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A Capital Story

Exploding the Myths Around Foreign Investment in Canada

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In this issue...
Overblown fears of a fire-sale of Canadian corporate assets to foreigners obscure the reality that Canada has become a net capital exporter, while losing appeal as a destination for foreign investments. Canada must change its trade, regulatory and tax policies to ensure that it can attract sufficient savings to fund productivity-enhancing investments.

The Study in Brief

The flow of foreign investment into Canada increased substantially in the latter part of the 1990s as part of a worldwide pattern of unprecedented levels of cross-border investment activity, prompting media stories about a broad-based foreign takeover of Canadian assets and even a book announcing the imminent disappearance of corporate Canada. Canadian companies were also actively investing abroad, however, and various economic indicators show that the level of foreign (specifically U.S.) ownership in the Canadian economy is about the same now as it was at the beginning of the 1980s. In fact, from 1987 to 1998, Canadians made more direct investments abroad, on a cumulative basis, than foreigners made in Canada. Only in the years 1999 and 2000 was there a substantial difference between sales and acquisitions as a result of a handful of big transactions. From 2001 to 2003, Canada was again a net acquirer of foreign assets. Canadian companies are clearly not disappearing into the hands of foreigners. In fact, from its long-standing historical position as a net capital importer, Canada has now become a net capital exporter.

In any event, cross-border investment activities must be viewed in the context of increasing economic integration between countries. Foreign direct investment is complementary to trade and scores of economic studies show positive economic effects associated with both inward and outward direct investment. To ensure that Canadian companies take full advantage of worldwide economic integration, have access to the best technology, the largest possible pool of investment capital and provide Canadians with the best jobs available, Canada must have internationally competitive policies with respect to its investment and trade.

On this front, there is much that Canada can do. Evidence shows that for over 20 years Canada has captured a steadily decreasing share of foreign investment directed toward the North American market or toward developed countries as a whole. Explanations for this pattern include more timid liberalization of foreign investment restrictions when compared to other OECD countries and especially a more punitive tax system. Ottawa should re-examine sector-specific foreign ownership restrictions, get rid of the Investment Canada Act, eliminate trade irritants while liberalizing trade further, lower the corporate tax burden and reduce withholding taxes on payments to non-residents in order to increase Canada's attractiveness as a destination for foreign investment.

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In the latter part of the 1990s, Canadians were deluged with media headlines such as "The quiet hijacking of corporate Canada",[1] "Real threat to independence is from U.S.",[2] "Canada risks being satellite to multinationals"[3] and even a book: *The Vanishing Country – Is it too late to save Canada*?[4] The outpouring of alarmist rhetoric left the impression that foreigners were swallowing Canada's corporate sector with frenzied greed. However, far too much of the discussion relied on anecdotal evidence and partial analysis. A careful look at the factual evidence tells a very different story.

The level of foreign investment in Canada was part of a worldwide pattern, and it was indeed unusually high for a few years near the end of the decade, just as Canadians were more actively investing and acquiring assets abroad. Cross-border investment activity has since returned to more historically consistent levels as global economic activity slowed. Looking at a broad array of indicators, it is clear that foreigners were not and are not taking over Canada's corporate sector.

Since the mid-1990s, Canada has been a net capital exporter. That development in itself is not a concern, although one of its root causes should raise policymakers' eyebrows: Canada has become a relatively less appealing location for foreign capital because of a general reluctance to ease foreign investment restrictions and especially because of a more punitive tax system compared to many other developed countries. The lack of competitiveness is reflected in the declining share of foreign investment locating in Canada, a pattern that has been in place for more than two decades. Since both inward and outward cross-border investments create substantial economic benefits for Canada, policymakers should work to reverse the trend by removing barriers to cross-border investment activities and by creating a business environment that is appealing to foreign investors. Greater trade and investment liberalization through regulatory change must become a priority for Ottawa and for its trade and investment partners. In the meantime, Canada can reform corporate taxes to enhance the country's attractiveness as an investment location.

Patterns in FDI in Canada

Foreign direct investment (FDI) is an activity in which an investor resident in one country obtains a long-term interest in, and a significant influence on the management of, an entity resident in another country. This may involve either creating an entirely new enterprise — known as a greenfield investment — or, more typically, changing the ownership of existing enterprises through mergers and acquisitions. Other types of financial transactions between related enterprises, such as reinvesting the earnings of the FDI enterprise or other capital transfers, are also defined as FDI (OECD, 2003). In the Canadian context, FDI refers to investments made by foreigners in Canada with a view to having an effective voice in the management of that concern.

1 Willard Estey, *Globe and Mail*, December 16, 1999.

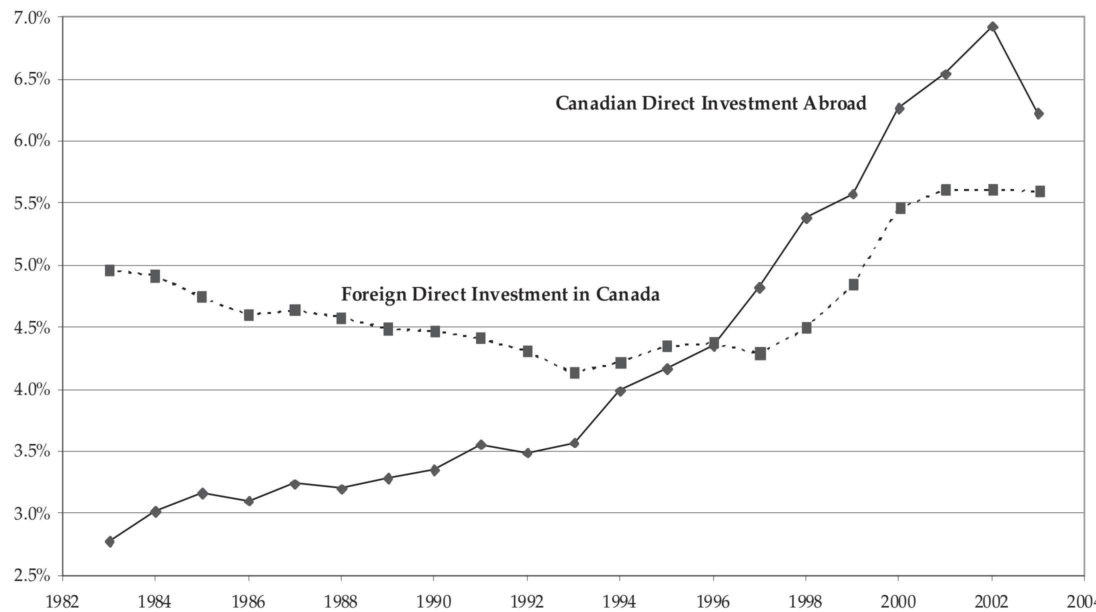
2 David Crane, *Toronto Star*, December 19, 1999.

3 Sandra Rubin and Robert Thompson, *National Post*, April 1, 2000.

4 Mel Hurtig (2002), *The Vanishing Country: Is it Too Late to Save Canada?*, McClelland and Stewart, Toronto.

The stock of FDI in Canada has steadily increased for the past two decades, reaching $360 billion in 2003. Scaled as a share of total Canadian business assets, however, it has been stable, hovering between 4 and 5 percent throughout most of the 1980s and 1990s, including during the 1997-to-2000 period of unprecedented worldwide cross-border investment activity, and levelling off around 5.6 percent from 2001 to 2003 (Figure 1).[5] Still, the share of FDI in Canadian business assets was only 0.6 percentage points higher in 2003 than it was 20 years earlier, hardly a phenomenal increase.

Figure 1: *FDI stocks as a Proportion of Canadian Business Assets**



*Business Assets refer to Total Assets, Corporations and Government Business Entreprises

Source: Statistics Canada

The United States accounts for most FDI in Canada. Historically, its share has been around 65 percent, with Europe making up 25 percent and Asia/Oceania sharing the remaining 10 percent. These proportions have been unchanged for the past two decades. Besides the United States, the other top investors in Canada are France, Britain, the Netherlands and Japan.

What Are They Afraid Of? Deconstructing the Inflow of FDI into Canada

Foreign investment in Canada can be classified in three broad categories:

- Acquisitions by foreigners of existing Canadian interests;
- Reinvested earnings of Canadian affiliates of foreign companies, and

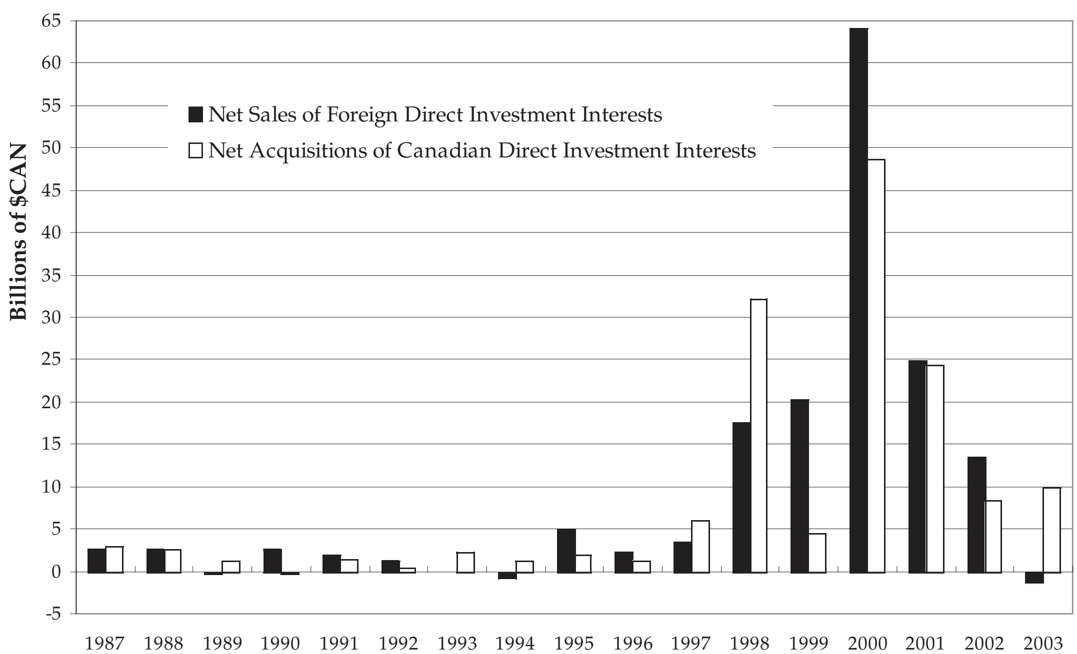
5 The peak in FDI at the worldwide and also at the Canadian level coincided with the sharp equity-price increase of the late 1990s and therefore a significant part of it may reflect a pure valuation phenomenon (OECD, 2003).

