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**Competition Policy Review Panel**  
**Research Paper Summary**

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**Title: Inward Foreign Direct Investment and the Canadian Economy**

**Subjects Addressed:**

- Foreign Direct Investment (FDI) in Canada
- Canadian Direct Investment Abroad (CDIA)

*The Advantages and Risks of FDI:*

There are many advantages to FDI, e.g. they are an important source of R&D diffusion, foreign firms have higher levels of productivity and trade propensities, inward FDI contributes to domestic capital formation, and FDI is complementary to trade.

The arguments made against inward FDI are related to head office activities, including R&D activities and decision making. Activities will only be moved from Canada to the investor's home country after an acquisition if this enhances profits. The evidence provided by the Institute for Competitiveness and Prosperity and the Conference Board of Canada indicates that in fact there has not been a hollowing out of the Canadian economy. Some of Canada's corporate stars have been bought out, but Canada has created many more global leaders.

CDIA can lead to a loss of jobs if it moves production abroad. If this is driven by a poor domestic competitive environment - high taxes, a lack of skilled labour or low R&D intensity - then the effects on the local economy are likely negative. If it is driven by the competitiveness of domestic firms which exploit their firm specific advantages abroad, the impact of these investments on the home country may be positive over the longer term.

Restricting FDI to Canada would hurt the Canadian economy by removing the discipline that comes with the threat of takeovers, restricting the amount of capital available, raising the cost of capital and leading to a loss of the spillovers from the higher productivity of foreign firms. Instead, policies should address the factors that give rise to foreign takeovers and the removal of headquarters, including thin Canadian capital markets, Canadian managers that lag behind, and disadvantages associated with being headquartered in Canada due to tax or other considerations.

Sovereign Wealth Funds (SWFs) seem to be for the most part passive investors. They could provide Canada with large pools of money and reduce the cost of capital. If a Canadian-headquartered corporation is restricted from financing from SWFs, this may be an incentive to move the companies' global headquarters to another country.

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*Historical Developments of FDI in Canada and CDIA:*

In 1970, the inward stock of FDI in Canada amounted to 28% of GDP, whereas the amount of outward FDI was on the order of 7%. Since then, Canada's outward FDI has grown at a compound rate of 13% and inward FDI at 8%. The importance of outward FDI relative to GDP increased until 2003, with a decline thereafter. The importance of inward FDI relative to GDP decreased between 1970 and 1977, plateaued over the 1977 - 1995 period, increased between 1995 and 2000 to approximately 1970 levels, and then remained relatively steady.

The pace at which Canadian multinationals have expanded globally has far exceeded the pace at which foreign multinationals have expanded in Canada. Since 1997, Canada has had more Canadian direct investment abroad (CDIA) than there was foreign direct investment (FDI) in Canada. Today, it is about 25% more CDIA than FDI. Canada's ratio of inward FDI to GDP is as high as in 1970, but its CDIA relative to GDP is much higher than in 1970.

Canada's share of the world's FDI fell from 15.7% in 1970 to 3.21% in 2006. This pattern is sustained whether we benchmark off of World FDI, Canada and US, G7, G7 less the US, or NAFTA. Hence this decrease cannot be attributed to the increased importance of China, India or Eastern Europe. Canada has been able to keep pace with the rapidly growing stocks of world FDI in terms of CDIA.

The US is by far the largest Canadian partner, followed by Europe, both with respect to inward and outward FDI. The importance of the US for Canada has decreased from 60% of CDIA in the 1980s to about 42%, and from 80% of FDI in the 1970s to about 60% today. This reduction has been directly linked the reductions in trade barriers between the two countries. Prior to trade liberalization, multinationals from each country had to locate inside the other country to avoid paying tariffs. The tariff reductions allowed multinationals to consolidate production and access the other markets by trade. Much of the US FDI into Canada now is in natural resources, energy, and commodities, followed by FDI into Canadian manufacturing, especially autos, and in Canadian service industries to access Canadian markets.

Canada's FDI relationship with Europe has grown from under 20% of both CDIA and inward FDI in the 1970s to roughly 30% today. Latin America, including Offshore Financial Centres (OFCs), receives 20% of CDIA, but is the source of just 3.4% of Canadian FDI in 2006. Four out of the top 10 destinations for CDIA are OFCs (including Barbados, Bermuda, and the Cayman Islands). The growth in their importance began around 1990 and rose to 20% of CDIA in 2004. Brazil accounts for 61.9% of all Latin American FDI into Canada.

