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Competition Policy Review Panel
Research Paper Summary

Author: Dr. Dane Rowlands, Senior Associate, Centre for Trade Policy and Law; Associate Director, The Norman Paterson School of International Affairs, Carleton University

Title: Formal and Informal Barriers to Canadian FDI

Subjects Addressed:

- Canadian direct investment abroad
- Determinants of FDI and barriers to FDI

Canadian outward Foreign Direct Investment (FDI) trends:

At \$523 billion in 2006, the reported stock of Canadian FDI abroad has grown steadily since 1987 at an average of 9.6% per year, though with significant variations in growth rates. Canadian FDI remains highly concentrated in North America (60%) and the United States (44%) in particular. However, the United States and United Kingdom have declined in relative importance since 1990, from 61% and 14% in 1990 to 44% and 11% in 2007. Offshore North American destinations have become more important.

A sectoral analysis shows Canadian outward FDI stocks primarily in the financial and insurance sector, manufacturing, and mining. The fastest growing sectors since 1999 have been retail services, management services, and professional services. Detailed data about specific sectors in specific countries are suppressed by Statistics Canada for confidentiality reasons.

Identifying Entry Points for enhancing Canadian outward FDI:

A range of indexes and rankings are reviewed, but lead to the conclusion that there is no simple way to determine unrealized potential for countries with respect to hosting FDI. The United Nations Conference on Trade and Development (UNCTAD) Inward FDI Potential Index country ranking measures factors (GDP, exports, infrastructure, etc.) that cannot be modified through negotiations. The World Bank's Ease of Doing Business Ranking can point to policy areas that could be improved to attract more FDI, but they are usually core features of domestic regulation.

The Organization for Economic Cooperation and Development (OECD) produced an analysis of FDI specific restrictions for 42 countries and nine sectors. It looks at foreign equity limits, screening and approval requirements, and other restrictions that include limits on boards of directors and management, movement of people, and input and operational restrictions. It finds that non-OECD countries tend to have more restrictive policies than OECD countries, particularly China, India and Russia. Among OECD countries, the most open countries tend to be in Europe. The most restricted sectors are electricity,

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transport, finance and telecommunications. Manufacturing, tourism, construction and distribution are generally less restricted.

Traditional FDI has been motivated by location-specific factors, such as particular natural resources. Globalization has led to FDI being dominated by mergers and acquisitions (M&As) to gain integrated supply chains, market access, and intra-firm synergies. M&A-based FDI is more sensitive to 'business friendly' operating conditions. For Canada, large Canadian resource extraction firms are very active in FDI and have more traditional motivations. They can negotiate specific arrangements on a case by case basis, though investment treaties to help secure the firm's property and other rights can be useful. M&A FDI is mostly directed towards OECD countries, where property rights are secure but supports for national treatment and streamlined regulatory and tax regimes for operating in multiple jurisdictions need to be negotiated.

Typologies and Surveys of Investment Restrictions:

Hardin and Holmes,¹ who designed a typology of investment restrictions, including direct (ownership limits, local content requirements) and indirect restrictions (net benefit assessment, limits on board participation), found that the data for constructing typologies is problematic (self-reported, inaccurate, and based on a diversity of sources). Evaluating the magnitude of informal barriers like screening requirements or requirements for joint ventures and technology transfers is difficult.

Gestrin (2003)² developed a similar typology to examine FDI restrictions in Africa, including general impediments that do not target FDI (tax policy, foreign exchange controls, labor laws, commercial laws, land laws, intellectual property laws, competition laws, and environment laws) and specific barriers (restrictions, bans, screenings, and taxes on entry, ownership and operations).

UNCTAD (2005)³ surveyed transnational corporations (TNCs), investment "experts", and investment promotion agencies (IPAs) about their views on what countries will attract investment, and which factors will impede FDI. The survey showed that China, India, the U.S., Russia, Brazil, Mexico, Germany, the U.K., Thailand and Canada are considered the ten most attractive countries for hosting FDI. These countries are large economies, many with recent rapid growth - clearly a large potential market size attracts FDI. TNCs and experts both cited protectionism and slow growth as threats to global FDI. Trade wars were seen as a big problem, highlighting the important connection between FDI and trade

¹ Hardin, Alexis and Holmes, Leanne, "Services Trade and Foreign Direct Investment", Industry Commission Staff Research Paper, Canberra: Australian Government Publishing Service, 1997.

² Gestrin, Michael V. "A Stocktaking of Investment Related Barriers in Africa", OECD-Africa Investment Roundtable, November 2003.

³ UNCTAD (2005) Prospects for Foreign Direct Investment and the Strategies of Transnational Corporations, 2005-2008 (New York and Geneva; UNCTAD).