- Other inflows of direct investment which consists mainly of loans from parent corporations to their Canadian affiliates.

Looking at these categories, it is clear that some Canadians and government officials welcome certain types of FDI inflows. For example, all of them would look favourably on a foreign-owned affiliate in Canada that re-invested some of its earnings for a plant expansion that would create additional jobs for Canadian workers. What some critics are quick to denounce, though, are net sales of Canadian interests; that is, existing Canadian assets passing into the hands of foreigners. In some years, this net result is a negative number, indicating that Canadians re-claim more assets located in Canada from foreigners than they sell to them. This happened in 2003 when, on balance, Canadian residents bought back more Canadian assets from foreigners than they sold to them. The last time it happened was in 1994.

Net sales of Canadian interests were unusually high only from 1998 to 2002, when they accounted for more than half of all the inflow of FDI into Canada. However, net acquisitions of direct investment interests, or how much existing foreign assets Canadians acquire, were also unusually high during that period (Figure 2). Taking a longer time horizon also helps to keep things in perspective. From 1987 to 1998, Canadians made more direct investments abroad, on a cumulative basis, than foreigners bought in Canada. Only the years 1999 and 2000 saw a substantial difference between sales and acquisitions as a result of a handful of big transactions which still prompted headlines about a fire-sale of Canadian assets. From 2001 to 2003, Canada was again a net acquirer of Canadian interests.

Figure 2: *Sales and Acquisitions of Existing Foreign Direct Investment Interests*



Source: Statistics Canada

Cross-Border Mergers and Acquisitions

Most sales and acquisitions of existing direct investment happen in the cross-border mergers and acquisitions (M&A) market. This was especially the case in 2001 when M&A deals accounted for 80 percent of total worldwide FDI flows (UNCTAD, 2003).[6]

Canada in the Worldwide M&A Market

As noted, some commentators claim that Canada is at a disadvantage in the global M&A market and that economic integration has made it easier for foreigners to snap up Canadian assets. Here again, the facts tell a different story. Estimates from the United Nations Conference on Trade and Development (UNCTAD) show that for the 1987-to-1999 period, Canada was a net cumulative purchaser on the global M&A market. That is also the case in every sub-period to 1999. Only when including the years 2000-to-2002 does Canada become a net seller, a result of two record-setting transactions: the $66.5 billion sale of Seagram Co. to Vivendi Universal SA and the $17.9 billion sale of the tobacco operations of Imasco Ltd. to British American Tobacco, both in 2000 (Schembri, 2002). Excluding them, Canada has been a net purchaser in the global M&A market from 1987 to 2002.

A recent Statistics Canada study (Marth, 2004) that looks at cross-border acquisitions in recent years arrives at the same conclusion. In number of acquisitions, the study finds that between 1997 and 2002, Canadian companies acquired 447 foreign entities, while companies located abroad acquired 345 Canadian firms (Table 1). In terms of value, however, foreign companies invested slightly more in Canada during the six-year period, again because of the Vivendi-Seagram transaction. Between 1997 and 2002, non-Canadian companies acquired $144 billion of Canadian entities, while Canadian firms acquired $124 billion of foreign companies. Looking only at transactions with the United States, Canada was a net acquirer of U.S. companies between 1997 and 2002, with acquisitions totaling $85 billion versus sales of $72 billion.

Considering these statistics, concern that Canadian assets have recently been caught up in a firesale in the cross-border M&A market and elsewhere clearly seem overstated. When the claim is made with respect to the United States, it is just plain wrong.

Nevertheless, even if the overall M&A market is quite balanced, the same might not be true of the market for very large corporations. They often provide employment for highly skilled and well-paid workers who make a disproportionate contribution to the local economy and tax base. Are we seeing a flurry of sales of large Canadian companies to non-Canadians?

Foreign Acquisitions of Large Canadian Corporations

One way to look at the issue is to restrict the range of cross-border M&A transactions to only those companies worth more than US$1 billion. Here again, the results do not support the foreign takeover hypothesis. From 1995 to 2002, there

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6 A very active mergers and acquisitions market accounted for a lot of the increase in cross-border investment activity in the latter part of the 1990s. There is evidence that takeover activity increases when the stock market suffers from significant misvaluations, which arguably was the case then. See Dong et al. (2003).

Table 1: *Cross-Border M&As Involving Canada From 1997 to 2002*

Year	Foreign Acquisitions of Canadian Companies		Canadian Acquisitions of Foreign Companies	
	Number	Value $B	Number	Value $B
1997	41	3.5	50	6.1
1998	49	17.6	77	32.2
1999	65	20.2	63	4.5
2000	88	64.1	103	48.6
2001	68	24.9	95	24.4
2002	34	13.5	59	8.4
1997-2002	34.5	143.9	447	124.2

Source: Marth (2004)

have been 35 transactions of US$1 billion or more where a Canadian company acted as the purchaser, compared to 32 where a Canadian company was the seller. Again, total sales of Canadian companies to foreigners during this period exceeded purchases in value only because of the Vivendi-Seagram transaction. Since transaction value might not be the best indicator of the size of the Canadian companies involved in M&A deals (consider the relatively high prices paid in the late 1990s for small technology start-ups), another way to assess how many takeovers of large Canadian companies have occurred in recent years is to use the Financial Post's FP500 rankings of Canada's largest corporations, as measured by sales.

Based on an analysis of these rankings,[7] between 1996 and 2002, foreigners acquired 48 corporations out of the largest 500 Canadian corporations in the base year. Of these, 36 passed to U.S. interests; the remaining 12 were acquired by a non-U.S. firm or the subsidiary of a non-U.S. company. Many of these corporations already had a substantial share of their voting equity held by foreigners and many were subsidiaries of non-Canadian corporations. Excluding those that had 50 percent or more of their voting equity directly held by non-Canadians already in 1996 brings the total down to 36 foreign acquisitions. That is an average of six corporations a year out of Canada's largest 500 corporations taken over by foreigners during a period of unprecedented M&A activity worldwide. It would be difficult to characterize this as a sell-off.

Most of the acquired companies were in the resources sector, either oil and gas or paper and forest products. Marth (2004) also finds that among the major industrial groups, the energy and minerals sector accounted for the most activity with respect to foreign acquisitions. His statistics show that the energy and minerals

7 We took the 1997 edition of the rankings, which lists the 500 largest corporations in Canada based on 1996 sales, and set out to find what happened to each of the companies listed in this edition between 1996 and 2002. Of course, many of these companies do not exist in their original form: they changed names, merged with, or were acquired by, another Canadian corporation, went bankrupt or were taken private by their parent company. Using the CanCorp Financials Database and a variety of other sources, we singled out each company that was acquired by foreigners between 1996 and 2002 and that was not already 100 percent foreign-owned in 1996.

group accounted for 31 percent of the $144 billion of Canadian firms acquired by non-Canadian companies between 1997 and 2002.

The Role of the Exchange Rate

Some commentators argue that the main reason for the foreign acquisition of Canadian companies in the late 1990s was the erosion of the Canadian dollar. However, while a devaluation of the Canadian dollar makes assets cheaper for foreign buyers, it also reduces earnings measured in stronger currencies, leaving the overall rate of return largely unaffected. Only if buyers from abroad have foreign-denominated cash flows out of which they can purchase devalued Canadian assets would the Canadian dollar's value have a more direct role in encouraging FDI (Razin, 2003). The simple observation that Canadian purchases of foreign assets have also been rising as the Canadian dollar depreciated is enough to cast serious doubt on this hypothesis. Aba and Mintz (2002) and Schembri (2002) both argue that the exchange rate plays little role in explaining foreign acquisitions in Canada.[8]

Foreign Ownership and Control

In considering the extent of foreign control in the Canadian economy,[9] there are two important considerations:

- Corporate assets under foreign control in Canada are almost exclusively found in multinational enterprises (MNEs);
- Because, as can be expected, ownership of multinationals is spread throughout the whole advanced world, no single country the size of Canada can expect to own the majority of the capital in all the multinational firms that are operating within its borders.

