Competition Policy Review Panel
Research Paper Summary

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Title: Head Office Location: Implications for Canada

Subjects Addressed:

- Head offices, their benefits, and factors for their location
- Hollowing-out and restrictions on foreign direct investment
- Subsidies and other inducements to attract head office investment

The Importance of Head Offices:

The role of head offices is to issue instructions to other units of a firm, coordinate production and sales activities, allocate resources, collect information, delegate tasks, and make the long-run, strategic decisions. For smaller firms, they are usually located together with the operating unit, but large companies often have one or more stand-alone head offices. They may have separate head offices for managing production, sales, and strategic planning.

While head offices only employ a few hundred workers, they generate indirect benefits to the local economy. Their employees are highly-skilled, contribute more to the tax base, and support innovative activities. There is also likely to be additional employment generated by related businesses in the business service industry. The majority of head offices outsource accounting, legal, and advertising services. Expenditures on outsourcing for these three services amount to 65% of the wage bill of head offices, mostly on advertising. Jobs related to head office activities tend to require high skills, pay high wages and contribute strongly to tax revenues. Head office activities are innovative and innovation may generate knowledge spillovers and above-normal profits. Head offices of major corporations can be philanthropic, funding arts, education, and other community programs.

Head offices can generate industry clusters, which attract more head offices. Virtuous circles develop involving business services and skilled human resources; the business services sector grows due to increased demand and provides better, more specialized services. Highly skilled human resources move to head office locations and are available to other head offices. Workers upgrade industry-specific skills, which will be available to current and potential employers.

Developments in the Numbers of Head Offices in Canada:

Data indicates that head office units are subject to significant entry, exit, and relocation. There is a certain level of concern that mergers with and acquisitions by foreign companies lead to a loss of head offices in Canada, or to a loss of the higher-value, strategic planning functions within head offices – this is referred to as a hollowing out of corporate Canada.

However, Canadian losses in control due to sales of Canadian assets in 2000 were largely offset by gains in control of foreign assets. We refer to this as the “two-way street;” Mergers and Acquisitions flow in both directions, with presumably small net effects on demand for head office services. The value of Canada’s international merger and acquisition activity is very high but reflects a small number of very large transactions. Over an extended period, Canada’s purchases of foreign assets largely offset sales of Canadian assets. Net sales occurred in 2005 and 2006. However, it seems unwise to extrapolate trends from this recent data; the two-way street phenomena will most likely reassert itself.

In addition, in the event of an acquisition by a foreign company, separate head offices may be maintained; only the corporate headquarters may be consolidated; or several or all regional head offices may be combined. This depends on economies of scale and costs of travel, communications, and the shipment of goods. The location of each head office will typically be close to the majority of production and sales units, either in Canada or abroad. In companies with several products, head offices in different countries may get ‘world product mandates,’ depending on where the inputs, expertise and demand are.

A Beckstead and Brown (2006)[1] study of Canadian Business Register data from 1999 to 2005 shows that head offices have increased by 4.2% and head office employment by 11%. Head office employment in foreign-controlled firms increased by more than that in domestically controlled firms (21% compared to 6%). Foreign firms accounted for the majority of the head office employment gain. Finally, ownership change from domestic to foreign resulted in a slight net addition of head offices and a slight increase in employment. Hollowing out has not occurred.

Head office births, deaths, and relocation occur at a high rate, but overall, the authors’ analysis of data from Canada’s “Survey of Employment, Payroll, and Hours” (SEPH) also shows that Canada has a reasonably healthy head office sector. Head office employment growth has kept up with aggregate service employment growth, and workers in the sector earn a premium over other service workers. This premium has remained roughly constant, a trend that is inconsistent with the proposition that foreign firms are truncating head office activities from above in Canada (i.e. moving high-level decision-making abroad).

[1] Beckstead, Desmond and Mark Brown, 2006, “Head Office Employment in Canada, 1999–2005,” Statistics Canada Economic Analysis Analytic Paper Series 11-624-MIE No. 014.

Determinants of Head Office Location:
In general, the United Nations Center for Trade and Development (UNCTAD) identifies the main determinants of head office location as international accessibility; a skilled workforce; high quality of life to attract international staff; low corporate and personal taxes; excellent information and communication technology infrastructure; well-developed business support services (legal, accounting, public relations); low risk (crime, exchange rates, regulatory and tax changes); and proximity to customers. The authors add to this proximity to production units and the cost and availability of office space.

