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COMMENTARY

INTERNATIONAL ECONOMIC POLICY

Reforming the *Investment Canada Act*:

Walk More Softly, Carry a Bigger Stick

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In this issue...

Why Canada needs to replace its intrusive net benefit test for foreign investment with a conceptually broader national interest test.

The Study in Brief

The Authors of This Issue

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During the past 30 years, Canada's share of world foreign direct investment (FDI) has been subject to a secular decline. Further, according to various measures of openness to foreign investments, Canada does not rank favourably against many of its peers. One of the culprits is Canada's foreign investment review process, imposed pursuant to the *Investment Canada Act*.

Before any foreign investment over a certain threshold is approved, Canada imposes a test of its "net benefit to Canada," including such things as its potential effect on Canadian employment, exports, and productivity. The test requires the prospective foreign investor to share confidential plans with the federal government and to demonstrate how these plans would be of net benefit to Canada. As a condition of approval, investors might be obligated to make legally binding promises, or "undertakings," concerning the net benefit of the investment over a period of a few years.

The current test is highly subjective and unpredictable, and does not necessarily cover many situations where Canada's interests might be involved beyond the calculation of a "net benefit." Furthermore, the test might be detrimental to the economy's long-run growth. This *Commentary* recommends scrapping the current test and replacing it with a national interest test.

A national interest test would reverse the onus and require the federal government to show that a foreign investment was contrary to Canadian interests in order to block a particular transaction. For proposed investments with no demonstrable or likely negative public policy implications, this approach would demonstrate that the government no more intended to intervene in a private transaction involving foreigners than it would in a transaction involving Canadians in similar circumstances. Such an assurance would reduce or even eliminate obstacles to direct investment into Canada that are not related to governments' ability to apply Canadian laws and achieve legitimate public policy objectives.

By adopting a national interest test, Canada could reduce uncertainty and costs to businesses while improving transparency and accountability with respect to Canadians and foreigners alike, without compromising the federal government's ability to implement national objectives and policies. The end result would be to increase Canada's attractiveness to foreign investors, an important and beneficial feature for our country's economic future.

Foreign direct investment (FDI)[1] regularly gets bad press in Canada. Headlines such as "For sale: Corporate Canada"[2] in the mainstream media exemplify the fears Canadians collectively hold about losing control of their economy.

The notion that FDI will turn Canada into a "branch plant" economy or, worse, an economy whose raw resources are sold abroad while transformation activities atrophy at home, is a durable one. It reflects long-standing concerns in Canada and in other medium-sized resource-rich countries, such as Australia, that have relied on external capital for their development.

A dispassionate examination of the effects of FDI, however, would dispel those fears: foreign investment typically has important benefits for both the home and host countries. In fact, Canada is not even a particularly attractive destination for foreign investment, as is evident from the marked decline in Canada's share of world FDI over the past three decades or so. In that context, it is important to ask what Canada could do to make itself more attractive to foreign investors.

One barrier to FDI that foreign investors would find particularly onerous, by international standards, is Canada's current procedures and tests for proposed foreign acquisitions in this country. At the same time, Canada's FDI policy is not sufficiently clear regarding the ability of the federal government to intervene to preserve Canada's interests.

In this *Commentary*, we show that there are less obtrusive approaches to dealing with FDI-related concerns than the screening process currently in effect in Canada. An effective approach would be to modernize the *Investment Canada Act* and related policies to ensure the country is both more open and seen to be open to FDI – thus contributing to raising Canadians' standard of living – while strengthening Canada's ability to act should any investment threaten to have a deleterious effect on achieving domestic public policy objectives. In particular, we argue that the "net benefit" test used to evaluate foreign investment proposals be abandoned, and the onus placed on the federal government to establish that a proposed investment would threaten the ability of Canadian governments to (i) apply their laws and regulations to foreign investors as they would to Canadian investors in similar circumstances or (ii) achieve significant policy objectives.

Why Canada Should Welcome FDI

The argument in favour of FDI is straightforward: FDI creates international linkages that foster the central elements of long-term economic growth – technology adoption, efficiency, and productivity (see Solow 1956) – which ultimately contribute to increasing standards of living.

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1 In general terms, FDI refers to the acquisition of a long-term interest in a company whose activities are conducted in a country different from that in which the investor resides. The Organisation for Economic Co-operation and Development (OECD) provides the following formal definition: "Foreign direct investment…is a category of investment that reflects the objective of establishing a lasting interest by a resident enterprise in one economy (direct investor) in an enterprise (direct investment enterprise) that is resident in an economy other than that of the direct investor. The lasting interest implies the existence of a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the enterprise. The direct or indirect ownership of 10% or more of the voting power of an enterprise resident in one economy by an investor resident in another economy is evidence of such a relationship" (OECD 2008, 48-49).

2 "For sale: Corporate Canada," *Globe and Mail*, September 9, 2006.

FDI and Economic Growth

FDI, whether through a "greenfield" investment – the establishment of a new business – an acquisition, or a merger, encourages economies of scale and scope, as well as innovation in a company's processes, management, and use of technology. This, in turn, can and generally does make the company more globally productive and competitive (Safarian 2011). A foreign firm can also have a beneficial impact on both its suppliers and customers. Local suppliers, for instance, must adopt levels of productivity and efficiency compatible with those of the more global company, which can also mean the transfer of technology between the foreign firm and domestic suppliers. Over time, domestic workers can help disseminate these technologies by changing employers or by starting their own firms (Lall 1980). Indeed, the mere possibility of takeover – or other forms of entry by foreign competitors – can be sufficient to generate these positive benefits in domestic firms in countries that are open to FDI.

The extent of the benefits of FDI often depends on certain factors inherent to the host economy. Notably, FDI contributes to economic growth if the receiving country has an educated workforce – or, more broadly, if it has the capacity to absorb and integrate new technologies (see Borensztein, Gregorio, and Lee 1998) – and a well-developed financial market (see Alfaro et al. 2004; Azman-Saini, Law, and Ahmad 2010). These are characteristics that Canada certainly possesses. The potential benefits of a particular foreign investment can break down, however, when decisions about the investment are not motivated by the drive to create value for the firm involved or by other normal commercial considerations (Safarian 2011). On that account, a policy of openness to FDI needs to allow the motives of the foreign investor to be examined, if there are reasons to believe that it might not (i) manage its acquisition with a view to maximizing its economic contribution to the firm and to its owners or (ii) otherwise act as a responsible corporate citizen in Canada.

But even when motivated by normal commercial considerations, investors and managers can make bad decisions that negatively affect their investments – and the same holds true whether the investor is domestic or foreign. For example, mergers and acquisitions among domestic firms do not always turn out as planned or create value for shareholders or a stronger entity more generally speaking. But nobody would argue that governments could presciently predict whether or not a domestic acquisition will be a success. In a sense, negative outcomes are simply part of the trial-and-error process inherent in capitalistic systems and, in fact, they are difficult to avoid. In short, while the policy and regulatory environment in which businesses operate should seek to foster best economic and social outcomes, there are no inherent economic reasons why laws and policies should apply differently to domestically owned and foreign-owned firms in similar circumstances.

