affect only trade between the individual EC Member States and non-EC countries. Such aid may only be dealt with under Article 113 of the *EEC Treaty* pertaining to the development of a common commercial policy among the EC Member States.

Exceptions to the general prohibition of competition distorting state aids are outlined in Articles 92(2) and 92(3) of the *EEC Treaty*. Article 92(2) exempts certain aid from Article 92(1) on the basis that it is unlikely to have significant anti-competitive effects. This aid includes, most importantly, social assistance provided to individuals that does not discriminate on the basis of the origin of goods affected, and compensation for damage caused by natural disasters or exceptional circumstances.¹³³

Article 92(3) of the *EEC Treaty* gives the EC Commission discretion to exempt industrial aids from Article 92(1) in relation to a number of other social and economic policy objectives. These objectives include:

- i. the economic development of regions in which there is an abnormally low living standard or serious underemployment;
- ii. the support of an "important project of common (EC) interest";
- iii. to remedy a serious disturbance in the economy of a Member State; and
- iv. to facilitate the development of certain economic activities or economic areas the related aid "does not

¹³³ In a Canadian context, this aid would include assistance provided under unemployment insurance, provincial medicare and other programs of this nature as well as disaster relief.

adversely affect trading conditions to an extent contrary to the common (EC) interest."

In addition, Article 92(3) allows the EC Council of Ministers, based on a proposal by the EC Commission, to designate additional categories of aid for exemption from Article 92(1).

The types of aid that may be permitted under Article 92(3) generally reflect the objectives of the Community outlined above. The provision of aid to disadvantaged regions, for example, is consistent with the promotion of a balanced expansion of regions within the Community as well as a harmonious development of economic activities. They accept, therefore, that derogations from the norm of open competition may be necessary to achieve the broader economic and social policy objectives of the Community. In other words, while undistorted competition is seen as an effective means to achieve a range of economic and social policy objectives, it is not considered to be an end in itself.

The *EEC Treaty* provides no specific guidance regarding the factors that may be taken into account when assessing industrial aids under Article 92(3). It is clear, however, that exemptions under the Article cannot be based solely on the national objectives of the country providing aid. Rather, related decisions must also take into account the objectives and interests of the Community as a whole.¹³⁴

Enforcement of the Community rules on state aid is provided for under Article 93 of the *EEC Treaty*. Compliance with the rules on state aids is not left to the individual Member States. Rather, Article 93 designates the EC

¹³⁴ This requirement was clearly adopted by the EC Court of Justice in the case of *Phillip Morris Holland B.V. v. Commission* (1980) Common Market Reporter (CCH), ¶ 8695. In this case, the Court upheld a decision of the EC Commission preventing aid to a company in the Netherlands to expand production in an area of the country having an unemployment rate above the national average as well as less than average per capita income. The Commission asserted that, although the region affected was underprivileged in relation to other areas in the same country, its position in relation to other regions in the EC should also be considered. The Court concurred with the Commission's view that state aids are appropriately considered under Article 92 of the *EEC Treaty*, "in a Community context."

Commission, an executive arm of the EC Council of Ministers, to be primarily responsible for the application of these rules. The Commission includes members from each of the EC States. In addition to applying the Community's competition rules, it is responsible for Community policy on science and technology, telecommunications, agriculture and other areas. Decisions of the Commission are based on majority consent among its members.

Article 93(1) of the *EEC Treaty* directs the EC Commission to keep under "constant review" all systems of aid operated by the Member States. To facilitate this review, Article 93(3) requires the Member States to notify the Commission of any plans to grant or alter aid. Notification is required far enough ahead of the actual provision of aid to allow the Commission to submit its comments on the plans.

If industrial aid has not been properly notified to the Commission, it can suspend further aid until its compatibility with the common market has been assessed. Persistent failure to notify the EC Commission of industrial aid can result in action being taken under Articles 169 to 171 of the *EEC Treaty* containing procedures for inducing Member States to comply with their *Treaty* obligations. In cases where the Court of Justice, acting on a reasoned opinion of the EC Commission, finds that a Member State has not complied with an obligation under the *Treaty*, Article 171 requires that the Member State take measures to comply with the obligation.

Investigations of the compatibility of industrial aid with the common market are conducted by Directorate-General IV which also enforces the EC rules on competition between enterprises. In cases where aid is found to be incompatible with the common market, the EC Commission, subject to appeal to the Court of Justice, can direct the relevant Member State to abandon or alter the aid.¹³⁵

¹³⁵ There have been several cases in which the Commission has compelled Member States to recover industrial aid on the basis that it was inconsistent with the common market or the enterprise receiving the aid did not fulfill restructuring or other commitments given in order to obtain approval for the aid. Two recent noteworthy cases in which this occurred involved car manufacturing in France and Great Britain. In the first case (see the Common Market Reporter (CCH), ¶95,483), the French carmaker, Renault, was required to repay

2. The Use of Industrial Aid in the EC

Articles 92 to 94 of the *EEC Treaty* have not prevented industrial aid from remaining an important feature of the EC economy. Two recently completed surveys have confirmed that the Member States, rather than Community authorities, account for the bulk of the industrial aid provided in the EC.¹³⁶ During the 1986 to 1988 period, the EC Member States together provided, on average, over ECU 33 billion (\$50 billion Cdn.) in industrial aid. In contrast, the amount of aid provided by the major Community funds outside of the agricultural sector, averaged about ECU 6.6 billion (\$10 billion Cdn.).¹³⁷ The significance of this aid in relation to economic activity in the EC is substantial. The average annual amount of aid provided to manufacturing by the EC Member States alone was about 4% of the sector's total value added, or about ECU 1,500 (\$2,300 Cdn.) for every worker in the sector during the 1986-88 period.¹³⁸

Industrial aid, as indicated by the following table, has been used extensively by the EC Member States to achieve a number of economic and social policy objectives. The table indicates that regional development was the principle objective of manufacturing state aid during the 1986-88 period, accounting for 35.7% of all such aid provided. Sectoral development was the

industrial aid on the basis that it did not complete a promised reduction in capacity. In the second case (see EC Commission Press Release IP(90)511), British Aerospace was required to repay certain aid provided in connection with its purchase of the Rover Group.

¹³⁶ See EC Commission, *Second Survey on State Aids in the European Community in the Manufacturing and Certain Other Sectors* (Brussels: July, 1990) and EC Commission, *supra*, note 126.

¹³⁷ It should be noted, moreover, that while the figure given for the Member States pertains specifically to industrial aid, the figure provided for the EC includes certain forms of aid that would not classify as industrial aid under Article 92 of the *EEC Treaty*. The figure for Community fund expenditure is taken from EC Commission, *Second Survey, id.*, Annex II, table IA. The figure for Member State aid is taken from, table III-1 below.

¹³⁸ EC Commission, *Second Survey, id.*, p. 10. These figures were even higher during the first period examined by the Commission, 1981-86. During this earlier period, aid to manufacturing averaged about 4.8% of the sector's value-added, or about ECU 1,750 per worker per year in the sector.

second largest source of manufacturing state aid, accounting for 26% of the total provided. As in Canada, much of this aid was provided to industries, such as iron and steel, shipbuilding, automobile manufacturing and textile manufacturing for the intended purpose of adjusting to changing domestic and international trade conditions. Substantial aid was also provided to sectors, such as aerospace, electronics and computers that are considered to be strategic or sensitive by individual Member States.¹³⁹ Other policy objectives for which substantial amounts of industrial aid were provided between 1986 and 1988 include innovation and R&D, small and medium-sized enterprise development, general investment promotion and trade and export enhancement.

¹³⁹ It may be noted that assistance to the EC iron and steel, and shipbuilding industries is covered by separate aid frameworks that are not directly subject to Articles 92 and 93 of the *EEC Treaty*. An indication of other sectors receiving substantial amounts of industrial aid from the EC Member States is provided by the annual reports of the EC Commission on competition policy.

TABLE IV-1

**Principle Objectives for Industrial Aid to
EC Manufacturing , 1986-1988**

Aid Objective	EC Member State Aid, Average Per Annum	
	ECU bil.	percent of total
Innovation, R&D	3.33	9.9
Environment	.18	.5
Small and Medium Size Enterprises	2.84	8.4
Trade and Export	3.24	9.6
Energy Economization	.45	1.3
General Investment	1.51	4.5
Iron and Steel, and Shipbuilding	2.94	8.7
Other Specific Industrial Sectors	6.17	18.3
Regional Aid	12.04	35.7
Other Objectives	1.04	3.1
Total	33.71*	100.00

Source: EC Commission, *Second Survey on State Aids in the European Community* (Brussels: July, 1990), table X and Annex IV.

*Total differs due to rounding.

It may be noted that the intensity and purposes of industrial aid vary widely between the EC Member States. Italy had the highest manufacturing aid intensity level of all the EC Member States between 1986 and 1988. During this period, industrial aid provided in the Italian manufacturing sector averaged more than 3,000 ECU per employee or about 6.7% of all manufacturing value-added in the country. Over 50% of this aid was related to regional development objectives. During the same period, industrial aid in the U.K. manufacturing sector averaged about ECU 800 per employee or

about 2.7% of all manufacturing value-added. Regional development objectives accounted for about 37% of this aid.¹⁴⁰

The empirical information, therefore, indicates that the EC Member States have traditionally had substantial scope within the Community's industrial aid framework to use industrial aid for a broad range of economic and social policy objectives. The differences in the intensity and objectives of industrial aid provided by the Member States further suggests that they have had substantial freedom to develop independent aid policies based on their particular concerns as well as their propensity to use industrial aid as an economic and social policy instrument.