The dominant motivation for FDI flows into Canada from the world seems to be natural resource seeking, as energy, metallic minerals, and wood and paper are the largest recipient industries. These are followed by service industries such as finance and insurance, services and retailing, investments which are most

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likely driven by a market access motivation. Manufacturing industries such as machinery and transportation are next. The dominant motivation for CDIA is market access in the services sector, followed by natural resource seeking. This is especially true for investment flows to and from the US and Europe. FDI from other OECD countries is more evenly distributed over sectors, and for CDIA to other OECD countries, natural resource access is more important.

At a more detailed level, the largest recipient industries of FDI in Canada in 2002 were Petroleum and Natural Gas, Motor Vehicles and Motor Vehicle Parts and Accessories, Investment Intermediaries, Chemicals and Other Chemical Products, and Beverages. The largest recipient industries of Canadian outward FDI in 2002 were Deposit Accepting Intermediaries, Insurers, Non-Ferrous Metals and Primary Metal Products, Investment Intermediaries, and Petroleum and Natural Gas.

*Comparison of Canadian FDI Trends with Other Countries:*

Through 2000, the United States saw its share of world inward FDI rise as much as Canada's share has fallen. Since 2000, Canada's share of inward FDI has continued to fall, and the US also began experiencing a decrease. As for outward FDI, Canada has roughly maintained its share at about 5%. The US has seen its outward share fall significantly.

Between 1980 and 2000, the US share of all FDI reaching the 3 NAFTA countries was rising, as was Mexico's share, whereas Canada's was falling. However since 2001 or 2, the US share began to fall and Mexico plateaued, whereas Canada's began to increase. In the past few years, the shares for all three NAFTA partners have been flat.

Canada was by a large margin the largest recipient of intra-NAFTA FDI in the 1980s and the 1990s. However, Canada share has fallen steadily from around 1983 to around 2000 (though it is still the largest recipient), whereas the US and Mexican shares increased. Since 2001/2, Mexico's share has been flat; the US saw a big drop and a sharp rebound, whereas Canada experienced a significant run up but then a share fall.

In 2001, Mexico surpassed Canada as a destination for FDI which originates outside of North America. That is, non-North American MNEs had a larger stock of FDI in Mexico than they did in Canada. This continued from 2001-2005. The reason was clearly to undertake production (manufacturing) to supply the entire North American market. However, since 2005, the stock of Non-North American FDI locating in Canada has exceeded that in Mexico again, with a concentration in the energy sector.

When comparing shares of inward and outward FDI relative to a country's GDP over the 1980-2006 period, Canada is an obvious outlier. No other major developed country has seen its share of inward FDI relative to GDP fall more

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than Canada. Canada's share of inward FDI relative to GDP in 1980 was higher than in 2006. Canada is not an outlier for CDIA.

*Explanatory Factors for Canada's FDI Performance:*

A gravity model for FDI analyzing inward FDI into each OECD country from each other OECD country based on the size of the host and home country, shared language, distance, exchange rates and free-trade agreements (FTAs) shows that, even though North America and Europe receive more FDI than predicted based on the model, Canada receives less FDI than predicted. This means that there are features of the Canadian economy that are not factored into the model, likely related to taxes, labour quality, management quality and access to capital and technology.

An appreciating exchange rate serves to discourage inward FDI. In Canada's case, the surge in the Canadian dollar over the past five years has mitigated the surge in inward FDI destined for Canada's energy and commodity sectors. Had the Canadian dollar not surged, all else constant, there would have been more FDI into the Canadian economy. Conversely, the surge in the Canadian dollar has enabled Canadian companies to acquire more assets globally.

There has been a reduction in the share of Canada's outward and inward FDI with the United States, but a marked increase in the shares of Canada's trade with the United States. These trends are *consistent with* the implementation of the FTAs. As barriers to trade have fallen, Canadian multinationals can concentrate production in Canada for the entire North American market, and vice versa.

As the tariffs fell, European FDI into Canada was unchanged, whereas Canada's FDI into Europe increased. FDI into Canada from Asia and Latin America rose. There was a larger increase in Canadian FDI into the U.S. than there was reduced U.S. FDI in Canada. There was less FDI into Canada from the rest of the world, but a large increase in CDIA to the rest of the world.