In other words, to insist that Canadians should own the majority of the multinational production facilities in Canada is to insist that Canada own the majority of the world's multinationals, which would require financing vastly in excess of all Canadian wealth.

In this context, have foreigners been increasing their control over Canada's corporate assets? According to the latest data from the Corporations Returns Act, they have not: Foreign-controlled companies held slightly over one-fifth of assets in Canada in 2000, the same proportion as in 1994, or even 1988. The proportion rose slightly during the late 1990s, but it declined for the second straight year in 2000, returning to levels recorded a decade earlier. Most of this decline took place in the finance and insurance industries, as the share of foreign control in the non-financial industries remained higher in 2000 than it was a decade ago.

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8 TD Economics (2002) offers a brief review of the different views. Some have argued that the exchange rate may play a role when the target company possesses a firm-specific asset that would generate a stream of revenue for the acquiring firm in a different currency than the currency of acquisition. Georgopoulos (2003) provides evidence that this may have occurred in Canada, but there is no consensus on this issue.

9 The concept of control is based on the potential to control by means of foreign ownership of 50 percent or more of the voting equity in a corporation. This potential may not be exercised, in which case controlled companies may still function with considerable autonomy in their financial, marketing or operational activities.

Foreign Ownership Among Canada's Large Corporations

The extent of foreign ownership among Canada's largest corporations decreased substantially during the 1996-to-2002 period. Based on foreign ownership statistics taken from the Financial Post's FP500 rankings,[10] there were close to 100 fewer companies with 10 percent foreign ownership or more among Canada's 800 largest corporations in 2002 than in 1996, or 251 instead of 350. Looking only at the top 50, there were 16 such companies in 2002, compared with 28 in 1996. In fact, whether looking at the top 50, 100, 500 or 800, the proportion of companies with 10 percent foreign ownership or more declined between 1996 and 2002 (Table 2).

Looking only at companies that have 100 percent of their voting interests held by foreigners, the conclusion changes little. While the proportion of companies entirely controlled by foreigners increased slightly among the larger sub-rankings between 1996 and 2003, it decreased among the 50, 100 and 200 largest corporations in Canada (Table 2).

The evidence emerging from foreign ownership statistics clearly invalidates the claim that non-Canadians have increased their control over Canada's business assets: Foreign ownership increased somewhat among smaller companies, while declining among Canada's largest companies. Overall, foreigners control a little over one-fifth of Canadian business assets, a proportion that is roughly unchanged in over a decade and that reflects the importance MNEs have always had and still have in the Canadian economy.

Canadian Affiliates of U.S. Corporations

If U.S. companies were acquiring or gaining control of a large number of Canadian firms, or if Canadian markets were increasingly served by expansion of U.S. com-

Table 2: *Percentage of Canada's Largest Firms With Voting Equity Held by Foreigners*

	10% or more		100%	
Sub-ranking	1997	2003	1997	2003
		% of firms		
First 50	56.0	32.0	20.0	14.0
First 100	58.0	34.0	24.4	16.0
First 200	56.5	38.5	27.5	26.0
First 300	53.0	39.7	27.3	28.0
First 500	49.6	37.0	26.8	27.4
Top 800	43.8	31.4	22.3	23.0

Source: Financial Post FP500

10 For each of Canada's 800 largest corporations, the FP500 rankings give the percentage of registered foreign ownership of voting interests, if it is 10 percent or more. A comparison between the 1997 and 2003 rankings enables us to establish if foreigners have increased their control over Canada's large corporations. Since the 2003 FP500 rankings are mostly based on 2002 financial statements, and the 1997 ranking on 1996 financials, the comparisons illustrate changes that have occurred between 1996 and 2002.

panies into Canada, the pattern would be reflected in such statistics as the number of Canadian affiliates of U.S. companies and in the shares of Canadian employment and GDP they account for. According to the annual survey of U.S. direct investment abroad conducted by the Bureau of Economic Analysis (BEA), there is no such trend. The number of non-bank majority-owned Canadian affiliates of U.S. companies[11] stayed fairly constant during the 1990s. There were 1,902 non-bank, majority-owned affiliates of U.S. parents operating in Canada in 2001, less than during the 1994-to-1997 period, and 69 more than there were in 1989 (Table 3). Correspondingly, the gross product[12] of these affiliates accounted for 10 percent of Canadian GDP in 2001, almost unchanged from 1989 and less than the 11 percent recorded in 1982.

According to the BEA survey, the share of the working Canadian population employed by U.S.-owned Canadian affiliates did not increase significantly during the past 20 years, hovering between 6 and 8 percent. It was 6.9 percent in 2001, about the same level as in 1989 and less than the 7.5 percent share registered in 1983.

Both the shares of Canadian GDP and employment accounted for by Canadian affiliates of U.S. companies would in principle reveal any significant increase in U.S. control of the Canadian economy. A closer look at these broad measures indi-

Table 3: *Summary Statistics for Non-Bank Majority-Owned U.S. Affiliates in Canada, Selected Years*

	1982	1983	1989	1994	1995	1996	1997	1998	1999	2000	2001
Number of majority-owned U.S. affiliates	n/a	n/a	1,833	1,939	1,917	1,925	1,948	1,803	n/a	1,863	1,902
Gross Product (billions of 2000 $US)	54.2	n/a	66.3	53.1	55.3	57.3	59.2	56.7	67.2	73.5	69.9
Gross Product as % of Canada's GDP	11.0	n/a	9.4	8.5	8.6	8.8	8.9	8.9	9.9	10.1	10.0
Total Assets (billions of 2000 $US)	n/a	153.1	230.5	220.7	239.0	260.6	271.8	281.5	344.6	399.1	453.3
Employees (thousands)	n/a	824.2	903.5	810.2	839.4	832.3	851.5	850.5	1004.2	1051.7	1044.2
Employees as % of employment in Canada	n/a	7.5	7.0	6.2	6.3	6.2	6.2	6.0	6.9	7.1	6.9

Sources: BEA, Statistics Canada. Data for 2001 is preliminary.

11 A majority-owned Canadian affiliate of a U.S. corporation is an affiliate operating in Canada and for which the combined ownership of all U.S. parents exceeds 50 percent.

12 Gross product, rather than sales or other measures, is generally preferred in assessing the impact of affiliates on a host economy or industry, because it measures only the affiliate's own production, whereas sales do not distinguish between internal production and production originating elsewhere. In addition, gross product measures the value added to the economy during a specific period, whereas some sales in a given period may represent production in an earlier period.

cates that the economy was slightly less dependent on majority-owned affiliates of U.S. corporations in 2000 than it was at the beginning of the 1980s. Because critical commentators usually fingered the U.S. as the prime suspect in the touted disappearance of corporate Canada, those are relevant findings.

Canada as a Destination of Choice for Foreign Investors

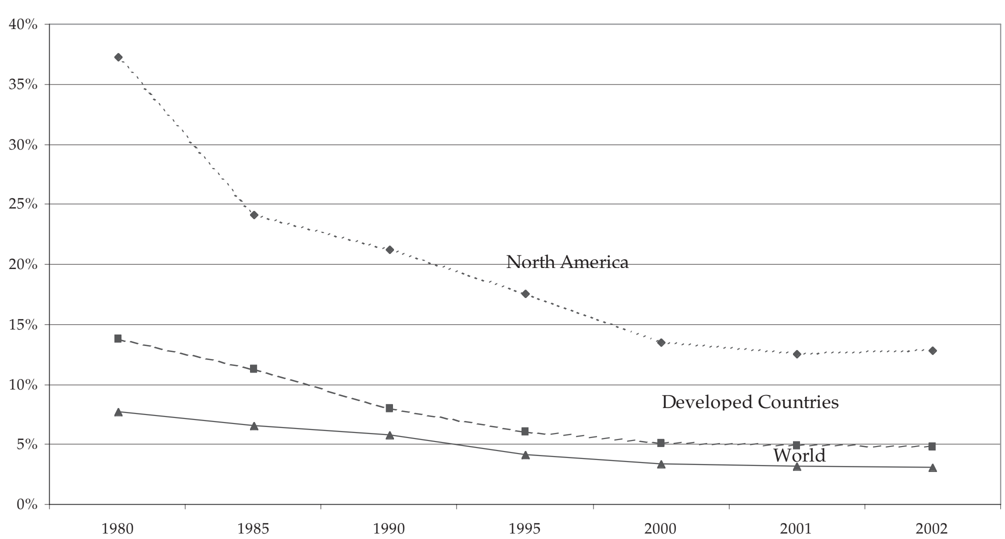
While the share of the world's stock of FDI located in Canada and the United States remained stable for the past two decades at about 20 percent, Canada's share of the North American stock of FDI has long been on a downward trend. In 1980, Canada was home to close to 40 percent of all the stock of FDI in North America. In 2002, this proportion was down to 13 percent (Figure 3). The same trend is apparent if we look at Canada's share of developed countries' total stock of FDI, or its share of world FDI. In terms of flows, foreign direct investment in Canada for 2003 was the lowest in 10 years at just $8.3 billion. For the last two quarters of 2003, foreign investors actually withdrew funds from Canada. While the amounts were low, a net withdrawal was last seen in the early 1990s.

These observations signal a deterioration in Canada's relative attractiveness as a destination for new investments, a critical issue that has not received enough attention and to which we return in a later policy section. We now turn to a brief review of the literature on the economic effects of inward FDI, with a particular focus on Canada.