In the future, it might be expected that the use of industrial aid by the Member States will be more constrained due to the EC 1992 measures for ensuring stricter adherence to the Community rules on state aids.¹⁴¹ The potential restrictiveness of these measures, however, should not be overestimated. The EC Commission directives and guidelines adopted since the start of the EC 1992 initiative do not rule out the use of industrial aid to achieve recognized objectives. Rather, they are generally intended to increase the transparency of the industrial aid being provided, and ensure that this aid is properly directed.¹⁴²

Industrial aid provided by EC authorities, while much less overall than Member State aid, is important in relation to certain goals and objectives of the Community. This is indicated by the following table listing the major aid programs of the EC Commission outside of the agricultural sector.¹⁴³

¹⁴⁰ See EC Commission, *Second Survey*, *supra*, note 136, pp. 10 and 30.

¹⁴¹ It has been suggested that the EC Commission was actually rather soft on subsidies before the late 1980's. In this regard, see Andel, N., "Public Finance and Trade: the European Community," in *Public Finance, Trade and Development, Proceedings of the 44th Congress of the International Institute of Public Finance*, Istanbul, 1988, pp. 171-87, referred to in Stefan Lehner and Roderick Meiklejohn, *supra*, note 11, pp. 1-114.

¹⁴² A number of these measures are discussed in the following subsection.

¹⁴³ It should be noted that the figures provided in the table do not necessarily represent aid provided directly to companies. Rather, much of the aid provided by the Commission is in support of infrastructure construction, programs for retraining workers and other projects

TABLE IV-2

**Major EC Commission Economic Development Fund
Payments and Commitments, 1980-89 (ECU million)**

Commission Program/ Objective	1980		1985		1989	
	payments	commit- ments	payments	commit- ments	payments	commit- ments
Regional Development	727	1,138	1,586	2,445	3,920	4,668
Social Fund	339	486	1,388	2,116	2,676	3,477
Research and Development	250	266	510	735	1,240	1,463
Total	1,316	1,892	3,484	5,296	7,836	9,608

Sources: Commission of the European Communities, *The Community Budget: The Facts in Figures, Third Edition, Situation 1990* (Brussels: 1992), pp. 34-36 and *The Community Budget: The Facts in Figures, 1989 Edition* (Brussels: 1991), pp. 36-38.

The table indicates that the EC Commission provided large amounts of regional aid during the 1980's. The involvement of the Commission in this area derives from the provisions of the *EEC Treaty* itself. In this regard, the Preamble to the *Treaty* includes the specific goal to "reduce the differences that exist between the various regions and the backwardness of the less favoured." Also, Article 2 of the *Treaty* establishes "a continuous balanced expansion" as one of the Community's principle objectives.

The EC Commission's primary program for promoting regional development is the European Regional Development Fund (ERDF). Payments made from this fund during 1989, as indicated in table III-2 were in excess of 3.9 ECU billion, or more than \$5 billion.¹⁴⁴ This aid has generally

that may indirectly assist companies in depressed regions. Accordingly, the figures in the table are not directly comparable to the figures in Table III-1 which represent Member State aid provided to businesses.

¹⁴⁴ See Commission of the European Communities, *The Community Budget in Facts and Figures* (Brussels: 1992), p. 34.

been given in support of infrastructure projects in less developed regions of the Community.¹⁴⁵ More recently the EC Commission has attempted to ensure that a greater proportion of this aid is put toward productive investments.¹⁴⁶ In the future, therefore, aid provided from the ERDF may be more likely to engender competition related concerns.

The European Social Fund, established by the *EEC Treaty*, is the oldest of the Community's structural funds. The main purposes of the fund are to reduce long-term unemployment in the EC and assist in the integration of youth into the workforce.¹⁴⁷ Substantial aid was also provided under this fund in 1989, over 2.6 ECU billion or about \$3.5 billion.

The promotion of research and development in the EC is another major area of involvement for the Commission. This involvement, as indicated in Article 130(f) of the *EEC Treaty*, is for the purpose of strengthening "the scientific and technological basis of European industry and to encourage it to become more competitive at the international level."¹⁴⁸ As indicated in the above table, EC Commission support for research and development during 1989 was in excess of 1.2 ECU billion or more \$1.6 billion, with commitments made during the year of about \$1.9 billion.¹⁴⁹

¹⁴⁵ Douglas Mair, "Regional Policy Initiatives from Brussels," *The Royal Bank of Scotland Review*, no. 169, March 1991, reports that about 90% of the ERDF expenditure on projects in 1987 and 1988 was in support of infrastructure projects.

¹⁴⁶ *Id.*

¹⁴⁷ For discussion of the European Social Fund, see for example, Ezio Toffanin, "The Main Purpose of the ESF," *Social Europe*, vol. 2, 1991, pp. 24-31.

¹⁴⁸ This provision was added to the *EEC Treaty* by the *Single European Act* which came into force on January 1, 1987. For further discussion of the EC role in R&D promotion, see EC Commission, *Research after Maastricht: an assessment, a strategy* (Bulletin of the European Community, supplement 2/92).

¹⁴⁹ This aid covers projects and programs in many sectors of the European economy. In this regard, see generally, EC Commission, *id.*

In addition to the above areas of concern, the EC has also been active in the promotion of small and medium-size enterprises. The EC Council of Ministers, in 1989, adopted the *Community Enterprise Policy* which includes measures to:

- i. eliminate unnecessary administrative, financial and legal constraints on the formation and development of small and medium-size enterprises;
- ii. improve the supply of information to small and medium-size enterprises regarding Community and individual member state policies, legislation and activities;
- iii. promote cooperation and partnerships between small and medium-size enterprises from different regions within the Community; and
- iv. improve statistical information on small and medium-size enterprises in the Community and develop further policies for promoting the growth of these enterprises.¹⁵⁰

It may be noted that the *Community Enterprise Policy* and other such measures are considered important not only to promote the success of small and medium-size businesses. In addition, by facilitating the access of these businesses to markets throughout the Community, they are seen as playing an important role in promoting economic and social cohesion in the Community.

Although still relatively small in relation to Member State aid, the overall trend in Community aid is interesting to note. Whereas the amount of industrial aid provided by the EC Member States remained relatively constant between 1981 and 1988, aid provided by Community authorities

¹⁵⁰ For a description of the *Community Enterprise Policy*, see EC Commission Press Release, IP(89) 481, Brussels, 21 June, 1989.

increased rapidly. Payments made under each of the major Community funds covered in table III-2 displayed a strong upward trend during both the early and late 1980's. As a result, payments made under these funds were almost 6 times higher in 1989 than 1980. The importance of EC aid in relation to aid provided by the Member States is likely to continue to increase as a consequence of the measures being adopted in connection with the EC 1992 initiative to establish stricter control over the granting of state aid.

3. The Treatment of Specific Categories of Aid Under the EEC Treaty

The *EEC Treaty* rules on state aids, while they have allowed the Member States to provide large amounts of aid for a variety of objectives, have also established important limitations on this aid. EC policy on the application of Articles 92 and 93 of the *EEC Treaty* to specific categories of industrial aid is outlined in a number of related policy statements and guidelines of the EC Commission. These statements and guidelines generally accept the provision of state aid as a legitimate means to achieve specific economic and social policy objectives. However, they impose restrictions on the types and amount of aid that may be allowed to limit its effects on the open and competitive operation of the common market.

This subsection examines EC Commission policy on the application of Articles 92 and 93 of the *EEC Treaty* to industrial aid relating to four policy objectives that are of major concern in both the EC and Canada, regional development, the promotion of certain sectors, research and development enhancement and small and medium-size enterprise promotion. In addition, it discusses specific measures that have been taken in the EC to deal with the provision of industrial aid to government owned or controlled businesses. Such businesses are an important part of the Canadian as well as the European economy.

(i) Regional Economic Development

The concerns dealt with by the EC Commission in the development of its policy on regional industrial aid are of interest from a Canadian as well as a Community perspective. The Commission views regional aid, in

appropriate circumstances, as an effective means to promote a more balanced economic expansion and greater social cohesion within the Community. It is also concerned, however, that the indiscriminate use of regional aid could actually have the opposite effect. In this regard, the EC Commissioner for competition policy has stated:

...unless national regional aid is strictly controlled in the more prosperous...regions and limited to areas which pose a problem at a Community as well as a national level, these areas will continue to pull ahead of the poorer regions, not just because of the existing mix of advantages but also because of the artificial advantage of public subsidies.¹⁵¹

A primary concern in the development of the EC guidelines on regional aid, therefore, has been to ensure that this aid is directed to regions that are the least developed from a Community perspective, as well as from the perspective of the relevant Member State.