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flows. IPA respondents noted financial instability, commodity price instability, and political instability (such as civil wars) as major risks to global FDI. Aside from protectionism, few of these concerns can be dealt with by negotiators. The results suggest that the indexes and rankings may be of second order effects compared to wider economic conditions.

In his 2003 study,⁴ Nunnenkamp provides a list of traditional determinants of FDI inflows: Population size; GDP per capita; GDP growth; administrative bottlenecks; entry restrictions; risk factors (e.g. politics). Non-traditional FDI determinants in developing countries are: complementary factors of production; average years of schooling; cost factors (taxes, employment conditions); restrictions on foreign trade; changes in trade shares. Other determinants are: post-entry restrictions and technology regulations. He uses survey data to show that traditional determinants retain their dominance in the distribution of FDI, except for the availability of local skills.

Azzimonti and Sartre (2007)⁵ draw attention to the importance of political instability. They focus on the propensity of some governments to expropriate assets (nationalization) or indirectly (through changes to tax codes and exchange rates, capital controls, bribery, and licensing). The authors claim that poor institutional quality, expropriation in its many forms, and a lack of policy commitment are negatively related to FDI.

Econometric Studies and Computable General Equilibrium (CGE) models: Nicolette, Golub, Hajkova, Mirza, and Yoo's (2003)⁶ econometric study seeks to quantify the effects of removing FDI barriers. The sample is one of OECD flows from 1980-2000. Openness of a country to trade greatly influences the level and composition of FDI flows. Barriers to trade inhibit vertical FDI (for integrated supply chains) but can encourage horizontal FDI, in which firms seek to access a protected market. Aggregate level economic conditions are important. Product market regulation, economy-wide regulations and labour market regulation appear to discourage FDI. The effect of poor quality and unreliable infrastructure was weak in the OECD data, possibly due to the offsetting desire by many firms to invest in infrastructure. Market size and factor endowments also attract FDI.

Hajkova, Nicoletti; Vartia, and Yoo (2006)⁷ examine the effects of taxation. The econometric results indicate that corporate tax rates have a significant and

⁴ Nunnenkamp, Peter. "Determinants of FDI in Developing Countries: Has Globalization Changed the Rules of the Game?" Kiel Working Paper No. 1112, July 2002.

⁵ Azzimonti, Marina and Sartre, Pierre-Daniel G. (2007) "Barriers to Foreign Direct Investment Under Political Instability", *Economic Quarterly* 93(3) Summer: 287-315.

⁶ Nicoletti, G., S. Golub, D. Hajkova, D. Mirza, and K. Yoo (2003). "The Influence of Policies on Trade and Foreign Direct Investment", OECD Economic Studies, No 36, 2003/1.

⁷ Hajkova, Dana, Giuseppe Nicoletti, Laura Vartia, Kwang-Yeol Yoo (2006). "Taxation, Business Environment and FDI Location in OECD Countries", OECD Working Paper No. 502, July 2006.

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inverse relationship with FDI inflows. Their study also shows that the effects of taxation can be severely over-estimated if other factors are not properly taken into account. Once other conditions are accounted for, tax policies become relatively unimportant in for FDI levels. The performance of tax variables in FDI estimations has been highly variable, partly because actual marginal tax rates can be hard to establish and statutory rates may not always apply.

Border restrictions, trade restrictions, and restrictive product and labour market regulations all discourage FDI; however, FDI-specific restrictions had a relatively low effect on FDI levels. This may be the case because their impact is being offset by the presence of other attractive features that themselves encourage restrictive policies.

Petri (1997)⁸ simulated the effects of policy changes, modeling FDI restrictions as a tax on profits. He simulated three liberalization policies: Cutting the FDI “tax” in half; reducing only barriers to trade; and reducing both tariffs and the FDI “tax.” Relaxing barriers to investment brings about greater benefits than relaxing trade barriers, and trade and investment are strongly complementary. An OECD (2005)⁹ study also examined FDI barriers and found that lowering barriers to FDI to “best practice” levels would raise incomes in the OECD region by ¾%.

Stakeholder Consultations:

In consultations with Canadian stakeholders, one of the first priorities for investment related negotiations was to ensure national treatment for Canadian investors and remove discriminatory regulations. A second concern was political stability and the capacity of weaker governments to credibly commit their successors to FDI agreements. Foreign Investment Protection Agreements (FIPAs) or equivalent provisions were seen as particularly helpful.

Another priority was the provision of double-taxation agreements. This aspect of taxation was seen as far more relevant to FDI decisions than the rate of taxation in the host country. Trade and FDI are intrinsically connected as FDI usually requires some exchange of goods and services; hence, trade liberalization is also beneficial for FDI. The provision of insurance and dispute resolution arrangements play important roles in reducing risk for investments.