The Effect of Inward FDI in Canada

What are the characteristics of the activities of foreign multinationals in Canada? In general, according to a study for Statistics Canada, foreign-controlled firms are larger, "have a higher labour productivity, pay more per worker and have a higher percentage of their employment in white-collar workers" (Baldwin and Gellatly 2007, 7). Even when controlling for size and the type of industry in which they operate, foreign multinationals often perform better than domestically owned companies, with concomitant advantages for their Canadian customers, employees, and suppliers.

Moreover, foreign-controlled firms in all sectors tend to innovate more frequently than do Canadian-controlled firms, and are more likely to have a research and development (R&D) division. Indeed, the Statistics Canada study shows that "foreign multinationals create and eliminate fewer jobs in response to output changes than their domestic counterparts" (Baldwin and Gellatly 2007, 8), contradicting the belief of many proponents of barriers to FDI that foreign firms are more likely to "cut and run" when the economy turns sour.

Neither does it seem that Canadian head offices are being hollowed out by foreign takeovers. In particular, again to quote the Statistics Canada study, "[a]s a result of foreign takeovers, more new head offices were created than lost in the post-1999 period, and employment in head offices was as high after the takeovers as it was before" (Baldwin and Gellatly 2007, 8). At the same time, we should note that most analysts would distinguish between decision-makers and knowledge workers, on the one hand, and other types of workers, on the other, in counting head office employment, and the Statistics Canada study does not do this, which casts some doubt on its being the definitive word on the effect of inbound FDI on head office functions in Canada. It is also true that, in a few prominent cases – such as US Steel's acquisition of Stelco, which was followed by mill closures and employment losses, and Rio Tinto's acquisition of Alcan – the purchase of Canadian firms by foreign investors has led to reduced head office and other economic activity in the acquired firm.[3] In general, however, looking at factors such as wages and salaries, purchase of local services, and the extent of community involvement, there is "no solid evidence that in Canada head offices of foreign-owned firms create fewer benefits for the local economy" (Institute for Competitiveness and Prosperity 2008, 14-15).

Indeed, in a number of cases, the acquisition by foreign owners has been linked to a lack of dynamism on the part of Canadian owners (Institute for Competitiveness and Prosperity 2008, 10-14). In that light, the fact that 77 percent of FDI in Canada takes the form of mergers and acquisitions involving existing Canadian assets, as opposed to greenfield investments, is well in line with global FDI trends and should cause no special alarm or concern. While the act of acquiring a business does not by itself immediately create physical investments or jobs, it often creates a new dynamism in the entity being acquired, for example by plugging it into the global value chains that increasingly characterize the world economy.[4] To compete in this global context, Canadian firms need the unfettered ability not only to invest abroad, but also to benefit from foreign investments here.

Furthermore, while the money backing mergers and acquisitions of Canadian entities might not be used immediately for new or expanded operations, it does not disappear; it gets reinvested, at least in some instances, in new Canadian companies, or otherwise contributes to the well-being of Canadians through, for example, increasing the value of pension plans that own shares in acquired or merged companies. As well, the prospect that a business might come onto the international acquisition market is in itself a major incentive to grow the business in the first place.

In short, a policy of more openness to FDI would give Canadian companies important access to a much larger pool of potential investors by tapping into vast international capital markets. In contrast, restricting the free flow of FDI has a detrimental impact on the value of Canadian assets, which acts as a disincentive to growing those assets.

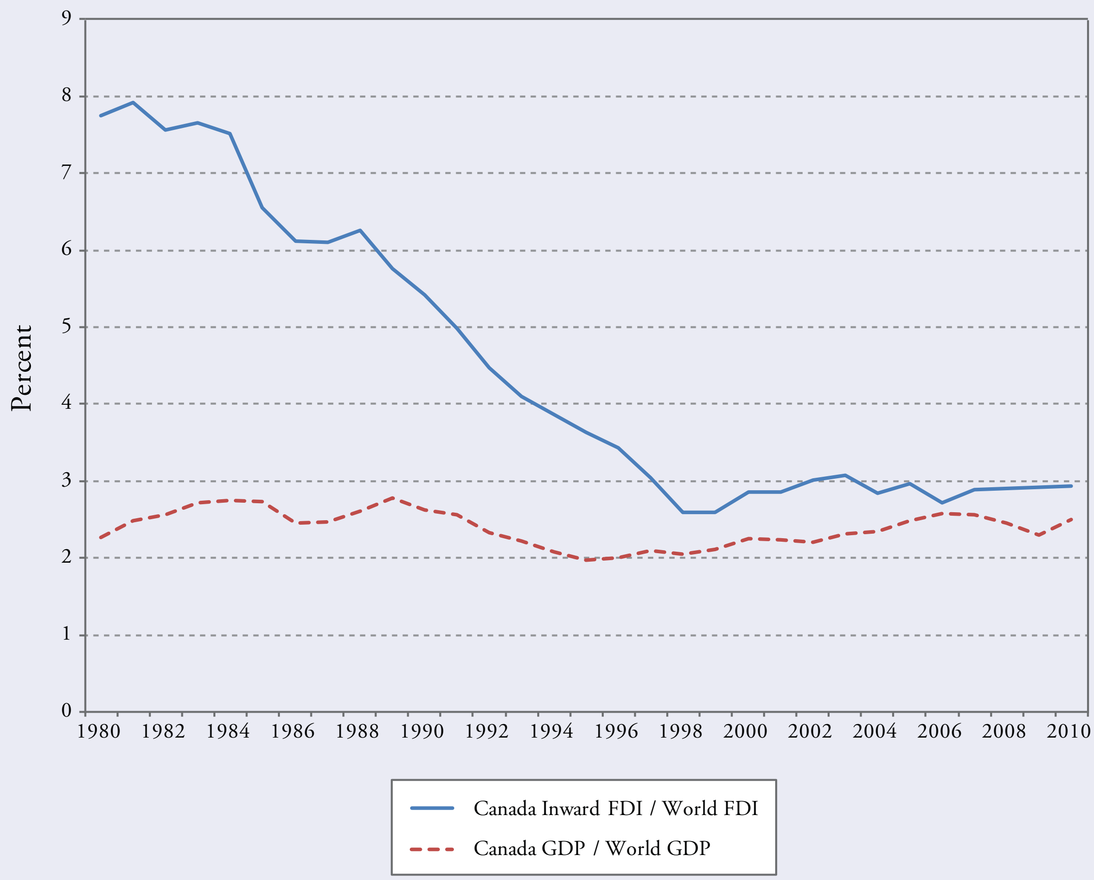
Canada's Attractiveness: A Reality Check

The stock of world FDI has been growing steadily in recent decades – except for a short period in the midst of the recent financial crisis. In 1980, the total stock of outward world FDI represented about 6 percent of world gross domestic product

3 Canadian-owned firms from time to time engage in similar behaviour to that for which foreign-owned entities are often blamed – including, in a number of cases, the transfer abroad of head office or high-value-added functions (see Brean and Schwanen, forthcoming). Accordingly, the nationality of ownership seems far less a guarantee of domestic economic well-being than an environment that encourages the location of high-value-added activities in Canada by all investors.