Davis and Henderson (2004)[2] and Strauss-Kahn and Vives (2007)[3] find that the probability of receiving a new headquarters is increasing with the number of same-industry headquarters in a region. In both the studies, the effect attenuates with an increase in HQs. The presence of specialized intermediate service providers including business services (advertising, employment agencies, computer services, legal services, engineering, and management services) and financial services (commercial banks, security and commodity brokers) exerts a positive and significant influence on the probability of receiving HQ investment. However, higher head office wages in a location and higher wages in the intermediate service input sectors deter investment, as do high corporate taxes.

Other factors for head office locations are that head offices agglomerate in order to share information about export opportunities, especially for export to “difficult” places, and that they are strongly drawn to locations with airports.

Head Offices in Canada:
In Canada, Toronto has the lion’s share of head offices. The Big 4 hosts of head offices are Toronto, Calgary, Montreal, and Vancouver. Calgary has gained head offices, while Vancouver and Montreal have lost head offices. The relocation rate over five years is 6.1%.

Not only do Toronto, Montreal, Calgary and Vancouver have the most head offices, the share of head offices in these cities exceeds their population shares. If one city is twice as large as another, then it is expected to have more than double the number of head offices.

Head offices tend to be located in cities with highly educated workers. A doubling of a city’s share of university graduates in the population is associated with three to four times more headquarters per capita. This does not indicate the direction of causality between head office location and education levels; likely it is a virtuous circle of head offices attracting skilled workers and vice versa.

[2] Davis, James C. and Vernon J. Henderson, 2004, “The Agglomeration of Headquarters,” Brown University manuscript.
[3] Strauss-Kahn, Vanessa and Xavier Vives, 2007, “Why and where do headquarters move?,” manuscript

Should Canada Adopt Special Inducements to Attract Head Offices?

There is some debate on the benefits of special government efforts to attract head offices or large manufacturing plants. Greenstone and Moretti (2004)[4] find that a new manufacturing plant is associated with a 1.5% increase in labour earnings in the new plant's industry relative to other counties. The wage bill also increases in the same industry in neighbouring counties. Effects on earnings in other industries are positive but not statistically significant. Property values increase by 1.1 to 1.7%. Fox and Murray (2004)[5] do not find evidence that receiving a large investment resulted in higher employment growth but rather that large investment crowds out other economic activity.

Ireland is often used as a model for generating economic growth by attracting foreign direct investment. From 1973 to 2006, Irish real per capita income quadrupled, and inward investment was thought to play a very substantial role in this success. Over the time from the 1950s to the present, Ireland has dismantled barriers to FDI, made export earnings tax exempt, upgraded education, introduced shorter sub-degrees in engineering and business studies, established a 10% corporate tax rate at a time when European rates were much higher, joined the European Union (EU), and provided generous treatment for R&D expenditures. This mix has been highly successful for attracting foreign investment and generating economic growth, but it is hard to assess which policies in particular were responsible for the success. The factor of significantly lower wages than other EU countries was likely a major determinant and cannot easily be replicated.

While it may be appealing to offer inducements to attract head offices, there is no compelling case for promotional policies. As measured by both sector-level data and special Statistics Canada tabulations, employment growth in the head office sector has been strong. Average earnings data for the sector also do not point to declines in the average quality of head office jobs in Canada. Additional investment can create negative externalities through congestion, and much of the benefits gained from luring head offices may be at the expense of other locations within Canada.

If, however, measures to attract head offices are adopted, we would be reluctant to advocate investment subsidies. They are not the most efficient or equitable way for cities to attract and retain head offices. Agency problems arise if politically influential companies succeed in lobbying for unwarranted subsidies. They also create prisoners' dilemma situations where everyone provides subsidies and every government is worse off because of the subsidies.

[4] Greenstone, Michael and Enrico Moretti, 2004, "Bidding for Industrial Plants: Does Winning a Million Dollar Plant IncreaseWelfare?", Massachusetts Institute of Technology manuscript.

[5] Fox, William F. and Matthew N. Murray, 2004, "Do Economic Effects Justify the Use of Fiscal Incentives?," Southern Economic Journal 71(1), 78–92.

Conclusions:
The data offer little support for policies that restrict inward foreign investment. Foreign acquisitions do not appear to be reducing head office employment or earnings in Canada. There is also no compelling case for promotional policies and investment inducements designed specifically to attract head offices, since the head office sector is strong. Subsidies are likely to be counter-productive since they can be subject to misallocation based on lobbying and they are likely to serve mostly to attract away head quarters from one Canadian city to another Canadian city.

The best policy response is to continue to promote policies aimed at fostering a knowledge-based economy and a competitive business environment, such as investment in education and basic research, R&D promotion, and low corporate taxes. This will benefit the economy as a whole and have the bonus benefit of attracting head offices.