Barriers to FDI in Countries of Interest for Canada’s FDI:

Based on current Canadian FDI stock and recent growth, the countries of most interest for Canadian FDI are the United States, the United Kingdom, Barbados, Ireland, France, Bermuda, the Netherlands, Hungary, Australia, Germany, the

⁸ Petri, A. (1997) “Foreign Direct Investment in a Computable General Equilibrium Framework”, Brandeis University.

⁹ OECD Working Paper No. 463, “The benefits of liberalizing product markets and reducing barriers to international trade and investment in the OECD”, OECD Economics Department, December 2nd, 2005.

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Cayman Islands, Brazil, Switzerland, Chile, Japan, Mexico, Singapore, Argentina, Hong Kong, Indonesia, Spain, Belgium, Peru, Sweden, China, South Africa, India, and Russia. Barbados, Bermuda, the Cayman Islands and, to some extent, Hong Kong are likely primarily transit points for Canadian investment.

Most of the countries in which there are large stocks of Canadian FDI are covered by some form of agreement (OECD membership, NAFTA and/or FIPA). Exceptions are the Caribbean countries, Hong Kong, Singapore, Indonesia and Brazil. Agreements could be reached with these countries on a bilateral basis (which is likely faster) or on a regional basis (through the Caribbean Community (CARICOM), the Asia-Pacific Economic Cooperation (APEC), the Association of South East Asian Nations (ASEAN) and Mercosur).

The main investment barriers in the United States are the *Exon-Florio Amendment to the 1950 Defense Production Act* and related legislation to allow the Committee on Foreign Investment in the United States ("CFIUS") to block the acquisition of U.S. corporations on the basis of national security. 'National security' is not clearly defined, which may lead to an overly wide application of the legislation. Other specific barriers to investment are present in the areas of shipping, aviation, energy, and communications. U.S. laws on "Conditional National Treatment" are problematic, as well as discriminatory tax laws including different reporting requirements for domestic and foreign firms, interest payment deduction rules that do not conform to international principles, and State unitary income taxes.

The EU has investment barriers in maritime transportation. In banking, insurance and investment services and the energy sector, a foreign investor will be granted the same rights and privileges as EU-based firms have in the foreign investor's home state. EU members are discussing regulating inward investment from foreign Sovereign Wealth Funds. The EU and the US have initiated a bilateral "Investment Dialogue" to monitor and cooperate on global investment issues.

France maintains restrictions on FDI in 11 highly specific and strictly delimited 'sensitive' sectors related to national defence, the security of information technology, and gambling. In addition, France allows for 'poison pills' - increased shareholder and employee voting power in the event of a hostile takeover, and France sometimes tried to protect national champions from foreign takeovers.

Germany has restrictions on foreign takeovers. German firms can retain the right to establish defences against hostile takeovers. Germany has laws that require foreign firms to make notification of intent if their planned investment would give them 25% or more equity in German firms in restricted armaments and cryptology firms.

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Irish legislation requires that firms providing health care services need to obtain a “Service Level Agreement” from the Irish public health authority. Germany, Ireland, Austria, Sweden, Finland, Hungary and Brazil have restrictions on land acquisition by foreigners. In all EU states other than Austria, Finland and Sweden, public utilities are allowed to be publicly monopolized.

Australia screens FDI projects above A\$50 million and can deny projects based on ‘national interest.’ More detailed examination provisions apply to sensitive sectors such as real estate, civil aviation, airports, maritime transport, banking, media services, and tourism. US firms engaged in Greenfield investments are exempted, and the review level is raised to A\$800 million on the basis of the FTA between Australia and the US.

Brazil has regulations on foreign ownership in the audio-visual and broadcasting sector, including a maximum of 49% foreign ownership in the cable industry, and restrictions on profit remittances for foreign cable and satellite television broadcasters. Foreign investors must register with the Brazilian Central Bank. There are restrictions on investment in health, nuclear development, print media, telecommunications, communications, road and rail transport, hydrocarbons, pensions, fisheries, aviation and aerospace, and a ‘national interest’ review. Foreign employees generally cannot exceed 33% of total company staff.

Chile screen FDI over US\$5 million, in sectors normally characterized by public provision, the media sector, and when the investment is made by foreign public entities or governments. There are some restrictions in coastal trade, air transportation, and the mass media, and access to the fishing sector is subject to reciprocity.

Mexico’s oil and gas sector remains closed to foreign investment, with some exceptions. Only Mexicans may own gas stations. Hydrocarbons are under state ownership. Liberalization of this sector is proceeding at a slow pace. Forestry, coastal and border property, and other sensitive sectors are also restricted, as are investments over US\$ 165 million leading to a foreign ownership share of over 49%. Some investments require a foreign security screening.

Argentina has generally tried to create an investment regime favourable to FDI, with minor restrictions related to national security. The main concern is exchange controls and barriers to capital movements that prevent or delay easy profit and capital repatriation.