4 Global value chains refers to the "slicing" of production functions – for example, call centres that service many companies – whereby companies and countries increasingly specialize and integrate themselves into the world economy.

Figure 1: Stock of Canadian Inward FDI as a Percentage of World Total, 1980-2010



Sources: United Nations Conference on Trade and Development; authors' calculations.

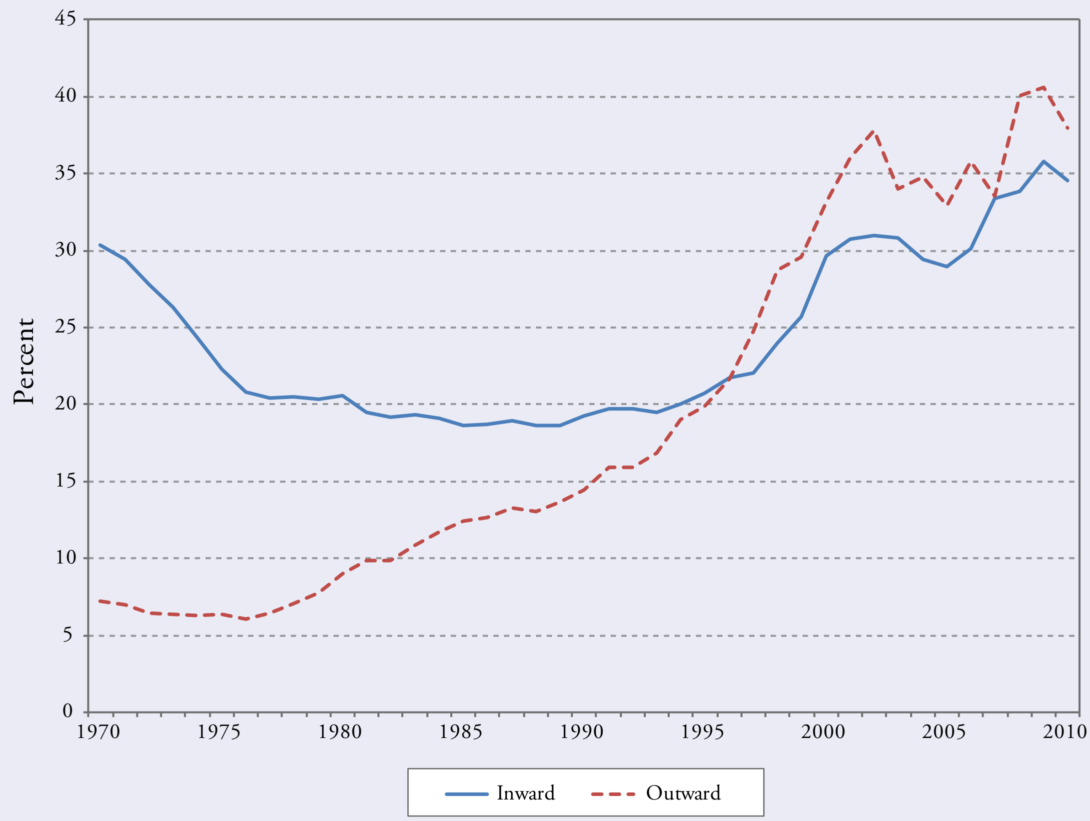
(GDP); it now stands at over 30 percent of world GDP. Yet Canada's relative attractiveness as a destination for foreign investment has been in long-term decline (see Figure 1), and Canada now attracts a share of world FDI that is about commensurate with the relative size of its economy.[5] While this is by no means a bad place to be, it is only average. In contrast, a number of developing countries – notably China and India – have dramatically increased their share of inward FDI.

Even relative to other member countries of the Organisation for Economic Co-operation and Development (OECD), Canada has experienced a decline in its share of inbound FDI. In short, the FDI pie is getting bigger but Canada is getting a much smaller share of the pie. Even the recent stabilization in Canada's share cannot be taken for granted, since it is due to a sharp increase in resource-related FDI coupled with rising but volatile commodity prices.[6]

5 The determinants of FDI are multiple and complex. The general economic environment and business climate are of primary importance, and so is the ease with which foreign investors can access a given market. But other factors, such as the levels of barriers to trade among countries, can have profound impact on FDI patterns. Part of the decline in Canada's inward FDI might be due, for example, to the introduction of the North American Free Trade Agreement, which allowed firms to operate more easily on a continental basis but lessened the need to have a Canadian affiliate.

6 In 2010, for example, 36 percent of the stock of all foreign investments in Canada was in the energy and other minerals sector, up from 18 percent ten years earlier (Statistics Canada, CANSIM Table 376-0038, and authors' calculations).

Figure 2: Stock of Canadian Inward and Outward FDI as a Percentage of Canada's GDP, 1970-2010



Sources: Statistics Canada, CANSIM database, tables 376-0037, 387-0017; and authors' calculations.

At the same time, Canada's stock of *outward* FDI has been growing – indeed, since the mid-1990s, Canadians have held a greater interest in foreign operations than have non-Canadians in companies operating in Canada (Figure 2). This is quite a reversal for the Canadian economy: for much of the twentieth century, the stock of Canadian inward FDI far outweighed the stock of Canadian outward FDI. But this story is a natural one for maturing economies; as Canadian companies gain confidence on the world stage, they expand abroad and acquire more foreign companies.

Indeed, the benefits of outward FDI can be as important as those of inward FDI. A Canadian firm, having developed some competitive advantage in the home market, can reap greater rewards from its initial investment by expanding its market abroad through FDI, including by taking advantage of the complementarity between its Canadian productive assets and those found in a foreign location. While similar benefits sometimes can be reaped by exporting from the domestic market or by selling or licensing assets to a foreign firm, internalizing these benefits often requires the firm to have a foreign presence (Dunning 1989). For these reasons, Canadian firms in goods-producing sectors and in an increasing array of services typically need to expand abroad if they are to consolidate their position in the domestic economy. This means that a more open global environment for investment is also in the interest of Canada more generally.

Canada's Approach to Foreign Investment in International Perspective

Canadians, therefore, should be wary of turning away investments that would support domestic growth. Yet Canada's current foreign investment review system places a number of unnecessary hurdles in front of FDI that investors do not face in countries that compete with Canada for investment. And these additional hurdles do not even provide either Canadians or foreign investors much clarity about what might justify the federal government's blocking a proposed foreign investment. Here, we examine these practices in international context.

The OECD ranks Canada as one of the most restrictive places in which foreigners can invest, especially among its OECD peers, but even among an average of 14 non-OECD economies, as illustrated in Figure 3. The index is based on explicit measures in place in each country, grouped by four types of restrictions: equity restrictions, screening and approval requirements, restrictions on foreign personnel, and operational restrictions – such as on the establishment of branches or the repatriation of profits (Kalinova, Palerm, and Thomsen 2010). The OECD records no overt restriction by Canada on the use of foreign key personnel, and only very few operational restrictions. On overt equity restrictions, however, Canada ranks worse than the OECD average, though still higher than countries such as Israel, South Korea, Japan, Switzerland, and the United States. While that does not make these restrictions less costly for the Canadian economy (in the sense that Canadians are not allowed to benefit from what foreign investors might be able to bring to sectors in which FDI is restricted), they are not what particularly hurts Canada's position in the OECD FDI restrictiveness ranking.

