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COMMENTS ON “SHARPENING CANADA’S COMPETITIVE EDGE”

Consultation Paper of the Competition Policy Review Panel

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January 11, 2008



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This note addresses specific questions raised in the consultation paper of the federal Competition Policy Review Panel. The views expressed are solely those of the authors. Questions appear in the order listed in the consultation document. Comments do not appear for all questions, although for continuity we have left the consultation document’s numbered questions place.

CANADA IN A GLOBAL CONTEXT

Should Canadians be concerned about foreign takeovers of Canadian firms? How important is domestic control and ownership of Canadian business activities to Canada’s economic prospects and ability to create jobs and opportunity for Canadians?

1. How important are company headquarters to Canada’s economic prospects and ability to create jobs and opportunity for Canadians? How important are global divisional head offices? What factors influence their location?

Changes in corporate control, along with sectoral and cyclical peaks and valleys in merger and acquisition activity, are an ordinary part of the economic landscape. Competition for assets and access to resources is integral to price discovery and to ensuring the flow of financial, physical and human capital to their most productive uses. The market for corporate control and the resulting discipline on managers is



hence important to the efficient allocation and management of those resources. Policies that impede market forces with respect to corporate control also impede Schumpeterian creative destruction, and therefore eventually limit innovation and retard growth.¹

Head offices are important because the human capital they attract increases the value of the human capital of people with which those headquarters interact. In other words, productive businesses and employees improve the productivity of other businesses and employees, whether they are suppliers, competitors, or downstream customers. Tax and regulatory policy can improve Canada's attractiveness as a destination or home for business establishments, including headquarters, and investments in them.

We note in passing that data do not indicate a significant trend toward "hollowing out" (which is often raised as an issue in most industrialized countries), nor is the number of Canadian head offices in decline. Even if the numbers were less favourable, however, policy should not seek to impede changes in corporate control, even if intended for the positive reasons just listed, because, if it did, the market for corporate control would fail to direct resources to their most valuable uses.

¹ See Howitt 2007, "Innovation, Competition and Growth: A Schumpeterian Perspective on Canada's Economy" www.cdhowe.org/pdf/commentary_246.pdf.



Productivity and numerous other economic measures indicate stronger performance on the part of foreign as opposed to Canadian controlled establishments.²

2. How do Canada's policies impacting direct investment, both inward and outward, affect Canada's competitiveness as a destination for FDI and as a platform for global growth?

Canada's policies for inward direct investment are generally permissive, outside of the sectoral investment regimes. However, there are reasons for concern with respect to the effective tax rate bearing on new business investment, and suspicion that Canada's relatively high tax rate limits inbound FDI.³

3. Do Canada's economic policies appropriately reflect our increased integration with the North American and global economy? How might these policies be changed to better reflect this new competitive environment?

Canada's economy is integrated with the North American and global economies, subject to some significant limits. Among them:

- *Bank Act* and *Insurance Companies Act* provisions pose several direct and indirect limitations on ownership and control, as well as on the scope of financial services firms may provide, and this limits their ability to grow and

² See Baldwin and Gellatly 2007, "Multinationals in Canada: An Overview of Research at Statistics Canada" (www.statcan.ca/bsolc/english/bsolc?catno=11-622-MIE2007014).

³ See Mintz and Tarasov 2007, "Canada Is Missing Out On Global Capital Market Integration" (www.cdhowe.org/pdf/ebrief_48.pdf).



compete effectively in domestic and foreign markets. See Koepple and MacGee 2007, “Branching Out: The Urgent Need to Transform Canada’s Financial Landscape and How to Do It”

(http://www.cdhowe.org/pdf/Commentary_251.pdf).