The Benefits and Costs of FDI — Theory and Evidence

FDI implies an inflow of funds into Canada with a positive entry in the capital account when it occurs. If this investment is successful, it later generates outflows in the form of interest, royalties and dividends to foreigners. The two primary benefits of foreign investment are:

Figure 3: *Stock of FDI in Canada as a Share of North American/Developed/World Stock of FDI*



Source: UNCTAD

- More total investment than could be possible if all investment had to be financed by domestic savings, and more capital for the operation of business enterprises with the associated jobs and income for Canadians;
- A higher rate of growth due to a more rapid rise in the capital available for each worker.

Among the alleged costs are:

- Profits earned by foreigners rather than domestic capitalists;
- Loss of control over the economy or over specific sectors like resource development, and
- Difficulty for some sectors, companies or individuals in adjusting to new competitive pressures.

The Benefits of Inward FDI

The ability of a country like Canada to use foreign capital to finance its economic base and achieve faster growth and higher living standards than would be possible if it relied solely on domestic savings is the overarching reason why most economists agree that FDI is beneficial to a host country. Specifically, empirical research in economics has shown that:

- FDI does not crowd out domestic investment on a one-for-one basis; instead, it adds to the stock of capital and generates increased output (Ries, 2002). A recent study found that overall, and regardless of the source, a dollar of additional FDI increases domestic capital formation in Canada by about 45 cents (Hejazi and Pauly, 2002).
- Canadian-based subsidiaries of foreign multinationals are much more trade oriented than their domestic counterparts. The ratios both of imports to sales and of exports to sales are higher for foreign subsidiaries compared to domestic companies, so much so that the relatively compact group of subsidiaries is responsible for a little more than half of Canada's total imports and a little less than half of total exports (Cameron, 1998). With respect to inter-corporate trade, evidence indicates that nearly two-thirds of imports by foreign-controlled multinationals in Canada are intra-company imports. Hejazi and Safarian (1999) confirm this complementary relationship between FDI and imports. Using a model to examine the link between trade and FDI, they find that FDI stimulates imports.

Multinational enterprises active in Canada are not, on the whole, operating subsidiaries where scientific development capabilities are truncated — at least not in comparison to domestically owned companies. Far from being passively dependent on R&D from their parents, foreign-owned firms in Canada are more active in R&D than Canadian-owned companies. They are also more involved in R&D collaboration projects, both abroad and in Canada. They are just as likely to develop links into a local university and other local innovation undertakings as are domestically owned entities. Foreign-owned companies do indeed make a significant contribution to technological progress and innovation in Canadian industry (Baldwin and Hanel, 2000). After controlling for size and industry, large foreign-owned companies have higher R&D intensity (R&D expenditures as a proportion of sales) than Canadian-owned firms (Holbrook and Squires, 1996). The story may not be the same across all industries, however. Concentrating on the manufacturing sector, which has one of the highest shares of foreign ownership, and using data from 1985 to 1994, Rao and Tang (2001) find that foreign-controlled firms spend significantly less on R&D than Canadian-controlled companies, although the two groups have increased their R&D outlays at the same rate.

Foreign-owned companies also generate a number of important indirect effects, also called spillover effects, on the Canadian economy. Academics and governments have studied spillover effects extensively in recent years, often focusing specifically on Canada and using Canadian data. Among their conclusions:

- FDI acts as an important channel for the diffusion of ideas and innovation across borders. Since businesses are often able to learn new processes and product innovations from innovators, without having to pay the full, or even part of the costs of innovation, the benefits of research are not fully appropriated by the innovator. In other words, benefits from R&D cannot be completely appropriated; there are spillovers that create a wedge between the rate of return to the company undertaking it and the total rate of return to all firms in the economy (Bernstein, 1991). As a result, Canadian-controlled companies benefit from the R&D carried out or imported by foreign-controlled firms.
- Foreign-controlled companies tend to be more productive than those that are Canadian-controlled, a finding that does not hinge on industry composition effects and that is consistent with what is found in other countries.[13] For example, a recent study looking at Canadian manufacturing companies found that, on average, Canadian-controlled entities were 25 percent less productive than those that were foreign-controlled during the 1985-to-1988 period, though the gap narrowed to 16 percent in the 1989-to-1995 timeframe (Rao and Tang, 2002). These findings confirm those of earlier studies, such as the one by Covari and Wisner (1993), which found higher average productivity of foreign affiliates compared to Canadian-owned manufacturing companies. The higher productivity of foreign (mainly U.S.)-controlled companies provides an incentive for domestically owned firms to achieve comparable levels of output per worker.

- Foreign takeovers of Canadian companies tend to benefit the stockholders of the target firms. A study of large Canadian corporations that non-Canadians acquired in the middle of the 1980s found positive long-term effects on the acquired entity: They tend to increase their capital investments, R&D spending and productivity and gain larger market shares and better economic performance after the takeovers (McDougall, 1995). Again,

13 Globerman, Ries and Vertinski (1994) also conclude that foreign-controlled establishments in Canada enjoy higher value-added per worker than their Canadian-owned counterparts, but attribute this finding to the fact that they tend to be relatively capital intensive and large.

> setting aside a potential loss of executives and head office functions, these findings illustrate that takeovers do not necessarily lead to net losses for the Canadian economy.

Other potential spillover effects on host-country companies arising from the presence of multinationals are numerous. Multinationals may reduce concentration of ownership and increase the degree of competition, forcing domestic companies to become more efficient; they may upgrade labour and management skills, which will subsequently benefit other corporations, and they can stimulate improvements in standards of quality and reliability by local component suppliers, as well as by local companies purchasing the products they introduce into the market (Blomström, 1991). FDI may also introduce new management approaches and corporate governance arrangements into the host country.[14] Evidence suggests that these spillovers from FDI reduce production costs and increase productivity in most Canadian industries (Gera, Gu and Lee, 1999).

It All Adds Up

How do all these direct and indirect economic effects translate into the net profit of economic growth and jobs? In a 1996 joint report for Industry Canada and the Department of Foreign Affairs and International Trade, Preston and Saiyed (1996) used the WEFA Canada Macro Economic Model to show how the direct effects of FDI are amplified through the responses from the trade and domestic investment sectors of the economy and through the positive influence of foreign investment on productivity. Although limited to an analysis that treats FDI as a one-time event, the authors' effort to integrate the different influences of FDI on a host economy led to the conclusion that additional FDI results in a substantial increase in economic growth at the margin and a significant number of new jobs. They estimated that $1 billion in foreign investment increases GDP by $4.5 billion and results in 45,000 jobs by the fifth year.

The Alleged Costs of Inward FDI

With the increase in FDI, direct investment income[15] accruing to foreigners has increased significantly in the past decade, rising to over $20 billion in each of the past five years from $2.5 billion in 1992. These payments represent interest and profits on capital invested by foreigners in Canada.

14 An industry-specific example is given in Teece (1991).

15 Direct investment income is defined as income (on equity and on debt) accruing to a direct investor resident in one economy from the ownership of direct investment capital in an enterprise in another economy. Income on equity includes (i) distributed income (dividends and distributed branch profits) and, (ii) reinvested earnings and undistributed branch profits. Income on debt consists of interest payable – on inter-company debt – to or from direct investors from or to associated enterprises abroad.

Loss of Profits to Foreigners

Insofar as the industries that receive FDI are competitive, FDI income provides a return on capital just sufficient to attract more of it from international markets.[16] Canadians in this case do not lose any profits that are more than the return just needed to compensate investors, unless the business has access to a special technology (like Nortel) or location (like a company with an oil deposit), but those would be reflected in the price of acquiring the Canadian company. Only if foreign companies earn returns in excess of what is needed to attract investments do foreigners derive income that is compensation to other factors of production, such as entrepreneurship.

Loss of Control over Industry

All industries in Canada are subject to Canadian law. Canada can, for example, regulate the rate of resource extraction in oil and gas and impose regulations equally on all Canadian- and foreign-owned companies in the country. Multinational firms, however, can pose a problem called extraterritoriality, or the extension of the laws of the country where the multinational is owned to activities of that entity in other nations. The usual international practice is for host countries to enforce the principle of national treatment, under which incoming multinationals are governed by the host country's laws. Although some nations have at times championed the principle of extraterritoriality by trying to make their multinationals operating abroad follow home country rules (an example would be the U.S. trying to prohibit subsidiaries of U.S. companies from trading with Cuba), the most practical response is to use diplomatic measures to limit its application rather than restricting FDI. The principle of national treatment provides sound protection for MNEs by preventing host countries from discriminating by applying tougher laws to foreign-owned than to domestically owned firms. Therefore, no reason is apparent why foreign investment should limit Canada's ability to control its economy and its environment as it wishes (Lipsey, Purvis and Steiner, 1991).

Short-term Adjustments

Still, it is possible to identify certain drawbacks to FDI. For example, some domestic companies might find themselves unable to compete or respond to the productivity and technological advantages of foreign entities, leading to a reduction in market share, profit and employment. Even if new foreign investment is beneficial in the long run for an economy as a whole, the benefits might come at the cost of short-term pain for certain companies or sectors of the economy as they struggle to adjust to new competitive pressures. For example, there is some international evidence that FDI increases the demand for relatively skilled labour in the domes-

16 In oligopolistic industries, however, profits can persist well into the long run, and company owners may make more than the normal return on capital. If so, ownership matters. Whether or not MNEs operating in Canada capture abnormal profits that would otherwise accrue to Canadians is an open question.

tic economy and contributes to wage inequality (Driffield and Taylor, 2000). It is early to judge the long-term impact of these newly identified effects, however. If the supply response to such incentives is for individuals to specialize and acquire more education, for example, it may be an advantage.