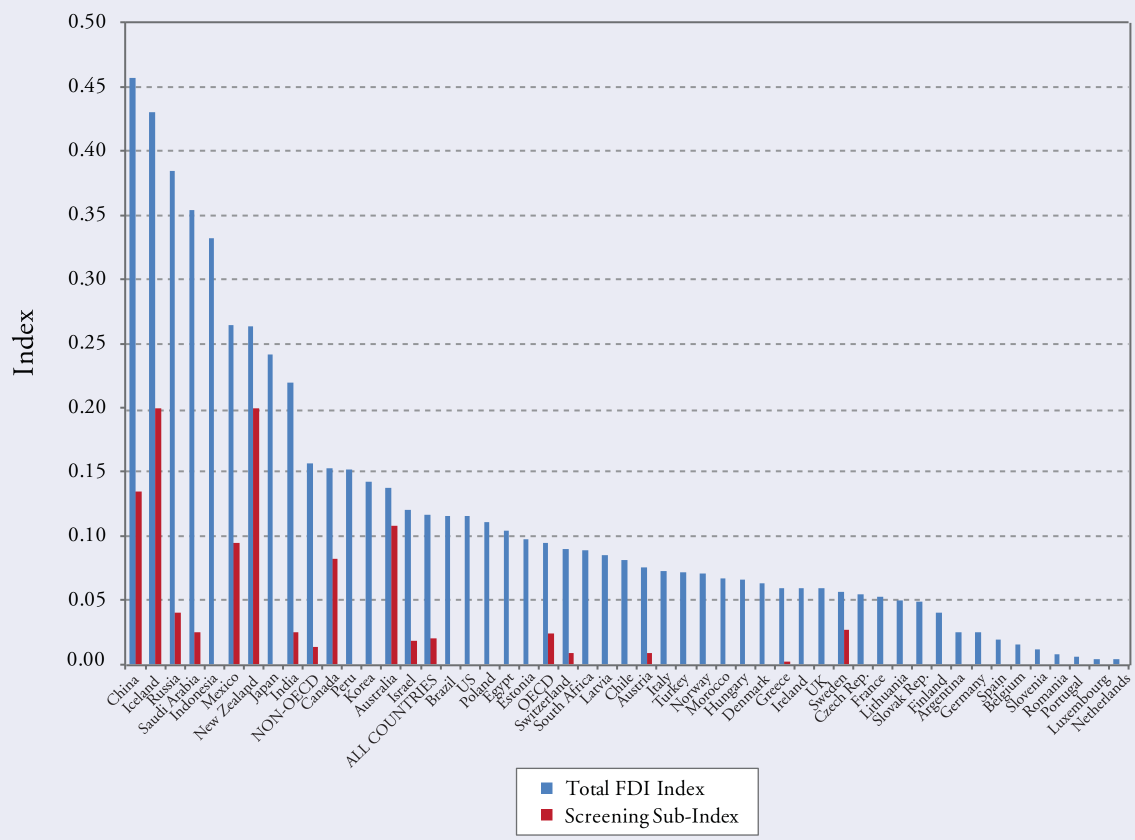
What gives Canada its bad overall mark is that it is one of only a few countries with a formal investment review or screening process for all proposed foreign investments above a certain value (or threshold); moreover, the threshold that triggers the review process is lower than in most other advanced countries that have a similarly general and compulsory screening process.[7] Indeed, of the OECD's 34 members: only Australia, New Zealand, Iceland, and Mexico scored worse than Canada on screening, and Australia has since relaxed its threshold. And only Iceland and Mexico scored worse than Canada on both screening and equity restrictions.

At the OECD, No One Can Hear You Screen

What to make of this international black eye? A number of observers have noted that the OECD FDI screening sub-index contains important flaws and, therefore, might not reflect the true extent of the screening faced by investors in Canada and elsewhere. Indeed, there are two main problems with the screening sub-index. First, it does not take into account informal barriers to foreign investments that exist in a number of countries. As the report of the Competition Policy Review Panel stated, citing Conference Board of Canada research, Canada's approach to screening FDI is "more explicit and visible than the approach adopted in many other countries that employ informal barriers." These barriers range "from state-owned enterprises and special government rights in certain companies to overt political interference in the engineering of "national champions" (Canada 2008, 30). On account of these more informal barriers elsewhere, the OECD FDI screening ranking is skewed against Canada.

7 The country thresholds used by the OECD in its 2010 rankings were those reported in the OECD Investment Committee's 2009 report updating countries' reservations to the OECD Codes and exceptions to the OECD National Treatment instrument. In its scoring, the OECD differentiates between screening thresholds of US$100 million or less, or corresponding to less than 50 percent of total equity (scored as more restrictive), and screening thresholds above that amount, or corresponding to more than 50 percent of total equity (scored as less restrictive). Countries with no formal screening process and with no formal notification process involving "discretionary elements" get a zero (perfect) score for "screening and approval."

Figure 3: OECD FDI Restrictiveness Index, 2010



Source: Kalinova, Palerm, and Thomsen (Pages 19-20).

Second, the OECD screening ranking does not take into account the more or less restrictive, arbitrary, or transparent nature of the various screening processes in countries that have them. To quote a prominent expert, "[s]creening can vary widely in its stringency, from routine notification and automatic approval to a national interest test where the foreign-owned firm has to make a case for entry rather than the government having to justify denying entry" (Golub 2009, 1250). By not taking into account the basis on which an investment might be approved or rejected (by meeting a net economic benefit or a national interest test, for example),[8] or the degree of transparency and accountability involved in the process, the OECD ranking misses important elements of the effective degree of restrictions on FDI.[9]

While the OECD ranking may be skewed against Canada due to the OECD's ranking not taking informal barriers into account, the fact that the rankings do not take the nature of the screening process into account may work in the opposite direction – making Canada appear more open

8 As Golub (2009) has done for FDI in services: in his ranking, a screening process under which the "investor must show economic benefits" is more restrictive than one under which there is "approval unless contrary to national interest."

9 The OECD itself acknowledges some of the shortcomings of its restrictiveness index. For example, in its 2010 FDI Restrictiveness Index publication, it states that, "[f]or screening, more so than for other policies covering FDI, the degree of restrictiveness of measures in place can vary greatly depending on how rules are implemented. As noted above, implementation issues are not addressed and no attempt is made to take into account factors such as the degree of transparency or discretion in granting approvals" (Kalinova, Palerm, and Thomsen 2010).

than it is. Indeed, a deeper comparison with a peer such as Australia, which we undertake next, shows that Canada's screening process does indeed impose unnecessary barriers to foreign investment.

Comparison with a Peer

A comparison between the Canadian and Australian processes is instructive given the two countries' similarities of government (both are federal parliamentary states), economic structure, and size. Australia also competes with Canada in many ways, particularly in the fast-growing Asian markets.

