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Competition Policy Review Panel
Research Paper Summary

Author: Andrew Sharpe and Meghna Banerjee, Centre for the Study of Living Standards, Ottawa

Title: Assessing Canada's Ability to Compete for Foreign Direct Investment

Subjects Addressed:

- Foreign direct investment (FDI), trends and determinants
- Canadian investment abroad
- Productivity, R&D, Innovation, Human Capital, Taxation, Regulation

The Benefits of Foreign Direct Investment (FDI):

Both economic theory and empirical evidence suggest that FDI has a beneficial impact on host countries through the generation of employment, improved factor productivity, the transfer of skills and technology, and the increase of exports. These benefits of FDI to host countries do not accrue automatically; targeted policies are required to ensure that the domestic environment is ready to absorb the new skills, technologies, and productivity-enhancing factors so that the benefits are actually realized.

FDI can improve factor productivity and income growth; integrate the host economy more closely into the world economy and reinforce openness to trade; improve human capital through training opportunities at foreign firms; spur competition, although mergers and acquisitions can also increase market concentration; and promote enterprise development (higher efficiency, new activities, synergies within MNEs). Technology transfer is the main channel through which FDI boosts productivity, both directly by foreign investors using the technology and indirectly through linkages with suppliers and purchasers in the host country (vertical spillovers), linkages with competing or complimentary firms in the same industry (horizontal spillovers), migration of skilled labour, and internationalization of R&D.

A number of potential costs of FDI have been identified, including loss of head office and ancillary functions, loss of sovereignty, loss of national icons, and less research and development. There is a lot of debate about these, but in general the effect of a business takeover depends on the strategy of the acquirer, which depends on the rationale for the takeover and the business environment.

Recent Trends in FDI:

In 2006, global FDI inflows reached \$1,306 billion USD billion, the second highest level ever recorded and just \$135 billion USD short of the peak reached in 2000. Increased cross-border M&A activity was responsible for much of the rise in global FDI. The five largest recipients of FDI in 2006 were the US, UK, France, China, and Canada.

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Canada performed rather poorly in terms of long-term average annual growth rate of FDI stock over the period 1990-2006 compared to the U.S. and major country groups. Canada's inward FDI stock as a share of GDP increased 50% over the 1990-2006 period (from 20 to 30% of GDP), but all other G-7 countries experienced larger increases. Canada's share of world FDI stock has declined since 1980 from 9.6% to 6.3% in 1990, 3.7% in 2000, and 3.2% in 2006.

Canada's performance in attracting FDI looks much better when one considers the most recent FDI inflows, rather than stocks. Annual FDI inflows into Canada increased from \$22.1 billion USD in 2002 to \$66.6 billion USD in 2006, with a higher compound average annual growth rate (31.7%) than many other countries and well above the world average (20.4%). However, if one uses the year 2000 as a base, FDI inflows in 2006 are essentially the same as in 2000 and over 1990-2006, the average growth at 8% was lower than in the CIS and Eastern Europe, Asia, the EU, and the US. Yet, more recently, net FDI inflows jumped by 47% in 2007 over 2006.

Canada was open to FDI immediately after World War II. In the 1980s, the rest of the world started opening up to FDI. It would have been unrealistic to expect Canada to retain its 1980s share of FDI. Given the tremendous growth in the world stock of FDI, if Canada had retained its 1980 share, its FDI/GDP ratio would have been 90% instead of 30% in 2006.

In 2006, the value of foreign acquisitions in Canada reached \$114 billion CAD – the highest value in the last decade. Over the 2001-2006 period, 36.5% of all FDI inflows were accounted for by M&A, with significant variability between years (6.7% in 2003; 58.1% in 2006).

Despite Canada's strong performance in attracting FDI, the United Nations Commission on Trade and Development (UNCTAD) points out in its *World Investment Report 2007* that, in comparison to its potential, Canada is underperforming. In 2006, Canada ranked 79th out of 141 countries in its FDI performance (ratio of share of global FDI to share of global GDP), while it ranked 4th in terms of its potential (index of structural variables).