News stories and catchy headlines often focus on very large M&A transactions or on the very latest figure on foreign ownership. They are quick to emphasize layoffs or other immediate negative short-term effects associated with the news. In doing so, they tend not to see the forest for the trees and cumulatively create the perception that foreign investment causes harm to average Canadians. While some of the positive research findings described in this paper are partial and tentative, and others point to possible drawbacks, the evidence overall points strongly towards beneficial economic effects of FDI and illustrate the need for a policy framework that encourages it.

Canada Does It Too

Canadian direct investment abroad (CDIA), refers to investments by Canadian investors in foreign business enterprises in which the investors have an ownership of at least 10 percent of the voting equity.

CDIA has been increasing since the beginning of the 1980s, and at a much faster rate than inward FDI, going from a share of 2.8 percent of Canadian business assets to close to 7 percent in the last two decades (Figure 1). While in 1983 the stock of CDIA was only slightly over half the stock of domestic FDI, by 2002 it was 25 percent higher, at $432 billion. Then, CDIA as a proportion of Canadian business assets fell in 2003 for the first time in more than 10 years, although much of the decline is nominal rather than real and reflects the substantial appreciation of the Canadian dollar against its U.S. counterpart in that year.[17] At the end of 2003, the stock of CDIA was $400 billion.

Canada is now a net exporter of capital as opposed to an importer, reversing the history of several centuries. This has important implications for policy analysis.

The two primary destinations for CDIA are the United States and Britain. Other top 10 destinations for CDIA include Barbados, Bermuda and the Cayman Islands. Each of these three small countries housed more CDIA in 2003 than did Japan or Germany. CDIA is recorded at its first destination and not at ultimate locations, however, and much of Canadian investment recorded for those countries is transient and will eventually be invested somewhere else. Tax considerations obviously have much to do with this situation.

Some CDIA Appears To Be Tax-Driven

Between 1993 and 2003, CDIA in the United States and Britain almost tripled in real terms. By contrast, during the same period, CDIA *more than tripled* in Ireland,

17 FDI stocks are recorded at historical costs and, for the outward stock, at historical exchange rates. Much of the decline in the stock of outward investment recorded in 2003 is therefore due to the substantial appreciation of the Canadian dollar against the U.S. currency in that year. Also, since the inward stock is older (at lower prices) than the outward stock, the latest figures may overstate the difference between the real value of the outward stock compared to the inward stock.

Switzerland, Barbados, Bermuda, the Bahamas and, especially, in the Cayman Islands, where it increased 38-fold (Table 4). In many situations, countries have been able to attract capital investment because they have low or no corporate income taxes, no withholding taxes and rules that facilitate business investment in services, especially in finance and insurance. Canadian companies are able to invest in foreign countries, even high-tax countries such as Germany, on a tax-efficient basis by indirectly financing the investment through third countries like Barbados, the Netherlands and Ireland. Indirect financing structures enable companies to be more competitive with a lower cost of capital because a multinational can sell foreign subsidiaries without triggering capital gains taxes paid in Canada, as well as attracting more than one deduction for interest and service costs for tax purposes at home and abroad for a single investment (Mintz, 2004).

Canadian multinationals, however, are not the only ones that can take advantage of the dysfunctional meshing of international corporate tax systems. Many multinationals, whatever their residence, are able to reduce taxes by shifting income into low-tax jurisdictions and taking advantage of the tax-efficiency related to financing, leasing and insurance decisions. The five countries with the greatest

Table 4: *Top Destinations for Canadian Direct Investment Abroad (CDIA)*

Country	1993	1998	2003	Ratio 2003/1993
		Billions of $2003		*Ratio*
United States	80.0	148.7	164.9	2.1
United Kingdom	15.3	27.8	40.7	2.7
Barbados	5.8	18.8	24.7	4.3
Ireland	3.0	10.1	18.2	6.0
France	2.1	4.3	11.6	5.5
Bermuda	2.7	6.3	10.8	4.0
Netherlands	2.2	7.3	10.7	4.7
Cayman Islands	0.3	1.1	10.6	37.6
Japan	3.4	3.6	9.1	2.7
Bahamas	2.7	6.2	8.8	3.3
Germany	2.1	4.6	7.8	3.7
Australia	2.9	4.2	7.8	2.6
Brazil	2.4	4.4	7.6	3.2
Chile	1.4	5.4	5.9	4.1
Indonesia	1.1	2.3	5.5	5.2
Argentina	0.5	3.3	5.2	10.5
Switzerland	1.3	1.9	4.0	3.1
Singapore	2.6	3.4	3.7	1.4
Belgium	2.3	2.5	3.0	1.3
Mexico	0.6	3.2	2.8	4.4

Source: Statistics Canada.

share of outbound and inbound investment to GDP from 1997 to 2001 were Belgium and Luxembourg, Hong Kong, the Netherlands, Sweden and Ireland (Table 5). In comparison, Canada's outbound and inbound FDI as a share of GDP was 9.5 percent, 17th highest among 93 countries. All, except Sweden, are well known as low-tax jurisdictions, facilitating holding-company activities for multinationals. Rules differ across countries so the practicality of certain jurisdictions being favourite locations for direct investment will vary across countries. Barbados is a favourite jurisdiction for Canadian companies because a Barbados-Canada tax treaty enables companies to achieve tax-efficient indirect financing structures. Barbados, however, is not the only jurisdiction that facilitates tax-efficient financing of Canadian multinational investments.

Mergers and Acquisitions

We described patterns in the sales and acquisitions of existing CDIA interests and in the slightly more precise category of mergers and acquisitions in the first part of

Table 5: *Foreign Direct Investment Inflows and Outflows as a Percentage of GDP For Major Countries, 1997-2001 Averages*

Country	FDI Outflows	FDI Inflow	Sum of Inflow and Outflows
		% of GDP	
Belgium-Luxembourg	35.8	35.7	71.5
Hong Kong	19.7	20.9	40.6
Netherlands	11.9	10.5	22.5
Sweden	8.7	10.6	19.3
Ireland	4.6	14	18.7
Denmark	7.5	8.2	15.7
United Kingdom	9.7	5.4	15.2
Singapore	5.4	9.8	15.2
Finland	10.1	5	15.1
Switzerland	9.8	4.6	14.5

Source: International Monetary Fund. From Mintz (2004).

the *Commentary*, which dealt with inward FDI (Figure 2). The statistics showed that Canadian purchases of assets abroad have cumulatively been higher than foreign purchases of Canadian assets for the 1987-to-1999 period and that this conclusion would also hold for the 1987-to-2002 period were it not for one record-setting transaction in 2000. In recent years, Canadian companies have shown a high demand for high-tech firms. Marth (2004) reports that between 1997 and 2002, Canadian acquisitions in the high-tech electrical and electronics sector amounted to as much as $54 billion, or 43 percent of the value of Canadian acquisitions of foreign companies.

The U.S. Connection

A number of Canadian corporations have affiliates operating in the U.S. and most CDIA in the United States occurs through these affiliates. According to another BEA survey, the Annual Survey of Foreign Direct Investment in the U.S., the number of majority-owned U.S. affiliates of Canadian companies operating south of the border increased slightly between 1992 and 1996, and seems to have remained stable between 1997 and 2001 (Table 6).[18] Of course, the effect of Canadian affiliates on the U.S. corporate sector is much smaller than the reverse, as represented by the smaller shares of U.S. GDP and U.S. employment attributable to Canadian-controlled affiliates. In 2001, these two shares were not far from their 1992 levels. Still, from 1996 to 2000, assets in the U.S. belonging to Canadian-controlled affili-

Table 6: *Summary Statistics for Majority-Owned Canadian Affiliates in the U.S., Selected Years*

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Number of majority-owned U.S. affiliates	1,091	1,108	1,117	1,142	1,154	842	849	843	843	838
Gross Product (billions of 2000 $US)	25.6	26.3	25.0	26.5	29.5	31.2	35.4	37.2	36.9	30.1
Gross Product as % of Canada's GDP	0.35	0.35	0.32	0.33	0.35	0.36	0.39	0.39	0.38	0.31
Total Assets (billions of 2000 $US)	191.0	198.2	194.5	227.1	266.7	306.3	400.9	397.8	420.6	358.6
Employees (thousands)	455.3	461.4	442.2	513.2	495.5	502.5	546.5	534.7	583	509.4
Employees as % of employment in U.S.	0.36	0.36	0.34	0.39	0.37	0.38	0.40	0.39	0.42	0.36

Sources: BEA, OECD. Data for 2001 is preliminary.

*Note: Starting in 1997, only affiliates that were required to report in the benchmark survey (that is, affiliates with assets, sales or net income greater than $3 million) are included in the count. However, estimates for exempt affiliates are included in other data items.

18 The number of affiliates reported for the last four years cannot be directly compared to the numbers reported for the 1992-to-1996 period, for reasons given in the notes to the table, but looking at the two sub-periods separately indicates that the number of majority-owned Canadian affiliates has probably increased slightly during the period 1992-to-2001. Also, available data do not go as far back as for the survey of U.S. investment abroad (Table 3), but Table 6 gives some summary statistics, comparable to those given in Table 3, for the 1992-to-2000 period.

ates surpassed in value assets in Canada belonging to U.S.-controlled affiliates. Preliminary data for 2001 indicate a reversal, however.

