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FOREIGN INVESTMENT IN CANADA: A REVIEW

by

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Foreign Investment in Canada: A Review¹

Much of the recent discussion in Europe and elsewhere about foreign investment has been foreshadowed in Canada where foreign investment has long been enshrined as a controversial issue of public policy.² In part Canadian concern reflects little more than xenophobic or nationalistic sentiment. In part it reflects frustration stemming from our failure to achieve more fully the national aspirations of self-sufficiency and international importance held out at times in the past for this country.³ In part, too, this concern reflects the view that the economic progress associated with foreign investment is incompatible with the development of a distinctive nationalism.⁴ In addition, foreign investment is seen as a serious threat to political sovereignty and cultural independence, raising such questions as the following: How much scope remains for independent political and social action in a country that has as much foreign ownership and control as Canada now has? To what extent have the U.S. and other foreign governments used, or might they use, the economic power of their investors to promote their own political, social and economic ends? And to what extent might foreign investors, aided and abetted by their home governments, exert political pressure within Canada in order to advance their private interests even if these do not coincide with Canada's national interests? Finally, there is doubt about the economic benefits of foreign investment, about the possibilities for increasing the benefits relative to the costs of foreign investment and about the benefits the country would lose if it had less foreign investment.

In addition to these general concerns, it should be recognized that opposition to foreign investment in some quarters is also based on little more than the straight-forward self-interest of particular groups in the community. In the business world these comprise local capitalists and competing labour groups whose profits, earnings and power are impeded by strong competition from abroad. In the political world, politicians and officials similarly find their power inhibited by having to deal with foreign investors who are less firmly within their grip and whose horizons frequently are international

*of course
but what is the gain
per year?*

rather than national. Protectionist opposition to foreign capital is exactly analagous to protectionist opposition to imports and similarly is sometimes manifest by cloaking vested self-interest in articulate nationalism.

The issue of foreign investment largely boils down to two questions, one empirical and the other political. The empirical question is concerned with the total net economic benefits in terms of income and employment that Canada derives from foreign investment and how changes in present policies are likely to affect these benefits. The political question consists of two parts: Is there a positive or a negative relation between the economic benefits arising from foreign investment and Canada's social and political development? And if there is a negative relation, how much economic benefit are Canadians prepared to trade-off to achieve their political and social goals more fully?

Size, Growth and Leading Characteristics

Before addressing these questions further, it will be useful to review briefly some of the main features of foreign investment in Canada in recent years. The various components of the capital account of the international balance of payments are shown in Table 1 for the decade ending in 1970. Several points may be especially worth noting:

- a) Total net capital inflows (column 9) declined substantially during the period from an average level exceeding \$1 billion in 1960-2 to about \$.5 billion in 1968-70.
- b) The most rapid increase in capital inflows has been in net portfolio investment (sales, purchases and retirements of Canadian and foreign bonds and stocks through financial markets, column 4) increasing from an average of about \$.3 billion in 1960-2 to \$1.2 billion in 1968-70.
- c) Direct investment (i.e., investment directly by one company in another without passing through financial markets) by foreign companies in Canada increased somewhat over the decade - from an average of \$.6 billion in 1960-2 to \$.7 billion in 1968-70 (column 2). The most significant change,

TABLE 1

THE CAPITAL ACCOUNT FOR CANADA'S BALANCE OF INTERNATIONAL PAYMENTS, 1960-70

Year	Direct investment in Canada	Direct investment abroad	Portfolio trans-actions	Other capital move-ments in long-term forms	Resident holdings of foreign bank balances and other short-term funds abroad	Non-resident holdings of Canadian short-term paper	Other capital move-ments in short-term forms(1)	Net capital movement	Allocation of special drawing rights	Net official monetary movements
1960....	+670	- 50	+ 217	+ 92	- 60	+ 56	+269	+1,194	...	- 39
1961....	+560	- 80	+ 312	+138	+ 142	- 58	+206	+1,220	...	+ 292
1962....	+505	-105	+ 294	- 6	+ 92	+ 4	+200	+ 984	...	+ 154
1963....	+280	-135	+ 471	+ 21	- 259	+ 43	+245	+ 666	...	+ 145
1964....	+270	- 95	+ 645	-	- 527	+169	+326	+ 788	...	+ 364
1965....	+535	-125	+ 546	- 92	+ 140	-140	+425	+1,289	...	+ 159
1966....	+790	- 5	+ 325	+ 57	- 603	- 12	+251	+ 803	...	- 359
1967....	+691	-125	+ 473	+316	- 259	- 47	-530	+ 519	...	+ 20
1968....	+590	-225	+1,063	+226	- 401	- 85	-712	+ 456	...	+ 349
1969....	+655	-255	+1,832	+ 25	-1,604	+250	- 87	+ 816	...	+ 65
1970....	+760	-215	+ 661	-392	- 376	+236	-441	+ 233	+133	+1,663

(1) Includes errors and omissions.
... Not applicable.

Source: D.B.S. Quarterly Estimates of the Canadian Balance of International Payments, Second Quarter, 1970, Table VIII, p. 31.

however, has been an almost three-fold increase in direct investment by Canadian companies in foreign enterprises - from an average of about \$80 million in 1960-2 to \$230 million in 1968-70 (column 3). Subtracting outflows from inflows, one finds that net direct flows into Canada declined slightly.

d) Short-term capital flows (columns 6 through 8) together with other long-term capital movements (column 5), comprising such items as assessments to international agencies, inter-governmental loans, receipts under the Columbia River Treaty, export credits and bank loans, have played a major role in determining the net movement of capital into Canada. Moreover, these items have fluctuated much more from year to year over the period than long-term direct and portfolio investment.

The figures shown in Table 2 relate to the control of Canadian industry by non-residents. As the figures indicate the share of the value of long-term capital controlled by non-residents (for the most part, defined statistically as non-residents owning at least 50 per cent of the equity) increased rapidly from 1948 to 1963 when ownership totalled about one-third of the major sectors shown. Since the early 1960's this figure has not increased very much, if at all. About 80 per cent of non-resident control at present is accounted for by U.S. residents. Since 1948 the relative importance of European direct investment has increased significantly. It is also noteworthy that during the sixties, as opportunities for investment in Europe and elsewhere have become relatively more attractive, Canada's share of all forms of long-term international capital flows has decreased very substantially relative to the share of total world capital flows coming to Canada in 1957-60.

