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IMPLICATIONS OF FOREIGN DIRECT INVESTMENT
FOR THE CANADIAN
FOOD AND BEVERAGE MANUFACTURING INDUSTRY

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Odette S. Vaughan

Industry Competitiveness Group
Policy Branch
Agriculture and Agri-Food Canada

Ottawa, Ontario, K1A 0C5
(613) 995-5880

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EXECUTIVE SUMMARY

- 1) This paper draws from the theory of foreign direct investment (FDI) and primary and secondary data to explore the implications of the strategic behaviour and structural changes of multinational food firms and the benefits and costs of FDI for the Canadian agri-food sector. A number of policy areas are examined in light of the findings related to FDI and multinationals.
- 2) Firms undertake FDI when their internalizable firm-specific advantages outweigh any disadvantages associated with operating in the foreign market and on balance the host country possesses a locational advantage for the firm. A variety of international corporate organizations characterize different roles for the parent and foreign affiliates of the multinational enterprise (MNE), such as the traditional multinational, the global firm, or the transnational.
- 3) FDI is significant in the Canadian food sector and multinational food firms play an important role in food industries worldwide. Both globally and for Canada, FDI is larger and growing faster than trade as a means of international commerce in the food industry. Sales of foreign affiliates account for some 60 percent of total international commerce in processed food products, while exports account for about 30 percent and sales through licenses and joint ventures the remainder.
- 4) Food firms seek opportunities in foreign markets to achieve growth and maximize profits. The primary determinants of FDI in food manufacturing are economic and strategic. Multinational food firms choose local production over exports primarily to maintain control over and fully exploit their intangible assets such as trademarks, technology and skills. Location advantages are also important, such as the size of a target market, the cost of delivery and inputs, and risk. Government policies are also locational considerations, but they tend to have an overriding influence on firms' decisions in only specific cases.
- 5) Multinational food firms show a strong preference to serve target markets with wholly owned local production, which is reflected in the traditional multidomestic structure of MNEs in the food industry. By producing in the host region and having full control over the management of a business, firms feel they can most successfully exploit their advantages. For instance, by ensuring product quality, timely delivery and superior customer service firms maintain and enhance the value of trademarks. In addition, food demand is often characterized by strong regional preferences. The ability to tailor products to local tastes can be a crucial asset for success in foreign food markets and can require producing in the target region. Strong consumer preference for domestically produced foods can also be an important influence on firms' production location decisions.
- 6) While producing in the target market is the dominant supply choice for multinational food firms, there has been a significant trend toward rationalization on a regional basis. Trade liberalization and increasing competitive pressures are encouraging food firms to increase specialization within geographic regions and invest in internationally cost competitive plants. This is particularly apparent in North America and Europe, regions that account for the lion's share of FDI in food. Food firms are aiming to exploit economies of scale, be more efficient, and purchase inputs from the most cost competitive source. This emphasizes the need for firms in Canada to be internationally cost competitive, especially vis-à-vis the U.S., and to embrace technologies and skills that will enhance their productivity.
- 7) FDI offers net benefits to the Canadian food industry. It brings gains from international

exchange, capital, access to international distribution systems, spillovers in terms of R&D and skills, and so on. However there are concerns about the ability of smaller firms to compete in markets dominated by MNEs and market power when the same few firms hold a large share of regional or global markets. The difficulty that foreign affiliates in Canada have in attracting resources from parents for R&D is also a concern.

8) In general, Canada is viewed as an attractive place to invest and few public policies negatively influence FDI in the food industry.- However attracting new foreign investment is a challenge for Canada's agri-food industry. Since many of its markets are small and growth potential is often limited compared to developing countries, better access to foreign markets and a more cost competitive agri-food sector would help to maintain and increase FDI in the Canadian food industry.

9) Based on the findings of this study, the following public policy areas are those in which the Canadian government could maximize the benefits or minimize the concerns of FDI in the food industry.

a) Market regulation in the Canadian agri-food sector can discourage FDI because of the effect it has on cost competitiveness. More market responsive marketing institutions, particularly within the supply managed industries, would have a positive influence on food firms' decisions to enter these industries.

b) Improving the functioning of trade agreements would have a positive effect on food firms' decisions to invest in Canada. Assured access to foreign markets, reduced technical barriers and more effective dispute settlement mechanisms are increasingly important as MNEs take a more global approach to production and marketing.

III

c) R&D policies that encourage firms to adopt new technologies and apply expertise to niche-type endeavors both for domestic and export markets are especially important for firms in Canada for a few reasons. First, Canada has relatively high costs compared to some countries and to offset this must be innovative with respect to production processes and new product development. Second, as a nation relatively well endowed with human and physical resources, Canada must take advantage of these strengths to grow and be competitive in a global economy. In addition, while affiliates in different countries must compete for parents' capital and the home region or large market regions are often chosen for R&D sites, MNEs can provide excellent opportunities for firms in Canada to reach large and fast growing markets around the world.

d) The success of export development programs in generating economic growth is influenced by the way international trade fits into firms' production location strategies. Food firms often progress from exporting to local production. Successful export development programs thus could lead to outward FDI. In addition, while MNEs participate in export programs and most likely benefit from information provided by governments on foreign markets, these programs would typically have less influence on the decisions of large MNEs than smaller firms. The contribution of export development programs to Canada's overall export performance, therefore, might be enhanced by putting more emphasis on the needs of smaller firms.

e) With the increasing integration of markets within-Canada and the U.S. and elsewhere, the task of governments to promote competition within the boundaries of individual nations is becoming more complex. Governments realize they cannot effectively carry out their mandates exclusive of the international activities of MNEs. Ultimately the coordination of national policies would be necessary to accomplish internationally efficient competition policies. This kind of international effort is beginning to be addressed in discussions concerning a multilateral accord on FDI.

10) Canada's inward FDI has been historically high but its outward FDI is becoming more substantial. Hence policies that prevent other countries from being too concerned about international distributive effects could be beneficial on balance. In general, countries that can effectively meet internal policy goals at the least cost to government and industry will be best able to attract and retain investment and be competitive in international markets. However the question of how to reconcile domestic and global objectives remains for the international community. A multilateral accord on FDI could promote global-welfare maximizing arrangements toward MNEs, including internationally efficient policies in R&D and corporate taxation as well as competition.

1. INTRODUCTION

Foreign direct investment (FDI) is significant in most advanced nations, and particularly so in Canada. In general, the international production of foreign affiliates is of greater importance and growing faster than exports in delivering goods and services to foreign markets.

Both FDI and trade will continue to develop as consumers, producers, suppliers and governments in different countries become more interdependent. This so-called "globalization" process is the result of numerous changes, including technological developments and financial innovations. In addition, there has been a general growth in political and economic liberalism since WWII and a subsequent lessening of protectionist sentiments. Major policy contributions to this have been successive rounds of the GATT and regional trade agreements in Europe and North America, as well as an easing of formal barriers to FDI among OECD countries and some developing countries.

In the food sector, international commerce also is dominated by FDI and firms are rapidly evolving into a global system. Affiliates of multinational food manufacturers play a significant role in the Canadian agri-food sector and this should continue in the future. However, parents' expectations of affiliates in Canada and worldwide are changing as international markets are becoming more integrated and international cost competitiveness is becoming more important. In the past multinational food firms tended to be multidomestic with foreign affiliates' largely responsible for supplying only their domestic markets. Now, multinational enterprises (MNEs) are rationalizing production within regions and across countries and affiliates around the world are expected to be cost efficient suppliers to both domestic and foreign markets. In addition, more and more, MNEs are exploiting benefits gained in one market for use in others around the world, in terms of sourcing inputs, supplying final products, transferring technology and human resources, and so on. This presents opportunities and challenges for the agri-food industries of Canada and other nations.

This study analyzes FDI in the food sector and the behaviour of multinational food firms, with a focus on the Canadian food manufacturing industry¹. While the theoretical and empirical literature on multinational enterprises (MNEs) is vast and covers many industries and countries, few studies have paid particular attention to Canadian food manufacturing². The objectives of this study are to examine trends in FDI and gain a better understanding of forces guiding FDI and trade in Canada and worldwide. In addition, we assess the implications of FDI for the economic welfare of Canada and identify relevant policy issues for Canada's food manufacturing industry.

¹The findings from interviews with the senior management of 17 multinational food manufacturing firms from the U.S., Canada, the U.K. and Switzerland are used in this paper. These interviews were conducted jointly by Agriculture and Agri-Food Canada and the USDA and are documented in Vaughan et al (1994) in terms of firms strategies for accessing foreign markets and the role of government policy.

²Cooper and Barkman (1990) provide a useful overview of importance of foreign ownership in Canadian food manufacturing and they report on a number of important studies related to multinationals in Canadian manufacturing.

2.

A number of public policy issues are raised in this paper as they relate to multinational food manufacturers and the Canadian food manufacturing industry. Primary areas of concern are policies that influence the attractiveness of Canada as a place to invest, especially in terms of agri-food sector policies that affect the ability of firms in Canada to be internationally cost competitive and the ability of trade policies to effectively improve access to foreign markets. In addition, foreign ownership has implications for R&D policy, export development programs and competition policy.

The paper is organized as follows. Section 2 provides a thorough overview of the economic theories of FDI and includes a discussion of corporate structures of MNEs from the business literature. Worldwide trends in corporate structures and FDI are given in Section 3, including a detailed outline of the factors influencing multinational food firms' decisions to locate production in Canada. In Section 4, notwithstanding data restrictions, an empirical analysis of economic benefits and costs of FDI for Canada's food manufacturing industry is provided. Public policies related to multinational food firms are discussed in Section 5; in particular, we point out those areas that should be considered to improve the benefits of FDI or in which multinationals should be given special treatment. Conclusions to the paper and implications for further study are given in Section 6.

2. THE THEORY OF FDI AND THE STRUCTURE OF THE MNE

2.1 *What is FDI? What is a MNE?*

Foreign direct investment, as opposed to portfolio investment, is the ownership of assets by a foreign firm for the purpose of "controlling" the use of those assets. Statistics Canada and the U.S. Department of Commerce define foreign investment as direct when a foreign firm has a stake of about 10 percent or more in a domestic operation. The 10 percent criterion, though arbitrary, is intended to reflect the notion that a large stockholder will nominally have a strong say in the operations of a firm even if that stockholder does not have a majority stake (at least 50 percent). In fact majority ownership generally appears to be common among multinational food manufacturers; in Canada, foreign food firms typically have a 100 percent stake in their affiliates.

Caves (1982) defines a multinational enterprise as an enterprise that controls and manages production facilities located in at least two countries. The term enterprise is used instead of company to draw attention to the top level of coordination in the hierarchy of business decisions. A company, itself multinational, may be the controlled subsidiary of another firm. The term multinational or parent is used loosely here to mean MNE. By definition parents are located in a "home" country and their foreign affiliates (or foreign subsidiaries) are situated in "host" countries.

2.2 *Background*

Hymer (1960) was the first researcher to propose a theory of FDI or international production. He hypothesized that firms possessing oligopolistic advantages or firms in a position to benefit from market imperfections, such as economies of scale, product differentiation, distribution networks, etc., may use these advantages to overcome the costs and risks associated with producing in foreign markets and competing with other firms in host countries. In this sense, Hymer proposed that oligopolistic firms may find it more advantageous to set up foreign affiliates rather than export to serve foreign markets.

Prior to this, researchers relied on mainstream, neoclassical-type trade and financial theories to explain international flows of products and assets. These theories were not inconsistent with the nature of the international economic system during this earlier period. That is, before the 1950s most trade was between firms in different countries and inter-industry in nature and most capital flows were portfolio in nature.

Since Hymer's pioneering work of the early 1960s, a large and growing body of literature and empirical research has explored the motivation for FDI. Many of these theories embody some aspects of industrial organization or imperfect competition theory as espoused by Hymer and later by Kindleberger (1969) and Caves (1971), among others. Graham's (1985) assessment of this literature is that there are essentially two distinct "families" of theories of FDI which to some extent are competing. Today, the profession seems no further ahead in its establishment and recognition of the significance of the dominant theories of FDI than it was about a decade ago.

Most prominent of the two families of theories is Dunning's (1979,1980) "eclectic theory" of the MNE which is a synthesis of a number of paradigms derived from one of three theoretical areas: industrial organization, neoclassical trade theory, and the theory of the firm. The second "family" of theories is called the "oligopolistic reaction" paradigm. There exists no synthesis for the

oligopolistic reaction paradigm, however it is considered to be derived from game theory and a number of researchers have espoused the theory—most notable among these are Knickerbocker (1973) and Graham (1974,1978). Behrman (1969) and Hymer and Rowthorn (1970) were the first to view FDI as caused by oligopolistic reaction. Behrman noted that FDI takes place largely not in industries of a host country or region dominated by a single firm, but in ones which are oligopolistic and within which interdependence among several sellers is significant.

Graham (1985) also comments on a third "family" of theories which view the MNE as an institution for international financial intermediation and propose FDI occurs to enable investors to diversify asset holdings across international barriers. A number of people have looked at market imperfections in capital markets as explanations of FDI. In particular, Aliber (1970) claimed that FDI takes place because home country firms capitalize the same stream of earnings at a higher rate than host country firms because the market is able to give different capitalization rates to future streams of income that are dominated in different currencies. Graharrt suggests that these theories have received little recognition because of their limited plausibility.