In terms of sectoral distribution, 36.5% of the FDI stock in Canada was in manufacturing in 2006, down from 48.4% in 2000. It still represents the bulk of investments, but its importance is declining. The mining and oil and gas extraction industry increased its share of FDI stock from 15.1% in 2005 to 16.2% in 2006, up from 8.5% in 1999. The finance and insurance industry held 12.2% of the FDI stock in 2006. Over the period 2002-2006, the finance and insurance industry and the services and retailing industry registered strong annual growth rates of 6.2% and 10%. Mining and oil and gas posted the highest annual growth rate over this period, at 12.3%.

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The United States accounts for the bulk of the FDI stock in Canada (68%). Their FDI stock in Canada is fairly evenly distributed among sectors. Only three other countries, the United Kingdom (8.7%), France (6.6%) and the Netherlands (5%), own more than 5% of the FDI stock in Canada.

Canada has been a net exporter of capital since 1996. Between 1997 and 2006, the ratio of FDI stock in Canada to the stock of Canadian direct investment abroad has hovered between a trough of 81.9% in 2002 and a peak of 90.6% in 2003. This is in large part the result of significant increases in Canadian direct investment abroad. The large FDI inflows in 2007 have resulted in FDI in Canada exceeding Canadian FDI abroad.

Canada's Performance in the Factors that Determine FDI Inflows:

The goal of FDI can be to access resources, markets, or efficiencies (e.g. low labour costs, highly qualified workers, infrastructure, or economies of scale). Among countries offering the resources, markets or efficiency-enhancing factors, investors are likely to select those with favourable macroeconomic environments, incentives to promote private enterprise (low taxes, efficient financial sector, foreign trade zones, labour or capital subsidies), liberal trade policies (openness in foreign trade, regional integration and access to regional markets), low regulatory burdens, open FDI regimes, good governance, and a high quality of life.

Canada has rich natural resources and is a world leader in mining technology. Energy and metallic minerals accounted for well over half of net FDI inflows in 2005-2007 and 27.9% of FDI stock in 2007. In 2007, Canada accounted for 19 - 20% of worldwide mineral exploration spending, much of it done by foreign-controlled firms.

The quality of Canadian human resources is in general high. At 46% in 2005, Canada has the highest proportion of working-aged adults with a tertiary education among OECD countries. Canadian students have done well in the PISA International Student Assessment tests, ranking second among OECD countries in science and third in reading and mathematics.

Canada does well in international studies of governance indicators. It ranks somewhat lower in the area of competitiveness. According to a World Bank report on governance and the *Global Competitiveness Report*, a problem may not be the level of regulation, but the time-consuming nature of the compliance process, e.g. the time needed to prepare, file, and pay taxes.

Canadian macroeconomic performance has been among the best in the OECD, and Canada's public finances are very sound.

Canada's labour market is relatively flexible. In the World Bank's 2008 *Doing Business* report, Canada ranked 19th out of 177 countries in the 'employing

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workers' index. It ranked 2nd among G7 nations and 3rd in the OECD in overall rigidity of employment and 3rd in the G7 and 7th in the OECD in non-wage labour costs.

Canada has consistently ranked at or near the top in the Human Development Index (HDI) since 1975, indicating a high quality of life.

Labour productivity growth in Canada, compared to other major OECD countries, has been weak. Since 2000, our business sector output has grown at 1% per year, which is only around 40% of the US rate. Canada's level of output per hour has fallen from 3rd highest in the OECD in 1950 and 1973 to 16th in 2006. The causes of the fall-off in labour productivity growth are still poorly understood. Possible explanations include measurement problems; the exploitation of poorer quality resources such as the oil sands; weak ICT investment; a failure to exploit advanced technologies; and weak wage growth leading to a slower rate of substitution of capital for labour.

