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Competition Policy Review Panel
Research Paper Summary

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Title: An Evaluation of the Investment Canada Act and its Operations

Subjects Addressed:

- Investment Canada Act
- Foreign direct investment in Canada
- Canadian investment abroad
- National security screening of investments
- State-owned enterprises

Overview of foreign direct investment in Canada:

Between 1985 and 2007, 77% of foreign investments took the form of acquisitions, and 87.5% of foreign investments were below the monetary thresholds for ICA review. The average annual number of acquisitions has declined slightly from 516 between 2000 and 2007, as compared to 632 between 1985 and 1999. Acquisitions by U.S. investors have declined slightly in relative importance, from 62.4% of all acquisitions in 1985–2000 to 60.2% in 2001-2007. This decline was offset by an increase in acquisitions by European Community investors from 21.2% of all acquisitions in 1985-2000 to 23.8% in 2001-2007. The distribution of investments was 28.7% of the total number of investments in manufacturing, 26.1% in business and the service industries, 24.8% in wholesale and retail trades, and under 7% in resources.

Purpose of the Investment Canada Act (ICA):

The stated purposes of the ICA are to encourage investment in Canada and to review significant investments in Canada by non-Canadians in order to ensure economic benefits to Canada. Investors are expected to put forward a case (based on their business plan) that the acquisition will confer a net benefit on the Canadian economy relative to what would be expected under Canadian ownership. If the investment is deemed not to be of net benefit, the investor can suggest changes to the business plan in order to improve the net benefits.

However, in order for a review process to have the potential to either increase the quantity of Foreign Direct Investment (FDI) or to enhance the economic benefits of FDI, the relevant markets have to be characterized by serious “failures” (e.g. potential for rents for investing companies). Otherwise, the efforts of regulators will lead to either reduced FDI or a redistribution of the economic benefits of FDI among Canadians (e.g. from those selling a business to those benefiting from undertakings, via a lower acquisition price to off-set the undertakings). While a potential for economic rents may exist sometimes, it is

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hard for the Investment Review Board to identify it while reviewing a business plan.

Criticism leveled against the Investment Canada Act:

Specific criticisms of the ICA tend to focus on procedures and policies. While the evaluation criteria are explicitly set out, there are no weights attached to individual criteria indicating which criteria are the most important. There is also no option to claim tradeoffs among the criteria (having fewer benefits under one criterion being offset by more benefits under another criterion). The ICA is often criticized for a lack of transparency both by investors and by citizens or groups interested in monitoring approval processes and commitments made. Investors also have concerns about consistency in the application of the criteria for reviewing investments. The limited public accountability raises risks that political lobbying can influence review outcomes.

Resource expenditures by companies and taxpayers associated with the ICA, including lobbying, negotiating, and the administration of reviews, represent “dead-weight” costs of regulation. The review process is time consuming, resulting in inefficient delays and transaction costs for investors.

Some reviews under the ICA may be duplicative of sector-specific statutes (e.g. culture, transportation, financial services). In the culture sector, reviews are triggered by the form of the product rather than its actual content (the telephone directory is a book but not a cultural product). Acquisitions are reviewed even if they only involve a relatively small “culture component.” For example, a foreign investor might acquire a drug store chain that sells books and magazines as a very small share of the chain’s total sales. A “minimum share of sales” threshold could remedy this problem.

Does the Investment Canada Act achieve its Goals?

The ICA has two goals, to encourage foreign investment and to improve the benefits foreign investment brings to Canada. The ICA is supposed to encourage foreign investment. However, the review process neither significantly reduces political risk by establishing a ‘rule-of-law’ process, nor does it facilitate information flows to investors. Hence, it does not increase the level of FDI.

The second goal, an enhancement of the benefits of foreign investment, is more difficult to assess. The main economic benefits of foreign investment (over domestic investment) generally are spillover efficiency benefits enhancing the productivity of other Canadian firms (through enhanced competition and through the leakage of technology and expertise). Undertakings under ICA tend to reduce the efficiency of foreign companies, hence they are more likely to reduce the pressure of competition and hence the efficiency benefits than to increase them.