Like Canada, Australia traditionally has held suspicious attitudes toward foreign investment even while relying on it for a significant chunk of its development, particularly in the resources sectors, and until the 1980s, Australia imposed significant restrictions on FDI, fearing loss of control over its economy. In recent years, however, Australia has shifted toward more open investment, emphasizing the need for FDI to take advantage of new economic agreements with Asian partners and with the United States. In particular, Australia has liberalized and streamlined its FDI screening process, with the most recent major liberalization coming in August 2009 under the Labor government – too late, in fact, to be reflected in the most recent OECD rankings.

As shown in Table 1, the differences in Canada's and Australia's FDI screening processes are quite striking. In addition to the fairly straightforward differences in notification requirements described in the table, it is worth commenting in some detail on the differences in the nature of the test, and in the transparency and accountability attached to the decisions.[10]

The Nature of the Test

Before any foreign investment is approved, Canada imposes a test of its "net benefit to Canada," including such things as its potential effect on Canadian employment, exports, and productivity. The test requires the prospective foreign investor to share confidential plans with the federal government – something that would not be asked of a Canadian company in similar circumstances – and to demonstrate how these plans would be of net benefit to Canada. As a condition of approval, investors might be obligated to make legally binding promises, or "undertakings," concerning the net benefit of the investment.

If the federal government examined large acquisitions of Canadian-owned firms by other Canadian-owned firms on the same basis, and exacted the same types of undertakings from the Canadian acquirer, we would be correct in concluding that this constituted an ultimately ineffectual form of interventionist industrial policy. In the context of the *Investment Canada Act*, however, such intervention is acceptable because the investor is foreign – that is, the policy discriminates against foreign investors (and against Canadians who want to sell their holdings to foreign investors) through requirements not made of Canadian firms in a similar situation. Except in cases where the government is directly involved in economically supporting the business being acquired, one would not typically think of imposing legally binding obligations on Canadian-owned businesses to employ a certain number of people or even to maintain a head office in Canada.

What benefits do Canadians derive from this detailed intervention when it comes to the acquisition of a Canadian company by a foreign

10 Beyond a certain point, such comparisons become difficult, because policy toward foreign investment ultimately is enmeshed in institutional and other deeply rooted legitimate differences among countries. Our examination here concerns policies and practices that apply generally to the direct acquisition of a domestic business by a foreign investor from a member country of the World Trade Organization. We abstract from special (and generally tighter) rules that apply to land or real estate in some countries, notably in Australia, or to sensitive sectors, notably in Canada the cultural sector. Likewise, we abstract from special (but generally more relaxed) rules that apply to greenfield investments or to indirect acquisitions.

Table 1: FDI Screening Process, Australia and Canada

	Australia	Canada
Notification	Required only for acquisition of existing businesses above the threshold, though proposed land and real estate investments and investments by foreign governments and related entities must all be notified.	All new foreign direct investments must be notified.
Test	***National Interest***. Government typically considers impact of proposed investment on national security, competition (taking into account investor's control of global supply), government's ability to implement public policy (including effects on tax revenues); the economy, and the community (including Australia's ability to remain reliable supplier to all customers). Government also considers character of investor – for example, whether it operates on a transparent and commercial basis – and investor's corporate governance practices.	***Net Benefit + National Security***. Foreign investor generally must satisfy the minister that the acquisition is likely to be of net benefit to Canada. The minister assesses factors related to employment, exports, productivity, Canadians in senior management and the location of head office, technology development, innovation, compatibility with national industrial, economic, and cultural policies, and Canada's ability to compete globally. Investor may be required to make legally binding undertakings to obtain approval. New national security test introduced in 2008.
Threshold	Acquisition by a single foreign person of 15% or more (or 40% or more by many foreigners in aggregate) of a business worth A$231 million or more in 2011 (A$1,005 million for investments from the United States and, soon, New Zealand).	C$312 million in book value of assets for direct acquisition by WTO investors. A higher general threshold, based on "enterprise value," was announced in 2009 but not implemented. More sectors would have come under this higher threshold.
Transparency	Minister must publicly explain why the proposed acquisition does not meet the test, and divulge undertakings investor had to make to meet the test (without divulging investor's private information). Data made available include number of proposals approved with conditions and number of proposals withdrawn by investors.	Minister must articulate (but not necessarily publicly) reasons for disallowing proposals and may articulate reasons when approving proposals. Undertakings not made public for reasons of commercial confidentiality. No data are provided on investment plans approved with conditions or notified to Industry Canada but subsequently withdrawn by investor.
Accountability	Treasurer has power to decide, on advice of independent Foreign Investment Review Board. Onus is on government to explain why it believes a transaction should not be allowed, or what conditions are required before approval is granted, based on what it defines as constituting the national interest.	Minister acts on advice of staff, in consultation with provinces, other departments, and Competition Bureau. Onus is on investor to show that the transaction would produce net benefits, as variously defined by government depending on circumstances. Businesses allowed to miss undertakings if minister deems circumstances have changed.

This table summarizes information on the relevant Canadian and Australian acts and guidelines which can be found at: http://www.ic.gc.ca/eic/site/ica-lic.nsf/eng/home and http://www.firb.gov.au/content/default.asp, respectively. In the case of Australia, foreign investment decisions taken by the Treasurer can be found under media releases, at: http://ministers.treasury.gov.au/Main.aspx?PageID=089&min=wms

investor? It is hard, in fact, to determine with certainty what difference the test makes, because it is difficult, if not impossible, to know what future action the purchased Canadian business would have taken had the acquisition not taken place.[11] And there are other problems with the test and related undertakings.

First, the undertakings required of foreign investors could prevent necessary economic adjustments – for example, by promising to maintain jobs with no long-term viability – and thus interfere with other policies aimed at raising the country's productivity (the best guarantor of "good jobs" in the long run), competitiveness, and standards of living. Undertakings also risk giving Canadians the impression that they are able to suspend the effects of normal changes in the marketplace, which only delays and amplifies the effects when adjustments eventually must take place. It is true that undertakings are not imposed for the long term since companies would be wary of committing to a Canadian investment if they were too constrained in how to manage their Canadian operations in response to changes in business conditions. Nevertheless, such government interventions impose unnecessary administrative and compliance costs and might even be perceived as extortionate, leading foreign investors to abandon their plans.

Second, the use of the mercantilist expression "net benefit" tends to taint the public debate in such a way as to portray FDI as bad unless proven otherwise. It also encourages the perception that any sizable privately owned asset that might be subject to a takeover by a foreign entity is, in some sense, the property of, or at least of strategic interest to, all Canadians. Thus, the test is philosophically close to now discredited "command-and-control" industrial policies, while at the same time not encompassing broader considerations of what might constitute the national interest. In part for these reasons, the report of the Competition Policy Review Panel suggested abandoning the net benefit test in favour of a "national interest" test, which would provide two main benefits: "First, it would align the test with Canada's basic policy premise that FDI generates positive benefits for the country. Second, it would counter the negative and misleading perception that the [*Investment Canada Act*] discourages – and that Canada does not welcome – FDI" (Canada 2008, 32).