There is, in addition, the question of take-overs of Canadian firms by foreign companies, which evokes a particularly emotional response in some quarters. Reasonably satisfactory data are available only for the period 1945 to 1961, which coincides with the period when the non-resident control over Canadian companies grew most rapidly.⁵ During the period 640 foreign mergers occurred, compared with almost 1200 domestic mergers. These figures

TABLE 2

PERCENTAGE OF TOTAL BOOK VALUE OF LONG-TERM CAPITAL
EMPLOYED IN CANADA CONTROLLED BY NON-RESIDENTS, SELECTED YEARS 1926-1966

(Percentage)

	<u>1926</u>	<u>1948</u>	<u>1961</u>	<u>1963</u>	<u>1966</u>
Manufacturing	35	43	59	60	57
Petroleum and natural gas	-	-	72	72	74
Mining and smelting	38	40	59	59	62
Railways	3	3	2	2	2
Other utilities	20	24	5	5	4
Total of above industries and merchandising and construction - TOTAL	17	25	33	34	34
U.S.	15	22	26	27	27

*change
to include
this*

Source: D.B.S. Daily Bulletin, February 13, 1970, D.B.S.S. Quarterly
Estimates of the Canadian Balance of International Payments,
First Quarter, 1966, and D.B.S. private correspondence.

TABLE 3

RATE OF RETURN IN U.S. DIRECT INVESTMENT IN CANADA, 1951-68

Net Earnings as a Percentage of
the Book Value of U.S. Direct Investment

<u>Average for</u>	<u>Manufacturing</u>	<u>Mining & smelting</u>	<u>Petroleum</u>	<u>Other</u>	<u>Total</u>
1951-55	13.7	12.0	1.8	9.9	10.7
1956-60	10.1	7.4	4.6	7.8	8.1
1961-65	9.2	9.3	5.0	7.7	7.7
1966-68	8.5	11.3	6.0	7.2	8.0

Source: Donald T. Brash, "United States Direct Investment in Australia,
Canada and New Zealand: Costs and Benefits" (mimeographed) 1970, p.10.

may be viewed in relation to a total population of firms in 1961 in Canada of about 100,000 and in the U.S. of 1,200,000. In terms of such characteristics as age, size and industrial distribution, the firms taken over in foreign mergers differed somewhat from those taken over in domestic mergers, but one may view these differences as not particularly large nor significant. On the other hand, foreign mergers had a significantly heavier concentration in vertical and conglomerate mergers, compared to horizontal mergers, than domestic mergers. In addition, the median profit rate of firms acquired in foreign mergers was, if anything, less than that of firms acquired in domestic mergers and the percentage of firms incurring losses when acquired through each type of merger was about 20 per cent, though somewhat higher for domestic than for foreign take-overs.

How has foreign control been related to industrial concentration in Canada? An examination of this question for the period 1954-64 indicates that "there was no visible trend in concentration, that there was on average a decrease in the importance of foreign control among the leading firms (in various industries) and that there was no apparent association between the change in concentration and the change in foreign control".⁶

Finally, it is interesting to note that on a per capita basis Canadians invest more in the U.S. than U.S. residents invest in Canada. In 1967, for example, per capita investment by Canadians in the U.S. totalled \$208 and by U.S. citizens in Canada it totalled \$141. Moreover, total per capita direct investment assets held by Canadians in the U.S. totalled \$107 compared with \$85 held by U.S. residents in Canada. Many Canadian investors have evidently found it more profitable to invest in the U.S. than in Canada. One of the main conclusions to be drawn from this is that given the size, growth and profitability of Canadian investment abroad, Canadians have substantial stake in maintaining an international environment that is favourable to foreign investment.

Stabilization Policy

With such large and variable flows of international capital, two questions arise concerning the stabilization of Canadian income and employ-

ment: i) To what extent have outside disturbances in international capital flows forced adjustments on the Canadian economy and, if so, how difficult has it been to offset unwanted consequences of these disturbances through domestic policy adjustments? ii) To what extent has the existence of highly mobile capital flows impeded or enhanced the effectiveness of domestic instruments of stabilization policy - monetary, fiscal, exchange rate, and debt-management policies?

Most of the evidence available relates to the period when Canada was on a flexible exchange rate system from 1951 to 1962, though some additional work has been done on the period since 1962.⁷ On the first question, the evidence indicates that autonomous changes in capital flows were fairly readily accommodated by corresponding changes in the current account without requiring major policy adjustments or significant disturbances in the rate of capital formation out of domestic savings. Moreover, the different types of portfolio flows tended to be mutually accommodating with an above-average long-term inflow typically associated with a below-average short-term flow, so that in aggregate the forces operating on the balance of payments tended to cancel each other out. In addition, for the period 1951-62, foreign capital flows in aggregate tended on balance to have a stabilizing rather than a destabilizing influence on the balance of payments and the exchange rate.

Comparing direct investment with portfolio investment, one finds first of all that portfolio investment posed a substantially greater adjustment problem than direct investment which under average conditions was fully accommodated through automatic income adjustments. Secondly, direct investment flows on balance changed domestic employment in the same direction as the change in the flow - raising employment when inflows increased and vice versa. Portfolio inflows which arose because of changes in U.S. interest rates had the same effect. But when increased portfolio inflows arose because of other outside disturbances they were probably deflationary and increases in short-term portfolio inflows were nearly always deflationary.

The evidence available on the second question posed above indicates that highly mobile international capital flows considerably increase the leverages of some types of stabilization policy and substantially reduce the leverages of other types, depending on whether exchange rates are fixed or free to respond to market forces. Thus, foreign capital flows have not so much altered Canada's ability to pursue independent stabilization goals as they have conditioned the manner in which the various instruments of policy need to be deployed so as to achieve these goals more effectively.