All in all, both the penetration rates of U.S.-owned affiliates in Canada and of Canadian-owned affiliates in the U.S. have been quite stable in the past decade. While the influence of neighbouring affiliates increased slightly in both economies during the 1990s, along with deeper economic integration between the two countries, the growth rate was moderate and the relative importance of Canadian affiliates of U.S. companies in the Canadian economy was less in 2001 than in the early 1980s (Table 3).

While there is a great deal of commentary about the implications of foreign investment in the Canadian economy, there is much less analysis of the possible consequences of increased Canadian direct investment abroad. Because the latter has now become proportionately greater than the former, it is important to look at the implications for the welfare of Canadians. Are Canadian companies investing abroad in response to poor opportunities at home? Is Canada losing jobs, opportunities and derived business? As illustrated in the previous section, inward FDI is generally considered beneficial to the Canadian economy. Is the same true of CDIA?

The Economic Impact of Outward FDI — Theory and Evidence

While research on the benefits and costs of outward FDI is sparser than for inward FDI, there has been increased interest from researchers in recent years. Studies generally support the view that FDI abroad is beneficial to a source economy, and particularly for a country like Canada, which requires access to foreign economies to overcome the limitations of its relatively small domestic market. This section provides a brief review of recent Canadian research on the impact of CDIA.

The Benefits of CDIA

A direct investment abroad implies an outflow of capital, with a loss in the capital account when it occurs. However, if that investment is successful, it later generates financial inflows in the form of dividends or interest. The relationship between Canadian direct investment income receipts and payments to foreigners on direct investment in Canada has become more balanced over the years. While the ratio of receipts to payments averaged .21 in the 1950s, 1960s and 1970s, it increased to .45 in the 1980s and .82 from 1990 to 2003.

In a small open economy like Canada's, the most critical role of CDIA is to facilitate access to international markets for Canadian companies, with the associated exploitation of economies of scale and specialization. Research on the economic effects of CDIA has shown that:

- The growth, productivity and profit-performance of outward-oriented Canadian companies have, on average, been superior to the performance of domestically oriented firms (Rao, Legault and Ahmad, 1994). The higher profitability of outward-oriented firms is usually attributed to their increased efficiency, which is partly due to their enhanced ability to exploit economies of scale and scope (Globerman, 1994).

- Outbound investment does not hurt trade or capital formation in Canada. CDIA is sometimes regarded as a substitute for trade — for example Feldstein (1995) argues that each dollar of foreign direct investment displaces one dollar of capital investment at home. Hejazi and Pauly (2002) empirically invalidate this claim in the case of Canada. They develop a model to measure the effect of FDI on capital formation and, using data from the years 1983 to 1995, find that on a net basis, CDIA has not had a significant impact on capital formation in Canada.
- CDIA and exports are complements rather than substitutes because foreign direct investment helps develop markets abroad for distribution of products produced at home and helps lower the cost of acquiring components that are imported (Graham, 1994 and Lipsey, 1995). This conclusion also applies to the case of Canada (Rao, Legault and Ahmad, 1994). A recent study used a gravity model to measure the link between CDIA and Canadian exports on a bilateral basis with 35 countries over the 1970-to-1996 period. CDIA was found to stimulate domestic exports (Hejazi and Safarian, 1999). Together with the conclusion that inward FDI stimulates imports, these findings imply that FDI and trade are complementary in the Canadian context.
- CDIA facilitates access to foreign skills and technologies and, just as for inward FDI, some of these gains may spill over to benefit non-affiliated domestic companies. While CDIA may also promote the transfer of Canadian technology abroad, this should not give rise to significant concerns. It is hard to estimate the extent of R&D relocation activities from Canada to a host economy, but according to their review and assessment of the evidence, both McFetridge (1994) and Globerman (1994) conclude that concern over technology transfers should not detract from the generally positive contribution of CDIA to Canadian innovation and technology access.

The Big Picture

While studies that take an all-encompassing approach to evaluating the overall benefits of Canadian investment abroad are hard to come by, one such examination estimates that CDIA made a positive contribution to real income in Canada during the 1980s (Rao, Legault and Ahmad, 1994). Overall, the evidence bearing upon the economic effects of outward FDI supports the view that it imparts net benefits to Canada over and above the benefits realized by the investors themselves (Globerman, 1994). Still, there are economic costs.

Alleged Costs to Outward FDI

Possibly the most often-heard concern about CDIA is the labour market effect and the potential loss of jobs (outsourcing).

Loss of Employment

While the decision to outsource certain activities is quite independent of ownership, there is a commonly held view that CDIA may transfer production facilities from Canada to foreign locations and reduce Canadian employment levels. As Gunderson and Verma (1994) point out, however, this argument comes back to the classic "lump of labour fallacy", according to which there are a fixed number of jobs in an economy so that investing in another country becomes the equivalent of exporting jobs. This concern rests largely on unstated premises that CDIA substitutes for exports and domestic capital formation. As shown, these premises are false.

In a long-term perspective, the employment-loss argument loses much of its force. In the long run, CDIA generates investment income, as well as contributing to exports and increased efficiency within the home economy. In fact, direct investment abroad leads to a change in the employment structure of the home country, away from low-value-added employment and toward higher-value-added work. Higher-value-added jobs reflect Canada's comparative advantage in knowledge-intensive occupations (Gunderson and Verma, 1994). Even if CDIA leads to some job losses in Canada, in one form or another, the net benefit to Canadians is still greater than not being in the foreign market at all (McFetridge, 1994). As Gunderson and Verma argue, outward FDI is properly viewed in the context of the restructuring that is needed in dynamic economies to ensure competitiveness and create jobs that are sustainable over the long-term.

Loss of Key Industries and Activities

Some industries are firmly rooted in a country because it provides natural advantages. For example, Canadian oil must be extracted in Canada and Canadian timber must be felled in Canada. Other industries, such as manufacturing and high-tech companies, are much more footloose. They can be moved to wherever the economic climate and policies are most favourable to them. The key characteristic of these industries is that they are knowledge-intensive. They also tend to generate positive spillover effects on the rest of the economy, so that keeping them at home will favourably affect the value of economic activity elsewhere in the economy. Tax policy is one important determinant for the location of those industries.

A similar issue relates to what are called key activities, which also tend to be knowledge-intensive and generate important spillovers. Examples include R&D activities and upper-management functions. The increased presence of Canadian corporations abroad invariably leads to further development of Canadian R&D abroad, either through acquisitions of technology-intensive firms or the re-allocation of some Canadian capacity abroad. The same is true of headquarters functions. The extent of these phenomena in the case of Canada is unknown, however. One reason is that comprehensive and reliable data is hard to come by. Another reason is that even if these trends were observed, policy responses would be extremely limited. Restricting the extent of CDIA abroad would certainly do more harm than good. Attempts to micro-manage and influence the location of certain activities of Canadian multinationals on the basis of the external benefits they confer would risk damaging the competitive power of the very companies Canada wants to help. The next section examines policy issues more closely.

Canada's Current Policy Stance

Since capital used for foreign investment is highly mobile, international investors are closely attuned to differences in business conditions between countries and may be more rapidly responsive to changes in relative business conditions. The policy challenge for Canada is to offer a competitive business environment to attract investment from foreigners looking to serve the North American market. Canada has good transportation and communication infrastructure as well as a top-tier education system. Many other developed countries have similarly good public infrastructure and education systems, however. Where countries differ more is with respect to regulatory and tax structures.

Regulatory Environments — Openness to Trade and FDI

Among OECD countries, Canada ranks as relatively open to trade, according to such indicators as the import coverage of non-tariff barriers and import-weighted manufacturing tariff rates. This reflects the country's relatively high degree of trade liberalization with the United States, its biggest trading partner (Nicoletti et al., 2003).

Formal international agreements on FDI have been far less extensive than on international trade, however, and barriers remain relatively high. Canadian governments regulate foreign investment through two broad frameworks: the Investment Canada Act and foreign ownership restrictions.

Investment Canada Act

The establishment and acquisition of Canadian businesses by non-Canadians is regulated at the federal level under the Investment Canada Act. While the settlement of any new Canadian businesses and most acquisitions of existing Canadian businesses by non-Canadians are subject only to a notification procedure under the Act, some investments are subject to full review and require approval prior to completion of the acquisition. In order for a reviewable transaction to be approved by the Investment Review Division of Industry Canada, it must result in a net benefit to Canada. The Act sets out a number of factors to be considered in determining whether the proposed investment meets this net-benefit test.