Australia also had a complex "net benefit test," whose application between the mid-1960s and mid-1980s corresponded with a sharp decline in capital productivity in that country. Australia now imposes a "national interest" test to determine the effect the proposed investment might have on the ability of the Australian government to implement broad policy objectives, including those related to national security. To be sure, Australia also includes "impact on the economy and the community" as part of what constitutes the national interest, but this element is not as central to the review system as it is in Canada. Rather, it is part of the broader framework that lists issues that might, in principle, raise concerns about Australia's ability to implement generally applicable practices in cases of foreign acquisitions of Australian businesses.

The key point is that, while Australia's test is conceptually broader in that it covers concerns related to the Australian government's ability to implement Australian policy and apply Australian law – and in that sense casts the net of concerns potentially wider than does Canada's test – it is not based on the battery of specific economic outcomes expected under the Canadian test. While the Australian test might be vaguer, it is also more principles-based and less intrusive of business plans than the Canadian test. Indeed, a

11 Foreign investors need not be held to their undertakings if the federal government deems economic circumstances have changed. The number and nature of these undertakings are not made available to the public; undertakings come to light only in the (rare) case of a legal dispute between the federal government and foreign investors. For example, the federal government recently took United States Steel to court for allegedly not living up to its promise to maintain jobs when it took over Hamilton-based Stelco in 2007.

lack of overriding principle is why Canada has had to issue specific tests and guidelines regarding national security and state-owned enterprises, in addition to its net benefit test. In Australia, these situations come under the conceptual umbrella of the national interest. In turn, the principled basis for the Australian test makes it easier for the Australian government to behave transparently and to be held accountable for its decisions concerning FDI than is the case within the Canadian system.

Transparency and Accountability

According to the report of the Competition Policy Review Panel, the Canadian foreign investment screening system also does not meet "contemporary transparency standards" (Canada 2008, 33), which, in turn, negatively affects its accountability to both the Canadian public and the parties to a proposed transaction. While the 2009 *Budget Implementation Act* included welcome measures to enhance the transparency of the *Investment Canada Act*, the general assessment of the Competition Policy Review Panel remains as accurate today as when its report was published. The 2009 amendments require the industry minister to articulate reasons for disallowing an investment proposal, but the reasons do not have to be made public. In any case, since the test is based on an assessment by government officials of detailed short-term corporate plans, it would be difficult for the minister to explain the reasons for a decision without also divulging corporate confidential information. For similar reasons, Canadians are not normally told the details, or even the existence, of the undertakings required of foreign investors, which makes accountability almost impossible.

As is the case in the United States with respect to national security screening, if it becomes apparent that a proposed acquisition will not receive approval, the foreign investor may well abandon or withdraw the proposal rather than go through the review process. Thus, while Canada has disallowed formally only one investment in the non-cultural industries since the *Investment Canada Act* came into effect in 1985, neither foreign investors nor Canadians in general have any way of knowing how many significant proposals were withdrawn and why, making it difficult to have a transparent view of the impact of the legislation.

In Australia, in contrast, advice concerning proposed foreign investments is made public, and both the reasons for the rejection of a proposal and any undertaking required of investors in the event of a proposal's being accepted are also made public. Furthermore, unlike in Canada, the onus is on the federal government to make the case that an investment would not be in the national interest, rather than on the investor to explain what benefit the country would derive from the investment.

In short, compared with the Canadian foreign investment screening process, Australia imposes a less intrusive test, yet one that is more comprehensive and principles-based, assumes that investment is good rather than requiring the investor to show that it will be, and obliges the government to be more transparent and accountable in its application. Yet no one would suggest that Australia is less well equipped than is Canada to block transactions that are not in its national interest. At the same time, the Australian system remains, in the view of many, too restrictive, too vague, and retains too many elements of political discretion.[12] Even so, Canada's system suffers by comparison in many important aspects.

12 There are also questions about whether Australia's screening agency, the Foreign Investment Review Board (FIRB), is truly independent. For a review of the debates in Australia, albeit preceding the federal government's recent increase in the threshold for FDI review and clarification of its policy (Australia 2011), see the proceedings of a late 2008 symposium on "Australia's Open Investment Future" (Institute of Public Affairs 2008). For a more recent in-depth view of debates about the possibility of political interference in the decision-making process, particularly in resources industries, and the role of the FIRB, see Larum (2011).

National Security and State-Controlled Entities

Screening of foreign investment in the interests of national security has become a more widespread practice, particularly since the terrorist attacks of 9/11, with Canada and China among a number of countries that have adopted such tests. For Canada, the issue is particularly important in light of the fact that national security is the only formal screening test practised by the United States, its closest and largest trading partner. Thus, US policy on the issue – and related questions about, for example, how such screening is applied to state-owned enterprises – contains lessons for Canada.

As national security is meant to cover threats to a country's ability to defend itself, or even to exist, processes to determine whether an individual foreign investment proposal constitutes such a threat are not generally classified as barriers to foreign investment *per se*. Canada's national security clause, like that of many other countries, including Australia, is open ended, however, in simply stating that transactions deemed "injurious to national security" could be blocked.

In contrast, the United States is more explicit about the factors to be used to determine if a particular transaction threatens to impair the national security.

In the United States, the Committee on Foreign Investment in the United States (CFIUS), an interagency committee operating under the authority of the president and chaired by the US Treasury, may investigate any transaction that could result in control of a US business by a foreign person to determine its impact on US national security. Ultimately, the president of the United States has the power to block, or even reverse, any foreign investment or acquisition believed to threaten national security, if existing laws, other than the *International Emergency Economic Powers Act*, are "deemed insufficient for the task."

The factors that the president and the CFIUS have to consider when determining whether or not a proposed foreign acquisition constitutes a national security threat include:[13]

- the domestic production needed for projected national defence requirements, as well as United States requirements for sources of energy and other critical resources and materials;
- the capability and capacity of domestic industries to meet national defence requirements;
- the control of domestic industries and commercial activity by foreign citizens as it affects the capability and capacity of the United States to meet the requirements of national security;
- the potential effects of the transaction on the sales of military goods, equipment, or technology to a country that supports terrorism or proliferates missile technology or chemical and biological weapons, and in general the potential for transshipment or diversion of technologies with military applications;
- the potential effects of the transaction on US technological leadership in areas affecting US national security, and in general on United States critical technologies;
- the potential effects of the acquisition on United States critical infrastructure, including energy assets;
- whether the transaction involves an entity controlled by a foreign government, and, if so, the foreign country's adherence to nuclear non-proliferation policies, its cooperation with regard to counterterrorism activities, and its export control record.

As in Canada, there is no threshold below which a transaction cannot be examined for national security reasons. Indeed, as in Australia (but not in Canada), screening is automatic if the transaction involves an entity controlled by a foreign government. It is also automatic if the transaction involves control of a "critical infrastructure" and has the potential to threaten US national security if it were not otherwise

13 This list is culled from Jackson (2010), pp. 14-15.

mitigated – that is, by undertakings on the part of the acquirer or government action that would mitigate the threat. When investors have reasons to believe that a national security concern might be triggered, they may voluntarily submit their proposed investment to a review; however, the CFIUS may, on its own, initiate a review of any foreign investment.