Over the years there has been concern about two main issues as far as stabilization policy is concerned: first, to what extent does a country that imports as much capital as Canada retain any ability to pursue independent stabilization policies; and secondly, to what extent does stabilization policy become totally absorbed in coping with the effects of foreign capital flows, leaving little or no scope for meeting domestic objectives? The evidence available suggests that concern on both scores is misplaced. Posing the counterfactual alternative of no capital flows, with or without exchange rate adjustments, the evidence available indicates that Canada's ability to pursue an independent stabilization policy has not been impaired by capital flows. Moreover, foreign capital flows have not imposed unwanted adjustments on the balance of payments or Canadian income and employment to an significant degree - they have not, in other words, converted the Canadian economy into the thirteenth reserve district of the U.S. as sometimes suggested.

Income and Employment Effects

Leaving aside stabilization questions, what have been the effects of foreign investment on the real income and employment of Canadians in the aggregate and how have these effects been distributed among various sectors and regions of the economy? In order to assess these questions, it is helpful to consider portfolio and direct investment separately.

Portfolio Investment

Portfolio capital imports represent a transfer of savings from foreigners to Canadians. Such flows are highly sensitive to changes in

the differential between interest rates in Canada and interest rates in the U.S. as well as to exchange rate adjustments, assuming a flexible exchange rate.⁸

Portfolio capital imports are economically profitable to Canada so long as the cost of such capital is less than the domestic opportunity cost of capital reflecting the marginal productivity of capital and the marginal rate of time preference in Canada. Estimating the domestic opportunity cost of capital poses a host of very complicated issues that cannot be pursued here. If one is prepared to accept that interest rates represent a reasonable approximation to the opportunity cost of capital, then the market mechanism tends to ensure that portfolio capital imports on balance are economically beneficial to the country. This is because borrowers will only borrow from abroad when a) the return on the project for which they seek foreign capital exceeds the cost of borrowing, and b) the cost of borrowing abroad is less than the cost of borrowing at home.

This picture is subject to several qualifications however. For one thing it assumes well-functioning capital markets that are relatively free of market imperfections such as a lack of knowledge and information, unwarranted allowances for risk and uncertainty and the absence of monopolistic powers on the part of borrowers and lenders. For another, given a rising supply price of foreign capital, increased capital inflows based solely on private cost considerations might result in an excess inflow from the standpoint of society.⁹ On balance, neither of these concerns seems likely to be very important because of the close integration of capital markets in Canada with those abroad, especially in the U.S., and because of the elastic response of international capital to changes in interest rate differentials.¹⁰

A more important qualification relates to future debt servicing payments. Unlike direct investment and portfolio investment in stocks, portfolio bond investment - which comprises the larger portion of portfolio investment - entails a fixed obligation to repay interest and principal which, in the face of changing economic circumstances, may be either a

heavier or an easier burden than expected. During the depressed 1930's, for example, the heavy foreign portfolio borrowing undertaken by Canadians during the more prosperous 1920's became a very onerous burden on the economy.

As far as the distributive effects of portfolio investment are concerned, such inflows have a beneficial effect on labour and other non-capital income and an adverse effect on incomes derived from capital. Moreover, by enhancing the supply of capital available in the country and thereby reducing capital costs from what they otherwise would be, investment in more remote and less favourably placed areas is made economically feasible. In addition, by keeping capital costs down foreign capital inflows make feasible more longer-term projects, such as investments in public utilities, housing, urban renewal and the like, for which interest charges, because of the length of the pay-back period, are an important cost.

Direct Investment

To the extent that direct investment simply provides for a transfer of capital from abroad through a different institutional channel, its income and employment effects in aggregate and on various sectors of the economy are much the same as portfolio investment. The controversy about direct investment stems mainly from two additional characteristics: first, the degree of non-resident ownership and control frequently associated with direct investment, in many cases within the context of a large multinational enterprise; and secondly, the extent to which direct investment constitutes a transfer not only of capital but also of a package of auxiliary factors, including technology, management and market access, that otherwise either would not be available at all to the Canadian economy or would be available only at substantially greater cost. Both of these characteristics give rise to the possibility of a variety of "external" economies and diseconomies - i.e. benefits and costs to society that are not reflected in private valuations.

Before examining these effects, it will be helpful to review some of the hypotheses that have been advanced to explain the flow of direct

investment to Canada and in the world more generally. Although this remains open to considerable uncertainty, it seems apparent that there exists no one unique determinant but several determinants of direct investment, the relative importance of each varying with time and circumstance. The various hypotheses that have been advanced may conveniently be grouped into four interrelated categories: (1) the rate of return expected on investment compared with the cost of capital; (2) the financial liquidity of both parent and subsidiary firms; (3) the increase in sales prospects in the host country in relation to plant and industry capacity (the familiar investment accelerator relationship); and (4) a series of longer-term strategic considerations. The first three of these categories correspond to hypotheses that have been posed and empirically tested to explain domestic investment in plant and equipment. Some evidence has been found to support the view that these factors also help to explain foreign direct investment flows.¹¹ The fourth category of determinants noted above emanates from the literature on industrial organization and includes several related notions. Among the strategic factors that have been emphasized are: the desire to hedge against foreign exchange risk;¹² economizing on transactions costs;¹³ protecting and extending existing investments and markets;¹⁴ competition for market shares among oligopolists;¹⁵ the desire to provide an assured source of raw supplies for the future and possibly to deny them to competitors;¹⁶ government policies through tariffs, subsidies and trade restrictions designed to foster import-displacing and export-oriented investment; the economics of new product development, beginning with exports, then expanding gradually through investment in sales and distribution facilities, assembly and finally full production;¹⁷ and the influence of product-differentiated oligopoly in horizontal direct investments and oligopoly, whether differentiated or not, in vertical direct investments.¹⁸

This latter framework, developed particularly by Professor R. E. Caves, emphasizes the similarity between international and domestic merger activity in markets that are geographically separated. Successful horizontal foreign investment requires that the investing firm have some special advantage in the

form of knowledge, production or marketing skills, access to markets or access to inputs which i) can be drawn upon in the new location and offers sufficient advantage to overcome the extra costs of producing in a foreign location and ii) is tied to the actual process of production and distribution, thereby implying a higher return via direct investment than through licensing or some other form of exploiting the asset. Vertical investment is associated with oligopoly and the incentives to reduce uncertainty and competition. An important feature of this explanation of horizontal direct investment is that capital flows tend to equalize profit rates in the same industry across nations rather than across industries within the same economy. Moreover, this explanation is consistent with the observed tendency for national corporations to invest in each others' markets and with the tendency for an excessive number of relatively inefficient-sized firms to overcrowd smaller markets - tendencies evident in Canada as well as in other countries.¹⁹ Some of the strategic factors emphasized by other writers can readily be fitted into the foregoing framework.