Nevertheless, some undertakings like increased expenditures in the host country on R&D and innovation activities can facilitate the formation of new spin-

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off companies. This increases productivity through technology and expertise transfers. Should the innovation undertaking come at the expense of spending on other expertise-building activities like management training and education, however, the loss in Canadian management expertise would off-set the gains in high-tech expertise. Hence, this aspect of spill-over benefits is difficult to assess on a global basis.

Generally, the funds for any undertakings can come out of any rents multi-national companies might gain in (imperfect) Canadian markets. If, however, there are no rents, or if rents are reflected in higher purchasing prices for the company, then undertakings under the ICA will be off-set by a reduction in other 'undertakings' or beneficial activities. Alternatively, they will be reflected in a lower acquisition price for the Canadian company than would otherwise have obtained, and/or they reduce the efficiency of the operation of the acquired business. For investment reviewers to evaluate all these factors is very difficult.

The ICA review could also theoretically increase net benefits by lowering the costs to Canada of foreign acquisitions. Costs have been expected in the area of a loss of R&D and management functions in Canada (a.k.a the 'hollowing out'), but historical data shows that this loss has not occurred. There is no persuasive evidence that FDI imposes widespread third-party economic costs on host economies. Specific acquisition can carry costs, e.g. significant lay-offs. Undertakings to maintain employment can reduce these costs. However, this reduction in short-run costs of labor market dislocation comes at the expense of reduced efficiency and possibly lower acquisition prices for Canadian companies. There is hence no reliable evidence on whether the ICA has contributed to increased benefits for Canadians from FDI.

In the cultural sector, the investment review has additional goals of encouraging increased expenditures on the creation of Canadian content. Undertakings by foreign acquirers that promote the expenditure and employment objectives of the review process will come at the expense of lower acquisition prices paid to owners of the acquired companies. The review process is a channel for transferring income from owners of acquired culture companies to other Canadian participants in the culture industry. If this transfer is deemed desirable, then maintaining the review process might be justified; however, the direct transfer of income through taxes and subsidies may be a more efficient way to encourage increased expenditures and employment in the culture industry.

Does the ICA review have an impact on the amounts of foreign investments? Three studies (Kudrle 1995, Vigeant and Ouellette 2003, and Baldwin, Gellatly and Sabourin 2006) have found a modest deterrent effect of the FIRA on IFDI and some evidence that the replacement of FIRA by the less restrictive ICA contributed to a small increase in FDI. Other studies by Globerman and Shapiro (1999 and 2003) were inconclusive.

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A Price Waterhouse (1997) survey of lawyers and corporate counsels also found broad agreement that, with the exception of the cultural sector, the landscape of the economy would not look appreciably different in the absence of the ICA. A 2004 survey by Rheaume shows that the poor quality of Canadian employees and suppliers and the state of Canada's infrastructure are more important factors in the investment decisions of the executives of foreign multinational companies.

Is there still a need for an Investment Canada Act?

The ICA does not appear to make significant contributions towards its current economic goals. However, a change in the focus of the review process might render that process more relevant to public policy. Just as in the cultural sector, **where** the aim is not to increase economic efficiency but expenditures on Canadian content, the goal of the general ICA review should not be an economic one, but a national security one (including culture as a component of national sovereignty).

A number of countries regulate inward FDI on the basis of national security concerns, although the definition of national security, as a practical matter, can be fairly broad. Most countries that screen inward FDI employ a "negative" test. The focus is on whether the proposed investment is likely to adversely affect national security (however broadly defined), and the onus is on the host government to make this case.

State-owned Enterprises (SOEs)

In recent developments, state-owned enterprises (SOEs) have become important investors. This raises new concerns, as some of them are suspected of having non-commercial objectives. One question is, hence, whether direct or indirect foreign government control of management should raise national security concerns.

A potential economic justification for tighter scrutiny is that the spillover efficiency benefits to Canada from investments by SOEs are likely to be smaller than those from private-sector investments. However, economic arguments to move in this direction are not compelling. Shapiro and Globerman (2007) reviewed the empirical literature examining the economic performance of government-owned versus privately owned firms. They concluded that SOEs from both developed and developing countries perform similarly to privately owned companies headquartered in similar countries. Since companies headquartered in developed countries tend to outperform companies headquartered in developing countries, spillover efficiency benefits are more likely to be related to where the foreign investor is headquartered.