Regional aid may be permitted under two exemptions listed under Article 92(3) of the *EEC Treaty*. First, as noted in the preceding subsection, Article 93(2)(a) provides for the granting of aid "to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment." Exemptions under this provision are normally based on the economic conditions in the relevant region in relation to the Community as a whole. Industrial aid normally will not receive an exemption under Articles 92(3)(a) unless it applies to regions in which the per capita GDP or purchasing power is less than 75% of the European Community average.¹⁵²

¹⁵¹ EC Commission Press Release, IP(91) 141, Brussels, 19 February, 1991.

¹⁵² See *Commission Communication on the Method for the Application of Article 92(3)(a) and (c) to Regional Aid*, (1988) 3 C.M.L.R. 703. GDP is adjusted to account for discrepancies in purchasing power between the Member States. In addition, certain regions may qualify for exemptions under Article 92(3)(a) due to the presence of exceptional circumstances. These regions include, for example, Northern Ireland and the Teruel region in Spain.

Exemptions under Article 92(3)(a) also depend on the intensity of aid being provided. Regional aid programs that cover more than 75% of the initial investment costs in a project generally will not be given an exemption. The extent of the aid that will actually be permitted, however, may be lower depending upon the "kind, intensity or urgency of the regional problems."¹⁵³

The type of aid provided is another important factor considered under Article 92(3)(a). The Commission is more likely to approve aid that is based on the initial investment or the number of jobs created in the relevant region.¹⁵⁴ Ongoing or operating aid, on the other hand is discouraged. Such aid may be permitted only in exceptional circumstances where it is needed to help a region overcome particularly severe and long term regional disadvantages.¹⁵⁵ It may be noted that the relatively more favourable view of the EC Commission regarding aid tied to the initial investment in a disadvantaged area is supported by the economic analysis of industrial aid discussed in chapter II. As noted, aid of this nature (i.e., fixed, rather than production aid) tends to be less of a threat to the competitive and efficient operation of the markets affected.

Exemptions for regional aid may also be provided under Article 92(3)(c) of the *EEC Treaty*. These exemptions are generally based on the economic position of the relevant region in relation to both the EC as well as other regions in the same Member State. In general, in order for a region to qualify for industrial aid under this provision, either its GDP must be at least 15% below the average for all regions within the relevant country, or its rate of unemployment must be at least 10% higher than the national average. It may be noted that these threshold differentials are increased for countries

¹⁵³ *Id.*, p. 706.

¹⁵⁴ These bases for the provision of aid are explained in *Communication of the Commission on Regional Aid Systems* (1979) O.J. C31/9, Annex.

¹⁵⁵ The circumstances in which operating aid may be permitted are outlined in *Commission Communication, supra*, note 152, at p. 707.

having a higher per capita GDP than the EC average or a lower than average rate of structural unemployment.¹⁵⁶

Industrial aid provided under Article 92(3)(c), because it is based on national as well as Community-wide regional economic disparities, is subject to stricter intensity ceilings than aid provided under Article 92(3)(a). Normally, an exemption under Article 92(3)(c) will not be allowed if the aid given exceeds a ceiling of between 20 to 30% of the initial investment in relevant projects.¹⁵⁷ Also, as in the case of Article 92(3)(a), aid is more likely to be approved under 92(3)(c) if it is tied to the initial investment or the creation of jobs in the relevant region, rather than operating losses or production.

(ii) Sectoral Aid

Industrial aid, as indicated in the preceding subsection, is of major importance in many EC manufacturing sectors. The basic principles followed by the EC Commission in dealing with sector specific aid under Article 92 are set forth in a Communication from the Commission to the EC Council of Ministers in 1978. These principles accept that sectoral aid, while it may have negative implications for competition, may be justifiable in certain circumstances to achieve the Community's economic and social aims.¹⁵⁸ The 1978 Communication, however, also sets forth a number of factors that the

¹⁵⁶ The formula used by the EC Commission to determine the degree of regional disparity that will normally required for exemptions under Article 92(3)(c) is provided in *id.*, at p. 709. The degree to which a region must be disadvantaged in a national context in order to qualify under Article 92(3)(c), however, may differ from the basic threshold under the EC Commission guidelines based on such factors as trends in unemployment, demographic pressures, net migration and productivity in the relevant region.

¹⁵⁷ The ceiling on the intensity of aid that may be provided under Article 92(3)(c) varies according to the "kind, intensity or urgency of regional problems." See *id.*, p. 710.

¹⁵⁸ These aims may include, for example, the correction of serious regional imbalances within the Community, the promotion of essential changes or developments in certain industries that otherwise might entail too high of a social or economic cost or to offset certain distortions of competition caused by actions taken outside of the Community. In this regard, see EC Commission, *Eighth Report on Competition Policy* (Brussels: 1979), pp. 122-27. Also see EC Commission *Eleventh Report on Competition Policy* (Brussels:1982), pp. 111-15.

EC Commission will take into account when assessing the compatibility of sectoral aids with the common market. These factors include whether the relevant aid is:

- i. adequately justified by circumstances in the industry concerned and provided at a level that is proportionate to the problem to be resolved;
- ii. designed to resolve problems and lead to long-term viability of the relevant enterprises rather than preserve the *status quo* and delay adjustments;
- iii. progressively reduced and clearly linked to restructuring of the relevant sector;
- iv. transparent and controllable; and
- v. unlikely to transfer industrial problems and unemployment to other Member States.

The application of the above principles and criteria to a specific industry is demonstrated by the *Framework on State Aids to the EC Motor Vehicle Industry (Motor Vehicle Aid Framework)* implemented in connection with the EC 1992 initiative.¹⁵⁹ The *Motor Vehicle Aid Framework* is one of several aid frameworks developed in the Community to facilitate the application of the state aid rules in industries and sectors characterized by abnormally high amounts of government assistance to manufacturers.¹⁶⁰ It was developed specifically to clarify and coordinate the

¹⁵⁹ See O.J. No C 123/5, 18.5.89.

¹⁶⁰ Other sectors in which such frameworks or guidelines have been developed include synthetic fibres, shipbuilding, steel and coal. It should be noted that the latter two industries are dealt with under state aid provisions contained in the Treaty establishing the European Coal and Steel Community. This Treaty, however, is due to expire in the year 2002.

large amounts of aid that many EC Member States provide to their domestic automobile manufacturers.

The *Motor Vehicle Aid Framework* acknowledges that aid to the industry can be an effective instrument for achieving certain economic and social policy objectives of the Community, especially regional economic development. In addition, it adopts a relatively lenient view toward aid for pre-competitive R&D in the motor vehicle industry (i.e., more basic research that is not related to the development of a specific product).¹⁶¹

A strict view is adopted, however, with respect to certain forms of aid and aid objectives that are particularly likely to impede the open and competitive operation of EC automobile markets. The *Framework* rejects outright the supply of operating aid in the motor vehicle sector even in disadvantaged regions. A strict stance is also adopted against state aid to help restructure or rescue manufacturers, or assist in the modernization or rationalization of facilities. The *Framework* provides that these activities should normally be financed by the company's themselves. In cases where related aid is permitted, the *Framework* requires that it be directly linked to plans for reducing capacity or restructuring.

The principles embodied in the 1978 Communication on sectoral aid are reflected in a number of recent decisions of the EC Commission and Court of Justice on the provision of state aid to automobile manufacturing. The Commission, over the past several years, has approved substantial amounts of aid to the automobile industry primarily to promote the development of economically disadvantaged regions or the restructuring or rationalization of facilities.¹⁶² In a number of other cases aid has not been permitted or repayment of aid has been demanded because it did not meet the conditions required for approval under the state aid rules. In one particularly noteworthy case, the government of France was required to take back ECU 6

¹⁶¹ The general policy of the EC Commission regarding R&D aid is outlined in the following subsection.

¹⁶² Numerous cases involving aid to the motor vehicle industry are discussed in the EC Commission, annual reports on competition policy.

bil. of aid provided to the state-owned car manufacturer Renault on the basis that the company did not keep a commitment to reduce capacity.¹⁶³

(iii) Research and Development Aid

The encouragement of research and development is a key element in the EC's strategy to "bring about a genuine European Community in technology, with the fundamental objective of strengthening the technological base of European industry and developing its international competitiveness."¹⁶⁴ This view is reflected in the treatment of R&D aid under the 1985 *Community Framework for State Aids for Research and Development*.¹⁶⁵ The *Framework*, while it does not automatically exempt R&D aid from Article 92, provides substantial scope for subsidizing certain types of R&D. A highly permissive approach is adopted toward aid that is linked to fundamental research (i.e., research that generally increases scientific and technological knowledge, but is not directed to specific commercial objectives). This aid, because it is considered unlikely to provide a specific competitive advantage to some firms over others, is considered unlikely come under Article 92 of the *EEC Treaty* except in certain circumstances.¹⁶⁶

Aid for more commercially oriented R&D has a much greater chance of coming under Article 92 of the *EEC Treaty*. Nevertheless, in many cases it may qualify for an exemption under either Article 92(3)(b) or 92(3)(c) of the *Treaty*. As noted, industrial aid may be permitted under these provisions "to promote the execution of an important project of common European interest" or "to facilitate the development of certain economic activities."