The empirical evidence available for Canada, though limited, lends some support to this picture of the determinants of direct investment. First, there is some evidence of a significant relationship between direct investment and i) Canadian GNP, and ii) long-run interest differentials which may be viewed as a proxy for the relative rate of return on investment in Canada and the U.S. - admittedly a very inadequate proxy.²⁰ This evidence also indicates that direct investment is related to developments in particular industries, such as the petroleum and mining industries. A second set of evidence emanates from an examination of foreign investment in the take-over of Canadian firms from 1945 to 1961.²¹ Year-to-year variations in take-over activity were significantly related to: (i) merger activity in the U.S., assumed to reflect changing attitudes to mergers and various strategic considerations as well as variations in the circumstances in the investing country conditioning the operations of the parent firm; (ii) the supply of internally-generated funds in Canadian corporations, assumed to reflect changes in corporate liquidity and credit conditions in Canada; and

(iii) the number of business failures in Canada, assumed to reflect changes in economic conditions and in the supply of firms for sale in Canada. Variations in take-over activity across industries during this period were associated with: (i) the initial distribution across industries of foreign and domestically controlled firms, which may be assumed to reflect various strategic factors referred to earlier; (ii) variations in internal cash flow across industries, again assumed to reflect corporate liquidity and credit conditions; and (iii) the level of tariff protection by industry. A third range of evidence is provided in a number of studies primarily concerned with the effects of Canadian tariffs. This evidence indicates a significant and positive association between the level of tariffs, on the one hand, and the level of foreign investment and control, on the other.²² It further indicates that the degree of foreign control among industries is positively related to differences in the degree of product differentiation found among industries as well as to differences in the rate of growth among industries.²³

Economic Benefits and Costs of Direct Investment

The net economic benefits (total benefits minus total costs) of direct investment are equal to: the productivity of the imported capital - the direct cost of the imported capital + the "external" benefits of the imported capital - the "external" costs of the imported capital. The first two parts of this equation refer to the direct benefits and costs of foreign investment and are reflected in the calculations of individual investors. "External" benefits and costs here refer to benefits and costs that are experienced not by the private investor but by society as a whole; they depend on indirect spillover effects and do not enter into private investors' decisions.

Both the direct and indirect benefits of direct investment are distributed to the public in several ways. One way is through tax payments to various levels of government, since under existing double-taxation agreements between countries the host country is able to tax the profits of foreign enterprises, thereby capturing a substantial share of the earnings on foreign capital and the rents earned on the package of auxiliary factors. These benefits may manifest themselves, secondly, through a lowering of prices and

an improvement in the quality of output in the host country or in higher incomes to local factors of production. And thirdly, these gains may appear in the form of increased productivity and output. In order to capture the benefits of foreign investment as fully as possible it is important to have a good set of tax laws and an efficient tax administration. In addition, it is important to maintain a highly competitive economy. To the extent that market impediments such as tariffs and collusive agreements reduce competition, they prevent the benefits of foreign investment from accruing as fully as they might to local residents.

Two fundamental points need to be emphasized in this connection. First, if foreign-controlled firms simply replace the output of domestic firms, charging the same prices for outputs and paying the same prices for inputs and maintaining production and employment at the same level, no gain accrues to the domestic economy except through the collection of taxes on the returns on the capital and auxiliary factors provided by foreign firms. Secondly, if through tariffs and subsidies foreign firms are induced to produce products locally that otherwise would be imported more cheaply from abroad, the benefits gained through tax revenues may be partly or entirely illusory. Quite conceivably the economic costs of the tariffs and subsidies to the economy may exceed the tax revenues collected from the foreign enterprise. This result, of course, is a consequence of the tax and subsidy policies adopted by the host country and not of foreign investment as such.

Such evidence as we have suggests that the marginal productivity of equity capital in Canada in recent years has averaged about 15 to 20 per cent.²⁴ The cost of foreign equity capital has been on the order of 7 1/2 to 10 per cent as indicated in Table 3. Most of the difference between the rate of return on equity capital and its cost has been paid to Canadian governments as taxes of one kind or another. To what extent this has been offset by the tariff and subsidy benefits accruing to foreign firms is impossible to say at present.

Two additional points relating to the cost of foreign direct investment are indicated by Table 3. Not only is the rate of return on U.S. direct

foreign interest now less than in the early 1950's but also it is now quite comparable to the rate of interest on industrial bonds. Moreover, the figures available indicate that the rate of return on U.S. direct investment in Canada has on average been significantly below the rate of return on U.S. direct investment in other countries.²⁵

An alternative approach indicates that under the full employment conditions prevailing from 1950 to 1956, net foreign investment had added about 3 1/4 per cent to Canadian GNP in 1956. The contribution of gross foreign investment would have been greater. Without foreign investment the growth in per capita GNP from 1950 to 1956 might have been about 20 per cent less than it was during this period.²⁶

As in the case of portfolio investment these gains in income and employment have favoured labour and other non-capital factors, longer-term investments, the frontier areas abundantly endowed with natural resources, regions that are relatively short of capital and areas that now are marginal from the standpoint of investment. It has also benefited those who are the beneficiaries of the increased government revenues made possible by foreign investment.