However, SOEs with non-commercial goals could pose other dangers. National defense contracting is not as big an issue as in the U.S., but the willingness of the U.S. government to allow Canadian-based companies to

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compete for U.S. Defense contracts might be compromised by a perception that the Canadian companies involved are security threats. This might be a reason for foreign investment screenings.

Another concern related to SOEs is their opaque senior management and corporate procedures. This makes it more difficult for domestic businesses and government agencies to assess the quality and integrity of the management, making them vulnerable to opportunistic behaviour and unwise investment decisions. This can reduce the “trust capital” in the Canadian market place as a whole, reducing economic efficiency and eroding an aspect of Canadian identity. However, establishing unilateral standards for accountability in the ICA would risk diverting FDI away from Canada. In light of the fact that developed countries, as a group, apparently see a need to address the issue of financial transparency on the part of SOEs, it is preferable for Canadian policy-makers to wait until international agreements emerge to form a multilateral approach.

The concern that SOEs might “hoard” natural resources in order to ensure adequate supply for home country users is relevant to Canadian policymakers only if the acquisitions of Canadian natural resource companies convey sufficient market power on the acquiring companies so that their withholding supply can significantly affect market prices. This outcome seems unlikely, since virtually all natural resources are sold in international markets in which Canada is a small supplier.

Other concerns about subsidized SOEs are that they might have an “unfair” capital cost advantage relative to Canadian-owned companies that must finance capital investments, including acquisitions, at market costs of capital and that foreign owners of critical infrastructure are less likely than domestic owners to respect the public trust that is placed in allowing ownership of the relevant assets.

Conclusions:

Given there is no strong economic justification for the ICA, national security should be the explicit focus of the screening activity. Canadian culture should be identified as an element of Canada’s “critical infrastructure” and as encompassed by a national security imperative. Refocusing the ICA away from economic considerations in favour of national security makes Canada’s review process more similar to those of other OECD countries. By itself, this is deemed as likely beneficial for Canada in its competition for FDI. The consolidation of the cultural protection objective under the broader aegis of national security would also sharpen the focus of the ICA, which would arguably make the review process more transparent to foreign investors and less costly to administer.

The criteria underlying the review process should be relatively narrow. While this report does not propose specific national security criteria, it does caution that the criteria should be transparent, specific and relatively

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circumscribed. The onus should be on the government to show that a proposed investment threatens national security, rather than putting the onus on the foreign investor to argue that the proposed investment is benign. Given the inevitable tradeoff between breadth and depth of the review process, it seems advisable to raise the size threshold for reviewable investments to focus on a relatively small number of large investments.

Special concerns have been raised about state-owned enterprises (SOEs) and Sovereign Wealth Funds (SWFs). However, it would be premature for Canada to modify the ICA so as to treat investments by SOEs or SWFs substantially differently from other investments that are covered by the ICA. Furthermore, specific concerns about those organizations, such as limited financial and strategic transparency, are being addressed at the multilateral level, and it is in Canada's interest to support a multilateral policy approach to shared issues surrounding behaviour such as transparency.

With respect to the cultural sector, there should be a "carve out" for investments in culture businesses so as to exempt from review foreign acquisitions of Canadian businesses that have a relatively small share of revenues generated from the sale or distribution of books and other culture products. In addition, tighter definitions of culture businesses should be drawn so that, for example, a Canadian company that distributes technical manuals is not considered a culture business.

To the extent that specific activities are designated as sensitive sectors for purposes of national security, duplication of regulation related to review and approval of foreign investments under the ICA and other administrative bodies should be minimized. This implies that there should be a harmonization of the relevant regulations and policies.

Implementing procedures to make the application of the review criteria more transparent to foreign investors, as well as to Canadians, should be a policy priority. The "optimal" disclosure policy is a difficult matter of judgment; however, it would seem possible to disclose reasons for approving (or not approving) proposed investments and the type of undertakings made without compromising the confidentiality of individual investors.