¹⁶³ See the Common Market Reporter (CCH), ¶ 95,483 for discussion of this case.

¹⁶⁴ O.J., no C 83, vol. 29, 11.4.86, s. 1.

¹⁶⁵ *Id.*

¹⁶⁶ Section 2.2 of the *Framework for State Aids for R&D*, *id.*, suggests that fundamental research may fall under Article 92 of the *EEC Treaty* "in exceptional cases where such research is carried out in or for particular firms."

The *Framework for State Aids for R&D* sets forth a number of criteria for assessing the acceptability of commercially oriented R&D. As a general principle, the *Framework* requires that R&D aid must not only contribute to the objectives outlined in Article 92(3) of the *EEC Treaty* but also must encourage "additional effort in this field over and above the normal operations that firms carry out in any case in their day-to-day operations or to respond to exceptional circumstances for which their own resources are too limited."¹⁶⁷ Aid that does not meet this criterion may be viewed as operating aid which, as noted previously, is normally prohibited under Article 92(1).

The *Framework for State Aids for R&D* also establishes a general ceiling on the intensity of aid for basic industrial research that may be approved by the EC Commission. To ensure that firms bear a significant part of the risks associated with R&D, the *Framework* provides such aid will not be approved if it accounts for more than 50% of the gross costs of the relevant project or programme.¹⁶⁸ The actual intensity of aid that will be permitted in specific cases may be lower than 50% depending on a number of other factors that the EC Commission may take into account.

The nearness of the relevant R&D to the actual production and marketing of products is one of these factors. The intensity of aid that will be accepted will generally be lower the closer the relevant R&D is to commercial application. Other factors that may affect the intensity of aid that will be permitted include the extent that competition in the EC is likely to be distorted, the riskiness of the relevant project, overall EC policy considerations and the availability of the results of the relevant R&D to other firms.¹⁶⁹

¹⁶⁷ *Id.*, section 8.2.

¹⁶⁸ *Id.*, section 5.3. The *Framework*, however, also indicates that higher aid intensity may be permitted in regard to particular projects that are recognized to be of special economic importance, linked to relevant Community projects or programs, designed specifically to assist small and medium-sized enterprises or related to certain other objectives or circumstances.

¹⁶⁹ *Id.*, section 8.2.

The *Framework for State Aids for R&D* also includes a number of provisions intended to enhance the transparency of R&D aid being provided by the Member States. Section 4.3.1 of the *Framework* requires that notifications of R&D aid include clear statements on the objectives to be achieved, the beneficiaries, the specific costs to be reduced and other relevant features of the proposed aid. In addition, the *Framework* indicates that the EC Commission, as a general rule, will request an annual report on aid programs that it approves.¹⁷⁰

Also, special provisions were included in the *Framework for State Aids for R&D* to increase the transparency of R&D aid provided indirectly through the placement of large government contracts with private companies. In this regard, the EC Commission, during 1990, completed an investigation of the conditions under which such contracts are granted. This study found that about half of the R&D contracts provided to the private sector by the EC Member States during 1987 contained some aid element.¹⁷¹ For this reason, and also due to the difficulties in determining the aid content in civilian R&D contracts, the report proposed that a further set of guidelines be developed on appropriate procedures for granting these contracts.

(iv) Aid to Small and Medium-Size Enterprises

The EC Commission's policy on industrial aid to small and medium-size enterprises (SME's) reflects two competing concerns. On one hand, these enterprises, are seen as suffering from unique disadvantages that may unduly constrain their ability to expand and develop. These perceived disadvantages, include, for example, disproportionate problems relating to financing, meeting legal and regulatory requirements and diversification. On the other hand, it is recognized that industrial aid, even if it is strictly for the benefit of

¹⁷⁰ *Id.*, section 6.

¹⁷¹ For discussion, see EC Commission, *XXth Report on Competition Policy* (Brussels: 1991), p. 238.

small or medium-sized businesses, can distort competition, particularly in markets where SME'S account for a major portion of supply.¹⁷²

The EC Commission, reflecting the first of these concerns has indicated that aid to small and medium-size enterprises may be permitted in cases where it is designed to help SME's overcome their peculiar difficulties and compete more effectively in the marketplace. However, favourable treatment will not be given under Article 92 of the *EEC Treaty* to aid that provides ongoing protection to SME's or shields them from the need to make adjustments required to be competitive in an open market setting.¹⁷³

The EC Commission has also adopted a number of other measures that are designed, directly or indirectly, to facilitate the provision of industrial aid to SME's. These enterprises are the principle beneficiaries of simplified notification and approval procedures adopted by the Commission for smaller aid programs. These procedures provide that the EC Commission, in principle, will not object to aid provided to enterprises employing 150 or fewer people and having an annual turnover of ECU 15m or less if one of the following conditions is met:

- i. amount of aid provided does not exceed 7.5% of an investment;
- ii. aid provided for job creation, does not exceed 3,000 ECU per job created; or
- iii. the total amount of aid provided does not exceed ECU 200,000.¹⁷⁴

¹⁷² For an expression of this view, see EC Commission, *Sixth Report on Competition Policy* (Brussels: 1977), pp. 131-34.

¹⁷³ *Id.*

¹⁷⁴ See O.J. C 40, 20.2.1990.

In addition, preferential treatment may be given to SME's under state aid guidelines relating to other aid objectives. For example, the previously discussed EC Commission guidelines on state aid for R&D specifically provide that a higher level of aid intensity may be allowed for programs developed for the benefit of small and medium-size enterprises.¹⁷⁵

(v) Aid to Public Enterprises

Government owned or controlled business enterprises (GBE's) are an important feature of the European, as well as the Canadian economy.¹⁷⁶ The right of the EC Member States to establish such enterprises is specifically protected under Article 222 of the *EEC Treaty*. Outside of activities relating to certain public service obligations, however, these enterprises, like private enterprises, are subject to the EC competition rules. Accordingly, state aid to government-owned enterprises is generally entitled to no more favourable treatment under the Community competition rules than is aid to privately held businesses.

Industrial aid to public enterprises was one of four main problem areas singled out by the EC Commission for critical review following the release of the *First Survey* of state aids in 1989. The Commission noted that the detection of this aid tends to be particularly difficult due to the direct financial linkages that exist between governments and the businesses that they own or control. That is, concern was expressed that these linkages can facilitate the use of forms of aid, such as equity infusions for loss-making investments or the acceptance of abnormally low dividends or returns on equity, that are highly difficult both to detect and measure. In addition, the Commission found that there was no generally accepted definition of state aid to public

¹⁷⁵ *Supra*, note 164, section 5.4. The intensity of R&D aid to small and medium-size enterprises that may be provided may be as much as 10 percent higher than would otherwise be permitted.

¹⁷⁶ The extent of government ownership and control of business enterprises in Canada is discussed in Chapter III, section 1, above.

enterprises and that large amounts of aid had apparently been provided to public enterprises without notification to EC authorities.¹⁷⁷

These concerns were addressed by the EC Commission in revisions to its policy on state aid to public enterprises set forth in a 1991 Communication to the Member States. The Communication clearly defines aid to public enterprises to include any difference "between the terms on which funds are made available by the state to public enterprises and the terms under which funds would be provided to a comparable private undertaking by an investor operating under normal market conditions."¹⁷⁸ The Communication, furthermore, outlines how this principle will be applied to capital injections, guarantees, loans and returns on investments.¹⁷⁹

In order to increase the transparency of aid to public enterprises, the 1991 Communication has also established stringent reporting requirements for relations between state-owned enterprises and their governments.¹⁸⁰ Specifically, it requires the Member States to supply the EC Commission with balance sheets and profit and loss accounts for all state-owned enterprises with annual turnover in excess of ECU 250m. Moreover, the Member States are required to regularly provide information to the EC Commission regarding the provision of capital, grants, loans and loan guarantees to state-owned enterprises, forgiven debt repayments benefiting state-owned enterprises and other relevant aspects of their financial dealings with enterprises covered by the Communication.¹⁸¹

¹⁷⁷ See Sir Leon Brittan, *A Bonfire of Subsidies? A Review of state aids in the European Community*, address to the London Seminar on Competition Policy, London, March 10, 1989 and EC Commission, *XXIst Annual Report on Competition Policy* (Brussels: 1992), pp. 126-29.

¹⁷⁸ O.J. C 273, 18.10.1991, ¶ 11. It should be noted that this definition of financial aid to state enterprises is consistent with an earlier definition set forth by the Commission in a 1984 Communication pertaining to such aid. In this regard, see EC Commission, *Fourteenth Report on Competition Policy* (Brussels: 1985), ¶ 198.

¹⁷⁹ *Id.*, ¶¶ 34-44.

¹⁸⁰ *Id.*, ¶¶ 45-54.

¹⁸¹ It may be noted, however, that the government of France (Case C-325/91) has appealed the scope of the information being requested by the EC Commission.

4. Summary and Discussion

The EC competition rules on state aids are an integral part of the legal and institutional framework for the Community's common market. These rules, in essence establish a norm that the Member States should not provide industrial aid in a manner that impedes the open and competitive operation of Community markets. The state aid rules also recognize that there may arise situations where derogations from this norm is warranted to achieve accepted economic and social policy objectives.