Even the strongest critics of foreign direct investment in Canada concede that it has resulted in increased income and employment.²⁷ Nevertheless, leaving aside non-economic considerations, they maintain that the economic costs are substantially greater than frequently suggested and that with changes in policy these costs might be reduced and the net benefits of foreign direct investment might be increased. These criticisms for the most part focus on a variety of "external" effects which it is suggested are quite costly. Other commentators, on the other hand, have suggested that the benefits of foreign investment are even greater than suggested by the direct benefits referred to earlier because of various "external" benefits that have been underrated. Evaluation of these "external" costs and benefits raises a host of complicated issues on which there is relatively little empirical information and which can only be very briefly reviewed here.²⁸

The "external" costs of foreign investment that have been mentioned by various writers include the following: the stifling, or alternatively the excessive promotion, of exports; the distortion of import markets; the failure to develop local research activities satisfactorily; centralization of philanthropic activities in the parent's head office and concentration of these activities in the home country; the inadequate effort made to train and develop local managerial and technical talent and drawing off to other countries the best talent that is developed; the stunting of local capital markets by failing to issue more securities locally or, conversely, the failure to bring more capital from abroad and relying too heavily on local savings; the repatriation of excessive sums in interest, dividends, fees and commissions of various kinds - a penalty that is compounded by phoney pricing practices followed within companies; the lack of co-operation with governments and government policies; the inability to develop strong local firms in the face of competition from foreign firms; the ever-present threat posed for Canada's balance of payments - and the list could readily be extended. The two areas of criticism that have perhaps been most emphasized in recent years are the failure of foreign subsidiaries to make more purchases locally and the deleterious effect of foreign subsidiaries on the development of indigenous entrepreneurship.²⁹

There undoubtedly are grains of truth in many of these allegations. What is uncertain is whether they add up to a mountain or a mole hill. The empirical work that has been done suggests that, broadly speaking, the performance of foreign-controlled firms has been as good (or as bad) as that of locally-controlled firms. For example, the performance of non-resident controlled firms is similar to that of resident-controlled firms with respect to exports, imports and research activity. Such limited data as are available indicate that non-resident controlled firms may be somewhat more efficient than resident-controlled firms. Perhaps the most important conclusion that these studies indicate is that many of the alleged inadequacies in the performance of foreign-controlled firms are primarily determined by the size and circumstances of the Canadian economy, including government policies on tariffs, competition,

taxes, research and education, rather than by ownership and control per se.³⁰

As far as "external" benefits are concerned, there seem to be two major possibilities. The first is in the training of labour and management which then becomes available over time to the economy generally, assuming that the foreign firm finances such training and that the skills in question are in demand in the economy. The second is through increases in productivity in domestic firms arising because these firms are induced to emulate more efficient practices in foreign firms.³¹ Here too, little is known empirically about how important these considerations may be in Canada.

In the absence of satisfactory information about the "external" costs and benefits of foreign investment in Canada it is impossible to say how these considerations on balance modify the picture of the net direct benefits given earlier. It is also virtually impossible to say anything with any assurance about how, in general, the net benefits of foreign direct investment might be increased through policy measures designed to increase total benefits and reduce total costs. In order to do so it is necessary to spell out empirically not only how proposed policies are likely to affect the benefits and costs of the current level of investment but also how they are likely to affect the level of capital flows. Finally, in the absence of information, it is not possible at present to say anything useful about how the benefits and costs of conventional direct investment compare in general with the benefits and costs of alternative methods of acquiring the capital and auxiliary factors normally associated with direct investment.

Some Common Fallacies

Of the many fallacies that have been expounded on this subject, only five will be considered here.

1. A key fallacy implied in many critical comments, is that foreign investment is a zero sum game in which a gain to the investor represents a loss to the host country. This is implied, for example, in such comments as "all the profits from U.S. investment in Canada are flowing into U.S. hands". This

proposition ignores the gains accruing to Canadians through (i) net tax payments, and dividends on shares held, directly or indirectly, by Canadians in foreign-controlled companies; (ii) increased earnings, lower prices, improved quality, higher productivity and increased employment opportunities.

2. A second and related claim is that the annual outflow of profits combined with principal repayments at some time in the future is bound to result in serious balance of payments difficulties. In some formulations this argument is extended to suggest that foreign investment leaves the host country in time with the dilemma of choosing between balance of payments difficulties or an increasing alienation of its capital stock to non-residents. This dilemma is alleged to be inevitable since the rate of return on the foreign stock of capital is almost certain to be greater than the rate of growth of the host economy.

These arguments pose an irrelevant comparison. It is no more relevant to compare the annual outflow of dividends with the annual inflow of investment than for a person to compare the amount he is paying out in interest this year with the amount he is prepared to borrow. His interest payments obviously reflect the amounts borrowed in previous years; what he borrows this year reflects his estimate of the benefits relative to the costs of borrowing money for some particular use in the future. Similarly, the dividends paid to non-residents reflect payments on an accumulated stock of outstanding claims and have little or no connection with how much net benefit Canada will gain from the capital it imports this year. This gain, moreover, is not reckoned in terms of balance of payments effects but rather in real income and employment effects for the economy. If the gain is positive in terms of real income and employment there is little more to be said. Only under highly implausible assumptions is it feasible to make a case against foreign investment in Canada simply on balance of payments grounds - especially for a country with a flexible exchange rate.³²

Two further points are worth noting in this context. First, well over half of the share of profits earned on non-resident equity is collected

in the form of corporation income taxes and foreign dividend withholding taxes. Hence, payments in dividends abroad are more than matched by government receipts. Similarly reinvested earnings by non-resident enterprises are more than matched by government receipts. In either case, the host government is provided with revenues at least as large as those received by non-residents that either directly or indirectly can be applied to investment controlled by local residents if the government wishes to do so. Secondly, given the decrease in the size of both dividend payments and annual capital inflows relative to Canada's GNP and external payments, Canada's capacity to carry its external debt is now greater than ten years ago.

3. The third proposition is the claim that foreign firms finance their expansion in Canada largely on the basis of Canadian-controlled funds. The figures cited to support this myth reflect a basic misunderstanding of the data. The myth rests on the assumption that internally-generated cash flows from the retained earnings and depreciation and depletion allowances in foreign subsidiaries should be regarded as Canadian-controlled funds. But this makes no more sense than to regard the assets giving rise to these flows as Canadian-controlled assets! The same definition of "control" used by the statisticians to define foreign subsidiaries must obviously be applied equally to both internally-generated funds and the value of the assets which generate the funds. The fact that internal cash flows are not transferred back and forth across the border every year in no way detracts from the fact that they are foreign-controlled funds, by the statistician's definition, in exactly the same way as funds raised by the firm by borrowing and equity sales abroad. Both sources of funds together reflect foreign-controlled financing of investment in Canada. On this basis, the figures available indicate that in 1967 foreign-controlled funds financed 81 per cent of the investment of foreign subsidiaries in Canada; 19 per cent was financed by funds raised in Canada.