Since the passage of the Act in 1985, no investment in Canada by a non-resident has been rejected under the review process, but in several instances applicants have accepted recommended structural changes. It is therefore difficult to establish the degree to which the screening process, and the potential denial of an investment, constitutes a deterrent to foreign investors.[19]

Foreign Ownership Restrictions

Various federal and provincial statutes place restrictions on foreign ownership in specific industries.[20] Under the federal Bank Act, no individual investor may hold

19 See Globerman (1991) for an evaluation in the context of high technology firms.

20 Globerman (1999) evaluates the effects and desirability of foreign ownership restrictions in Canada.

more than 10 percent of the shares of a bank listed in Schedule 1 and the aggregate holdings of non-residents and their associates may not exceed 25 percent of all shares. A similar rule applies to federally incorporated trust companies and loan companies under the Trust and Loan Companies Act. The federal Broadcasting Act provides that broadcasting licenses may not be issued to non-Canadians or to companies that are effectively owned or controlled, directly or indirectly, by non-Canadians. The federal Telecommunications Act restricts foreign ownership to 20 percent of the shares of a telecommunications common carrier. The Insurance Companies Act limits foreign ownership in an existing Canadian-owned life insurance company to 25 percent in the aggregate, and 10 percent for any individual non-resident; provincial legislation also places restrictions on foreign investment in the insurance industry. Non-resident ownership of certain types of land is restricted in many provinces. Some industries are dominated by Crown corporations, restricting both private domestic and international foreign ownership. Other industries where foreign investment is currently affected by federal or provincial regulation include oil and gas, farming, book publishing and selling, aviation, fisheries, liquor sales, mining, mass media, collection agencies, engineering, optometry, pharmacies, and securities dealers.

Just How Important Are Regulations?

To quantify the relative importance across countries of regulations affecting foreign investment, the OECD has assembled a new set of indicators.[21] According to these measures, worldwide liberalization of FDI flows has been substantial over the past two decades. Still, under the broad total-economy FDI restrictions index, Canada ranked among the most restrictive countries with respect to foreign investment in 2000, second only to Iceland among OECD countries. From 0 to 1 (less restrictive to most restrictive) Canada received a 0.352 score, twice the OECD average of 0.175.

Since most foreign investment in North America is intended to serve the North American market, a more important comparison would focus on Canada's North American partners, and especially the United States. Such a comparison is given in Table 7.

One problem with the way the restriction index is computed for Canada, however, is that it adds 0.2 to the value of the index for each sector in which new investments must pass a screening test to prove economic benefits to the host country. Since all new investments in Canada, depending on their dollar value, may potentially have to undergo review under the Investment Canada Act, all the

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21 The indicators are described in Golub (2003). They focus on restrictions that discriminate against foreign firms in the form of limitations on national treatment or most favoured nation, and ignore domestic limitations on market access that affect domestic and foreign firms equally. The indicators take into account foreign ownership limits, screening/approval/notification requirements for new foreign investment, restrictions on the composition of boards of directors/managers, restrictions on the movement of people and other operational restrictions, such as limits on the foreign content of business components. They ignore incentives given to foreign investors, such as tax holidays or business subsidies. Restrictions are examined by sector and are aggregated with a combination of import and FDI weights to produce the total score.

Table 7: *Indexes of FDI Restrictions 1998/2000*

Industry / Country	Canada	Canada No Screening	U.S.	Mexico	OECD Average
Business Services	0.23	0.03	0.05	*0.34*	*0.13*
Telecommunications	0.53	0.33	0.40	0.40	0.37
Fixed	0.63	0.43	0.35	0.43	0.42
Mobile	0.23	0.03	0.55	0.33	0.23
Construction	0.23	0.03	0.05	0.33	0.10
Distribution	0.23	0.03	0.05	0.24	0.15
Finance	0.51	0.31	0.15	0.33	0.18
Insurance	0.28	0.08	0.15	0.33	0.19
Banking	0.58	0.38	0.15	0.33	0.18
Hotels and Restaurants	0.23	0.03	0.05	0.38	1.10
Transports	0.59	0.39	0.54	0.48	0.33
Air	0.63	0.43	0.55	0.50	0.39
Maritime	0.38	0.18	0.65	0.53	0.33
Road	1.00	0.80	0.28	0.37	0.23
Electricity	0.73	0.53	0.50	1.00	0.77
Manufacturing	0.23	0.03	0.05	0.03	0.09
TOTAL	0.35	0.15	0.17	0.27	0.18

Source: Adapted from Table 3 in Golub (2003).

indexes include the 0.2 score. This likely overestimates the restrictive effect of the Act because there are fairly high thresholds under which new investments are not subject to review, and no investment that has been subject to review has ever been turned down by the review division. To remove this component of the score, we subtract 0.2 from the raw Canadian scores given in the first column and show the results in the second column of Table 7.

Removing the Investment Canada Act shows restriction indexes that are more in line with those of the United States and with OECD averages. The generally high indexes in the electricity sector across countries reflect the presence of state-owned monopolies, which by their nature preclude foreign ownership. In other sectors, such as fixed telecommunications, banking and transportation, Canada's relatively high indexes reflect the foreign ownership limits described earlier. However, in other sectors like business services, construction, distribution and manufacturing, there are basically no restrictions on foreign investment. The indexes are not zero because Canada imposes licensing requirements for members of boards of directors, a restriction of small quantitative impact.

Looking at the adjusted FDI restriction measures, it would appear that except for sectors in which Canada imposes stringent foreign ownership limits, such as fixed telecommunications,[22] air transportation and banking, Canada is not at a significant regulatory disadvantage compared to other OECD countries and, more importantly, compared to the United States. To explain Canada's diminishing relative attractiveness as a destination for new foreign investment, it is essential to go beyond the effects of investment regulations alone.

Trade Restrictions as Investment Barriers

Because trade and FDI are complementary activities that multinational enterprises use to expand their supply chains across national borders, trade restrictions also influence Canada's appeal as a location for foreign investment. Even following the Canada-U.S. Free Trade Agreement (CUSFTA) and the North American Free Trade Agreement (NAFTA), both of which reduced tariff barriers, there remain many regulations related to the administration of the Canada-U.S. border that may act as investment deterrents. For example, while NAFTA eliminated some tariffs, it introduced new border barriers in the form of rules of origin requirements, considered by some commentators to be the most restrictive in the world. In addition, since the Islamic terrorist attacks of September 11, 2001, numerous new security requirements have been implemented. For international investors looking to serve the U.S. market, those can be avoided by investing directly in that country. While relatively recent trade and security restrictions cannot explain the long-term decline in the Canadian share of North American FDI that began more than 20 years ago, they may be responsible today for some of the reluctance of foreign investors to increase their stake in the Canadian economy. In any case, this points to the need to consider North American perimeter approaches to customs and security.[23]

Tax Competitiveness

Although Canada has been reducing corporate taxes in the past four years, it still retains one of the highest corporate tax regimes in the world. Canada's general corporate income tax rate, now 35 percent, is the fifth highest among industrialized countries, following Germany (39 percent), Italy (36 percent), Japan (41 percent) and the United States (40 percent).[24] The average OECD corporate income tax rate is now approximately 30 percent. Moreover, Canada provides less valuable deductions for capital costs (depreciation and inventory expenditures) compared to many other countries, including Germany and the U.S. Finally, other corporate levies, such as capital taxes and sales taxes on capital components, are higher than elsewhere.

Chen and Mintz (2003) compare nine OECD countries and find that Canada's effective corporate tax rate in 2001 was higher than those of other countries except

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22 Restrictions on foreign ownership in the telecommunications sector are currently under government review.

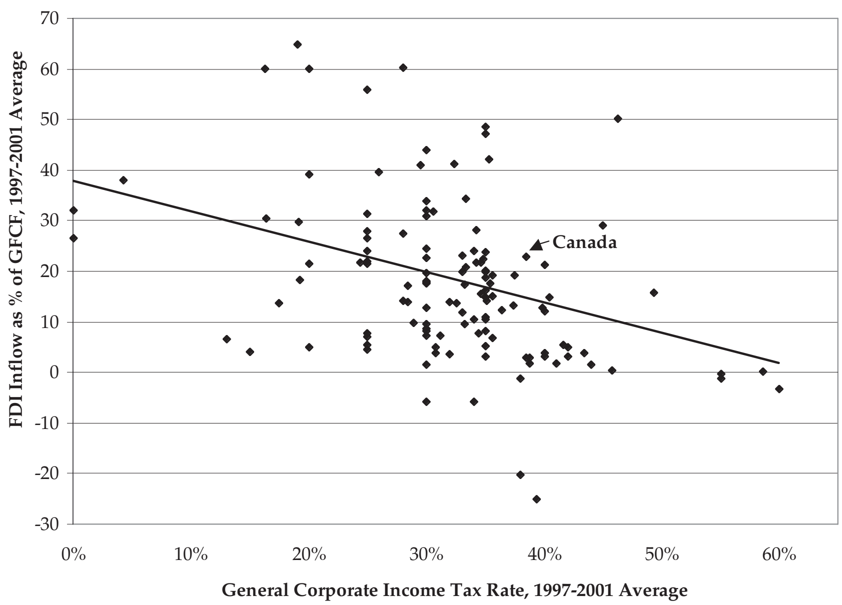
23 See Goldfarb (2003, 2004) and Goldfarb and Robson (2003).

24 KPMG (2004) and Chen and Mintz (2003).

for Germany.[25] These estimates include corporate income taxes, capital taxes and sales taxes on capital component purchases. Recent OECD estimates of effective tax rates on inward FDI[26] in manufacturing using only corporate income taxes also placed Canada as one of the most punitive host countries for inward FDI in 2001. Since 1991, not only have estimates of Canada's effective tax rates been higher than OECD averages, but the gaps have increased significantly.

In a world of increasing capital mobility, where investment decisions are sensitive to relative tax burdens, Canada's tax regime certainly does not help in attracting foreign investment. Indeed, there is evidence of a negative correlation between corporate tax rates and the amount of FDI a country receives. Although other factors, such as the size of the market, the cost of labour and infrastructure, are important in explaining the location of investment, taxes also have a significant influence. A simple correlation between the general corporate income tax rate and the inflow of FDI for a large sample of countries shows a significant negative relationship (Figure 4). The correlation shown in this figure implies that every one percentage point fall in Canada's statutory corporate income tax rate would boost the inflow of FDI into the country by $1.2 billion a year.