In practice, the EC state aid rules have provided an adaptable framework for reconciling competition and other policy concerns relating to state aid within the Community. The rules have allowed the individual EC Member States to provide substantial amounts of industrial aid for a broad range of recognized economic and social policy objectives. These objectives include, for example, regional economic development, research and development, sectoral adjustment and small and medium-size enterprise development.

At the same time, the EC state aid rules have played an important role in limiting the potential for industrial aid to impede the open and competitive operation of EC markets. This role, is reflected in the frameworks and guidelines that EC Commission has developed on the application of the state aid rules. These generally include provisions for: (i) encouraging the use of types of aid that are less of threat to the competitive and efficient operation of markets; (ii) enhancing the transparency of aid being provided; and (iii) establishing ceilings on the amount or intensity of aid that will be permitted.

The EC industrial aid framework, however, also includes certain features that are potentially of concern from an economic perspective. One such feature is the highly decentralized nature of decision-making under the framework. That is, outside of certain aid provided by the EC Commission, it is the individual Member States that determine where and how much

industrial aid will be provided in their jurisdictions.¹⁸² This makes it difficult for the EC to coordinate industrial strategy across the Member States and develop industrial policies to deal effectively with Community-wide problems.

This limitation on the EC industrial aid framework is the subject of increasing attention within the EC. A number of the Member States have called for the EC Commission to take a more active role in defining and implementing a European industrial strategy. In particular, the Commission has been asked to take a more proactive role in promoting the development of specific sectors of the EC economy, such as automobiles, electronics, textiles and defence.¹⁸³ In addition, the EC Commission has recently proposed an increase in the funds available to it for promoting R&D to ECU 4.2 billion by 1997 from ECU 2.4 billion. Concurrently with this request, the Commission has indicated that it is intending to take a more market-oriented approach for determining which R&D it will support, rather than continuing to focus on basic research.¹⁸⁴

The potential costs of enforcing the EC state aid rules may also be important to consider. These costs derive from the requirements to: notify significant amounts of industrial aid to the EC Commission, detect instances of unnotified aid, assess the compatibility of notified or otherwise detected industrial aid with the economic and social policy of the Community, and enforce compliance with the decisions of the EC Commission and Court of Justice. The EC Commission has been able to significantly reduce these costs

¹⁸² Even in relation to aid that it provides to a Member State, the EC Commission may play only a reactive role. For example, regional aid provided by the Community normally is on the basis of requests for additional funding from the Member States for projects that they are proposing. The EC Commission has traditionally played only a limited role in determining the types of projects for which funding should be requested.

¹⁸³ In this regard, see *The Economist*, January 25, 1992, pp. 65-68.

¹⁸⁴ See *International Trade Reporter (BNA)*, April 14, 1992, pp. 696-97. As noted earlier, a more proactive approach is also being adopted by the EC Commission in regard to aid provided under the ERDF. Specifically, the Commission is attempting to have the Member States direct this assistance to specific business investment in economically depressed regions rather than to infrastructure development in these regions. For discussion, see Mair, *supra*, note 145, pp. 33-43.

through the development of frameworks and guidelines on the application of the state aid rules, the provision of automatic exemptions for relatively small amounts of aid and other measures. The costs of enforcing the state aid rules in the Community, however, remain high. Indeed, the associated resource costs have been suggested as a major constraint on the EC Commission's ability to effectively enforce the state aid rules.

V. CANADIAN INDUSTRIAL INCENTIVES IN THE 1990'S

1. The Challenges

The legal and institutional framework underlying the provision of industrial incentives in Canada will be required to face many difficult challenges during the 1990's and beyond. In a globalizing marketplace, it will be increasingly important to avoid the provision of incentives that unnecessarily distort the competitive and efficient operation of Canadian markets. Such aid will be a threat to the domestic market conditions required for the development of internationally competitive businesses. In addition, it may threaten Canadian businesses' access to needed foreign markets by triggering actions under their countervailing duty systems.

The Canadian industrial incentives framework will also require careful consideration during the 1990's for other reasons. The strict budgetary constraints facing governments across the country are making it necessary to restrict the use of incentives to cases where they can be justified on valid economic, social or other policy grounds. In addition, given the potential for incentives to distort interprovincial trade, it should be an important issue during future discussions on strengthening the Canadian economic union.

The preceding chapters of this report suggest a number of issues relating to the Canadian industrial incentives framework that will require reconsideration during the 1990's. A particular area of concern is the scope that exists for conflicting or overlapping policies to be developed among the provinces and the federal government. As indicated earlier, decision-making within the Canadian incentives framework is, in many respects, highly

decentralized with input being provided by a large of committees, agencies and departments at both the provincial and federal levels of government. Yet, few formal mechanisms currently exist at either the provincial or federal levels of government to coordinate or discipline industrial incentives.

The lack of formal mechanisms for coordinating or disciplining industrial incentives in Canada has meant that potential problems of overlapping or conflicting incentives have generally been managed on a case by case or *ad hoc* basis. This approach has been successful in many situations for preventing outright conflict between provinces. For example, during the late 1970's, an arrangement was developed between the federal government, Ontario and Quebec specifically to stave off the threat of competing programs to modernize and expand the two provinces' pulp and paper sectors. In addition, negotiations between the federal government and individual provinces have led to the creation of numerous joint industrial aid programs for specific sectors or objectives.

The traditional approach for coordinating or disciplining federal and provincial industrial incentives in Canada, however, is at a crossroads. The ability of this approach to deal with overlapping or conflicting industrial incentives, which has already been questioned by many commentators, is being further eroded by several trends in both the Canadian and world economies. Of particular concern in this regard, is the increasing industrial policy role of the provinces discussed in the preceding chapter. This trend is not only augmenting the range of issues that will have to be coordinated among the provinces and the federal government in order to avoid overlap and conflict, but also, the number of parties that will have to be involved in related agreements.

The ability of an *ad hoc* or case by case approach to effectively coordinate industrial aid in Canada is also being eroded by the increasing pace of technological change and escalating international competition in Canadian as well as world markets. These trends are increasing both the complexity of the problems that industrial incentives programs must deal with and the need to rapidly implement these programs. This will be difficult to do,

however, without specific mechanisms for coordinating and disciplining the policies of provincial and federal governments.

A further emerging issue is the use of less transparent forms of incentive. Governments in Canada, at least in comparison to the U.S. and the EC, have traditionally tended to rely on relatively transparent forms of incentives, such as operating grants and capital assistance.¹⁸⁵ As indicated in chapter III, however, provincial and federal governments in Canada have broad potential to use less direct types of incentives which tend to be much more difficult to detect and measure. These other incentives include, for example, the supply of loans, goods or services at below market prices, certain capital injections to government or private businesses, the provision of land or infrastructure to private businesses and tax write-offs.

Despite its potential importance, the use of indirect industrial incentives by provincial and federal governments in Canada has not been systematically examined. There is reason, moreover, to suspect that these incentives will be increasingly used in Canada in the future. Because they tend to be less visible than direct incentives, indirect incentives may be preferred as a means to reduce the threat of subsidies being detected under U.S. and other countries' countervailing duty laws. In addition, in times of tight budgetary restraint, indirect incentives, such as the supply of electricity at below market prices or of loans at below market rates, may be preferred because they have less direct implications for the relevant government's financial position.

Another major challenge for the 1990's will be developing Canadian interests in relation to the framework for disciplining industrial incentives in North America. As indicated in chapter I, the most recent draft of the

¹⁸⁵ The nature of industrial aid provided in the U.S. is described in US Policy Studies Group (Dalhousie University, Halifax, N. S.), *A Review of Economic Development Programs of the US Federal Government and Eleven States*, prepared for the Policy Directorate, Bureau of Competition Policy, Consumer and Corporate Affairs Canada (Ottawa: December, 1992) and Industry, Science and Technology Canada, *Subsidies in the North American Pulp and Paper Industry*, *supra*, note 66. For a description of the nature of industrial provided in the EC, see the EC Commission surveys on state aids discussed in section 2 of chapter IV above.

North America Free Trade Agreement specifically provides for consultations to take place on possibly replacing the current countervailing duty system with an alternative set of rules.

The replacement of the North American countervailing duty system could benefit Canada in a number of ways. In particular, it might reduce the threat that the current countervailing duty system engenders for Canadian businesses' access to U.S. and Mexican markets. This access is of crucial importance for many Canadian industries. Over 75% of all Canadian exports during 1991 were destined for U.S. and Mexican markets. These exports were equal to more than 20% of all Canadian GNP for the year.¹⁸⁶

The replacement of the North American countervailing duty system might also benefit the competitiveness of Canadian businesses by establishing stricter controls on industrial incentives in the U.S. and Mexico. For a variety of reasons, the provision of industrial incentives by all levels of government in the U.S. tends to be highly difficult to detect and estimate.¹⁸⁷ Recent studies of these incentives, however, suggest that it is larger and much more widespread than is generally believed. In this regard, a recently completed study of the industrial aid programs of the U.S. federal government and eleven U.S. states including, California, New York, Ohio, Michigan, Texas and others, indicates that both levels of government are highly active in this

¹⁸⁶ See *Canadian Economic Observer*, Statistics Canada, catalogue no. 11-010, December 1992, tables 1.2, 5.1.1 and 5.1.2.