4. The fourth proposition frequently implied and sometimes stated is that foreign direct investment will flow into Canada unabated even if

substantially less favourable conditions are provided to investors. This argument is usually linked to the abundance of natural resources in Canada and rapidly growing demand for these resources in the U.S. as well as elsewhere. There is no reason whatever to believe that Canada now has or ever will have anything approaching a monopoly on investment opportunities as this proposition implies - even in resource industries. In recent years, in fact, investment opportunities in Europe and elsewhere have become more attractive relative to investment opportunities in Canada and Canada's share of international direct investment flows has decreased substantially. Moreover, the evidence cited earlier indicates that investors are sensitive to economic conditions and do respond when conditions change.³³

5. Finally there is the proposition that foreign direct investment has not added to the stock of capital in Canada but has simply been a substitute for domestic investment. This question has been examined in detail for the period from 1951 to 1962 when capital imports were particularly large.³⁴ This evidence provides no reason at all for believing that foreign investment was a substitute for domestic investment; instead foreign investment complemented domestic investment. For the period as a whole every \$1.00 of new direct investment from abroad was associated with \$2.00 of additional domestic investment. In periods of recession this latter figure fell to \$1.50 and in boom periods it rose to \$3.00.³⁵

Non-economic Considerations

Although many of the economic aspects of foreign investment remain open to considerable doubt, there is much more doubt and uncertainty about its political and social aspects. These latter aspects, it seems fair to say have caused considerably more concern than the economic aspects. Hence, it is particularly unfortunate that much of the discussion of the non-economic aspects of foreign investment has amounted to little more than a series of bald assertions with little or no analytical or empirical content.

One of the first questions to contemplate in considering non-economic arguments about foreign investment is whether the alternative held out to the present situation assumes a major reduction in non-resident

ownership and control - say on the order of at least 10 percentage points over a decade - or merely a marginal reduction of a few percentage points. This is also an important question when considering the economic consequences of foreign investment but it is especially important in considering the non-economic consequences since many of these are deeply rooted in our society, can only be modified slowly and are unlikely to be much affected by marginal adjustments in present ownership and control patterns.

On past performance at least, Canadian governments, presumably reflecting the priorities of the Canadian population, have not been prepared to take the radical steps necessary to bring about major changes in non-resident ownership and control patterns, evidently because of the substantial economic costs and adverse distributive effects that such steps would probably entail. Nor do many persons outside government circles advocate particularly radical steps.³⁶ Most suggested changes in policy imply slow and marginal adjustments and it is within this context that it seems realistic to examine the various non-economic aspects of foreign investment.

A second major point to be recognized is that many of the alleged non-economic problems of foreign private investment are not attributable to investment as such, even though it serves as one of a series of transmission belts, but are questions of intergovernmental relations and co-operation. There is little reason to believe that these problems, such as the extra-territorial extension of U.S. laws to Canada via subsidiaries, will be attenuated significantly by a marginal reduction in foreign investment and trade. Indeed, to the extent that such a reduction implies more, rather than less, government intervention in private decisions, it may entail greater rather than fewer problems of inter-governmental relations.

Thirdly, there is the question of whether there is a positive or a negative relationship between the economic benefits made possible by foreign investment and Canada's social and political development as an independent state with a clearer identity internationally. If one is

considering marginal adjustments in foreign investment, then this question is much less important than if one is considering major adjustments since the non-economic consequences of marginal changes in foreign investment seem unlikely to be very significant either way. In any event, it is apparent that in fact very little is known about this question at present and that in principle either outcome is feasible. Following one line of argument, one may assume a negative trade-off and then pose the question of how much "nationalism" Canadians should be willing to purchase by foregoing economic benefits.³⁷ Alternatively, one may argue that national development is closely linked to raising the level of per capita income in the country, thereby providing the wherewithal to invest more resources in the intellectual, cultural and social development of the country as well as in the sharing of international responsibilities. Moreover, in order to reduce the long-standing drain of many able Canadians to the U.S. the evidence suggests that it is important to narrow as much as possible the continuing gap in real per capita income between Canada and the U.S. In addition, a richer country is likely to have a larger reserve of resources to see it through a period of difficult political relationships with its neighbours than a poorer country. On the face of it at least, it would be hard to argue that Canada is now less of an independent state with less power internationally than it was twenty years ago. To what extent this is attributable to foreign investment is highly uncertain however, nor is much known about how the political and social aspects of the country would differ if Canada had had a significantly smaller inflow of capital during the past two decades.

A fourth consideration of major importance within this context relates to regional nationalism and regional attitudes to foreign investment. As indicated below Provincial Governments generally have been more favourably disposed to foreign investment than the Federal Government. Moreover, there is considerable evidence that many Provinces would strongly resist

any measures by the Federal authorities to restrict foreign investment to a significant degree. In these circumstances one may question whether such restrictions, which would result in much federal-provincial dispute, would be likely to foster national unity and the social and political development of the country.

Finally, it is sometimes argued that there are certain key sectors of the economy where it is necessary to preclude or to restrict foreign investment, such as banking, communications and transportation, in order to maintain resident control and ensure political and social independence. Here again the argument is based mainly on assumption and assertion rather than analysis. It is not obvious, for example, that a country like the United Kingdom which allows extensive foreign banking operations suffers politically and socially compared to Canada which does not.

Recent Canadian Policy on Direct Investment

Canada continues to rely heavily on foreign investment and the degree of non-resident ownership and control over domestic industry is greater than in any other industrialized country. Over the years the Canadian economy has remained among the most open in the world to foreign investors. At the same time there has been a steady trend during the past decade towards exercising more control over foreign firms and reducing the dependence on foreign direct investment. Some of these measures have taken the form of incentives of one kind or another to strengthen resident-controlled firms relative to non-resident firms and to encourage non-resident firms to perform according to standards that are regarded as being more clearly in Canada's national interest.³⁸ In addition, measures have been introduced to increase financial disclosure by all larger companies and in 1967 the government issued "guiding principles of good corporate behaviour". Finally, the government has imposed direct restrictions in a number of cases such as requiring all applicants for radio and T.V. licences to be Canadian citizens, to inhibit investment in Canadian newspapers and financial institutions. And recently the Government has intervened directly to prevent American control

of a major uranium mine and an oil company.