The need to ensure national security is one thing, but national security matters can share common ground with business matters, as evidenced by the US legislation's explicit reference to security of key supplies, infrastructure, and the need to maintain the United States' technological lead in a number of sectors as factors to be examined in assessing the national security implications of a foreign investment. In this sense, national security involves the ability of governments to commandeer, or at least to count on, domestic control of commodities, infrastructure, and technology. This, in turn, raises the possibility of invoking "national security" to block investments, when the real motivation is to protect domestic industry from foreign competition (including foreign investments).[14] Extensive US guidelines regarding the application of the national security test for reviewing foreign investment exist to limit the ability to invoke the test for protectionist reasons, but their existence highlights the potential conflict.

The French example is instructive in this regard. France lists "gambling," "private security," "supply of goods or services related to the security of information systems," and "businesses under contract to supply research or equipment to the Ministry of Defence or its subcontractors" among a number of "sensitive sectors" in which foreign investments resulting in significant control of French assets are notifiable and potentially reviewable (WTO 2011, 66-67). Because the OECD screening index does not include screening for these sensitive sectors, France registers as having no screening process in place. Yet it would seem from the French list that the net of industries thus protected against foreign investment (including investment from other EU countries) is cast rather wide. As a recent study by the US Congressional Research Service concludes, "it can be difficult to determine if foreign investment policies ultimately result in enhanced national security or are a form of economic protectionism" (Jackson 2011, 23).

The basic lesson here is that the way governments and governmental bodies invoke national security also should be submitted to transparent checks and processes, lest national security be used to justify basically protectionist, anticompetitive measures that have little connection to a commonsense understanding of national security. With respect to Canada's national security clause, in particular, the US experience indicates that it could usefully be expanded upon to clarify, ideally through guidelines, the conditions under which a foreign investment proposal might be considered injurious to national security, with the important caveat that these conditions should be well circumscribed to make it difficult to invoke them for purely protectionist objectives.

The concerns that national governments have expressed about takeovers of domestic companies by state-owned or controlled enterprises (SOEs) or funds, dubbed "sovereign wealth funds," owned by public entities, are related in part to national security, but more broadly to concerns that another government might be able to exercise control over economic developments in the host country. As a growing analytical and policy convergence suggests, however (see OECD 2007, chap. 3), the concern is not, or should not be, about SOEs or public funds, such as those of most public pension plans, that invest at arm's length from political decision-makers (Cook-Bennett 2007). Rather, the concern is about entities that

14 For example, the *Jones Act*, or section 27 of the *US Merchant Marine Act of 1920*, requires that all goods transported by water between US ports be carried in US-flagged ships, constructed in the United States, owned by US citizens, and crewed by US citizens and permanent residents. Yet, despite its protectionism and anticompetitive nature, supporters of the act invoke national security to keep it from being substantially amended.

are under the direct control of, or closely connected to, governments and that are, or can be, used by their home country to further its own politically-driven economic, security, or other goals. In acting this way, these entities raise not only potential national security concerns but also potential concerns about their impact on economic development broadly speaking.

Australia and the United States, among others, have dealt with concerns about SOEs by requiring a special scrutiny – in both countries, including automatic notification regardless of the value of the investment – of investments by such entities. But the test, whether on the basis of national interest or of national security, is the same as the general test applied to all reviewable foreign investments.[15] Recently issued Canadian guidelines speak not only of "how and the extent to which the investor is controlled by a state" but also of the governance and commercial orientation of SOEs, to ensure adherence to Canadian standards of corporate governance and "compliance with Canadian laws and practices." They provide a level of clarity and a standard of review that are not only welcome in the case of SOEs, but should help guide other aspects of Canada's foreign investment review regime.

"Strategic" Sectors and Informal Barriers

While national security is a concept whose application sometimes can be used to shield industries from change for purely protectionist reasons, an even more elastic concept, and one that is creeping into Canadian debates on FDI even though it has no basis in the *Investment Canada Act* (Frigon 2011, 9), is that of "strategic" economic sectors, firms, or other assets such as natural resources. Simply by virtue of being dubbed "strategic," these assets, the argument goes, should be protected from foreign ownership.

This concept underlies the array of informal barriers that exists in many countries, but that the OECD FDI restrictiveness index does not record. It is often expressed via government stakes in business ownership or governance. For example, a number of governments in European countries have minority shares in large national companies, including veto rights that can be used to prevent foreign takeovers (Mandel-Campbell 2008). The French government, for example, set up a *Fonds stratégique d'investissement* in 2008 specifically to remedy the fact that the mission of its other sovereign funds, which manage public pensions and other state schemes, is not principally to support the development of French industry. The new fund's mission is to "*sécuriser le capital d'entreprises stratégiques*," although it explicitly shies away from the support of "non-viable" enterprises. The fund has invested in over 60 companies, many of them France's largest and most recognizable names, with Alcan EP the only non-French-owned entity among them. The OECD has called this initiative a step backward under its "freedom of investment process" (OECD 2011, 26-27).

Often, such state support for "strategic" enterprises leads to charges that these enterprises, protected from foreign acquisition or competition but themselves planning to expand abroad, benefit from an unfair competitive advantage. This reality exists even, for example, within the European Union, where the Italian government took extraordinary measures to protect "strategic companies" – which previously had not been defined as such – after the French company Lactalis acquired 29 percent of Parmalat. To justify this intervention, the Italian finance minister invoked reciprocity with French legislation that protects strategic enterprises. Similar questions have been raised in the Canadian context, with recent actual and attempted takeovers of Canadian

15 For example, Australia's "Foreign Investment Policy" states that "[p]roposals from foreign government entities operating on a fully arms length [sic] and commercial basis are less likely to raise national interest concerns than proposals from those that do not" (Australia 2011, 7). The idea is to protect Australia's interests from "non-commercial dealings," not to prevent investment by foreign SOEs.

mining firms by Brazilian and Australian-based investors prompting the question of whether Canadian-based firms would have had reciprocal access. As a result, at least one influential expert has called for a Canadian policy of maintaining reciprocal restrictions vis-à-vis countries that would prevent takeovers of their own national companies (Martin 2011).

In our view, the strategic-asset concept is too blunt a guide for sensible policy on foreign direct investment. In the same way that Canada's current net benefit test encourages a mercantilist way of thinking, the concept of strategic assets encourages considering any sizable privately owned asset to be better off in Canadians hands. Furthermore, while it is valid to be concerned with policies of the acquirer's home country that harm legitimate Canadian interests, the response should not automatically be tit-for-tat retaliation against potential investors (and the Canadian businesses they wish to acquire), just as it might make sense to liberalize imports unilaterally without necessarily waiting for others to offer reciprocal access.

Implications for Canadian Policy

Canada needs a principled but flexible approach to screening foreign investment proposals that clearly recognizes the value of foreign ownership while allowing the federal government all the latitude it needs to intervene if it believes blocking a particular transaction is necessary to uphold broad public policy objectives, including promoting a world in which Canadian businesses can grow beyond the country's borders.

A review of just a few key comparators makes clear that, by adopting best practices on the clarity of principles, predictability of application, transparency, and accountability underlying foreign investment review – suitably adapted to this country's legal and institutional framework – Canada could improve its attractiveness for desirable foreign investment. At the same time, the federal government needs to be clearer about instances under which a proposed foreign investment might not be in Canada's interest. The current reliance on a net benefit test is unsatisfactory from the point of view of both openness to productive foreign investment and the desirability of maintaining a clear, predictable, transparent, and accountable foreign investment review regime.