- Securities regulation among the provinces limits capital market integration from the perspective of investors as well as issuers.
- The *Income Tax Act* and its regulations limit the participation of nonresident investors in Canadian venture capital markets. See Hurwitz and Marett 2007, “Financing Canadian Innovation: Why Canada Should End Roadblocks to Foreign Private Equity” (http://www.cdhowe.org/pdf/commentary_244.pdf).
- Canada maintains import tariffs and in some cases quotas on a wide range of intermediate and consumption goods. These barriers have long been known to be economically damaging, and the pressures being felt by many industries that use protected goods as inputs while selling outputs in competitive markets make their early elimination all the more desirable. Particularly objectionable are supply management policies in agriculture. They have an especially pronounced negative effect, raising prices to consumers, limiting competition and innovation in food supplies, and hurting the ability of Canadian producers of processed foods to serve potential export markets and serve markets within Canada owing to lack of competitive supplies.
- Ownership rules in telecommunications and broadcasting, and content rules in the latter, limit cross border flows of investment and service provision.

INVESTMENT POLICIES

1. What impact has the ICA had on the Canadian economy and Canadian competitiveness, and specifically on our ability to attract FDI?

Lack of transparency with respect to foreign investors’ undertakings makes it difficult to comment on completed transactions. Data do not exist with respect to



transactions that do not take place, hence we note only that Canada's share of worldwide inbound foreign direct investment has not shown favourable trends.

2. What changes to the ICA and Canada's investment review regime would help Canada address the challenges and complexities of the modern global economy, within the constraints of Canada's international obligations?

- What, if any, changes to the investment review process would enhance Canada's competitiveness and improve Canadians' understanding of the benefits of FDI?
- Should the net benefit test be adapted to reflect the new competitive environment? If so, how?

Overall, the scope of ministerial discretion needs careful attention – the narrower the scope, the less likely it is that ministers may find themselves under political pressure regarding ordinary business transactions.

The net benefit test contains little economic content, and does not commend itself to broader or more stringent application.

The *Bank Act* and the *Insurance Companies Act* require individuals or related groups, if they propose to take significant positions in financial services business of a certain size, to satisfy suitability requirements in the judgment of the finance minister. The test implies a minimal degree of transparency with respect to corporate control. This model may be helpful in devising rules (to apply outside the financial sector) that would permit a greater degree of comfort to Canadians who are concerned about state and quasi-state agencies which propose to acquire domestic businesses.

SECTORAL INVESTMENT REGIMES

Canada maintains specific regimes to govern, review or restrict investment in six sectors: telecommunications, cultural industries, broadcasting, transportation services, uranium production and financial services.



1. What changes, if any, are required to Canada's sectoral investment regimes to minimize or eliminate negative impacts on Canada's competitiveness?

Liberalization of investment rules is appropriate in most areas. In financial services, conduct as well as prudential legislation and regulation can be adjusted to ensure systemic safety and soundness, irrespective of ownership structure or location. Limits on cross-pillar service provision and corporate ownership could be sharply reduced, in the interest of fostering ordinary market competition among institutions of significant scope and scale.

Conduct regulation may be appropriate in broadcasting; however legislation with respect to ownership is not required to achieve traditional goals with respect to conduct. As to content and cultural industries and protection thereof, subsidies may be effective ways of achieving policy goals with respect to cultural output, if any. Whether or not output subsidies are pursued, regulation of content is generally undesirable in a democratic setting.

Controls over investment in transportation and uranium production serve no public purpose and may safely be ended.

2. What have been the impacts of these investment regimes on productivity and competitiveness in the specific sectors?

These are difficult to measure, but there is some economic consensus that productivity and income growth in Canada are considerably slower than potential. It is worth noting that financial and telecommunication services are critical intermediate inputs in a modern economy, which means that harmful effects of less robust competition and innovation in these industries may show up in other sectors as well, rather than being isolated – and thus relatively easy to identify – to the regulated sectors themselves.

3. Are there alternative mechanisms that would achieve the non-economic policy objectives of the sector while also ensuring maximum competitiveness of firms operating in the sector?



Discussed above.

COMPETITION LAW

1. How does Canada's competition policy affect Canadian competitiveness in an environment of globalization and free trade?

Limits on mergers tend to restrain firms' abilities to achieve economies of scale in domestic markets or to achieve scale that would facilitate their growth in global markets. The result is lower productivity and income growth.