In addition, while Canada had the highest public R&D expenditure as a percentage of GDP among G7 nations in 2005, Canadian business R&D expenditure as a share of GDP was 6th amongst the G7 countries. Expenditure on R&D by foreign affiliates in Canada was also 2nd lowest among G7 countries, although its percentage of R&D by foreign affiliates in total R&D by enterprises was the 2nd highest in the G7 in 2003. It is unclear how important productivity and private sector R&D is for FDI location decisions - foreign businesses determine their own productivity and innovation performance.

The 2006-2007 *Global Competitiveness Report* ranked Canada 13th out of 125 countries in innovation. Canada's comparative advantages lie in the availability of scientists and engineers, utility patents, quality of scientific research institutions, and university/industry research collaboration. Its comparative disadvantages lie in government procurement of technology products, company spending on R&D, technological readiness (i.e. the quickness with which an economy adopts existing new technology), and business sophistication (quantity and quality of suppliers, well-developed production-processes, and sophisticated products).

Although Canada has a good physical infrastructure, there are some indications that its position may have slipped. The *Global Competitiveness Report 2006-2007* ranked Canada 13th out of 125 countries in this category, taking into account the availability and quality of energy, transport, and telecommunication services infrastructure.

In 2007, the marginal effective tax rate (METR) on capital for large and medium sized corporations at 30.9% was high, although it is declining rapidly. Relative to G7 countries, Canada was 4th in 2007; the United States, France and Germany had a higher METR. To improve Canada's business tax

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competitiveness, improvements in the structure of the tax system are needed, e.g. harmonizing provincial sales taxes, eliminating provincial capital taxes on productive investment, a review of capital cost allowance rates, and making the tax system more neutral across firm size. The planned level of the METR in Canada in 2012 is 16.4%, well below the OECD average and the other G7 countries.

While Canada has eased its FDI restrictions, it still has the highest level of restrictions among the G7, and the 2nd highest in the OECD. (These measures ignore hidden institutional or behavioural barriers).

Conclusions:

Canada has experienced a drop in FDI share, mostly because many parts of the world previously closed to FDI have opened up. Canada's FDI share is roughly comparable to its GDP share and it the third highest in the G7. However, Canada will face increased competition from high-growth economies with large markets and low labour costs. In order to remain a major player, Canada should improve its already favourable business environment and develop and communicate its comparative advantages.

To begin with, Canada should continue its efforts to establish a more competitive tax environment, including working with the provinces. Improvements need to be made in the administration of regulation, so that they can be enforced with minimum cost to businesses. The federal government's "smart regulation" initiative is a good step. A review of FDI regulation in Canada is required to ensure that the current regulatory regime protects Canadian interests efficiently, with minimum damage to its world competitiveness.

Canada must improve its labour productivity substantially. Suppliers will need to enhance their technological readiness to adopt new technologies more quickly, and to upgrade the skills of their workforce. The government can support this with tax incentives such as income tax credits for employers and workers to offset training costs, and government financial support for technological upgrades.

Canada could deepen its advantage in higher education by ensuring that skills and competencies are developed in technical fields, and increasing the proportion of adults that have university degrees. Quality of education must be given the highest priority, so that there is no quality/quantity trade-off. Government programs that support stay-in-school initiatives, provide career counselling, offer incentives to Canadian employers and workers to upgrade their skills, and improve immigrant credential recognition are important.

In the absence of advantages of market-size, scale of production, and labour costs, Canada will have to define and develop its advantages in what it can produce efficiently within global supply chains. The analysis of existing and

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potential advantages in Canada points towards a possible specialization in high-value, knowledge and technology intensive products and services. Another area of specialization could be emerging technologies such as bio fuels, genetics, environmental technologies and artificial intelligence.

It is in Canada's interest to successfully manage the frequent problems in the Canada-U.S. trade relationship, and ensure that NAFTA provides foreign investors with North American market access. Modernizing physical infrastructure in urban regions, highways, airports, ports, and along borders, including maintenance, is indispensable to the free flow of goods and services.

Finally, increased global competition for foreign direct investment means that Canada will have to effectively communicate its strengths to the world.