Accordingly, we propose that a more encompassing, but clearer and more meaningful, test would be to determine if the proposed investment threatened Canadian governments' ability to (i) apply their laws and regulations as they would to a Canadian investor in similar circumstances or (ii) to achieve significant policy objectives, including Canada's national security. This proposed test takes its cue partially from Canada's own "compliance with Canadian laws and practices" test for state-owned enterprises. How would such an overarching test be beneficially applied?

What Would Our Proposed Test Mean in Practice?

Scrutiny of foreign investment by governments exists the world over, and every country, including Canada, has barriers that are more or less formal and, in the final analysis, rest on the judgment call of the government of the day as to what is in the national interest or what suits more immediate political concerns. Nevertheless, specific guidelines are needed for applying the test, as much to protect government from claims that choices are purely politically motivated as to protect foreign investors and Canadian entities wishing to dispose of assets or raise capital in the normal course of business.

In determining whether a proposed foreign investment being reviewed should go through, the federal government should consider the following questions:

1) *Does the acquisition threaten to prevent the effective application of competition, commercial, employment, and other laws, regulations, and practices in Canada?* The broad standard here should be that Canadian employees, suppliers, customers, and remaining shareholders should not be discriminated against because of the foreign ownership. A foreign acquirer could not "refuse to deal with" (either to sell to or buy from) Canadians. This standard should be applied in very close cooperation with – and be

applied by – relevant Canadian authorities such as the Competition Bureau.

2) *Is the nature or character of the investor such that it is likely to make economically unjustified or politically motivated decisions that would disadvantage Canada at the expense of other locations where the investor operates, particularly its home jurisdiction?* This test would attempt to anticipate possible negative effects on Canada's economy, by focusing not on securing hard-to-enforce undertakings, but on the revealed intentions of the investor, who might seek to veil non-economic or politically motivated plans. This part of the test could be akin to the "fit and proper" test under section 526 of the *Bank Act*, whereby, if a foreign bank wants to establish branches in Canada, the finance minister needs to be assured that the proposed bank "will be operated responsibly by persons with the competence and experience suitable for involvement in the operation of a financial institution." Such a test would allow the federal government to deal with issues related to SOEs and sovereign funds, including circumstances where, for example, a foreign government might seek to acquire Canadian assets to exploit them in a manner contrary to Canadian interests. One way to determine evidence of harmful political intentions in such cases would be to investigate whether a Canadian-based proposal to acquire a similar target in the foreign investor's home country would be approved there.

3) *Does the proposed investment otherwise threaten the security of Canada or its allies?* This part of the test could dovetail with the existing Canadian national security clause. But that clause is broad and open ended, and could usefully be made more descriptive about what foreign investment proposals would be considered injurious to national security.

To the extent that foreign ownership is currently barred or limited in some sectors because of an assumption that domestic ownership is essential to achieve public policy goals pertaining to that sector, a national interest test applying on a case-by-case basis to proposed foreign investments in those sectors would be a better approach than the current outright ban or limits, if a fourth question is introduced:

4) *Does the acquisition demonstrably threaten other significant public policy goals?* This question would address policy goals potentially not covered by the first three questions. Here, particular attention could be paid to sectors – such as culture – in which blanket strictures against foreign investment are currently in place as a means of achieving policy goals to make sure more openness to FDI does not threaten these goals. Indeed, current restrictions on ownership in the cultural industries could become irrelevant if this test were enforced judiciously – for example, by freeing up fresh capital to be injected into the sector while preventing the dilution of Canadian content. In this example, the government would reach its conclusion on the advice of the Department of Canadian Heritage and other experts and interested parties. If an investment were rejected, it would be based on the specifics of the proposed investment and its effects on policy objectives, rather than on the foreignness of the investor. Additional concerns of this type might include the public interest in knowledge or technology developed in partnership with government for a public purpose but that might devolve to foreign owners due to a takeover.

Such a national interest test would allow Canada to dispense with the current net benefit test and would be inherently compatible with the increased transparency, predictability, and accountability sought after by the Competition Policy Review Panel, many practitioners, and the Canadian government itself. As the United States and Australia, and as recommended by the Competition Policy Review Panel, the federal government should issue more detailed guidance, making more regular use of departmental guidelines and backgrounders developed in consultation with the relevant provinces, departments, and agencies. These would not be simply administrative guidelines but policy guidelines, like those Australia published in 2011 in a new "easy-to-read" version or the case studies issued in the United States by the CFIUS.

By itself, the adoption of a national interest clause would go a long way toward enhancing the transparency, predictability, and accountability of the screening of foreign investment proposals. A national interest clause would be more principles-based than the current net benefit clause, and would open the door to more transparent and predictable interpretation of how the test is applied. That the test would be based on the federal government's policy objectives rather than on proprietary corporate plans would also allow for a more transparent and public assessment of foreign investment proposals. The minister should have to articulate publicly the reasons for accepting or rejecting the proposed investment, which would improve the accountability of the screening process to the Canadian people.

Conclusion

Canada should welcome foreign direct investment, and more of it, while securing its ability to intervene in the event a foreign investment threatens Canada's national security or interests or would prevent Canadian governments from achieving a significant policy objective or applying their laws and regulations as they would to a Canadian firm in similar circumstances.

Too often, however, Canada compares itself to averages of peers, an approach that can lead to complacency. Instead, Canada should aim for best, or at least better, practices. The key FDI policy issue is how to improve Canada's attractiveness as a destination (as well as a source of) cross-border direct investment without diminishing its control of policy levers. Canada currently applies a general net benefit test to screen proposed foreign direct investments. While such a test sounds objective, it is, in fact, highly subjective and unpredictable, and does not necessarily cover many situations where Canada's interests might be involved beyond the calculation of a "net benefit." Furthermore, the test might be detrimental to the economy's long-run growth.

In our view, a national interest test should be applied to foreign-owned entities on the same principles that would apply, in similar circumstances, to domestically owned entities whose actions would similarly run against the national interest. Under such a test, the onus would be on the federal government to show that a foreign investment was contrary to Canadian interests, since we could not expect investors to decide what was in Canada's national interest. Moreover, if the federal government should have to explain specifically why a proposed transaction failed the test or what undertakings the investor would have to make to meet the test, the process would be more transparent. For proposed investments with no demonstrable, or likely negative, public policy implications, this approach would demonstrate that the government no more intended to intervene in a private transaction involving foreigners than it would in a transaction involving Canadians in similar circumstances. Such an assurance would reduce or even eliminate obstacles to direct investment into Canada that are not related to governments' ability to legislate and act to achieve public policy objectives.

In short, by amending the screening process for foreign investment along the lines we propose, Canada could reduce uncertainty and costs to businesses while improving transparency and accountability with respect to Canadians and foreigners alike, without compromising the federal government's ability to implement national objectives and policies. The end result would be to increase Canada's attractiveness to foreign investors, an important feature of the country's economic landscape.

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