Figure 4: *General Corporate Income Tax Rates and Inward FDI as a Percentage of Gross Fixed Fixed Capital formation (GFCF) for 126 Countries**



*One outlier does not appear on the graph.

Sources: UNCTAD, authors' calculations

25 See also Chen and Mintz (2002), who find that Canada has one of the highest marginal effective tax rates on entrepreneurial investments.

26 Yoo (2003). An effective tax rate on inward FDI refers to the amount of the tax paid by businesses as a percentage of the income they earn from investments. The effective marginal rate applies to a marginal investment that earns a rate of return on capital just sufficient to attract investor financing, while the effective average tax rate applies to an infra-marginal investment that earns some economic rent, based on 20 percent rate of return on capital, gross of tax, (on a risk-adjusted basis, however, the economic rent would likely be overstated).

More sophisticated multivariate analyses prompt the same general conclusion. One recent study analyzes bilateral FDI flows across 11 OECD countries for the 1984-to-2000 period and, after controlling for country size, distance and market potential for each country-pair, finds that relatively high corporate taxation discourages FDI inflows (Bénassy-Quéré et al., 2003). The most comprehensive study to date found that each percentage point increase in the corporate tax rate causes the stock of FDI to fall by 3.3 percent.[27] For example, the current stock of FDI in Canada is $360 billion — an increase in the effective tax rate by one percentage point would cause the stock of FDI to decline by $11.9 billion, a figure consistent with the estimate mentioned previously with respect to the impact of corporate tax rate cuts on FDI flows (assuming capital depreciates at a rate of 10 percent).

Policy Directions — Creating a Business Environment Conductive to FDI

Because Canada's share of worldwide FDI is declining, it should seek to review and adjust its regulatory and tax policies to attract more productivity-enhancing capital investments. Specific issues include:

Sector-specific foreign investment restrictions. Although Canadian foreign investment restrictions are high in the fixed telecommunications, financial services, air and road transportation and some culturally sensitive sectors, many other countries also tend to erect barriers in these sectors. Still, Canada should examine the degree to which these restrictions are necessary. For example, many analysts argue for a merger in banking only if foreign entry is eased. Canadian restrictions on foreign ownership in the telecommunications sector are currently under government review. Easing regulations in the air transportation sector has also come back on the Canada-U.S. agenda recently.[28] These regulations require close examination.

Investment Canada Act. The *Investment Canada Act* is largely ineffective — most, if not all, investments are approved as a matter of course. Because businesses must comply with these regulations and governments incur the expense of administrating them, there is little justification for the continuation of the review process.

Trade liberalization. Additional progress on trade liberalization would help attract foreign capital to Canada by reducing the remaining disincentives and costs associated with moving goods to the U.S. Robson (2004 forthcoming) discusses several possible avenues that have been examined extensively and that seem to attract a consensus among experts. Such avenues include reducing remaining tariff barriers, unifying Canada-U.S. tariffs and rules of origin requirements, minimizing security impediments at the border, developing harmonized and mutually recognized standards among trading partners and including investor-state provisions in future trade agreements. Most of these policy developments cannot be realized

27 See de Mooij and Ederveen (2003); they provide a comprehensive analysis of 25 studies on taxation and foreign direct investment.

28 See Lazar (2003); he recommends increasing the foreign ownership limits in the airline industry to 49 percent immediately and eliminating the limit of 15 percent ownership of Air Canada by any individual or group of related individuals.

without international cooperation, however, and obtaining such cooperation is often fraught with political difficulties.

Corporate taxation. Tax policy stands out as an area where Canada could make significant strides in attracting foreign investment. As noted, Canada's corporate tax regime compares unfavourably with that of most other OECD countries and more importantly with that of the United States, its main competitor in attracting foreign investment destined to serve the North American market. It is time for Canada to create a policy advantage with an internationally competitive business tax structure. Compared to foreign investment regulatory changes, lowering the corporate tax burden has the added advantage that it would favour domestic business investment as much as it would favour foreign investment activity. Chen and Mintz (2003a, 2003b, 2004) show how further business tax cuts would encourage new investment in Canada, domestic as well as foreign.

Withholding taxes. Another important barrier to capital flows into Canada is the withholding tax on payments made to non-residents. Currently, such payments are subject to a federal tax rate of 25 percent, reduced according to treaty arrangements — the typical tax rate for major treaty partners is 15 percent for portfolio dividends, 5 percent for direct dividends paid to owners with at least 10 percent ownership of a Canadian company, 10 percent on interest (all non-arm's length and arm's length interest payments related to short-term debt) and 10 percent or none on royalties. The provinces do not levy withholding taxes although Ontario partially denies a corporate tax deduction for certain payments made to non-residents in the guise of a withholding tax.

Canada's withholding tax policies are rooted in its history as a capital importer. Withholding taxes are designed to prevent an erosion of the income tax base as well as ensure that Canada derives some income that would otherwise accrue to foreign investors or, in some cases, foreign governments (some governments, such as the U.S., Japan and Britain, allow resident parents to credit Canadian taxes against their home tax liabilities owing on income repatriated from abroad). However, such withholding taxes also discourage investment in Canada. Mintz (2001) says that the elimination of withholding taxes under the Canada-U.S. treaty would increase capital investment in Canada by over $28 billion dollars.

However, as noted, Canada is no longer a capital importer but a capital exporter. Because Canada does not tax dividends paid from treaty countries, reductions in negotiated foreign withholding taxes could increase the competitiveness of Canadian companies since high withholding taxes at home encourage high withholding taxes among treaty partners. Capital exporting countries, such as those in the G-8, have negotiated reductions in withholding taxes in order to encourage greater capital flows. Most of the G-8 countries have now eliminated withholding taxes on interest and in some cases, such as Britain and the United States, withholding taxes on dividends.

The Technical Committee on Business Taxation (1998) recommended that Canada should eliminate withholding taxes on arm's length interest (interest related to indebtedness of more than five years is already exempt). Such taxes tend to increase the cost of short-term borrowing in Canada because international financial lenders are unable to credit the 10 percent withholding tax that applies to gross interest payments (margins earned on international lending are a small fraction of the transaction). In order for Canadian borrowers to attract capital, they must pay higher interest to compensate for the withholding tax. Most debt is structured to avoid payment of the tax but the effect is to bar foreign lending in short-term debt markets.

Similarly, withholding taxes on interest charged by foreign governments affect Canadian lenders in international markets. Since other major industrialized countries have eliminated both arm's length and non-arm's length interest withholding taxes under their treaty arrangements, Canadian lenders are potentially left out of the international transactions. Even for non-arm's length debt, recent changes to U.S. treaties have the potential of eroding Canadian company competitiveness in international markets. Specifically, Canadian companies operating through third countries will be denied U.S. treaty benefits, resulting in a 30 percent withholding tax on interest payments from Canadian subsidiaries operating in the U.S. to Canadian foreign entities operating in third countries. This would be a substantial U.S. tax on Canadian companies that would reduce the value of shares held by Canadians.

Canada should revise its treaty networks in the longer term to reflect its new status as a capital exporter. The current Canada-U.S. treaty negotiations that have centred on interest withholding taxes should come to a swift conclusion with the elimination of interest withholding taxes to encourage the integration of Canadian and U.S. capital markets. Dividend withholding taxes should become the next order of business.

Conclusion

The foreign takeover of corporate Canada is a myth. Stories and publications to that effect were prompted toward the end of the 1990s by unprecedented cross-border investment activity worldwide, which coincided with the stock market boom and shared with it a significant misvaluation component. When taking a longer time perspective and looking at the more recent history, however, it is clear that Canada is not selling out its corporate assets: For both the period from 1987 to 1998 and from 2001 to 2002, Canada has been a net importer of foreign direct investment. Only in the years 1999 and 2000 were net sales of Canadian interests significantly higher than net acquisitions of direct investment abroad and that was because of a handful of record-setting transactions, not a broad-based takeover of Canadian assets.

Foreign control of Canadian corporate assets is basically the same now as it was in 1988, just a little over one-fifth, reflecting the fact that Canada is a small, open economy with a lot of markets served by foreign-owned multinationals. This finding also applies to U.S. multinationals, which are not now a more significant part of the Canadian economy than they were 20 years ago.

Evidence-based Canadian and international research shows that foreign-owned companies provide substantial economic benefits to a host country like Canada. The same goes for Canadian outward-oriented firms. In fact, Canadians should worry that the country accounts for an ever-decreasing share of the stock of foreign investment located in North America, or in developed countries altogether, because it signifies that Canada's relative attractiveness as a location for new investments is waning. Except in a few specific sectors, some where regulations are now being re-assessed, Canada's regulatory structure does not seem to be a major impediment to foreign investment. The same cannot be said of Canada's corporate tax system; its effective corporate tax rates are still among the highest of the developed countries and they are particularly uncompetitive when compared to those in the United States. Withholding taxes under Canada's treaty arrangements are also relatively high for a capital exporting country. Lowering the corporate tax burden is the most readily available and effective policy that governments could follow to make Canada a more competitive environment for both domestic and foreign business investment. And we should remove, finally, the phrase "foreign investment" from the Canadian lexicon of fearsome phenomena.

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