¹⁸⁷ The detection and estimation of industrial aid tends to be particularly difficult in the U.S. because of the relatively high level of local government involvement in this area. As indicated in Industry, Science and Technology Canada, *Subsidies in the North American Pulp and Paper Industry*, *supra*, note 66, p. 29, for example, the federal government accounted for about 30% of the aid provided to the U.S. pulp and paper industry during the 1980's as compared to about 44% in Canada. Local governments were an insignificant source of aid in Canada but accounted for over 16% of all of the aid provided in the U.S. Also, governments in the U.S. tend to rely more extensively than Canadian governments on forms of industrial aid, such as tax incentives, the provision of goods and services, low-cost financing and favorable public procurement contract terms, that may be difficult to detect and measure. For example, direct grants, which tend to be the most easily detected and measured form of industrial aid accounted for over half of the total aid provided to the Canadian pulp and paper industry during the 1980's but were an insignificant source of aid to the U.S. industry.

area.¹⁸⁸ The report notes, moreover, that there has often been intense rivalry between states to attract businesses through the provision of industrial aid and other measures.¹⁸⁹

Other work that has been done on industrial incentives in the U.S. indicates that the cumulative effect of federal, state and local government aid may be substantial in individual sectors or industries. For example, a recent study of industrial aid in the U.S. pulp and paper industry found it to be equal to about 5.5% of total U.S. investment in the sector during the 1980's, and over 20% in a number of specific instances. The study further concluded that the ratio of government aid to new investment in the pulp and paper sector was actually higher in the U.S. than in Canada during the 1980's.¹⁹⁰

It should also be noted that the completion of NAFTA could greatly increase pressure on governments in the U.S. and Mexico, as well as Canada to use industrial incentives as a means to attract or keep businesses. That is, as barriers to trade between Canada, the US and Mexico are further lowered, it is likely that companies will increasingly attempt to serve North American markets for individual products out of a single production base rather than bases within each country. Competition to attract such bases of supply or protect local production could entail substantial economic costs and perhaps even lead to the effective repartitioning of some North American markets.

2. Approaches for Meeting the Challenges

This section discusses possible approaches for dealing with the challenges facing the Canadian industrial incentives framework. Subsection (i) considers the potential development of rules within the legal and institutional framework for the Canadian common market to coordinate and discipline the provision of industrial incentives in Canada. Subsection (ii)

¹⁸⁸ US Policy Studies Group, *supra*, note 185 p. 41.

¹⁸⁹ *Id.*, p. 11.

¹⁹⁰ Industry, Science and Technology Canada, *Subsidies in the North American Pulp and Paper Industry*, *supra*, note 66, p.22.

considers more limited approaches for dealing with industrial incentives. The basic approaches considered include the development of framework rules or guidelines for coordinating and disciplining industrial incentives in Canada, and possible amendments to the roles and responsibilities of departments and agencies within the federal government. Subsection (iii) deals with the potential development of a new framework for disciplining the use of industrial incentives within the North American Free Trade Area. The section discusses the possible benefits of adopting elements of the EC industrial aid framework within the North America Free Trade Area rather than continuing to rely on the GATT-based countervailing duties framework.

(i) Industrial Incentives and the Canadian Economic Union

The use of industrial incentives by provincial and federal governments in Canada has received little attention during the discussions to date on furthering the Canadian common market. The related experience of the EC, however, suggests that this should be a fundamental concern. As noted in Chapter IV, the EC, since its inception, has recognized industrial aid as a serious threat for the effective establishment of its common market. The seriousness of this threat is indicated by the inclusion of provisions in the Community's founding treaty as well as the EC Commission's recent efforts to establish stricter disciplines on industrial aid as part of the initiative to complete the Community's internal market by 1992.

Provisions on industrial incentives may also be required to ensure and protect the completion of the Canadian common market. The continuing widespread use of industrial incentives by provincial and federal governments in Canada, detailed in chapter III, indicates that they are potentially a major threat to the effective establishment of open and competitive Canadian markets. This threat appears to be increasing due to greater provincial involvement in the industrial policy area as well as a trend toward decentralization of federal government decision-making on industrial incentives.

The state aid provisions in the *EEC Treaty* might be considered as a model for the development of framework disciplines on industrial incentives

within the Canadian common market. As indicated in chapter IV, these provisions have provided an adaptable framework for preventing state aid from repartitioning the EC common market. While allowing the use of industrial incentives to achieve a variety of recognized objectives, they have also lessened the implications of incentives for the competitiveness and efficiency of EC markets.

The EC state aid provisions contain a number of features that might also provide important benefits in a Canadian setting. One such feature is the norm that industrial aid should not impede the open and competitive operation of interjurisdictional markets. The development of a similar norm within Canada would be consistent with the importance of open and competitive markets both for enhancing the overall efficiency of the Canadian economy and promoting the development of internationally competitive businesses. It would also complement with existing competition legislation in Canada which has a similar normative basis, but is limited in application only to private sector business activity.

Certain enforcement aspects of the EC state aid framework might also be adapted for a Canadian setting. The requirement that exists under the EC framework to prenotify certain aids might also be highly useful in Canada for increasing the transparency of industrial incentives as well as detecting competition distorting incentives.

A Canadian industrial incentives framework, however, should also take account of key differences between the economic, legal and institutional settings in the EC and Canada. One such difference is the more limited role of lower levels of government as providers of industrial incentives in Canada as compared to in the EC. As indicated above, provincial incentives remain a smaller proportion of all incentives provided in Canada when compared to the share of EC industrial aid provided by the Community's Member States. Moreover, while the provinces' proportion of all industrial incentives has greatly increased over the past 20 years, it is unlikely that the federal government in Canada, with its strong fiscal and expenditure powers, will ever assume as small a role in the supply of industrial incentives in Canada as the EC Commission has in the European Community.

The much different nature of the Canadian, as compared to the EC economy, is a further important consideration. Canada, unlike the EC, might be characterized as a small open economy. On one hand, this makes the segmentation of Canadian through industrial incentives an even greater concern for the competitiveness and efficiency of Canadian businesses. That is, already small Canadian markets that are further segregated by industrial incentives would be even less capable of promoting the development of world-class businesses.

On the other hand, having a small open economy could limit the threat to the competitiveness and efficiency of Canadian markets from industrial incentives. That is, the natural flow of trade in many Canadian markets is international rather than interprovincial. In such markets, industrial incentives in Canada may affect trade and competition between Canadian and foreign businesses more so than between businesses within Canada.¹⁹¹

In developing a framework for coordinating and disciplining industrial incentives within a Canadian common market, it would also be necessary to take account of the country's distinct legal and institutional setting. The adoption of the EC state aid framework in Canada would require the creation of legal machinery and institutions having no close counterparts in this country. There are no organizations within Canada that, similar to the EC Commission, have responsibilities in the areas of industrial policy, competition policy enforcement and competition policy adjudication.

These and other differences between the EC and Canadian settings support the establishment of a different industrial incentives framework within the Canadian common market. The generally lower threat that incentives engender for the openness and competitiveness of markets in Canada as compared to the EC, and Canadian experience in dealing with incentives issues using a case by case or *ad hoc* approach, suggest that a less legalistic and rigid framework would be appropriate.

¹⁹¹ For discussion of this issue in a North American context, see subsection (iii) below.

This could be approached in several ways. For example, rather than relying on a central authority for enforcement, a Canadian industrial incentives framework might provide greater scope for intergovernmental resolution of related disputes. The Canadian industrial incentives framework might also embody a stricter test for anti-competitive effects (i.e., the framework might come into play only in cases involving the threat of substantial anti-competitive effects), as well as narrower requirements for the notification of certain industrial incentives.

(ii) Amending the Current Industrial Incentives Framework

The disciplines on industrial incentives in Canada might also be increased through more limited measures taken within the current legal and institutional setting. The development of frameworks or guidelines for major categories of industrial incentives, as has been done in the EC, could be effective for this purpose. The scope of these frameworks or guidelines, ideally, would include all federal and provincial industrial incentives falling within the relevant category. Substantial benefits might also be gained, however, through the development of frameworks or guidelines within specific regions of the country. That is, as indicated by chapter III, it is within regions of the country that competition for businesses or investment tends to be particularly intense. Moreover, some infrastructure as well as interest already exists within the regions for developing incentives related frameworks or guidelines.¹⁹²

A category of industrial incentives for which the establishment of frameworks or guidelines in Canada might be particularly beneficial is regional economic development assistance. This aid is widely used across Canada and accounts for a substantial proportion of all industrial aid provided in the country. Yet, there are currently no broad mechanisms for ensuring that it is directed to disadvantaged regions in accordance with their state of economic development relative to other regions of the country.

¹⁹² This infrastructure is provided by such organizations as the Western Premiers' Conference and the Council of Maritime Premiers. Moreover, as noted in section 2(ii) of chapter III, some interest has already been expressed within these organizations in restraining certain interprovincial competition for businesses and investment.

Rather, the amount of development assistance that is received by different regions may also depend on political considerations, the fiscal strength of the relevant province and a variety of other factors.