Finally, although the modern theory of international trade maybe attempting to explain some of the characteristics of intra-industry and intra-firm (multinational enterprise) trade of goods by relaxing some of its assumptions, in particular, by allowing for imperfect market conditions, this body of theory does not seem to attempt to explain the motivations for using foreign direct investment *per se* to access foreign markets.

2.3 The "Eclectic Theory of the MNE

Dunning and Norman (1985) suggest that the extent of a firm's international economic involvement, along a continuum from arm's length transactions such as exporting, to contract transactions such as licensing, to internal transactions within the same institution (hierarchy) such as FDI, depends on the presence, or lack thereof, of three types of advantages. These advantages are as follows:

i)-Ownership-specific advantages: The endogenous competitive advantages of a firm relative to those of other firms are so-called ownership-specific advantages. These advantages manifest themselves as mobile, intangible assets which are exclusive or proprietary to their owners.

Examples of these are most kinds of human capital (including marketing expertise and technical know-how), product differentiation, brand image, product quality, property rights (including patents, formulae and trademarks), and technology. Those intangibles most commonly associated with multinational food firms are the reputation and quality of branded products, the ability to tailor products to local tastes, marketing expertise, production technology, customer service and knowhow in commodity trading.

ii) Location-specific advantages: The exogenous, non-exclusive assets of a firm are its so-called location-specific advantages. These advantages are captured from the environment (foreign market, country or region) in which the firm's capital and goods are transacted. They may be in the form of consumer needs and tastes, market structure (for example, number of firms, product differentiation,; barriers to entry, etc.) and non-market (government) intervention such as those policies concerning tariff and non-tariff barriers, and restrictions on FDI.

5.

iii) Internalization-advantages: The advantages of administering international transactions within the same firm rather than using external markets are so-called internalization-advantages. By internalizing activities within the firm and across countries, multinationals are able to reduce transactions costs related to market imperfections. For example by using affiliates instead of exports to serve foreign markets, MNEs are able to avoid costs associated with tariffs and exchange rates.

Transaction-cost economizing is the term often used to describe this benefit. The notion of transaction-cost economizing is generally attributed to Coase (1937); however Williamson (1975) and others elaborated on this approach and give it application to the multinational firm. The economies gained are both in terms of scale and synergy and the more the boundaries of a firm are pushed out the more important these economies become. These economies are essentially firm rather than country specific and can be associated with factors such as market rationalization, company organization, risk diversification, and the sharing of company-wide resources in terms of, for example, R&D, services, marketing, information, distribution, purchasing, and financing.

Internalization also -allows MNEs to better exploit and protect monopolistic ownership advantages, such as trademarks and know-how. Dunning and Norman suggest that internalizable ownership advantages can range from being advantages that arise from the actual possession of property rights which cannot be fully appropriated through exports or contracts, to advantages that are external to any one activity but internal to the firm associated with transaction-cost economizing.

It is hypothesized that all three advantages—ownership, location and internalization (OLI)—must be present in order for a firm to engage in FDI. Thus a firm will invest in operations outside of its home market when it holds proprietary assets that can be efficiently exploited internally within the firm. In other words, FDI is the matching of internalizable firm-specific advantages with location specific advantages. For any given multinational, ownership advantages can have more or less to do with transaction-cost minimizing than intangible asset efficiency, and can also be more or less country specific than firm specific.

2.4 The “Oligopolistic Reaction” Theory of the MNE

This family of theories proposes that international production, at least in part, is undertaken by oligopolists based in different countries in order to counter, check or forestall moves by rival oligopolists.

To some extent, oligopolistic reaction competes with the OLI paradigm because of the fact that if a firm's motivation for FDI is to respond to or anticipate the action of a rival, that firm will not necessarily act to match a firm-specific advantage to some location-specific advantage. However, it is recognized that rivalry can act in tandem with other motives. And furthermore, even if rivalry is a major motivation for penetration of foreign markets, the exact form of penetration (greenfield which adds capacity to a market or acquisition which may not add capacity) is likely to be affected by various OLI advantages such as government policies, international firm economies and factor proportions.

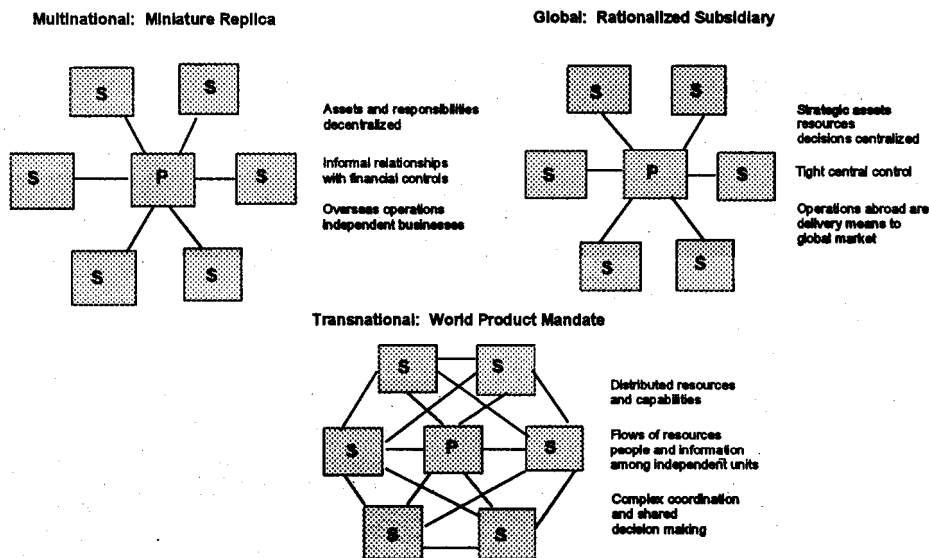
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2.5 Structural Organization of the MNE

Once a firm becomes an MNE, the determinants for which are discussed above, a variety of international corporate organizations may be employed any of which is largely determined by the products and culture of the firm. Configurations of an MNE in terms of location of parents' and affiliates' administrative offices, manufacturing plants, R&D facilities, etc. are presented in this section.

Various theoretical firm organizations are cited in the business literature.³ Three such international firm structures are discussed here: 1) the traditional multinational firm with subsidiaries sometimes referred to as "miniature replicas"; 2) the global firm with "rationalized subsidiaries"; and 3) the transnational firm with subsidiaries producing "world product mandates" (Figure 1). The main differences between the strategies used in these organizational structures are shown in Table 1.

Figure 1
International Firm Organizations



Note: P=Parent S=Subsidiary

Source: World Link Sept/Oct 1990, from Investment Canada (1991a).

³³ See Crookell (1990a) and Investment Canada (1990) concerning corporate organization and firm restructuring. Bishop and Crookell (1986) also provide an analysis of corporate structure, specialization and options for foreign subsidiaries in Canada operating in a global economy.

Table 1
Structure and Control in Multinational Enterprises

| | Miniature Replica | Rationalized Subsidiary | World Product Mandate |
|---------------------------|------------------------------|------------------------------------|--------------------------------------|
| Production | S | S | S |
| Selling | S | S | S |
| Process Technology | S | S | S |
| Management | S | P | S |
| Marketing | S | P | S |
| Product Renewal | P | P | S |
| Exporting | n/a | P | S |

Note: S=subsidiary has primary responsibility, P=parent has primary responsibility, n/a=not applicable
Source: Bishop and Crookell (1986, Table 7-1, p314).

Multinational Firms and Miniature Replicas

The traditional multinational corporation pursues a broad geographic distribution of resources, however there are relatively low levels of coordination among regional activities. Subsidiaries act quite independently of each other and there is duplication of activities between regions. The term miniature replica is sometimes used to describe the subsidiaries since they can produce many of the products manufactured by the parent but in relatively small volume.

Subsidiaries have considerable autonomy and country managers have a great deal of responsibility for activities in their own region. However they tend not to export extensively. In addition they tend to have relatively low R&D propensities though many import parent technology and over time may develop R&D to carry out independent product innovation to suit local conditions and tastes.

Global Firms and Rationalized Subsidiaries

The global corporation may be characterized as having a high level of foreign investment, a balanced geographic distribution of company resources and a high level of integration and coordination among regional activities. Production and R&D activities may be specialized within regions and the results shared across geographic boundaries.

Rationalized subsidiaries of global corporations serve primarily as a source of supply of one or a few products in large volume for world markets and import the balance of their needs from the parent in order to achieve production efficiency through specialization. Subsidiaries have little input into corporate planning and country managers have an administrative rather than a strategic role.

The global firm organization becomes more appropriate as product knowledge becomes more important than market knowledge, hence this international structure is generally more applicable to industries such as aircraft and computer manufacturing than packaged food manufacturing. Greater efficiencies may be achieved from the global strategy yet better local knowledge can be gained from the traditional multinational strategy.

Transnational Firms and World Product Mandates

The transnational subsidiary incorporates a world product mandate approach, whereby one or two products is manufactured by each subsidiary for the world market and individual subsidiaries perform their own R&D and global marketing as they relate to the subsidiaries' area of specialization. These subsidiaries function much like a domestic product division yet they interact with the corporate worldwide sales force and the corporate R&D centre and inform the parent of strategic initiatives. Most world product mandate arrangements emerge as a result of subsidiary initiative being recognized and rewarded by the parent.

The transnational structure in combination with a "matrix".organization is a complex option suitable to a mature multinational enterprise attempting to achieve an optimal blend of efficiency and local sensitivity. Within a matrix organization, strategic planning is shared among product divisions and geographic areas. Both parents and subsidiaries acquire a global perspective yet subsidiaries behave more autonomously than those in global corporations and inter-subsidiary movement of resources and human capital is encouraged. Companies with some product divisions requiring a strong local focus and others producing a fairly standardized product that has market acceptance around the world also may be suited to the transnational option.

For practical purposes, an MNE may be best served by choosing any one or combination of the three structures that most closely complements its products and then cope with the organizational deficiencies.

2.6 Conclusion

Foreign direct investment (FDI) is the ownership of assets by a foreign firm for the purpose of "controlling" the use of those assets. A firm that controls or manages those assets or facilities in more than one country is referred to as a multinational enterprise (MNE).

A large body of literature and empirical research has explored the motivations and determinants of FDI. The most prominent theory of FDI is Dunning's "eclectic theory" of the MNE which is a synthesis of a number of paradigms derived from one of three areas: industrial organization, neoclassical trade theory, and the theory of the firm. The eclectic theory proposes that the extent of a firm's international involvement depends on the presence, or lack thereof, of three types of advantages: 1) ownership (proprietary intangible assets such as trademarks and technical knowhow; 2) location (exogenous characteristics of the foreign market and government policies) and; 3) internalization (the ability of a firm to internalize transactions within the firm and across countries in - order to have greater control over ownership advantages and to gain from economies of scale and scope).

A firm will undertake FDI when its internalizable firm-specific advantages outweigh any disadvantages associated with operating in the foreign market and on balance the host country

possesses a locational advantage for the firm. A variety of international corporate organizations are cited in the literature that outline different roles for parents and foreign affiliates. Three types are presented here: 1) the traditional multinational firm with independent affiliates and the duplication of subsidiary activity across regions 2) the global firm with rationalized affiliates that have little or no strategic decision capability and supply one or two products in large volume for world markets 3) the transnational firm with affiliates interacting with the parent on strategic initiatives to produce world product mandates.

3. TRENDS IN CORPORATE STRUCTURE AND FDI

3.1 MNE Corporate Structure: Implications for Foreign Affiliates

With trade liberalization and worldwide developments in technology, transportation, communications, etc., markets are becoming more standardized and firms in many industries are becoming more global and less multinational in structure. That is, MNEs are becoming less of a collection of firms acting domestically and increasingly following integrated international strategies whereby they can exploit benefits gained in one market for use in another (Investment Canada, 1990).

Indeed food companies worldwide are becoming increasingly involved in international business, and sister companies of large multinational food firms are becoming more interactive and trade oriented due to potential benefits from specialization and transaction cost economizing. However, largely due to local consumer demand and the nature of food products, multinational food manufacturers are often constrained to being more multidomestic with subsidiaries oriented toward their domestic markets, rather than globally integrated with subsidiaries oriented toward export markets (Rama, 1991, p22). Food manufacturers, much like retailers, distributors and producers of consumer packaged goods, will tend to be somewhat less global in structure than, say, manufacturers of electronic equipment, since food products tend to be less standardized across regions. Also, in some cases, it does not make economic sense to transport food products more than a certain distance.

Standardization is one means of lowering costs through centralized production and exploitation of scale economies. The extent to which standardization occurs in food manufacturing will be largely a function of the degree of convergence of consumer demand for food products among geographic regions. Presently, there are a number of cases of relatively standardized, global brands in international food investment. However, by and large, consumer tastes remain fairly divergent across countries and hence in order to successfully access foreign markets food manufacturers must tailor products to local tastes. In some cases, the need to tailor also would apply to brands sold across different countries. In addition, wide ranging tastes within multicultural or higher income areas are motivating reasons for tailoring products in target markets.

Philip Morris remarked in its 1992 Annual Report, that while it develops global brands by sourcing and marketing globally and has created cross-border category management for core products such as cheese and worldwide strategy councils for coffee, it relies on international managers who understand local cultures and how to customize products. The need for food manufacturers to take into account local preferences requires some degree of decentralized downstream, consumer-linked activity, such as marketing, to take place within target markets.

