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Competition Policy Review Panel
Research Paper Summary

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Title: Are there global or regional supply chains? Implications for head office location in Canada.

Subjects Addressed:

- Head office location
- Global or regional supply chains
- Impact of foreign vs. domestic ownership on company performance

Regional supply chains:

Many large corporations now operate as (often transnational) networks rather than as hierarchical organizations. These networks can be internal to the company and/or external with other firms. Many of the *Fortune* Global 500 companies outsource to emerging markets (China, India, and Southeast Asia) to reduce cost and increase operational efficiency. Global supply chains have become possible with reductions in transportation and communication costs. But there are also costs in terms of supply chain management and global risk control. Despite the potential outsourcing opportunities, the reality for Canadian firms is that most of them have their suppliers and markets within NAFTA.

A study by Rugman and Verbeke (2004)¹ found that, of 380 *Fortune* Global 500 multinational enterprises, 9 had adopted a global strategy (selling at least 20% of their product on each of three continents including NAFTA, the EU, and Asia), 25 followed a bi-regional strategy (selling at least 20% each on two continents and less than 50% on any one continent), and 320 had a home-region focused strategy (selling over 50% on their own continent) in 2004.

An analysis of the information on upstream and downstream activities of 34 large (by sales) and internationalized (by foreign to total sales ratio) Canadian firms shows that over 75% of the firms have their major supply chains within NAFTA. 7 of the 34 companies (20%) have over 80% of their sales in Canada and 22 (65%) have over 50% in NAFTA (but under 80% in Canada); 4 (12%) have over 20% of their sales in each of two global regions (NAFTA and EU or NAFTA and Asia), 1 company (3%) has over 50% of its sales in a host region (the EU), and no company has over 20% of its sales in each of the three regions, though one is almost there. Hence, 85% of Canadian firms conduct their downstream activities in their home region.

¹ Rugman A.M. and Verbeke, A. A perspective on regional and global strategies of multinational enterprises. *Journal of International Business Studies* 35(1) (2004): 3-18

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For upstream inputs (locations of raw materials, natural resources, other inputs, R&D activities, and firm infrastructure and operations), 38% of firms (13 firms) have their upstream activities mainly in Canada; 41% of firms (14 firms) locate their upstream activities in NAFTA; only 18% (6 companies) perform their upstream activities in two regions; and 3% (1 company) have upstream activities in all three regions. Hence, 79% of Canadian firms conduct their upstream activities mainly in their home region.

Canadian firms should locate their head offices within NAFTA. It makes sense for them to locate head offices in the United States for potential indirect benefits of networking and political access to regulatory groups.

Firm-specific advantages add value to head offices:

Firms have country specific advantages (CSA), reflecting the natural resources of Canada (for mining, energy, and forest products), and firm specific advantages (FSAs). The location of head offices for firms relying on strong CSAs is unimportant. The location of head offices for firms that rely mostly on FSAs is important to the extent that these firms have FSAs in knowledge, proprietary technology, brand equity, and managerial and marketing expertise. There may be social losses if these firms move their head offices outside of Canada.

Performance comparison between Canadian and foreign-owned enterprises:

There is no statistically-relevant difference in the financial performance between Canadian-owned firms and foreign firms with operations of a similar scale in Canada. The data analyzed for this finding was a five-year average of returns on sales, returns on assets, and *Tobin's q* [(market value of equity + book value of preferred stock + total debt)/(total assets)]. Hence, the sale of Canadian companies to foreign interests will not, on average, affect their financial performance.

Baldwin and Gellatly (2007)² found that foreign-controlled firms typically have larger plants, higher wages, higher productivity, and more frequent innovations. However, when comparing the Canadian-owned multinationals with foreign-controlled firms, studies show that there is not much difference between the two sets of firms in terms of value-added per worker, gross output per worker, worker wages, the share of non-production workers, and types of technologies used. The findings of this study are consistent with those in Baldwin and Gellatly. Essentially the empirical evidence over the last 30 years is that there is a strong country effect, making both foreign-owned firms in Canada and Canadian-owned firms perform in a broadly similar manner. Both groups of firms build on Canada's strong natural resources and are limited by Canada's small market and institutional protection in some sectors.

² Baldwin, J.R. and Gellatly, G. *Global Links: Multinationals in Canada: an Overview of Research at Statistics Canada*. Research paper, no. 014, The Canadian Economy in Transition Series (Ottawa: Statistics Canada, Micro-Economic Analysis Division, 2007).

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The advantage of pursuing a regional supply chain:

The coefficients of *Sales ratio in NAFTA* are significantly positive in affecting firm performance in terms of returns on sales and returns on assets. Firms that have a large percentage of sales in NAFTA tend to perform better in returns on sales and returns on assets. This could mean that focusing on regional supply chains and locating divisional head offices within NAFTA countries may improve the performance of Canadian firms.

Conclusions:

Canadian firms should locate their head offices within NAFTA to take advantage of the economic integration between Canada, the United States and Mexico. Having offices in the United States or Mexico may benefit Canadian firms because this may strengthen their supply chains. This will ultimately improve the competitive advantages of Canadian firms and their financial performance.

Since Canadian-owned firms do not have better financial performance than foreign-owned firms, the Canadian government should not be concerned about the reduction of head offices of Canadian-owned firms and does not need to design special policies for protecting Canadian-owned companies or keeping all their divisional head offices within Canada. The location of head offices reflects corporate strategy and internal firm processes. Government should keep a hands-off policy in dealing with the corporate head office issue.

Keeping head offices with strong FSAs within Canada bring economic and social benefits to the local economy (spillover benefits). Government should build an environment more conducive to the development of FSAs for Canadian firms. The government can provide tax incentives to facilitate knowledge clusters in important cities. It can also gradually open protected sectors such as financial industries for foreign firms to improve the competition level. Canadian firms can strengthen FSAs through intense competition.

Canadian firms tend to have lower performance if they have a higher sales ratio outside NAFTA. Focusing on the global market and global supply chains hence does not necessarily lead to better performance for Canadian firm. There seems to be no need for policies to encourage firms to seek suppliers and customers in the global market. The government should instead devote their resources to design policies that are helpful to develop regional supply chains.

Government should facilitate the further deepening of NAFTA so that the legal and institutional framework for doing business in North America reflects the high degree of economic integration already in place. For example, Canada should seek to harmonize Canadian standards with those of the United States as soon as possible. Government concern about job losses and the related retraining assistance policies should be directed towards a regional trade agreement such as NAFTA rather than towards the World Trade Organization.