At present a Task Force is at work within the Federal Government reviewing Canadian policy on foreign investment. Whether further regulations and restrictions emerge from this review and what form any changes in policy may take remains to be seen. One of the most important and interesting features of Canadian policy at present is the apparent difference in attitude toward foreign direct investment between most of the Provincial Governments and the Federal Government. Most of the steps taken to promote greater local control and the restrictions placed on foreign control have been Federal measures. At the same time, many Provincial Governments have been actively encouraging more foreign investment, in some cases providing incentives to enhance the inflow. Moreover, Provincial Governments have resisted Federal measures that might reduce inflows of foreign capital.

In addition to the difficulties posed by widespread ignorance about the answers to many of the relevant questions that arise and by conflicts of interest between different political jurisdictions, developing an explicit national policy on foreign investment is made more difficult still by the highly heterogeneous nature of foreign direct investment, and the wide diversity of circumstances prevailing among firms in the same industry and among different industries. Aside from general requirements about providing information and broad guidelines for corporate behaviour, it is extremely difficult, if not impossible, to frame a comprehensive national macro policy to cope with what at bottom is a micro phenomenon, many of the costs and benefits of which can only be sensibly evaluated at a micro level. Thus a general policy runs considerable risk either of being very loose and ineffective in achieving whatever combination of objectives is sought or, alternatively, of imposing constraints that do have some bite but do more harm than good because the policies, being general in conception, are geared to some bogus or dimly-perceived norms that are approximated only rarely in actual fact.³⁹

Just how difficult it is to assess circumstances within an industry

as well as the operations and performance of large multinational firms included in the industry is well illustrated by the recent Report of the Royal Commission on Farm Machinery.⁴⁰ Interestingly enough, in this industry one of the leading multinational corporations is an indigenous Canadian firm, for all practical purposes controlled in Canada. By itself this apparently has provided little or no protection against the oligopolistic practices followed by the industry at the expense of Canadian interests.

There is little doubt that, other things being equal, most Canadians favour domestic over foreign investment and that there is much genuine concern about the implications of the present level of non-resident control over Canadian industry. At the same time, it is widely recognized that Canada continues to reap substantial economic benefits from foreign investment.⁴¹ Moreover, it is far from clear what new policies can be devised that will abate the concern about foreign investment without also incurring substantial economic costs - costs falling primarily on many of the poorer areas and the poorer members of the community. It is an open question, furthermore, whether the economic losses resulting from such policies will not do more to harm than to enhance Canada's national development. Simply adopting new policies in response to felt urges, more or less on blind faith, runs a high risk of incurring economic losses and of hampering rather than advancing Canada's development as a nation.

F O O T N O T E S

1. For a survey of the issues within a broader context see Harry G. Johnson, "Survey of the Issues" (mimeographed) 1970 - a paper that has been drawn upon at several points in this review. The author also wishes to acknowledge the valuable comments and suggestions on an earlier version of this paper made by R. E. Caves.
2. An excellent review of European concerns and various suggestions whereby governments might help to foster domestic enterprises capable of standing up to competition from large multinational corporations controlled by U.S. residents is provided by Christopher Layton Cross-Frontier Mergers in Europe (Bath: Bath University Press, 1971).
3. In introducing the tariffs giving rise to the National Policy in 1879, the Minister said, "the time has arrived when we are to decide whether we will be simply hewers of wood and drawers of water; ... The time has arrived when we must consider whether we will allow matters to remain as they are, with the result of being unimportant and uninteresting ... or (whether we) will rise to the position which I believe Providence has destined us to occupy".
4. In the words of Professor George Grant: "Those who want to maintain separateness also want the advantages of the age of progress. These two ends are not compatible, for the pursuit of one negates the pursuit of the other. Nationalism can only be asserted successfully by identification with technological advance; but technological advance entails the disappearance of those indigenous differences that give substance to nationalism" G. P. Grant, Lament for a Nation, (Toronto: McClelland and Stewart, 1965) p. 76.
5. G. Rosenbluth, "The Relation Between Foreign Control and Concentration in Canadian Industry" Canadian Journal of Economics III (February 1970), p. 28.

6. These data are presented and described in Grant L. Reuber and Frank Roseman, The Take-Over of Canadian Firms, 1945-61, An Empirical Analysis, Economic Council of Canada; Special Study No. 10, (Ottawa: Queen's Printer, 1969). The data cover only those foreign and domestic mergers coming under the jurisdiction of the Combines Act.
7. Richard E. Caves and Grant L. Reuber, Capital Transfers and Economic Policy, 1951-1962 (Cambridge: Harvard University Press, 1971). For an examination of evidence since 1962 see R. E. Caves and G. L. Reuber, "International Capital Markets and Canadian Economic Policy Under Flexible and Fixed Exchange Rates, 1952-69" (mimeographed) 1971.
8. Caves, Reuber Capital Transfers op. cit., p. 90, provide estimates of the elasticity of capital flows with respect to changes in interest rates ranging from 6 to 11 for long-term portfolio capital and from 6 to 8 for short-term capital. The estimates of the elasticity of capital flows vis-à-vis exchange rate changes range from 6 to 33 for long-term portfolio investment and 13 to 108 for short-term investment.
9. This is because the supply curve facing individual borrowers, each of whose transactions by themselves are small in relation to the capital market, will be seen as completely elastic; in aggregate, however, the supply price of capital will increase as all borrowers simultaneously seek to borrow more abroad. As a consequence, individual borrowers will consider the average cost of capital to them rather than the marginal cost which is relevant from the standpoint of society.
10. For empirical evidence see Duncan M. Ripley "Some Determinants of Canadian Municipal and Provincial Bond Flotations in the United States", Review of Economics and Statistics 52(November, 1970) 417-426.
11. Alan K. Severn "Investment and Financial Behavior of American Direct Investors in Manufacturing" (mimeographed) 1970. Guy V. G. Stevens, "Capital Mobility and the International Firm" (mimeographed) 1970.
12. R. Z. Aliber, "A Theory of Direct Foreign Investment", The International Corporation: A Symposium Charles P. Kindleberger (ed). (Cambridge: The M.I.T. Press, 1970) pp. 57-90.