At the same time, competitive pressures are forcing multinational food manufacturers to try to rationalize upstream activities, such as production and research, in order to lower costs. Trade liberalization, in particular, is facilitating the rationalization of production. With modern, centralized plants, multinationals can serve a number of segmented markets either-at-home or abroad by switching production runs to accommodate different formulations tailored to target market tastes and different labelling and packaging requirements. However, other things equal, multinationals must consider the tradeoff between the added benefits from economies of scale and the added costs associated with delivery.

Indeed, a number of location-specific factors influence multinational food firms' plant location decisions, primarily the availability and cost of inputs, economic and political risks, tariffs and other government policies as well as the value of products relative to their deliver cost, the size of markets and economies of scale. However, unless these kinds of economic and political factors clearly weigh in favour of producing in the home country multinational food firms generally prefer to locate production in the target market or at least in the host region. Multinational food firms preference for serving markets with affiliates instead of exports is due to the added control over intangible assets, such as trademarks and proprietary, technology, that local production offers. Maintaining the quality and reputation of branded products by ensuring that they reach target markets with a superior appearance and in a timely manner for instance, is a valuable asset to many food firms. The ability to tailor products to local tastes and needs also is often best exploited by producing in the host region. In addition, there can sometimes be local resistance to imported products.

i

The implication of international corporate restructuring for foreign-owned production in Canada's food industry, depends on a number of factors. The order of importance of these factors would vary according to the characteristics of firms and products; however, in general, it appears that public policies are not a predominant factor⁴. The following are the primary factors; the ordering is based on conjecture and is intended to give only a sense of comparative importance.

1) The importance of controlling and exploiting intangible assets and customizing products to local consumer needs and tastes.

Much foreign ownership of Canadian-food manufacturing is by the U.S. and the U.K., countries that generally have similar tastes to those in Canada. This could lessen the need for local Canadian production, though MNEs may find that Canadian consumers have a preference to support certain locally produced food products.

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In addition, the need to build and maintain product reputation and provide the necessary, level of service to Canadian customers in order to maximize product success is often the most important factor favouring local production for multinational food firms in Canada. For food firms with products associated with valuable intangibles such as trademarks or technology, the combination of both production in the host region and a local sales/marketing group can guarantee the best success in a foreign market.

⁴ This is based on the findings from interviews with the 17 multinational food firms (see footnote 1).

2) The size of the market relative to the minimum efficient scale.

A market that is small relative to the minimum efficient scale of a plant may be best served by a large, centralized regional plant. Many Canadian markets are relatively small, which favours production in foreign multinationals' home country or in larger, nearby markets.

On the other hand, shorter production runs in multi-product plants, developed to meet the traditional needs of the small Canadian market, are seen by some firms as an advantage in producing for small, specialized domestic and foreign market segments. However other firms discount this with the claim that longer run, higher volume plants can efficiently switch production among products, containers and labels for small market needs. The nature of the product and production process would likely determine the most efficient method.

Econometric estimates of returns to scale suggest that Canadian food industries have operated under conditions of constant to only modestly increasing returns to scale.⁶ A number of factors can limit the potential to realize economies of scale in food manufacturing; for instance, costs arising from the perishability of and availability of agricultural inputs when output is being increased, and demand conditions such as the need to tailor food products. Canada's relatively small and geographically segmented populations also limit market demand and firms' ability to capture scale economies.

Anecdotal evidence indicates, however, that scale economies are important at the output levels of many food firms in North America and Europe. Competitive forces are encouraging firms to modernize plants by introducing more up-to-date technology and increasing capacity so that the technology can be more optimally utilized. Increased production is often being used to supply larger markets that have been rationalized on a regional basis. For instance, some U.S. MNEs have shifted production to Canada for export to the U.S. and vice-versa. This is discussed further in terms of trade liberalization under point 8.

3) The cost of delivery relative to the unit value of a product.

A relatively high cost of delivery (freight, duties, etc.) in terms of unit value encourages local production. In addition, despite advances in technology, perishability or the inability of a product to "travel well" can put limits on the transportability of some food products and hence favour local production.

4) The availability and affordability of raw agricultural products and other inputs.

Because many agricultural inputs are available at competitive world market prices, the price of raw ingredients affects the decision of whether to produce in Canada for only a few products. For example, the higher price of supply managed poultry in Canada vis-a-vis the U.S. does not favour local production of products containing these inputs. On the other hand, the U.S. sugar and

⁶Robidoux and Lester (1988) estimate that Canadian food industries operate under conditions of constant returns to scale and Baldwin and Gorecki (1986) estimate modestly increasing returns to scale, from Hazledine and Lapointe (1990, p12).

peanut programs encourage Canadian production of products containing these inputs due to the more competitive prices for sugar and peanuts in Canada.

Ingredient costs typically account for a large proportion of production costs in food manufacturing and therefore this can be an important factor in firms' production location decisions. Other input costs, however, usually have little impact on the choice of production location. In particular, labour costs typically do not account for a significant portion of total costs. Furthermore, higher productivity can offset higher wage rates. However, to the extent that productivity is higher and wage rates are lower in the U.S. than in Canada, these could be important factors for production in Canada in those cases where other factors such as control of intangibles and tailoring are less important; a possible example of such a product could be private label biscuits.

5) Difficulties in establishing or accessing distribution systems.

These factors can affect a firm's ability to successfully access target markets, and therefore a firm may choose to supply the market with exports, which involves less financial risk than local production.

In Canada, however, these difficulties do not appear to substantially weigh against multinationals' choice to set up local production. Instead, a local presence here would most likely provide the additional benefit of better control over product distribution and hence quality and presentation.

6) The level of risk associated with politics and economics.

Canada is considered to have a relatively stable political and economic environment and therefore potential risks associated with factors such as government stability, changes in the exchange rate, the state of the infrastructure, and the reliability of the workforce do not usually have a negative affect on multinationals' decisions to locate production in this country.

However, multinational food firms sometimes choose to supply foreign markets with exports or licenses while attempting to establish a market presence, since these methods of supply involve less financial risk than direct investment.

7) The amount of initiative subsidiaries display toward developing-domestic and export markets and, equally, the amount of receptiveness offered by parents toward this initiative given the financial, management and technical capacity of each party.

While Canadian subsidiaries and sister companies worldwide must work within the strategic framework set out by the parent, it is in the interest of every sister company, regardless of nationality, to take full advantage of its resources in order to attract scarce capital from its parent and better compete in domestic and foreign markets.

Traditionally Canadian subsidiaries of multinational food manufacturers have been primarily responsible for supplying the domestic market with relatively little competitive pressure from outside countries. However with the threat of or actual increasing competition from imports, among other things, Canadian subsidiaries are challenged to improve their competitiveness in order to secure existing domestic markets and hopefully meet growth targets for these markets.

Furthermore, to attract capital, managers and staff of Canadian subsidiaries must be able to enhance their growth by taking the initiative to carve out niches for themselves, at least in terms of finding export markets for existing products, technology, skills, etc. They must also seek opportunities in terms of research in and development of new products, techniques, and so on for domestic and worldwide markets. These kinds of efforts are evident among Canadian affiliates of food manufacturers and will likely become more so.

8) Trade liberalization and its affect on multinationals' choice between using exports or direct investment to supply foreign markets.

Tariff reductions under-the GATT contributed to significant rationalization in Canada in general during the 1970s, mostly in industries containing many multinationals (Magun et a/,1988). In recent history, the initiation of the FTA in 1989 has probably accelerated ongoing adjustments in Canadian food manufacturing more than any other single event with perhaps the exception of an unprecedented number of historically high-valued mergers and acquisitions during the 1980s.

The results of three prominent surveys on the anticipated response to the FTA of Canadian manufacturers indicated that trade liberalization generally would induce a positive response, that is, specialization of some sort rather than exit.⁷ It was also anticipated that adjustment may be more difficult for small- and medium-sized Canadian firms and some affiliates of multinationals which were confined to Canadian markets. A generalization from the surveys was that Canadian producers had not attempted to and do not intend to compete by exploiting all available economies of large plant scale or large batch size. Instead, the anticipated approach to be adopted by both foreign and domestic firms appeared to be one of "niche-playing" or exploitation of small batch know-how. Finally, trade liberalization was not expected to result in an appreciable increase in plant closures by either foreign or domestic firms.

A post-FTA survey of Canadian firms on responses to the FTA indicated that although the message to subsidiaries in Canada has been that if they do not change their strategy they will likely fall victim to their parents' superior cost performance, the general expectation is that subsidiaries-will find a way to specialize their product lines, increase their trade, and lower their production costs.⁸

Fear that foreign multinationals would withdraw from Canada because of tariff elimination alone has gained little support. After several successive GATT rounds, bilateral Canada-U.S. investment has become dictated more by market and cost considerations than by tariffs. The most important factors influencing FDI are the desire to overcome transaction costs, such as transportation and distribution costs, and other market imperfections such as the public goods nature of trademarks

⁷Erdilek (1986) surveyed 28 U.S.-controlled MNEs in Canada. Lazar (1986) surveyed 102 firms in 10 Ontario industries. In 1987, Rugman (1988,1990) surveyed 16 firms from among the largest Canadian controlled MNEs and 10 firms from among the largest U.S.-controlled affiliates in Canada, including firms in the food and beverage industry.

Crookell (1990b) surveyed a number of foreign affiliates in Canada as well as parents of U.S.-controlled MNEs.

and distribution lists. The process of internalizing markets through FDI will continue even in a free trade environment between Canada and the U.S.

Changes in the structure of multinational food manufacturers is taking the form of closer integration of Canadian and U.S. production. Specifically, production is being rationalized at the product level in both countries and strategic management also appears to be more coordinated between the two countries, including the introduction of regional North American managers. At the same time, however, it appears that foreign affiliates in the Canadian food industry could be exploiting advantages of shorter run production.

9) Other public policies, particularly those affecting firms' cost competitiveness.

Firm, strategies for supplying foreign markets are influenced by a host of domestic sectoral, horizontal and macroeconomic policies, such as export programs, export subsidies, regulations governing FDI, and monetary and fiscal policies. However these policies are seen to be a decisive factor in the choice between supplying a country with exports, local production, or not at all in only relatively exceptional situations. In Canada, supply management is a policy often cited in terms of its effect on input costs and firms' investment decisions. Public policies involving foreign firms in Canada are discussed in further detail in section 5.1.

-Among these nine factors, there are those that favour production within the home country and those that favour production in Canada. Those favouring production in Canada tend to offset those favouring production in the home country (or other host countries which might then export to Canada). In general, however,- changes in location-specific factors are encouraging multinational food manufacturers to rationalize production on a more regional basis in order to reduce transaction costs and be more cost competitive. The regions forming are North America, South America, Europe and Asia.

In North America, in product-specific cases, more Canadian production is now being exported to the U.S. as substitutes or supplements to U.S. production, and vice-versa. In very few cases has the full range of a foreign affiliate's production in Canada been entirely substituted by imports from the U.S. In addition, foreign affiliates in Canada also appear to be increasingly seeking foreign markets. While some export arrangements are on an ad hoc basis to dispose of excess capacity or respond to temporary requests from the parent, others are more strategic in nature.

3.2 Growth in FD/9

In general, worldwide production by foreign affiliates has been growing faster and is of greater importance than exports in delivering goods and services to foreign markets (Investment Canada, 1993, p10). For processed food and beverage products, international commerce is by far dominated by foreign direct investment. Henderson and Handy (1994) estimate that in 1990, sales of foreign affiliates accounted for about US\$1 trillion of the total US\$1.5 trillion in international commerce while exports accounted for about US\$325 billion and sales through licenses and joint ventures the remainder.

In North America, sales of U.S. food and beverage manufacturers in Canada are about three times the value of U.S. exports of food and beverage products to Canada (Figure 2a&b). Similarly, sales of Canadian food and beverage manufacturers in the U.S. are at least fifty percent more than the value of Canadian exports of these products to the U.S. While U.S. and Canadian exports to Mexico still exceed affiliate sales in this country, multinational food firms from both the U.S. and Canada are becoming more involved in local production in Mexico in terms of licensing, joint ventures and affiliates.

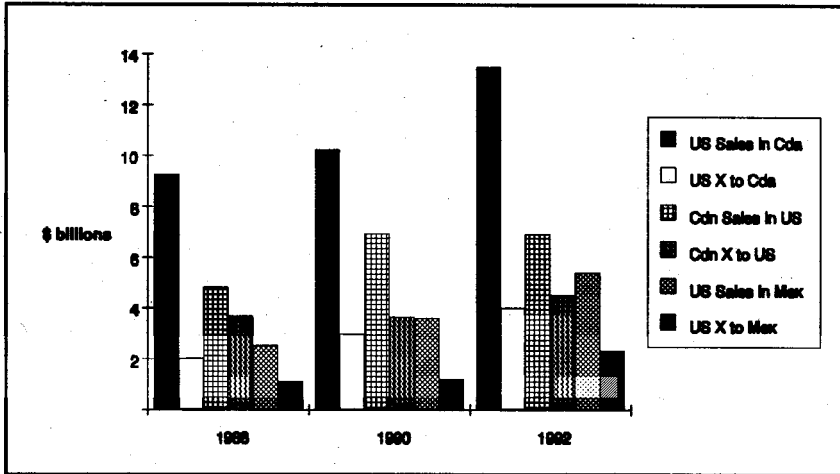
FDI in Canada, in general, is fairly high which is common in advanced countries. In Canada's food and beverage manufacturing industry, Statistics Canada reports that between 1983 and 1992 FDI grew 7 percent annually from about \$4.5 billion to \$11 billion. From a share of 6.5 percent of total FDI in Canada (excluding finance), FDI in food and beverage manufacturing grew to almost 10 percent (Figure 3).