Peru restricts FDI in the broadcast sector to a minority share. FDI in land and resources within 50 km of borders requires special approval. Foreign employees in a firm are limited to 20% of personnel or 30% of payroll. Peru has a free trade agreement with the US.

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Indonesia retains significant barriers to FDI. Investment in some sectors is completely closed (harmful chemicals, illegal drugs, alcohol, casinos, air traffic systems, ship certification, radio frequency management, satellite monitoring, some forestry activities, taxi and bus operations, motion pictures and media, and small retail operations), while several others are only partially open (major infrastructure and transportation sectors such as water, airlines, shipping and seaports, nuclear power and the electricity sector). In addition, regional differences between Indonesian jurisdictions make the investment landscape complex and hard to predict.

Japan has the lowest inward FDI-to-GDP ratio of all major OECD countries, which suggests high investment barriers (despite rankings that put Japanese FDI barriers as less stringent than Canada's). There are prior application requirements for FDI into the aircraft and weapons sectors, and the petroleum and leather industries, and some restrictions in agriculture, forestry, fishing, mining, and maritime shipping. Most FDI barriers are informal, e.g. corporate culture and lack of transparency. Japan's competition laws affect FDI through their provisions on joint ventures, and private and corporate shareholdings.

China has widespread formal restrictions on inward FDI; yet FDI flows remain extremely high. The complexity of China's regulations makes them difficult to analyze. Canada will have little capacity to negotiate directly with China on many of these regulations, and a plurilateral or multilateral approach might be more desirable. China has FDI restrictions in a long list of sectors deemed critical to the national economy, including equipment manufacturing, automotive, electronic information, construction, iron and steel, nonferrous metal, chemical, telecommunications, finance, survey and design, and science and technology. Restrictions are based on national security, critical industries and the need to distribute the benefits of FDI more broadly in terms of affecting more regions and people. China has made extensive use of investment conditions, such as technology transfer, domestic procurement, joint ventures, and ownership caps. There are heavy reporting and approval requirements.

In India, FDI is prohibited in railways, atomic energy, atomic minerals, postal services, legal services, gambling, betting, lotteries, and basic agriculture or plantations (except tea). Approval is required for equity investments of more than 24% in sectors reserved for small and medium sized firms, and for investments in retail trade, defence equipment, coal, lignite, diamonds, precious stones, telecommunications, broadcasting, aviation, banking and insurance. Various caps on foreign participation apply. FDI is subject to an "industrial licence" in areas related to alcohol, tobacco, electronic aerospace and defence equipment, industrial explosives, hazardous chemicals, and drugs and pharmaceuticals.

Russia's foreign investment regulations and notification requirements can be confusing and contradictory. The apparent lack of protection for foreign investors, corruption, lack of transparency, and seemingly arbitrary application of laws and

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regulations has eroded the confidence of investors. Ownership caps on FDI are 49% in media and telecommunications, 49% on white wine, and 25% in aviation. National treatment laws are in place, but may be subject to exceptions based on national interests. There are explicit restrictions on FDI in 39 strategic sectors, including nuclear related industries, munitions and armaments, water, fishing, some mining, industries dealing with infectious diseases, aviation and aerospace, data transmission, encryption, and natural monopolies, e.g. parts of the energy sector. Foreign investors must register their activity, including every new affiliate, which can be onerous. Activities of banks with foreign participation are restricted, and local staff must constitute at least 75% of total staff. There are also discriminatory tax and land ownership rules.

Recommendations:

There are a number of useful typologies and rankings of formal FDI restrictions for use by policy makers. They are suitable for direct targeting in FDI liberalization negotiations, and are available on a country specific basis, and with some differentiation by sector. These specific FDI restrictions do affect FDI flows, but the effect may not sufficiently large to serve as a firm basis for prioritizing them.

Informal barriers to FDI are difficult to identify and measure, and less suitable for negotiation. Other economic conditions and policies clearly affect FDI, but often cannot be changed through negotiations (market size), and/or are non-discriminatory. Even if there is fairly conclusive evidence that certain policies deter FDI (and the evidence is often inconclusive), it might be inappropriate and intrusive to seek to negotiate changes to taxes, infrastructure provision, product market regulations or employment protection laws.

FDI liberalization can usefully be coupled with, and become an extension to, more traditional trade liberalization exercises. The main priorities identified by Canadian stakeholders were national treatment for Canadian investors, Foreign Investment Protection Agreements (FIPAs), and double-taxation agreements. Political risk insurance (e.g. through Export Development Canada) and dispute resolution mechanisms are helpful. Other priorities arise from the discussion of FDI barriers above. Canada should address some of these restrictions in bilateral or multilateral negotiations.

There is a lack of data dealing specifically with Canadian outward FDI. Further research is necessary and requires access to data that likely exists at Statistics Canada, but is not publicly available.