This situation raises more than just the usual concerns regarding the potential competition and efficiency implications of industrial incentives. In addition, it may actually expand, rather than narrow the gap between richer and poorer parts of the country. Provinces that are already better off might be expected to have greater financial resources available to bid for the location of new businesses and investment. This, in turn, may make it even more difficult for more disadvantaged areas to catch up.

The preceding chapters also suggest a number of other industrial incentives objectives for which national or regional rules or guidelines might be feasible. These include, in particular:

- (i) the promotion of small and medium-size enterprises;
- (ii) the development specific sectors (e.g., steel, forestry, petrochemicals);
- (iii) the enhancement of research and development;
- (iv) general investment promotion; and
- (v) increased employment and training.

As indicated in chapter III, these objectives also account for much of the industrial incentives provided in Canada and are widespread at both the provincial and federal levels of government.

The development of industrial incentives guidelines or frameworks is one area in particular where Canada might benefit from the experience of the EC. The Community, as indicated in chapter IV, has already developed a number of these guidelines and frameworks under its competition rules on

state aid. The aid objectives covered by the EC measures, moreover, include several that are also of major concern within Canada.

The basic approach of the EC frameworks and guidelines includes a number of features that might provide a useful guide for the development of related Canadian measures. The EC frameworks and guidelines generally include provisions designed to encourage the use of types of aid that tend to be less of a threat to the competitive and efficient operation of markets. They also generally include measures designed to enhance the transparency of aid, coordinate aid policy across jurisdictions and keep aid within acceptable levels.

Amendments to the roles and responsibilities of existing federal government agencies and departments may provide another effective means for better disciplining industrial incentives in Canada. While the federal government's role as a provider of incentives has clearly declined relative to the provinces since the 1960's, it is still the largest supplier of direct industrial aid in the country. In addition, the federal government can exert substantial influence over the provision of industrial incentives by the provinces through the provision of funds in support of joint federal and provincial programs.

As indicated in the preceding chapter, however, the federal government does not have one agency or department with a clearly defined role to oversee the large number of existing federal and joint federal-provincial industrial incentives programs. Rather, related responsibilities are held by many departments and agencies within the federal government each having a much different mandate, role and policy perspective. This being the case, it should not be expected that systematic consideration will always be given to competition and other economic concerns relating to industrial incentives. In respect of this situation, consideration might be given to appointing one federal government department or agency to review and oversee all federal industrial incentives to ensure that it is provided in accordance with an appropriate set of microeconomic, competition and other policy principles.

(iii) Toward a North American Industrial Incentives Framework

The GATT countervailing duty system, which underlies the industrial incentives framework in North America, is designed primarily to give countries a way to protect their domestic industries against "unfair" subsidized competition from other countries. The *GATT Code on Subsidies and Countervailing Duties*, other than certain export subsidies, does not prohibit the granting of industrial incentives.¹⁹³ Rather, it allows countries to apply trade sanctions against imports of foreign subsidized products where it is found that these imports have caused, or are a threat to cause material injury to producers of like products within their jurisdiction. These sanctions normally involve the imposition of countervailing duties of as much as the amount of the estimated rate of subsidy.

The international countervailing duties framework engenders many areas of concern for the competitive and efficient operation of markets. At a general level, it may be questioned whether the basic objective of the framework, the protection of domestic producers against subsidized foreign products, provides an appropriate foundation for controlling and disciplining subsidies. This objective does not place an onus on countries to take account of the full implications that the application of countervailing duties may have for an economy. In particular, there is no requirement for consideration to be given to the potential costs to consumers of having their access to low-cost imports being interrupted by countervailing duties.¹⁹⁴

A further major concern regarding the countervailing duty system is that it does not, outside of certain export subsidies, distinguish between subsidies provided in relation to different economic or social policy

¹⁹³ Examples of prohibited export subsidies are provided in the Annex to the *GATT Code on Subsidies and Countervailing Duties*.

¹⁹⁴ The conditions under which countervailing duties may lower or raise the net economic welfare of the country imposing them are discussed in Alan Deardorff and Robert Stern, "Current Issues in Trade Policy: An Overview," in Robert Stern (editor), *U.S. Trade Policies in a Changing World Economy* (Cambridge, Mass.: The MIT Press, 1987), pp. 51-60 and Alan Sykes, *Countervailing Duty Law: An Economic Perspective* (Toronto: University of Toronto, Faculty of Law, 1988-89), Law and Economic Series WS 1988-89 (7).

objectives. The GATT *Code on Subsidies and Countervailing Duties* specifically recognizes a number of legitimate objectives for industrial aid, such as the development of disadvantaged regions, the restructuring of industries harmed by the removal of trade barriers, the encouragement of R&D, the maintenance of employment and the encouragement of retraining. However, subsidies granted in relation to these objectives are generally not accorded any different treatment.¹⁹⁵

The basic elements of the international countervailing duties framework also entail a number of other areas of concern. The material injury test that must be satisfied in order for the framework to be applicable engenders two different sets of issues. On one hand, the need to satisfy this test means that the countervailing duty system may not be applicable in many cases where subsidies are distorting the competitive and efficient operation of international markets. Rather, so long as a subsidy does not cause material injury to foreign producers in their domestic markets, it will generally not be subject to discipline.¹⁹⁶ Moreover, even in cases where the countervail system does apply, it may only be after a long period during which trade and competition has been distorted.

The material injury test, on the other hand, may also allow action to be taken against foreign incentives in cases where it is not warranted even to protect domestic producers against "unfair" foreign competition. This problem derives from the non-symmetrical treatment of foreign and

¹⁹⁵ See the GATT *Code on Subsidies and Countervailing Duties*, Article 11. It may be noted that the proposed amendments to the international countervail system would go some way toward giving greater importance to recognized objectives for industrial incentives. In particular, the proposed *Code*, Articles 8 and 9, would provide for more lenient treatment of certain R&D and regional subsidies.

¹⁹⁶ It should be noted that the proposed Dunkel Draft subsidy provisions would go some way toward increasing the ability of countries to use the international countervail system to offset the effects of foreign subsidies on domestic producers' sales in third country markets. In this regard, they would allow for remedial measures to be taken by a country suffering "serious prejudice" to its interest as a consequence of the provision of industrial subsidies by another country. A finding of serious prejudice can be made even in cases where the subsidy under consideration only affects exports of the non-subsidizing country to third countries. In this regard, see Articles 5-7 of the proposed *Agreement on Subsidies and Countervailing Measures*.

domestic subsidies under the material injury standard. Countries are not required to take account of subsidies that they themselves are providing to domestic producers when determining the effects and level of foreign subsidies. Findings of material injury, therefore, may be made even in cases where domestic producers are actually more highly subsidized than the foreign producers under examination.

Another element of the subsidy countervailing framework that engenders serious concerns for the competitiveness and efficiency of related markets is the calculation and use countervailing duties. Rates of countervailing duty are determined on the basis of all capital, operational, export and other subsidies provided to the relevant producers. These are collapsed into a single rate of subsidy for each of the relevant producers which is then used to establish the level of countervailing duty if a positive material injury finding is made.¹⁹⁷

The calculation of countervailing duties, therefore, does not take account of the specific type of the aid that is provided to foreign producers. The economic analysis of industrial aid, however, indicates that this can have important implications for its competition, trade and efficiency implications. For example, as indicated in chapter II, lump sum aid, while it may maintain foreign production, may not affect the price at which products are supplied.¹⁹⁸

A further important problem with the way that countervailing duties are calculated is that they need not take account of offsetting industrial subsidies to the domestic industry. In this regard, the *GATT Code on Subsidies and Countervailing Duties*, article 4(2), only provides that

¹⁹⁷ Capital assistance and other lump sum aid is generally allocated over a period of time reflecting such considerations as the expected lifetime of related plant or equipment.

¹⁹⁸ For discussion of the difficulties of using countervailing duties to offset the effects of foreign subsidies, see, for example, Joseph F. Francois, "Countervailing the Effects of Subsidies: An Economic Analysis," *Journal of World Trade Law*, vol. 26, no. 1, February 1992, pp. 5-14 and Barbara J. Spencer, *Capital Subsidies and Countervailing Duties in Oligopolistic Industries* (Vancouver, B. C.: University of British Columbia, Faculty of Commerce and Business Administration, Research Papers in International Business, Trade and Finance, 1988).

countervailing duties may be no more than "the amount of the subsidy found to exist, calculated in terms of subsidization per unit of the subsidized and exported product." The level of countervailable duties that is established under the GATT framework, therefore, may be well above what is actually required to put some or all domestic producers on an equal footing with the relevant foreign suppliers.

It should be noted that this is an inherent problem with the use of industrial aid to counteract or discipline foreign subsidies. While rates of countervailing duties can be adjusted according to the estimated amount of the subsidies received by individual foreign producers, the protection that import duties provide cannot be targeted for the benefit of individual domestic producers. Accordingly, attempts to take account of the subsidies that are received by some domestic producers might be seen as inadequately protecting the interests of those that are less highly subsidized.