In 1989, the year the Canada/U.S. Free Trade Agreement was initiated, there was an unprecedented, albeit slight, dip in the stock of FDI in Canadian food and beverage manufacturing. However between 1989 and 1992 the stock of FDI in these industries grew at an annual rate of 9 percent reaching an historical high by 1992. On balance, new investments have exceeded divestments during this period of significant restructuring. According to another Statistics Canada source, the sales of foreign-controlled food and beverage manufacturing firms in Canada increased at an average annual rate of about 7 percent between 1988 to 1992 from \$18 billion to \$23 billion (Figure 4). Total food and beverage manufacturing sales increased at about 1 percent annually over this period.⁹

9 The standard measure of FDI is the book value of the stock of parents' equity in, and net outstanding loans to, their foreign affiliates. Book value figures can understate the size of older investments; however the market value method, which reflects prices of the current period, is generally not provided.

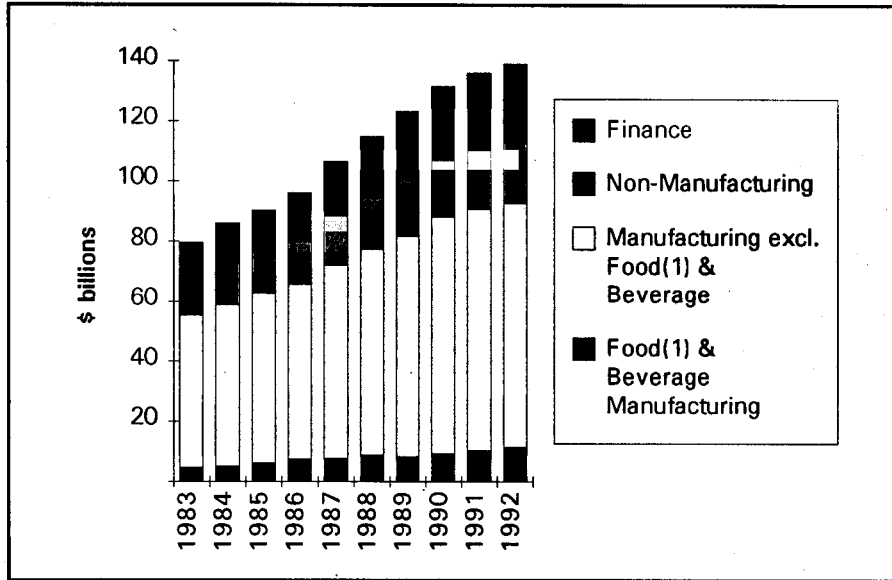
⁹ Empirical studies by Harris (1985) and Magun (1986) on the anticipated effects of a bilateral Canada/U.S. free trade agreement on the Canadian food manufacturing industry predicted no significant gain or loss in production for Canada or the U.S. Brown and Stern (1987) predicted U.S. food manufacturers would have a slight advantage in terms of increased output over their Canadian counterparts.

Figure 2a
U.S., Canada, Mexico, Trade and Affiliate Sales,
Food and Beverage Products,
1988, 1990, 1992



Note: Mexican affiliate sales in U.S. are confidential (likely small). Mexican affiliate sales in Canada are confidential (likely negligible). Canadian affiliate sales in Mexico are confidential (likely small).

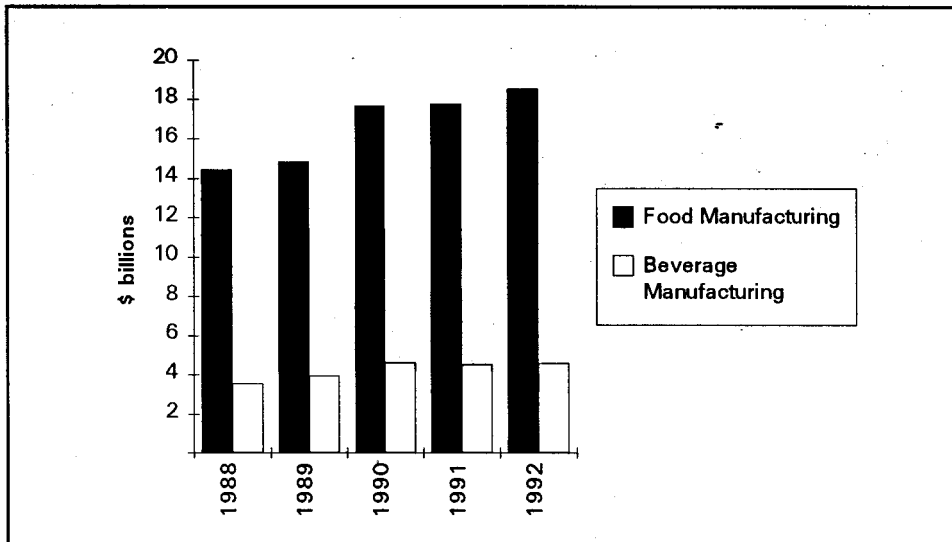
Figure 3
FDI in Canada by Industry,
1983 to 1992



⁽¹⁾Includes tobacco.

Source: Statistics Canada, *Canada's International Investment Position*, Catalogue 67-202.

Figure 4
Sales of Foreign-controlled Firms,
Food and Beverage Manufacturing Industry in Canada,
1988 to 1992



Source: Statistics Canada, *Corporations and Labour Unions Return Act (CALURA)*, Catalogue 61-220, special run excluding retail from the food manufacturing group, 1994.

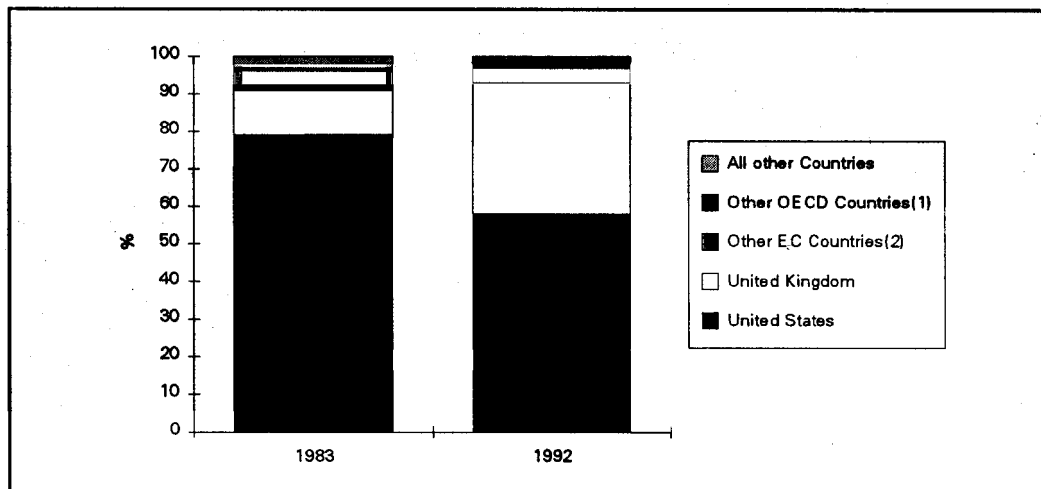
3.3 Geographic Sources and Industry Composition of FDI

For all industries, the geographic source of FDI has been diversifying both globally and in Canada in the past decade. The U.S. accounted for almost 80 percent of FDI in the Canadian economy in 1978 but less than 65 percent in 1991, while the United Kingdom, Japan, West Germany and Hong Kong increased their shares over this period (Investment Canada, 1991).

For the global food and beverage manufacturing industry, the U.S. and United Kingdom traditionally have been the most important sources of FDI. In 1985, of the 100 largest agribusinesses worldwide, the parent firms of 38 were located in the U.S., 25 in the U.K., and 7 in Canada (Rama, 1992, p41). During the 1980s, however, the U.S. share declined and there was a correlative increase in direct investment from European and Japanese multinationals.

Indeed, while the stock of FDI in Canadian food and beverage manufacturing has remained relatively undiversified and is dominated by U.S. direct investment, the United Kingdom has increased its share quite significantly in the past several years. In part this was due to the acquisition of Canada's largest food manufacturer, Canada Packers, by the British-owned Hilldown Holdings. In 1990 the U.S. owned almost 60 percent of the stock of FDI in food and beverage manufacturing and the U.S. and United Kingdom, combined, owned almost 95 percent. The United Kingdom's share increased to 35 percent from about 12 percent in 1983 (Figure 5).

Figure 5
Distribution of FDI in Canada by Geographic Area,
Food and Beverage Manufacturing Industry,
1983 & 1992



⁽¹⁾Other OECD countries: Japan, Austria, Iceland, Norway, Sweden, Switzerland, Turkey, Austria, and New Zealand.

⁽²⁾Other EC countries: Belgium, France, Italy, Luxembourg, Netherlands, West Germany, Denmark, Ireland, Greece, Portugal and Spain.

Source: Statistics Canada, *Canada's International Investment Position*, Catalogue 67-202.

As the total stock of FDI in Canadian industries grew during the 1980s, the industry and country composition changed somewhat. A breakdown of the stock of FDI in Canada by industry and by country is shown in Table 2. While direct investment from the U.S. and United Kingdom is predominant in many industries, industry distributions by geographic areas are quite distinct from each other. For instance, in 1992 about 20 percent of the United Kingdom's total direct investment in Canada was in the food and beverage industries whereas similar figures for the U.S. and Japan are 8 percent and less than 1 percent respectively.

Table 2
Foreign Direct Investment in Canada, by Industry and Geographic Area,
1983 & 1992

| Industry | \$ millions | | | | | | | | | | | | Total | | |
|--------------------------------|---------------|---------------|----------------|---------------|--------------|--------------|--------------------|---------------|--------------------------|--------------|---------------------|--------------|---------------|----------------|------|
| | United States | | United Kingdom | | Japan | | Other EC Countries | | All Other OECD Countries | | All Other Countries | | | Total | |
| | 1983 | 1992 | 1983 | 1992 | 1983 | 1992 | 1983 | 1992 | 1983 | 1992 | 1983 | 1992 | | | 1983 |
| Manufacturing | | | | | | | | | | | | | | | |
| Food ⁽¹⁾ & Beverage | 3,481 | 7,093 | 726 | 3,321 | 13 | 28 | 34 | 62 | 91 | 467 | 164 | 110 | 4,509 | 11,081 | |
| Wood & Paper | 2,238 | 6,180 | 377 | 1,78 | 95 | 1,189 | 183 | 224 | 353 | 1,156 | 16 | 22 | 3,262 | 8,949 | |
| Energy | 15,568 | 12,633 | 1,537 | 2,846 | 640 | 80 | 2,009 | 2,296 | 50 | 179 | 798 | 2,741 | 20,602 | 20,775 | |
| Chemicals | 7,295 | 10,578 | 929 | 1,518 | 10 | 241 | 400 | 2,189 | 287 | 661 | 24 | -16 | 8,925 | 15,171 | |
| Metals | 4,289 | 5,442 | 283 | 356 | 86 | 1,038 | 110 | 1,689 | 97 | 1,730 | 183 | 106 | 5,048 | 10,361 | |
| Machinery | 2,803 | 4,114 | 49 | 294 | 17 | 339 | 68 | 442 | 42 | 256 | 16 | 71 | 2,995 | 5,516 | |
| Trans. Equipment | 5,901 | 10,159 | 258 | 708 | 351 | 855 | 226 | 686 | 20 | 154 | 83 | 154 | 6,839 | 12,716 | |
| Electronics | 2,707 | 5,996 | 167 | 352 | 12 | 306 | 195 | 796 | 86 | 409 | 14 | 172 | 3,181 | 8,031 | |
| Non-Manufacturing | | | | | | | | | | | | | | | |
| Finance | 6,839 | 12,693 | 1,987 | 6,195 | 150 | 822 | 915 | 3,698 | 476 | 1,593 | 204 | 1,259 | 10,571 | 26,260 | |
| Construction | 1,528 | 3,008 | 604 | 938 | 49 | 177 | 1,543 | 1,274 | 253 | 312 | 369 | 342 | 4,346 | 6,051 | |
| Trans. Service | 1,091 | 3,057 | 73 | 205 | 4 | 67 | 16 | 153 | 39 | 174 | 57 | 9 | 1,280 | 3,665 | |
| Consumer Goods | 3,707 | 4,700 | 856 | 385 | 274 | 267 | 351 | 462 | 298 | 188 | 26 | 159 | 5,512 | 6,161 | |
| Other ⁽²⁾ | 2,260 | 2,814 | 103 | 247 | 72 | 477 | 60 | 326 | 15 | 143 | 91 | 179 | 2,601 | 4,186 | |
| Total | 59,707 | 88,467 | 7,949 | 17,543 | 1,773 | 5,886 | 6,110 | 14,297 | 2,087 | 7,422 | 2,045 | 5,308 | 79,671 | 138,923 | |

⁽¹⁾Includes tobacco.

⁽²⁾Includes general services, accommodation, restaurants and food retailing.

Source: Statistics Canada, *Canada's International Investment Position*, Catalogue 67-202, Table 12, 1993.