2. What changes to Canada's competition regime would enhance the competitiveness of Canadian firms in the global economy? What international best practices, if any, would strengthen Canadian competitiveness as a destination for foreign investment if we were to adopt them?

Canada's competition policy tends to foster competitors, rather than actual and potential competition. Structural models of competition that are based on measures of concentration measures predate a modern understanding of dynamic competition for the marketplace. A structure/ conduct/ performance paradigm, such as dominates much merger analysis, cannot properly accommodate potential competition. As Neil Quigley has written:⁴

⁴ Quigley, Neil. 2004. "Dynamic Competition in Telecommunications: Implications for Regulatory Policy" (www.cdhowe.org/pdf/commentary_194.pdf).



[H]igh levels of competition and substantial benefits to consumers do not, in fact, require that numerous competing providers operate in the market. Investment in new technologies and services that allow a firm to compete with existing technologies may provide greater benefits than competition among providers of the same technologies and services in the market. Competition from potential providers ... will force firms already in the market to invest in order to preserve their market position. Consumers will benefit from this investment even if incumbent firms are not replaced by potential competitors.

And

[R]egulators find it convenient to focus on both the number of companies supplying the market and trends in prices as measures of rivalry. One problem with such an approach, however, is that competition is much more complex and dynamic than these static measures suggest. For example, if regulators ignore the role of actual and potential technological change as a cause of competitive tension in markets, then they may understate the extent of the actual competition and invoke regulatory policies that are inconsistent with the long-term interests of consumers.

3. Does Canada's approach to mergers strike the right balance between consumers' interest in vigorous competition and the creation of an environment from which Canadian firms can grow to become global competitors?

Discussed above. For the most part, broader as opposed to narrower definitions of relevant markets are to be preferred, and attention given to potential competition and dynamic competition for the market. Efficiency gains should also be given full weight, irrespective of the believed incidence of those gains. As discussed above, in Koepl and MacGee (2007) and elsewhere, the competition concerns surrounding mergers and concentration in financial services no longer seem warranted, and a liberalized ownership regime, including with respect to cross-border investment, is overdue in Canada.



PROMOTING CANADIAN DIRECT INVESTMENT ABROAD

1. What barriers, either formal or informal, do Canadian firms face when seeking to make investments and acquisitions abroad?
2. How should the government adapt its policies to promote increased Canadian direct investment and acquisitions abroad? What measures have been adopted by other countries that are relevant to Canada?

Since the mid-1990s, Canada has become a relatively high-saving country: it is now a sizeable annual net foreign investor, and has recently shown net positive balances as a direct investor also. More than in the past, considerations of reciprocity should colour Canada's approach to foreign investment, and avoid policies that might make the foreign activities of Canadian institutional investors more difficult and less financially rewarding.

3. Are there policies or approaches that would be useful in addressing the particular challenges faced by small and medium-sized enterprises as they seek to become global competitors and participants in global value chains?
4. What impact does a higher-value Canadian dollar have on CDIA?

BECOMING A DESTINATION FOR TALENT, CAPITAL AND INNOVATION

1. How can Canada better promote inward FDI? What policy change could contribute to the achievement of this objective?
2. In particular, what mix of policy changes would be required to make Canada the preferred point of entry to, and location in, the North American market for the high-value activities of non-North American business entities?

In a world where more factors of production are mobile, providing an attractive environment for human capital may be a more important source of competitive advantage. Many things matter on this front: urban amenities, good public services,



and other factors that influence overall quality of life. Undeniably, however, people with high levels of skills and earning power will focus strongly on after-tax incomes. Policies that enable companies to pay high gross incomes, and personal income taxes that leave a larger share of those gross incomes in the pockets of the people that earn them, are a key source of competitive advantage for a jurisdiction that seeks high-value business activities.

3. Is the modernization of Canada's competition and investment laws sufficient for successfully attracting foreign direct investment in Canada? What other priorities and policy issues should governments address?
4. What impact does a higher-value Canadian dollar have on Canada's competitiveness as a destination for investment?
5. What further could be done in Canada to promote an ongoing review of Canadian competition, investment and productivity performance aimed at Canada's sustained competitiveness?