The replacement of the present countervailing duty system with a competition-based framework for disciplining industrial incentives in North America may be one means to avoid many of the above problems. Certain aspects of the EC state aid rules could provide a useful starting point for the development of this framework. The basic elements of the EC approach avoid many of the inherent shortcomings of the international countervailing duty framework. This approach, as indicated in chapter IV, involves a general prohibition of competition and trade distorting industrial aid, with exceptions being permitted for recognized economic, social and other policy objectives. A further key element of the EC approach has been the development of guidelines and frameworks establishing acceptable limits on the amount and types of industrial incentives that may be permitted.

From the perspective of promoting open and efficient competition, the remedy permitted under the EC industrial incentives framework, the prohibition of unauthorized incentives, has major advantages over the use of countervailing duties. The prohibition remedy works by removing the actual source of the market distortion. Countervailing duties, on the other hand, attempt to indirectly nullify the effects of foreign subsidies on domestic producers through the imposition of offsetting import duties. As indicated

above, however, such duties are highly unlikely to restore appropriate trade and competition levels.

The competitive effects test triggering the application of the EC industrial aid rules has important advantages over the material injury test under the countervailing duties system. It is less likely than an injury test to permit substantial trade and competition distortion before remedial action can be taken. Indeed, the requirement under the EC state aid rules to prenotify means that they may come into effect before there is any possibility of trade and competition distortion.

A further advantage of the EC industrial aid framework over the countervailing duty system is the scope that it provides for preferential treatment of certain types of industrial incentives as well as incentives provided in relation to certain recognized objectives. This scope, as indicated in chapter IV, can be used to promote the use of forms of incentives that tend to be less disruptive of the competitive and efficient operation of markets. In addition, it promotes lower or higher levels of permissible incentives based on the importance of their underlying economic, social or other policy objectives.

Finally, from both a competition and more general policy perspective, an important advantage of the EC industrial aid framework is that it can create greater certainty regarding the treatment of industrial incentives. Incentives that are approved under the EC framework, or that are found to be within accepted limits, are no longer potentially subject to remedial action. This is not the case under the countervailing duties system where attempted remedial action may occur well after the relevant incentives have been provided and have taken effect.

VI. SUMMARY

The legal and institutional framework underlying the provision of industrial incentives in Canada is in an important period of transition. Concerns relating to the effectiveness of past industrial aid programs, tight fiscal restraints, the globalization of markets and new theories on industrial policy are leading governments in Canada and elsewhere to re-examine the role and use of industrial incentives. At the same time, the industrial incentives framework in Canada is having to adjust to the demands of provinces for a greater industrial policy role. In addition, the provision of industrial incentives in Canada may require fundamental rethinking to take advantage of the potential, created by the Canada-U.S. Free Trade Agreement as well as the possible implementation of the North American Free Trade Agreement, to develop better framework mechanisms for disciplining industrial incentives within North America.

The purpose of this report has been to examine the interface between competitive and efficient Canadian markets, and the evolving industrial incentives framework in Canada. As indicated by the economic analysis of industrial incentives, outlined in chapter II of the report, there are many ways in which industrial incentives can inhibit the competitiveness and efficiency of Canadian markets. These effects should be an important consideration in relation to the use of industrial incentives, however, to achieve different economic, social and other policy objectives.

The economic analysis of industrial aid also indicates that there are situations where it might be used to enhance the competitiveness and efficiency of markets. This may be the case, for example, where subsidies are used to promote entry to noncompetitive markets, mitigate the effects of certain economic externalities or counteract the effects of certain other market imperfections.

A key determinant of the net economic implications of industrial incentives, in any situation, is likely to be the design of related programs or projects. Careful consideration of the competitive implications of the elements of related projects or programs can help to mitigate their economic

costs while allowing them to achieve their economic, social or other policy objectives. For example, economists generally favour the use of lump sum rather than production incentives or subsidies, on the basis that they tend to be less disruptive of efficient markets. Other specific elements of industrial incentives programs that may require careful consideration include: (i) the way in which the objectives to be achieved are specified; (ii) the range of potential beneficiaries; (iii) restraints on the quantity of, or time that the incentives will be available; (iv) the choice of factors determining the availability of incentives; and (iv) the nature of the conditions attached to the receipt or use of incentives.

The discussion in chapter III of the report indicates that industrial incentives continue to play a highly important role in shaping the Canadian economy. For the federal government, and increasingly the provinces, direct and indirect business incentives are a major instrument for the achievement not only of economic objectives, but also a wide range of social and other policy goals. While it is difficult to measure accurately, there is little doubt that the amount of industrial incentives provided in Canada is large. In addition to billions of dollars of direct incentives that are annually provided to businesses in Canada in the form of operating subsidies or capital assistance, a further uncounted amount of indirect assistance is provided by both the provinces and the federal government through tax incentives, preferential loans, loan guarantees and the provision of free or low-priced goods and services.

The provision of industrial incentives in Canada has become much more decentralized during the past several years due primarily to greater provincial involvement in the industrial policy field and changes to federal regional economic development policy. This has enhanced the potential for destructive interprovincial competition for investment as well as the difficulties involved in coordinating industrial incentives programs. In addition, it has increased the threat that industrial incentives engender for efforts to develop a more open and competitive internal market in Canada.

The industrial incentives framework in Canada currently contains few formal mechanisms for coordinating and disciplining related provincial and

the federal government activity. Rather, where major problems or conflicts have arisen, they have tended to be dealt with on a case-by-case or *ad hoc* basis. As indicated in chapter III, however, the ability of this approach to meet the needs of the Canadian economy is being challenged by ongoing developments in the Canadian, as well as the world economy. These include not only developments referred to above, such as the increasing industrial policy role of the provinces, but also, complications relating to the increasing pace of technological change, the globalization of markets, greater international competition for investment, the potential for increased use of less transparent forms of industrial incentives in Canada and the threat of Canadian interests being undermined by foreign industrial aid and countervailing duties.

In the EC, in contrast to Canada, the threat that industrial incentives pose to competitive and efficient markets are explicitly recognized. The EC legal and institutional framework, since its creation, has included rules designed specifically to restrict the provision of competition distorting industrial aid by its Member States. The analysis of these rules in chapter IV indicates that they have generally provided an adaptable framework for reconciling competition and other policy concerns relating to the provision of industrial aid in the EC. The rules have allowed the EC Member States to provide such aid in relation to a number of recognized economic and social policy objectives. At the same time they have played an important role in limiting the potential for this aid to unnecessarily or excessively impede the open and competitive operation of EC markets. They have encouraged the use of types of aid that tend to be less of a threat for competitive and efficient markets, enhanced the transparency of industrial aid and lead to the establishment of limits on the amount of aid that may be permitted for recognized policy objectives.

The EC state aid framework, however, also contains characteristics that may be difficult or costly to implement in other jurisdictions. The high degree to which decision-making on industrial aid in the Community is decentralized has been a barrier to the development of a broad-based European industrial strategy. In addition, the EC industrial aid framework

includes legal and institutional features and mechanisms that may be difficult or costly to replicate elsewhere.

Despite these concerns, certain aspects of the EC approach might be highly beneficial for dealing with industrial incentives in the Canadian economy. As noted, such incentives should be a major area of concern during any further discussions on enhancing the Canadian common market. Consideration should be given to the development of framework rules to ensure that the provision of incentives by the provinces and the federal government does not prevent the effective establishment of open and competitive markets in Canada.

The EC's competition-based state aid rules might be considered as a model for such a framework. In developing a Canada-wide industrial incentives framework, however, it would also be necessary to take account of the unique features of the Canadian economy, and legal and institutional setting. Certain features of the Canadian economy, Canada's experience in coordinating and disciplining industrial incentives on a case-by-case or *ad hoc* basis, the continuing importance of the federal government as a provider of industrial incentives and other considerations suggest that a more consultative and less rigid industrial incentives framework would be appropriate for Canada.

The development of frameworks or guidelines dealing with specific objectives for incentives should also be considered. Widely used objectives for industrial incentives in Canada, for which guidelines or frameworks might be developed, include, among others, regional economic development, small and medium-size enterprise development and the promotion of research and development. The development of frameworks or guidelines relating to particular objectives is one area where Canada may be able to benefit directly from the experience of the EC. As indicated in chapter IV of the report, the Community has developed several such instruments in relation to aid objectives that are prominent in both Canada and the EC. Measures adopted within the federal government itself could also be highly beneficial. Consideration could be given to creating a single center of

responsibility within the federal government with an explicit role to oversee and coordinate its vast array of industrial aid programs.

Finally, the EC industrial aid approach might also serve as a model for the development of a North American industrial aid framework to replace the current countervailing duties framework. Aspects of the EC industrial aid approach, such as the prohibition of unacceptable industrial aid rather than the use of offsetting duties, might be highly useful for avoiding many of the inherent shortcomings of the international countervailing duties system.

In sum, the provision of industrial incentives for economic, social and other policy purposes has long been, and continues to be an important part of the Canadian economy. However, a host of factors, ranging from the globalization of markets to Canadian economic union considerations, are making it increasingly important for Canada to establish a legal and institutional framework that ensures that these incentives effectively support the competitiveness and efficiency of Canadian businesses. This report strongly supports efforts to achieve this goal through internal trade negotiations, further negotiations on free trade in North America and other means.

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