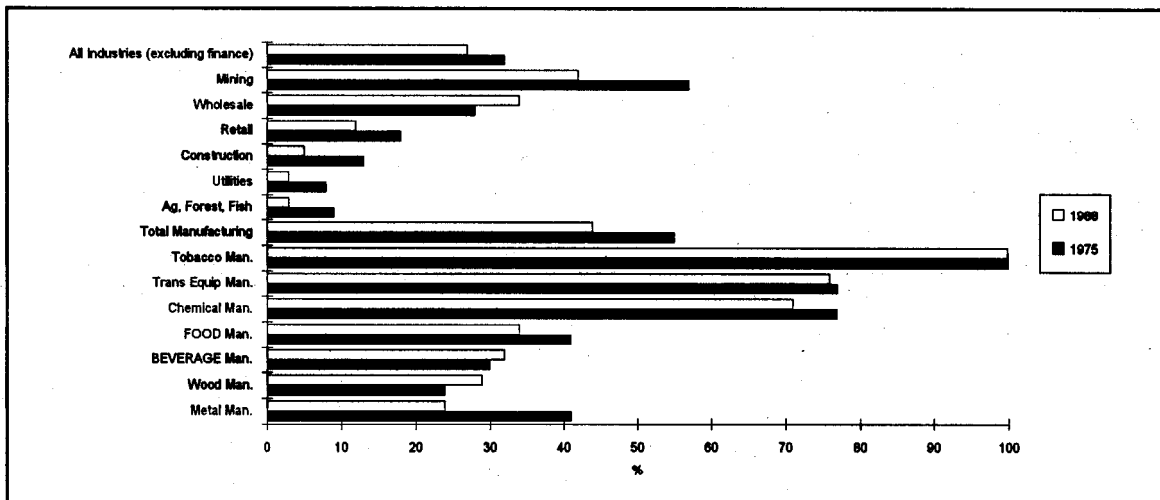
3.4 Composition of Foreign and Domestic Assets and Sales

In 1988, about 34 percent of total corporate assets in Canadian food manufacturing were foreign-controlled and the remainder domestically-controlled. While foreign ownership in food manufacturing is significant, it is less than the average (44 percent) for all manufacturing industries. Indeed in the chemical manufacturing industry and transportation equipment manufacturing industry about three-quarters of total corporate assets in Canada are accounted for by foreign firms and virtually 100-percent of the tobacco manufacturing industry is foreign owned (Figure 6).

The share of foreign-owned assets is relatively high in food and other manufacturing industries compared to non-manufacturing industries; for example in 1988 foreign-owned assets accounted for 12 percent of total assets in the retail industry, 5 percent in the construction industry, and 3 percent in total in the agriculture, forestry and fisheries industries (ibid).

While the stock of FDI in Canadian industries has continued to expand, during the 1970s and through to the mid-1980s there was a decline in the foreign-controlled portion of corporate assets relative to the domestically-controlled portion in a number of Canadian industries including food manufacturing. Foreign control of all nonfinancial assets in Canada fell from a peak of 37 percent in 1971 to just under 24 percent in 1985. By 1988, however, the share of foreign-controlled nonfinancial assets in Canada increased somewhat to 27 percent (Statistics Canada, CALURA, 1991, p45).

Figure 6
Share of Industry Assets of Foreign-controlled Firms in Selected Industries, 1975 & 1988



Source: Statistics Canada, *Corporations and Labour Union Return Act* (CALURA), Catalogue 61-210.

According to Statistics Canada, the main factors contributing to the decline included restrictive government policies such as the Foreign investment Review Act (FIRA) and National Energy Program and, toward the end of the period, relatively strong growth of Canadian-controlled corporations (ibid). Statistics Canada also reported that the subsequent upward trend was associated with the global wave of merger and acquisition activity, including increases in takeovers of Canadian corporations by foreign firms particularly in the energy sector. However the surge in takeover activity subsided in 1990, and a commensurate slowdown in the upward movement of the foreign-controlled asset share was forecast.

In the food manufacturing industry, the overall share of foreign-controlled assets fell from 41 percent in 1975 to 34 percent in 1988 (Figure 6). During the same period, the share of industry sales by foreign-controlled food manufacturing firms fell from 37 percent to 31 percent (Table 3).

Table 3
Share of Industry Sales by Foreign-controlled Firms
in Canadian Food and Beverage Manufacturing Industries

| | 1975 | 1980 | 1986 | 1988 |
|--|------|------|-------------------|------|
| | % | | | |
| Total Food and Beverage Industries | 37 | 30 | 29 | 31 |
| Food Industries | 37 | 29 | 27 | 28 |
| Meat and poultry products | 15 | 11 | 1 | 1 |
| Dairy products | 38 | 32 | 26 | 23 |
| Fish products | 11 | n/a | 1 | n/a |
| Fruit and vegetable products | 67 | 63 | 63 | 56 |
| Flour, prepared cereals, feed products | 42 | 24 | 30 | 45 |
| Bakery products | 28 | 18 | 6 | 12 |
| Other food products ⁽¹⁾ | 64 | 58 | 67 | 66 |
| Beverage Industries | 37 | 35 | 44 | 36 |
| Soft drinks | 50 | 48 | 56 ⁽²⁾ | 64 |
| Distilled beverages | n/a | 35 | 56 | 46 |
| Brewed beverages ⁽³⁾ | n/a | n/a | n/a | n/a |
| Wines | 36 | n/a | 25 | n/a |

⁽¹⁾Includes tea and coffee products, flavourings and colours, oils/salad dressing products, sauces, soups, snack foods, confections, frozen prepared foods and other miscellaneous food products.

⁽²⁾Figure for 1984; figure for 1986 is confidential.

⁽³⁾Foreign sales in the brewing industry are relatively small.

Source: Statistics Canada, *Corporations and Labour Unions Returns Act (CALURA)*, Catalogue 61-210.

Within the food manufacturing industry, the share of sales of foreign-controlled corporations grew in some industries and declined in others. For instance during this period the meat/poultry, dairy, fish, fruit/vegetable, bakery, distillery, and wine manufacturing industries saw a contraction in the share of foreign sales, while the prepared cereal/flour/feed, soft drink, and "miscellaneous" food manufacturing industries saw an expansion (ibid).

The share of foreign firms' sales in the miscellaneous food manufacturing industry (66 percent) has remained relatively high over the past few decades and by the end of the 1980s was higher than in other food manufacturing industries. The miscellaneous food industry classification includes a wide variety of foods such as teas, coffees, pastas, snack foods, malt products, starch products, egg products, meat preparations, frozen dinners, jams, peanut butter, flavourings, spices, sauces, and margarine—many of which are relatively high value-added and differentiated brand name products. Rama (1992) notes that large multinational food manufacturers generally focus on differentiated products and that international growth in FDI has been primarily in the high value-added food products.

In addition to the reasons given above by Statistics Canada, a decline in the proportion of production accounted for by multinationals may also be affected by the period of time over which new technologies remain proprietary or the relative importance of firm-specific intangible assets such as brand names (McFetridge, 1989, p9). For instance a decline in the importance of firm specific intangibles can be related to the increased importance of generic brands in food retailing. To the extent that generic brands capture larger shares of the market, rents to manufacturers' brand names are reduced and ultimately one would expect fewer of them and fewer international transfers of them. Differences in the share of foreign ownership across food industries also may be explained by the relative importance of high value-added, brand name products to multinationals in these industries.

The proportion of local production accounted for by multinationals also could change if it became more advantageous to transfer these assets by arm's length exports (ibid). As outlined above, it is evident from firm interviews that a number of location-specific factors affect multinationals' choice between exporting food products to Canada rather than producing here. Delivery cost relative to product value, input costs, government policies, and the size of the market relative to the minimum efficient scale can be important factors influencing food manufacturers' choice whether to produce in or export to Canada. However, one of the most dominant factors influencing firms' choice often is the desire to produce in the host region in order to gain the greatest benefits from intangible assets, such as the ability to customize products, building and maintaining trademark reputation, and providing the necessary level of service to local customers.

While foreign food firms' proportion of local production may decline over periods of time for any of the reasons cited here, there continues to be growth in foreign food firms' assets and sales. The sustained, large multinational presence in Canadian food manufacturing indicates that those factors favouring local Canadian production clearly more often outweigh those which make it more advantageous to supply Canada through exports.

3.6 Conclusion

Both foreign direct investment and trade are increasing, however international commerce in processed food and beverage products is by far dominated by direct investment. Sales of foreign affiliates account for about US\$1 trillion of the total US\$1.5 trillion in international commerce while

exports account for about US\$325 billion and sales through licenses and joint ventures the remainder. In North America, sales of U.S. food and beverage manufacturers in Canada are about three times the value of U.S. exports of food and beverage products to Canada. And similarly, sales of Canadian food and beverage manufacturers in the U.S. are at least 50 percent more than the value of Canadian exports of these products to the U.S.

With trade liberalization, increasing competitive pressures, and worldwide developments in technology, transportation, communications, etc., multinationals are becoming less of a collection of firms acting domestically and increasingly following integrated international strategies whereby they can exploit benefits gained in one market for use in another. This trend is also observed among multinational food manufacturers, however, they are often constrained to being more multidomestic with subsidiaries oriented toward domestic markets, rather than globally integrated with subsidiaries oriented toward export markets.

This is due, in part, to the fact that food products are less standardized across geographic regions than other manufactured goods, resulting from the need to tailor food products to local tastes. For certain products, or in general, consumers in different countries may also have a preference for locally produced foods over imports. In addition, the rationalization of global and regional production in food manufacturing, and subsequently the choice to export from the home country or host countries to target markets, is limited to the extent that benefits from economies of scale offset costs associated with delivery. Moreover, some food manufacturing firms think local production is a prerequisite to their success in a target market due to the additional control it offers over valuable intangible assets, such as the quality and reputation of brand name products.

For Canada, it is apparent multinationals' desire to have control over their firm-specific advantages has had a strong influence on the implication of ongoing worldwide structural changes of multinational food manufactures. Indeed, while Canada offers a relatively attractive investment environment both in terms of politics and economics, the desire of multinational food firms to have the greatest possible degree of control over trademarks and other intangibles is likely one of the most dominant factors influencing the continued large foreign presence in Canadian food manufacturing, despite quite significant changes in the mandates of some multinational food manufacturers.

In recent years, manufacturers of brand name food products in Canada have been facing greater competition from private label products as well as imports due to trade liberalization. However, the group of foreign food firms in Canada continues to register growth in both sales and assets; and after 1989, the year of the initiation of the FTA, the stock of FDI in Canadian food and beverage manufacturing grew annually to an historical high of \$11 billion in 1992.

Multinational food manufacturers are rationalizing production more on a regional-basis than a country-basis and, as plants within regions become more specialized, more trade is occurring within geographic regions. The rationalization of production on a regional basis is largely the result of a need to gain scale economies and be internationally cost competitive. While consumer demand has not converged to the extent that standardized food products dominate global food manufacturing, the ability of food manufacturers to switch production runs of plants in one target market to accommodate different formulas and labelling requirements in other target markets is facilitating the rationalization process.

In general, the geographic regions forming are North America, South America, Europe and Asia. In North America, in product-specific cases; more-Canadian production is now being exported to the U.S. as substitutes or supplements to U.S. production, and vice-versa. In very few cases has the full range of a foreign affiliate's production in Canada been entirely substituted by imports from the U.S. In addition to increased intra-regional trade due to rationalization, foreign food firms in Canada are seeking export opportunities both in North America and around the world to utilize excess capacity or expand capacity. Affiliates' export initiatives, however, must complement the broader strategic plans of the multinational parent.

4. ECONOMIC BENEFITS AND COSTS OF FDI"

Potential benefits of FDI can be broken down into two broad categories. First, to the extent that FDI facilitates trade in goods and services, gains similar to those achieved from conventional integration through trade may be realized; these include gains from rationalization and increased competition. Second, positive externalities may arise that were not part of the motivation of the multinational, most notably spillovers of R&D to the host economy.

On the other hand, host countries can potentially incur losses due to foreign ownership. These losses can result from, among other things, the "headquarters effect" of R&D and transfer price manipulation. In addition, gains or losses may be realized from FDI in terms of employment and the trade balance of individual sectors of the host economy.

The large presence of foreign ownership in the Canadian food manufacturing industry means that potential gains and losses could be significant. Nonetheless, it is a presumption that FDI yields net gains in efficiencies and externalities. The magnitude of benefits and costs associated with ^multinationals is difficult and in some cases impossible, to measure. However, we are able to provide some empirical analysis and comment on various aspects of the economic impact of FDI on the Canadian economy and the food manufacturing industry.

4.1 *International integration*

Standard economic analysis suggests that there are three possible sources of gains from international trade. They are comparative advantage, increasing returns to scale, and increased competition. These can be explained as follows. Differences in countries' factor endowments and trade allow countries to specialize and gain from their differences. Trade enables countries to produce a narrower range of goods than they would otherwise, and thus gain larger and more efficient scale of production. Finally, trade may widen the extent of competition and thus reduce potential monopoly power of large firms.

The argument for benefits through increased international exchange in terms of foreign direct investment is that FDI will allow countries to specialize more effectively in both the production of tangible goods as well as intangibles such as R&D, trademarks and marketing expertise, and thus benefit more from comparative advantage and economies of scale-. At the same time, FDI may increase market competition in the host country.

4.1.1 *Transaction Cost Minimizing*

Multinationals may magnify the gains from trade in tangible goods because of their ability to reduce transaction costs by engaging in intra-firm trade rather than arm's length transactions with unrelated parties.