The Canada-US FTAs go beyond tariffs and include national treatment provisions and other protections for investments. These impacts further reduced US FDI to Canada but off-set some of the tariff-related decline in FDI from the rest of the world and some of the tariff-related increase in CDIA. Nevertheless, the results show clearly that the tariff effects dominate – thus explaining the fall in Canada's share of inward FDI.

This analysis also shows that R&D intensity is an important driver of FDI, both inward and outward. Therefore, sectors in Canada that undertake more R&D are both sources of CDIA and targets for inward FDI. This result is certainly consistent with the observation that much of Canada's FDI, outward and inward, is in the same industry (that is, like trade, much FDI is intra-industry).

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Average corporate tax rates are not statistically significant in explaining Canadian inward FDI. They are negatively related to CDIA in countries other than the U.S., but insignificant for Canada's FDI with the US. Hence, industries that have higher tax burdens in Canada undertake less FDI in the global economy. Much of this result may be undermined by the increasing use of offshore financial centres by Canadian business.

Much earlier work has documented a complementary relationship between trade and FDI. The author finds that inward FDI and imports are positively related. Outward FDI and exports are not complementary in this analysis; exports are likely not a statistically significant factor in a model with tariffs as another factor.

On net there is generally more manufacturing FDI in Canada, but less FDI in services. This is no surprise given the restrictions placed on FDI into many of Canada's services sectors, and the importance of Canada's manufacturing sector to the US auto industry.

*Physical, Institutional, ICT, and S&T Infrastructure:*

The literature clearly establishes that there is a causal link between infrastructure and economic growth, notwithstanding the caveat of reverse causality (whereby economic growth also causes infrastructure improvements). Infrastructure in the wider sense can be classified into four categories: Physical infrastructure, Institutional infrastructure (ease of doing business, governance, financial markets, etc.), Information Technology (IT) and Telecommunications infrastructure, and Science and Technology (S&T) infrastructure.

In comparison to other G7 countries, Canada is very strong on governance, transportation infrastructure (except the ports), and the number of Internet users. Areas of relative weakness are the level of public investment in infrastructure, Canada's net capital stock of public infrastructure per capita or relative to GDP, the ports, costs of shipping by container, mobile phone subscriptions, expenditure on Information and Communication technology relative to GDP, and the low amount of credit intermediated by the financial sector and granted to the private sector.

Canada's overall institutional infrastructure around doing business is very strong, but weaknesses are a cumbersome and costly process of dealing with licenses, relatively high costs associated with firing employees, and a relatively expensive process of enforcing contracts. In 2001/2002, the size of the underground economy in Canada was estimated to be 15.8% of GDP, higher than in the other G7 countries except Germany.

Canada lags most G7 countries on several indicators of Science and Technology, including expenditures on R&D relative to GDP, Patent and

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Trademark applications, and royalty payments, which is reflected in the relatively low share of high tech exports in total exports.

Although this study does not link Canada's FDI performance to these weaknesses or strengths, other studies have found these to be important in explaining FDI patterns.

*Conclusions:*

The reduced inward FDI after the CUSFTA and the NAFTA was a function of less efficient plants in Canada being closed and operations being moved to the United States. Some of the FDI that Canada lost was not as efficient as what replaced it, but what replaced it was often not in Canada. Tariff reductions have thus worked to significantly reduce Canada as an attractive location for U.S. and non-U.S. firms. Companies could locate in Canada and export to the U.S., but the potential for interruptions in access to this larger market (e.g. 9/11) are an important factor. Poor R&D performance, relatively high Canadian taxes, and lower productivity performance relative to the U.S. may also play a (secondary) role. Increased trade, GDP and CDIA are positive results from the free trade agreements.

Policy with respect to inward and outward FDI should not be restrictive. Rather, the government should address any underlying causal factors that make FDI problematic, for example low R&D, problems related to the physical and institutional infrastructure of the country, high taxes and restrictive regulations leading to firms moving their production abroad. A very important factor is to reduce uncertainty around access to the large and rich U.S. market.

In negotiating any future agreements, Canada should consider the impact on FDI in any cost-benefit analysis. Market access and protection (National Treatment) for Canadian investors should be embedded in any future trade agreement.