13. J. C. McManus, "The Theory of the International Firm", (mimeographed) 1971.
14. John H. Dunning Studies in International Investment, (London: George Allen & Unwin, 1970) p. 67-8.
15. S. H. Hymer The International Operations of National Firms: A Study of Direct Investment (M.I.T. doctoral dissertation, Cambridge, Mass., 1960).
16. Maurice Byé, "Self-financed Multi-territorial Units and Their Time Horizon", International Economic Papers No. 8, (London: Macmillan and Co., 1958) pp. 147-78.
17. Raymond Vernon, "International Investment and International Trade in the Product Cycle", Quarterly Journal of Economics 80 (May, 1966) pp. 190-207.
18. Richard E. Caves, "International Corporations: The Industrial Economics of Foreign Investment", 38 Economica (February, 1971) pp. 1-27. By horizontal investment is meant investment to produce the same goods and services as the firm already produces. Vertical investment, on the other hand, either produces inputs for existing production processes or absorbs the output of these processes.
19. See, for example, H.C. Eastman and S. Stykolt, The Tariff and Competition in Canada (Toronto: Macmillan of Canada, 1967), particularly Chapter 4; H. Edward English, Industrial Structure in Canada's International Competitive Position (Montreal: Private Planning Association of Canada, 1964); Ronald J. Wonnacott and Paul Wonnacott, Free Trade Between the United States and Canada (Cambridge: Harvard University Press, 1967), particularly pp. 235-245.
20. Caves, Reuber, Capital Transfers op. cit., p. 90.
21. Grant L. Reuber and Frank Roseman, "International Capital Flows and the Take-Over of Domestic Companies by Foreign Firms: Canada, 1945-61", (mimeographed) 1970.

22. E.g., Thomas Horst, "American Participation in Canadian Markets: A Multinational Firm Approach", (mimeographed) 1970; Eastman, Stykolt, op. cit., Chapter 4.
23. Eastman, Stykolt, op. cit., Chapter 4.
24. These figures are indicated by three types of evidence: (i) given tax rates on profits in excess of 50 per cent and interest rates on bonds on the order of 7½ to 10 per cent, a pre-tax rate of return on equity of 15 to 20 per cent is implied; (ii) data collected from business firms under various auspices suggest pre-tax rates of return frequently in excess of 15 per cent; and (iii) direct estimates, based on a Cobb-Douglas production function and empirical evidence on labour's share of output, suggest rates of return on the order of 15 per cent.
25. Figures on rates of return are subject to a number of qualifications, some of which are mentioned by Brash, op. cit., pp. 9-10.
26. Rudolph G. Penner, "The Benefits of Foreign Investment in Canada, 1950 to 1956", Canadian Journal of Economics and Political Science, 32(May, 1966) pp. 172-83.
27. E.g., Kari Levitt Silent Surrender (Toronto: Macmillan of Canada, 1970) "Twenty years of unprecedented intake of American capital, technology, know-how and marketing connections have probably resulted in increased income and employment", p. 118.
28. For two excellent theoretical discussions of some of the issues in question see Caves, op. cit., and Harry G. Johnson, "The Efficiency and Welfare Implications of the International Corporation", The International Corporation op. cit., pp. 35-56.
29. For two excellent discussions of these and other questions pertaining to the economic behaviour of subsidiaries of international corporations see: Donald T. Brash, "United States Direct Investment in Australia, Canada and New Zealand: Costs and Benefits", (mimeographed, 1970); A. E. Safarian The Performance of Foreign-Owned Firms in Canada (Montreal: Private Planning Association of Canada, 1969).

30. Safarian, op. cit., Chapter 9.
31. These points are elaborated by Caves, op. cit.
32. These circumstances are elaborated in Johnson, "The Efficiency and Welfare Implications of the International Corporation", op. cit., pp. 53-4.
33. One report alleges that as a consequence of the government's action blocking the sale of Denison Mines in 1970, 85 per cent of drill contracts in the uranium exploration field were cancelled. European experience also provides evidence that attempts by one country to regulate foreign investors have resulted in a diversion of foreign investment to other Common Market countries.
34. Caves, Reuber, Capital Transfers op. cit., Chapter 4.
35. Ibid., pp. 265-7.
36. E.g. Foreign Ownership and the Structure of Canadian Industry (Ottawa: Queen's Printer, 1968).
37. Along the line of the analysis developed by Albert Breton, "The Economics of Nationalism", Journal of Political Economy LXXII (August, 1964) pp. 376-86.
38. E.g. in 1960 tax incentives were introduced to increase investment in local enterprises; in 1961 the Industrial Development Bank made special provision to assist firms that otherwise might sell equity to foreign firms; in 1962 incentives were provided to encourage research activities in Canada, in 1963 special depreciation allowances were made available to firms, 25 per cent of whose equity was owned by Canadians and whose directors were local residents; in 1971 tax reforms were introduced to foster increased resident ownership and control and the Canadian Development Corporation was established with the same purpose in mind.
39. Thus, one finds in countries, such as Mexico, which have adopted relatively stringent policies, that the requirements set out in fact are frequently more honoured in the breach than in the observance. Ad hoc exceptions condoned by not enforcing the law abound together with a

variety of legally-ordained exceptions. The result bears little or no resemblance to the prospect of a finely-tuned, clear and rational policy framework carefully designed to minimize costs and maximize benefits, as sometimes held out by the advocates of a detailed and explicit national policy on foreign investment for Canada.

40. Royal Commission on Farm Machinery, Special Report on Prices (Ottawa: Queen's Printer, 1969) and Report of the Royal Commission on Farm Machinery (Ottawa: Queen's Printer, 1971).
41. It is interesting to note that the main recommendation advanced by Kari Levitt to arrest the disintegration of Canada as a nation under the impact of foreign investment, as she sees it, is the development of a new value system in which there is less emphasis on the individual, in which a lower priority is given to being wealthier, having more leisure and having more luxuries, in which greater emphasis is given to submerging private values and tastes to national values and tastes and where "the desire to control and shape the conditions of life within a community" is given higher priority. Op. cit., pp. 152-3.