Multinationals also allow *de facto* intra-firm trade in the results of research and development and other intangible assets. Among other things, multinationals set up foreign plants instead of using exports to serve foreign markets when they are unable to appropriate the full benefits of R&D

" This section is based on an analysis for the U.S. economy presented in Graham and Krugman (1991,Chapter 3) and secondary data for Canada's food manufacturing industry.

through trademarks or patents. In other words, by establishing plants in different countries, MNEs can internalize market activities and thus better-control and exploit their firm-specific advantages such as R&D, management skills, brand names, and customer service.

While FDI may be expected to provide gains from integration that are qualitatively similar to the conventional gains from trade, the magnitude of these gains would be difficult to estimate. Indeed no figures are available on cost comparisons of transacting through normal channels versus a firm, for either tangibles or intangibles.

It is known, however, that a substantial portion of trade in tangible goods is intra-firm in nature. For instance, in the mid-1980s, approximately 65 percent of total Canadian imports were purchased by foreign firms of which about 55 percent were sourced from affiliated suppliers. Similarly, about 55 percent of total imports by the food and beverage industry in Canada were accounted for by foreign firms and 35 percent of these imports were received through intra-firm channels.⁴²

Of the group of foreign food manufacturing affiliates in Canada, those that are U.S.-controlled appear to engage in relatively more intra-firm trade than those of other nationalities, probably due to Canada's proximity to the U.S. Estimates show that in 1989 more than three-quarters of U.S. exports to U.S.-controlled food manufacturing affiliates in Canada were sourced from the U.S. parent group, while the remainder was sourced from unaffiliated U.S. persons (Table 4). Similarly, over three-quarters of U.S. imports from U.S. food manufacturing affiliates in Canada were to the parent group (ibid).

In addition, while the volume of trade in food products between the U.S. and the group of U.S. food manufacturing affiliates worldwide is modest, most of this trade is intra-firm. In 1989, about one-third of U.S. food exports were accounted for by U.S. multinational food manufacturers; 13 percent of U.S. food exports were to foreign affiliates of U.S. firms and 71 percent of this; was shipped by the parent group (Handy and Henderson, 1992). Similarly, while only 2 percent of sales of foreign affiliates of U.S. multinational food manufacturers were exported back to the U.S. in 1989, at least 85 percent of these exports were to the parent group in the United States.

4.1.2 *Specialization*

Increased international exchange in terms of foreign direct investment may allow countries to benefit more from comparative advantage and economies of scale. This occurs to the degree that MNEs allow countries to specialize more effectively in both the production of tangibles and intangibles.

For any given multinational, these economies are associated with reducing production and transaction costs and can be realized via market rationalization, company organization and risk diversification. Economies also can be related to the sharing of company-wide resources in terms of R&D, services, marketing, information, distribution, purchasing, trading raw, intermediate or final goods, financing, etc. In theory, the more important economies of scale and economies of synergy the more a firm might gain by expanding into additional geographic markets. Figures are not available to indicate the magnitude of gains from rationalization resulting from multinational

⁴² Alam et al (1989, Tables 6&8).

activity in general. However, we can look at the level of specialization among multinational food firms and foreign affiliates in Canada.

Rama (1992) notes that while the 100 largest OECD-based multinational food manufacturers appear to be concentrated in grain, miscellaneous food, oils and fats, and soft drink industries, they are also highly diversified. Large firms in general may derive advantages from product diversification in terms of supplying a wide range of market segments and exploiting firm-specific skills and technology. And small firms of any kind may be inherently more specialized due to financial constraints and the high cost of development and promotion of numerous product lines.

Despite potential gains from rationalization, an increase in average output per plant, and an apparently high degree of product specialization on average for total manufacturing in Canada, the level of specialization of foreign manufacturers is below that of their domestic counterparts (Table 5). Furthermore, larger foreign manufacturers (revenue greater than \$20 million) on average are significantly less specialized than smaller and medium-sized manufacturers. Over the period 1979 to 1984, all size groups among both foreign-controlled and domestically-controlled manufacturing firms became more specialized. However for the average food, beverage and

Table 4
Estimates of Trade⁽¹⁾ Between Parents of U.S. Multinationals and U.S. Affiliates
in Canada and Worldwide,
Food and Beverage Manufacturing Industry,
1982 & 1989

| \$ millions US Imports | | | | |
|---|---------------------------------|------|---------------------------------|-------|
| | From US Affiliates in Canada | | From US Affiliates Worldwide | |
| | 1982 | 1989 | 1982 | 1989 |
| To US Parents | 52 | 250 | 780 | 1,200 |
| To US Parents and Unaffiliated Persons | 84 | 325 | 874 | 1,300 |
| \$ millions US Exports | | | | |
| | To US Affiliates in Canada | | To US Affiliates Worldwide | |
| | 1982 | 1989 | 1982 | 1989 |
| From US Parents | 270 | 450 | 1,380 | 1,965 |
| From US Parents and Unaffiliated Persons | 545 | 580 | 2,330 | 2,665 |

⁽¹⁾Converted to Canadian dollars.

Source: Based on data from the U.S. Department of Commerce, Bureau of Economic Analysis, *U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and Their Foreign Affiliates*, various years.

tobacco manufacturer, there was little change in the degree of specialization and, if anything, it became somewhat more diversified.

Traditionally, many large foreign food manufacturers in Canada produced a range of those products manufactured by the parent but in relatively small volume for the Canadian market, thus limiting the potential of plants to realize economies of scale. However, with advances in technologies, a worldwide economic slowdown, trade liberalization and increased market access, a more competitive business environment has encouraged food manufacturers to improve productivity and exploit potential gains from multinational activity. Again, multinational food manufacturers are responding to these pressures and opportunities by restructuring corporate organizations so that at least some production is consolidated within one geographic region for export to neighbouring regions in order to generate longer production runs and achieve economies of scale.

Table 5
Specialization⁽¹⁾ of Food, Beverage and Tobacco Manufacturing, and
All Manufacturing; All Manufacturing by Nature of Control and Size Group,
Percentage Distribution
1979 & 1984

| | Level of Specialization ⁽²⁾ | | | | | | | |
|----------------------------|--|------|------|-------|------|------|------|-------|
| | 1979 | | | | 1984 | | | |
| | HID | MIS | HIS | Total | HID | MIS | HIS | Total |
| Food, Beverage and Tobacco | 4.3 | 41.4 | 54.3 | 100.0 | 5.1 | 40.9 | 54.0 | 100.0 |
| All Manufacturing: | 3.8 | 40.9 | 55.3 | 100.0 | 3.7 | 39.3 | 57.0 | 100.0 |
| Canadian-controlled | 2.8 | 40.3 | 56.8 | 100.0 | 2.9 | 38.5 | 58.6 | 100.0 |
| < \$5 million | 2.0 | 37.6 | 60.5 | 100.0 | 1.8 | 35.1 | 63.1 | 100.0 |
| \$5 - 19.9 million | 4.5 | 49.7 | 45.8 | 100.0 | 4.2 | 45.7 | 50.1 | 100.0 |
| > \$20 million | 11.5 | 55.2 | 33.3 | 100.0 | 2.9 | 38.5 | 58.6 | 100.0 |
| Foreign-controlled | 8.5 | 43.7 | 47.8 | 100.0 | 8.3 | 43.4 | 48.3 | 100.0 |
| < \$5 million | 2.5 | 35.0 | 62.6 | 100.0 | 1.7 | 32.5 | 65.8 | 100.0 |
| \$5 - 19.9 million | 7.1 | 47.5 | 45.4 | 100.0 | 4.4 | 47.4 | 48.2 | 100.0 |
| > \$20 million | 19.8 | 52.3 | 27.9 | 100.0 | 19.2 | 50.8 | 29.9 | 100.0 |

⁽¹⁾The level of specialization is calculated on a weighted basis of the number of products a firm produces and the importance of each product identified at a 4-digit Industrial Commodity Classification level with respect to the firm's total shipments. Three levels of product specialization are defined here; highly diversified (index=0.0 - .25), moderately diversified (index=0.26 - .75) and highly specialized (index=0.76 - 1.0).

⁽²⁾HID=Highly Diversified; MIS=Moderately Diversified; HIS=Highly Specialized.

Source: Alam, J., S. Li, and R. Oldenburg; "Analysis of Performance of Multinational Enterprises," Department of External Affairs and International Trade Canada, and Department of Industry, Science and Technology, Working Paper, October 1989.

4.1.3 Competition

At issue is whether FDI widens the extent of market competition and thus reduces potential monopoly power of large food firms, or whether it has the opposite effect.

FDI can enhance competition by increasing the number of firms in a market and hence, similar to trade, boost the volume of supply and put downward pressure on prices. However multinational food firms tend to enter a country more by acquisition than greenfield investment, resulting in the same number of firms and possibly fewer plants in a market. In addition, multinational food firms can possess a number of advantages that could preclude other firms from entering the markets they serve and potentially lessen price competition. For instance, MNEs typically sell differentiated, brand name products in segmented markets, often they invest heavily in preserving and promoting quality and reputation, and they tend to operate larger plants than their domestic counterparts allowing them to more fully exploit economies of scale. Furthermore, at the regional and possibly global level, a large share of some product markets are held by a few firms.

On the other hand, a number of exogenous factors exist that put pressure on these kinds of advantages. Canadian antitrust rules provide a check against the potential lessening of competition resulting from FDI. The Bureau of Competition Policy investigates anticompetitive practices and reviews mergers and joint ventures.¹³ In some product areas, changes in consumer demand for private label products may be resulting in more price sensitive demand for brand name products. Imports also create a more competitive environment and trade liberalization is enhancing this.

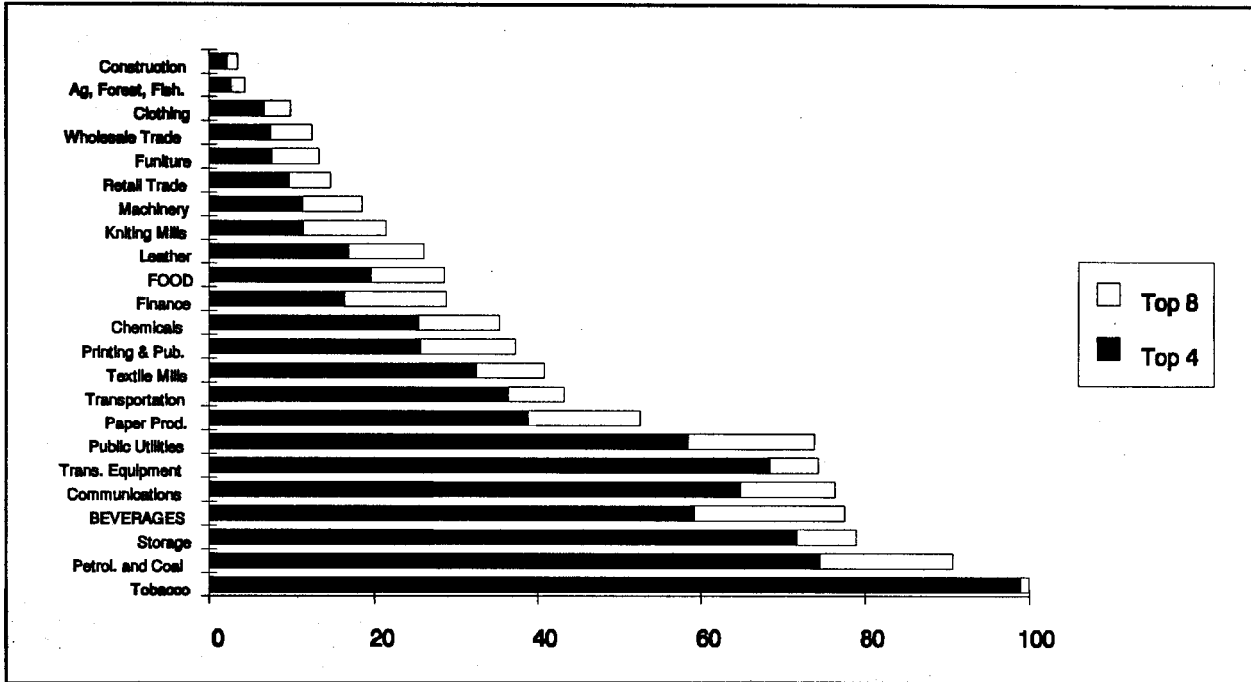
A few facets of foreign ownership merit noting here. The degree of corporate concentration within the food industry as a whole is relatively moderate compared to other industries (Figure 7). In 1988, the 4- and 8-firm concentration ratios for the food industry were 19.6 percent and 28.7 - percent respectively, at the national level. Although these statistics might suggest the largest firms in the food industry, foreign- or domestically-owned, have only a moderate degree of market power, market power is more a function of concentration in specific industries or market segments. ;Note that these ratios are much higher for the beverage industry, 59.2 percent and 77.6 percent.

¹³ There have been very few cases involving investment proposals and foreign firms in the food industry where the Bureau rejected or proposed changes to an application.

When corporate concentration is categorized by nature of control, the foreign-controlled group is more concentrated than the Canadian-controlled group, though in certain food and beverage - i industries: sales for the -group of foreign firms were relatively small in the late 1980s anyway (Figures 8a&b). These statistics also indicate that in the late 1980s the largest domestically controlled firms contributed somewhat more to Canadian food and beverage manufacturing than the largest foreign firms.

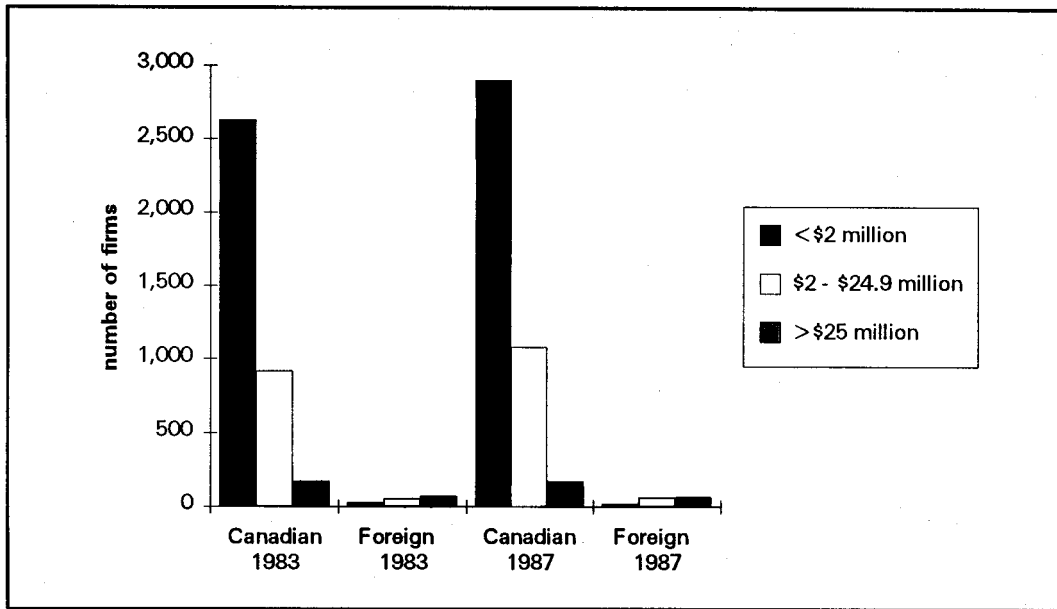
On the other hand foreign food manufacturers accounted for a greater proportion of the larger, and a smaller proportion of the smaller, food manufacturers in Canada. Statistics on size distribution show that within the group of firms registering less than \$25 million in revenue (small to-medium sized firms) there were 80 foreign firms and 3,981 domestically-controlled firms in 1987. Within the group of firms whose revenue exceeded \$25 million (large firms), however, there were 67 foreign firms and 170 domestically-controlled firms (Figure 9). Over the period 1983 to 1987 the correlation between firm size and ownership strengthened, with the number of small and medium-sized domestically-controlled firms growing and the number of smaller foreign controlled firms shrinking. While there was little change in the number of firms with sales greater than \$25 million, foreign- or domestically-controlled, foreign firms continued to account for a significant proportion of larger food firms. In addition, the average revenue of foreign affiliates exceeds that of domestic firms in each of the three size categories shown in Table 6.

Figure 7
Share of Revenue Controlled by Leading 4 and Leading 8 Enterprises
within Selected Industries,
1988



Source: Statistics Canada, *Corporations and Labour Unions Returns Act (CALURA)*, Catalogue 61-210.

Figure 9
Number of Food and Beverage Manufacturing Firms in Canada,
by Nature of Control and Size Group by Sales,
1983 & 1987



Source: Statistics Canada, from Allen, D., "Business Performance Following a Takeover," Investment Canada, Working Paper No.11, April, 1992.

Table 6
Average Firm Revenue, by Nature of Control and Size Group by Sales,
Food and Beverage Manufacturing in Canada,
1983, 1985, 1987

| | | 1983 | 1985 | 1987 |
|----------------------------|----------------------|-------------|---------|---------|
| | | \$thousands | | |
| Canadian-controlled | < \$2 million | 528 | 519 | 537 |
| | \$2 - \$24.9 million | 6,735 | 6,862 | 6,920 |
| | > \$25 million | 113,826 | 120,386 | 133,573 |
| Foreign-controlled | < \$2 million | 693 | 717 | 615 |
| | \$2 - \$24.9 million | 9,205 | 9,202 | 9,937 |
| | > \$25 million | 141,906 | 161,413 | 179,781 |

Source: Statistics Canada, from Allen, D., "Business Performance Following a Takeover," Investment Canada, Working Paper No.11, April, 1992.

The incidence of foreign ownership has varied considerably across the food sector and during much of the past few decades has tended to be highest in those industries which typically produce more highly processed, differentiated, packaged food products, such as ready-to-eat breakfast cereal, rather than less further processed, homogeneous-type products, such as fresh meat. This is generally consistent with findings that food firms invest abroad, in part, to exploit their advantages in differentiated, brand name products. Indeed foreign ownership has been relatively high in the following manufacturing industries: canned and frozen fruit and vegetable products, breakfast cereal and flour products, cookie and biscuit products, confectionery and snack products, soft drinks, and distilled beverages (Gorecki, 1982, p18 and Table 3).

Of course in the last few years there would have been a marked increase in the level and degree of foreign investment in the Canadian meat slaughtering industry vis-à-vis the acquisition of Canada Packers (now Maple Leaf Foods) by U.K.-owned Hilldown Holdings and the greenfield investment in Alberta by U.S.-owned Cargill. In the case of Maple Leaf Foods, however, there appears to be an emphasis on developing the more value-added end of the meat business. And Cargill, while not necessarily focussing on further processing, has been able to exploit economies of scale to some extent due to the advantage it possesses in terms of access to the U.S. market.

A study by Cahill and Hazledine (1989, p16) classifies Canadian food manufacturing industries in terms of degree of market power for a period during the 1970s. Most of the industries that they found to exhibit market power were the same as those that Gorecki and Table 3 indicate as having relatively high levels of foreign ownership. For instance, Cahill and Hazledine claimed that industries that displayed a combination of oligopolistic market power⁴ and cost-heterogeneity⁵ were: canned and frozen fruit and vegetable products, flour milling and breakfast cereal, bakeries, confectionery, and soft drinks. Industries that showed signs of oligopolistic price-raising market power were: biscuits, distilleries and breweries. And the fish products industry was categorized as an industry showing cost heterogeneity. Industries that were judged to be workably competitive whereby firms do not earn a significant margin of profit over normal profit rates were: slaughtering and meat products, poultry products, dairy products, animal feed products, cane and beet sugar products, and vegetable oil products.

In summary, whether the presence of multinational food firms in Canada has increased the number of firms in relevant markets beyond what there would have been otherwise and enhanced price competition is not unambiguous. Nor is it clear whether MNEs have decreased the number of firms and in this way influenced price competition. Trade agreements are increasing competitive pressures through both imports and potential FDI, which will tend to weaken firms' market power in Canada. At the same time, however, multinational food firms of all nationalities are rationalizing production within North America in order to improve efficiency and it could become more difficult for smaller firms to successfully compete without improving cost and product competitiveness.

⁴Incumbent firms are able to raise price above marginal cost despite the presence of potential entrants with costs no higher than the incumbents.

⁵Entrants are barred since they are unable to produce at a low enough cost.

4.2 Externalities and Other Benefits and Costs

There can be benefits to FDI which diffuse to other parts of the host economy. These external benefits take the form of horizontal or vertical spillovers that accrue to domestic firms, including competitors, suppliers and customers. They can include science- and engineering-based production innovations as well as management and operating skills. For instance, foreign multinationals' research scientists might interact with other scientists, their R&D activities might encourage students to enter the field, their R&D results might be used by other firms, and so on. Conversely, there can be external costs involved with FDI associated with, among other things, the loss of favourable spillovers, especially those related to technology. This happens when foreign firms decide to keep sophisticated activities in the home country (usually close to headquarters).

A number of questions may arise with respect to externalities. For instance, do positive externalities exist? Empirical analysis of positive externalities is difficult, since generally they do not generate paper records of the kind that market transactions do. Another question is whether there is a strong "headquarters effect" motivating multinationals to keep R&D and other sophisticated activities at home. There have been a number of empirical studies of the behaviour of multinationals related to the headquarters effect.⁶ Two general conclusions that may be drawn from these studies are that multinationals, especially U.S.-based MNEs, tend to locate their R&D activities in their home country, but that experienced multinationals of all nationalities tend to increasingly place R&D activities in host countries. This topic is discussed below in the context of food manufacturing.

Other factors discussed here are the effect FDI may have on government revenue related to transfer price manipulation and the possible effect of FDI on employment and trade within the food and beverage industry.

4.2.1 Research and Development

Relative to other industries in Canadian manufacturing, the food and beverage manufacturing industry as a whole has a low propensity to spend on R&D; though this is to be expected since firms in the food manufacturing industry in general are less dependent on high technology than firms in many other industries. Within the (Canadian food and beverage industry, however, the group of foreign firms has a higher propensity to invest in R&D than its domestic counterpart (Table 7).⁷ Regardless of ownership, large food firms (revenue greater than \$25 million) are more R&D intensive than medium- or small-sized firms. But large foreign-owned food firms as a group, which account for some 95 percent of all foreign sales and about half the number of foreign firms, have a greater propensity to invest in R&D than their large Canadian counterparts.

¹⁸ See Vernon (1974), Franko (1976), and Cantwell (1989) in Graham and Krugman (1991,p65).

⁷ The sizeable ratio of R&D expenditures to sales for large foreign firms in 1983 appears to be an anomaly and may be related to difficulties in extracting accurate R&D data from corporate tax returns.

According to data collected by the U.S. Department of Commerce, in the food and beverage manufacturing industry, U.S. affiliates in Canada contribute relatively less to R&D than both the group of parents in the United States and other U.S. affiliates in major industrialized host countries (Table 8). These data also indicate that between 1982 and 1989 there was a decline in the ratio of R&D to sales for the group of U.S. affiliates worldwide as well as for the group of parents in the U.S. However, while actual spending on R&D grew during this period for the U.S. parent group and the group of affiliates, in many countries spending was the same or lower. In particular, spending remained the same for the group of affiliates in Canada.

Table 7
Percentage of Revenue Spent on Research and Development,
Food and Beverage Manufacturing and all Manufacturing,
by Nature of Control and Size Group by Sales,
1983 & 1987

| | All Manufacturing | | Food and Beverage Manufacturing | |
|---------------------------|----------------------|------|------------------------------------|------|
| | % | | | |
| | 1983 | 1987 | 1983 | 1987 |
| All Firms | 0.57 | 0.44 | 0.30 | 0.11 |
| Domestic | 0.50 | 0.32 | 0.11 | 0.06 |
| Foreign | 0.64 | 0.56 | 0.83 | 0.24 |
| < \$2 million | | | | |
| Domestic | 0.20 | 0.13 | 0.01 | 0.00 |
| Foreign | 1.19 | 0.94 | 0.01 | 0.00 |
| \$2 - 24.9 million | | | | |
| Domestic | 0.32 | 0.21 | 0.01 | 0.01 |
| Foreign | 0.47 | 0.34 | 0.08 | 0.06 |
| > \$25 million | | | | |
| Domestic | 0.64 | 0.42 | 0.15 | 0.08 |
| Foreign | 0.65 | 0.58 | 0.88 | 0.26 |

Source: Alam, J., S. Li, and R. Oldenburg, "Analysis of Performance of Multinational Enterprises," Department of External Affairs and International Trade Canada, and Department of Industry, Science and Technology, Working Paper, October 1989.

Factors likely contributing to a lower R&D intensity among Canadian affiliates of U.S. multinational food firms are the relative similarity of tastes between Canada and the U.S. and the geographic proximity of the two countries which might lower the cost of transferring R&D from the U.S. to Canada. A desire to capture economies of scale in R&D is also a likely consideration in the location of R&D facilities. To the extent that it benefits multinationals to establish facilities within larger U.S. markets to service all of North America, there would be a greater concentration of R&D facilities in the U.S.

Affiliates of multinational food manufacturers in Canada typically are responsible for ensuring product quality and that products are tailored to the Canadian market. Some affiliates perform a number of innovative R&D activities beyond this basic requirement. However affiliates in Canada are increasingly faced with the task of competing with sister companies around the world, some of which are in larger or faster growing markets, for their parents' scarce resources in order to develop products, processes, etc. for the domestic and worldwide markets.

4.2.2 Transfer Pricing and Tax Avoidance

Transfer prices are those prices charged for goods and services sold within the same firm, including transactions between parents and subsidiaries of multinationals. Since corporate taxes are calculated

on profit, a loss of government revenue is incurred if subsidiaries of multinationals

38

Table 8
R&D Expenditures and Percentage of Revenue Spent on R&D,
Affiliates of U.S. MNEs in Canada and Selected Countries,
Food and Beverage Manufacturing,
1982 & 1989

| | R&D Expenditure US \$millions | | Ratio R&D to Revenue (%) | |
|-----------------|----------------------------------|-------|-----------------------------|------|
| | 1982 | 1989 | 1982 | 1989 |
| US Parents | 714 | 1,044 | 0.64 | 0.54 |
| All Foreign | 119 | 191 | 0.50 | 0.48 |
| Canada | 12 | 12 | 0.23 | 0.19 |
| United Kingdom | 43 | 60 | 0.79 | 0.84 |
| Germany | 15 | 33 | 0.52 | 0.22 |
| The Netherlands | 8 | 13 | 0.29 | 0.26 |
| Australia | 8 | 19 | 0.56 | 0.55 |
| France | 10 | 21 | 0.46 | 0.71 |
| Brazil | 3 | 3 | 0.12 | 0.14 |
| Japan | 4 | 4 | 0.62 | 0.22 |
| Mexico | 3 | 2 | 0.19 | 0.13 |

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Operations of U.S. Affiliates of Foreign Companies*.

manipulate transfer prices to transfer profits out of a host country and thus avoid paying taxes on those profits to the host government.

In the U.S., a study by Grubert et al/ (1991) using Internal Revenue Service (IRS) data shows that in 1987 taxable income as a percentage of total assets and of total sales was lower for U.S. affiliates of foreign firms than for domestically-owned firms (Table 9). The study also shows that about half of the difference in the amount of taxes paid as a percentage of total assets between the two groups was attributable to variables other than transfer pricing, but they do not show directly that the other half was due to transfer price manipulation.

The IRS has stepped up its auditing effort to more closely monitor internal pricing practices of multinationals and it is litigating a number of cases involving U.S. multinationals with Mexican in-bond plants, or maquiladoras (Thurston,1993). Many U.S. multinationals are now keeping more detailed records to avoid costly audits and court cases with the IRS, and some now have advance pricing agreements with the IRS whereby the two parties agree on a methodology the firm is to use to calculate transfer pricing.

In Canada, statistics show that taxable income as a percentage of total sales is generally lower for domestically-controlled firms (Table 9). This fact alone does not discount the possibility of the existence of transfer price manipulation among Canadian affiliates of foreign firms, but it suggests that if manipulation is occurring it is likely being more than offset by other factors.

Table 9
Taxable Income as a Share of Sales, Foreign Affiliates
and Domestically-controlled Firms in Canada and the U.S.,
Selected Industries
1987

| | Canada | | United States | |
|-------------------------|--------------------------------|--------------------------------------|--------------------------------|--------------------------------------|
| | Affiliates of Foreign Firms | Domestically- controlled Firms | Affiliates of Foreign Firms | Domestically- controlled Firms |
| | % | | | |
| All Non-financial Firms | 4.88 | 3.70 | 1.00 | 3.51 |
| Manufacturing Firms | 5.12 | 4.42 | 2.39 | 4.21 |
| Food | 6.79 | 2.48 | - | - |
| Beverage | 4.72 | 4.20 | - | - |
| Wholesale Trade | 2.22 | 2.36 | 0.29 | 1.41 |

Source: Figures for Canada calculated from *Corporations and Labour Unions Returns Act* (CALURA), Catalogue 61-210, 1991. Figures for the U.S. are taken from Graham and Krugman (1991,p82), original source is H. Grubert, T. Goodspeed, and D. Swenson, "Explaining the Low Taxable Income of Foreign-controlled Companies in the U.S.," paper presented at a conference at the National Bureau of Economic Research, Cambridge MA, August 1991.

4.2.3 Level and Quality of Employment

Level of Employment

Employment in food and beverage manufacturing industries and all manufacturing industries in Canada increased steadily between 1983 and 1988-89 (Table 10). During the latest recessionary period and the early stages of the FTA, employment in most Canadian industries experienced a decline.⁸ Employment in food manufacturing grew from 184,600 in 1983 to 207,700 in 1988 and then fell to 179,600 in 1993. Figures as of May 1994 indicate that Canadian employment is on the rebound, and in the food industry has reached a level of approximately 181,200.

There are data that shed some light on changes in levels of employment for foreign or domestically controlled firms. However whether foreign food manufacturers behave in a manner that would influence the level of employment in the food manufacturing industry in an unfavourable way is not clear. Certainly there has been recent concern about the influence mergers and acquisitions had on employment levels during the 1980s in North America, and apparently foreign multinationals were involved in these activities to a greater extent than domestic firms.

Between 1978 and 1985 the group of foreign firms in all Canadian industries showed a slight net loss in employment of about 1.6 percent and the group of domestic firms registered a net gain of approximately 13.7 percent (Table 11). The loss of employment among foreign firms was the result of both a relatively high number of company "deaths" compared to "births" and the contraction of existing operations. Of the domestic firms, multinationals experienced a small overall decline in employment while non-MNEs were largely responsible for the overall gain in Canadian employment. Table 12 indicates that declines in employment of both foreign and domestic firms in Canadian manufacturing occurred in the medium- and large-sized firm categories. By contrast, employment in the service industry grew regardless of the nature of control or size of firm.

For affiliates of U.S. food manufacturing firms in Canada and other regions of the world, employment followed a declining trend similar to the one observed above in Table 10. That is, employment was in a decline between 1983 and later half of the 1980s, then it expanded to relatively high levels by 1989 which more than offset the preceding contractionary period (Figure 10). The group of U.S. parents in food and beverage manufacturing also experienced a decline in employment, followed by a period of growth; between 1987 and 1988, employment fell from 28,834,000 to 27,297,000, and grew to 33,305,000 by 1992.⁹

¹⁸ As mentioned earlier, empirical studies by Harris (1985) and Magun (1986) on the anticipated effects of a bilateral Canada/U.S. free trade agreement on the Canadian food manufacturing industry predicted no significant gain or loss in production in Canada or the U.S.; however, Harris predicted that rationalization of the Canadian food manufacturing industry would cause a fall in employment, even as output were increasing.

⁹ U.S. Department of Commerce, U.S. *Direct Investment Abroad: Operations of U.S. Affiliates of Foreign Companies*.

Table 10
Canadian Employment in
Food and Beverage Manufacturing Industries and Total Manufacturing,
1983 to 1994

| | Employment in thousands | | | | | | | | | | | |
|---------------------------------|-------------------------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|
| | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994* |
| Total Manufacturing | 1,695.3 | 1,736.2 | 1,775.3 | 1,836.1 | 1,918.7 | 1,996.2 | 2,004.3 | 1,885.4 | 1,691.5 | 1,599.2 | 1,596.7 | 1,649.1 |
| Total Food Manufacturing | 184.6 | 180.8 | 186.0 | 190.1 | 203.8 | 207.7 | 202.7 | 197.4 | 187.8 | 184.0 | 179.6 | 181.2 |
| Meat and Poultry | 36.9 | 37.1 | 38.7 | 42.2 | 46.5 | 48.1 | 47.5 | 45.4 | 42.5 | 45.0 | 44.2 | 44.1 |
| Fish | 26.3 | 22.2 | 24.0 | 24.0 | 27.5 | 28.2 | 26.4 | 25.1 | 23.7 | 22.5 | 19.1 | - |
| Fruit and Vegetables | 17.7 | 19.2 | 18.9 | 19.9 | 21.2 | 20.9 | 19.8 | 19.5 | 17.2 | 16.2 | 16.5 | - |
| Dairy | 21.3 | 20.7 | 21.5 | 20.9 | 21.6 | 21.7 | 22.2 | 23.3 | 23.6 | 20.6 | 20.2 | - |
| Flour, Cereal and Feed | 17.3 | 17.4 | 17.4 | 17.4 | 17.5 | 17.4 | 17.1 | 17.2 | 17.0 | 15.0 | 16.2 | - |
| Vegetable Oil Mills | 0.8 | 0.9 | 0.8 | 0.8 | 0.9 | 0.9 | 0.9 | 0.9 | 0.8 | 0.8 | 1.1 | - |
| Bakery | 29.7 | 28.2 | 28.8 | 29.5 | 31.9 | 32.1 | 30.7 | 30.3 | 27.0 | 27.9 | 27.8 | - |
| Sugar and Confectionery | 8.4 | 8.4 | 8.5 | 8.4 | 8.5 | 8.8 | 8.5 | 8.3 | 8.7 | 9.5 | 9.6 | - |
| Other Food Products | 26.2 | 26.6 | 27.3 | 26.9 | 28.2 | 29.7 | 29.5 | 27.4 | 27.1 | 26.4 | 24.9 | - |
| Beverages | 33.7 | 33.1 | 33.4 | 33.4 | 32.4 | 32.5 | 31.5 | 31.2 | 26.7 | 24.7 | 24.6 | - |
| Tobacco | 7.5 | 7.1 | 6.6 | 6.3 | 5.7 | 5.3 | 5.1 | 4.8 | 4.8 | 4.8 | 4.7 | - |

*As at May 1994.

Source: Statistics Canada, *Annual Estimates of Employment, Earnings and Hours*, Catalogue 72-002.

Table 11
Percentage Change in Canadian Employment,⁽¹⁾
by Nature of Control and by Component,
between 1978 & 1985

| Nature of Control | Total Net Change in Employment | Percent Change in Employment due to Births and Deaths of Firms | | | Percent Change in Employment due to Expansion | | |
|-----------------------|--------------------------------|--|--------------|----------------------|---|-----------------|----------------------|
| | | Births (1) | Deaths (2) | Net Change (1) - (2) | Expansion (3) | Contraction (4) | Net Change (3) - (4) |
| | | | | % | | | |
| Canadian Non-MNE | 19.2 | 36.8 | -28.2 | 8.6 | 24.8 | -14.3 | 10.5 |
| Canadian MNE | -0.3 | 4.2 | -1.1 | 3.1 | 16.8 | -20.1 | -3.3 |
| Total Canadian | 13.7 | 27.7 | -20.6 | 7.1 | 22.6 | -15.9 | 6.7 |
| Foreign - U.S. | -0.8 | 4.1 | -8.1 | -4.0 | 17.7 | -14.4 | 3.3 |
| Foreign - Other | -4.2 | 7.3 | -11.4 | -4.1 | 17.7 | -17.7 | 0.0 |
| Total Foreign | -1.6 | 4.9 | -9.0 | -4.1 | 17.7 | -15.2 | 2.5 |

⁽¹⁾Excluding commercial services and public administration industries.

Source: Alam, J., S. Li, and R. Oldenburg, "Analysis of Performance of Multinational Enterprises," Department of External Affairs and International Trade Canada, and Department of Industry, Science and Technology, Working Paper, October 1989.

Table 12
Canadian Employment in Manufacturing and Service Industries,
by Nature of Control and Size Group by Sales,
1978 & 1985

| | Canadian-controlled | | Foreign-controlled | |
|-----------------------|---------------------|--------------------|--------------------|--------------------|
| | 1978 (thousands) | 1978-1985 % change | 1978 (thousands) | 1978-1985 % change |
| Manufacturing: | | | | |
| < \$5 million | 400.1 | 52.2 | 6.6 | 171.2 |
| \$5 - 19.9 million | 422.1 | -2.8 | 47.2 | -3.4 |
| > \$20 million | 1,154.5 | -9.8 | 819.0 | -11.5 |
| Total | 1,976.7 | 4.3 | 872.8 | -9.7 |
| Service: | | | | |
| < \$5 million | 1,078.4 | 55.0 | 11.9 | 111.8 |
| \$5 - 19.9 million | 768.4 | 8.1 | 46.1 | 10.2 |
| > \$20 million | 1,821.7 | 1.2 | 428.5 | 10.3 |
| Total | 3,668.5 | 18.4 | 486.5 | 12.8 |

Source: Alam, J., S. Li, and R. Oldenburg, "Analysis of Performance of Multinational Enterprises," Department of External Affairs and International Trade Canada, and Department of Industry, Science and Technology, Working Paper, October 1989.

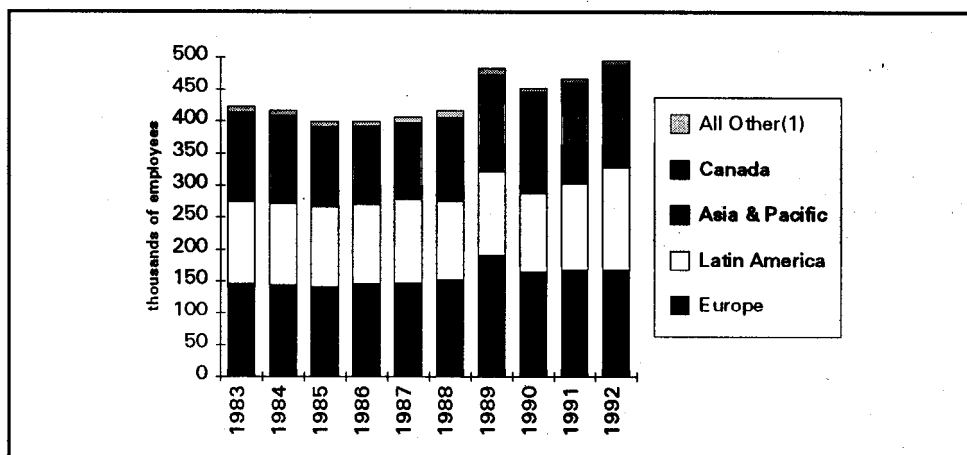
For those U.S. affiliates in Canada, employment declined from about 41,800 in 1983 to 33,200 in 1987, despite a modest increase in direct investment stemming from the group during this period (ibid). Then it continued to rise each year between 1987 and 1991 to reach a level of about 49,400 employees, despite recessionary pressures and numerous structural changes associated with the FTA. In 1992, preliminary estimates indicate that employment of U.S. affiliates in Canada remained close to 1991 levels. Declines in employment for the group of U.S. parents and the group of affiliates in Canada and elsewhere may be related to divestitures and corporate restructuring resulting from the wave of merger and acquisition activity at this time. Overall, between 1985 and 1992, employment in Canada grew about 23 percent. During the same period, employment for the group of parents in the U.S. expanded slightly faster, at a rate of about 29 percent.

Quality of Employment

It is sometimes argued that FDI leads to the "better" jobs being kept in the home country and the "not-so-good" jobs being exported to the host country. A second concern is that foreign-controlled firms might pay less for labour of any given skill level. In Canadian food manufacturing, data are not available to compare value added or compensation per employee between foreign and domestic firms. However, some indirect evidence is available.

For all manufacturing industries in both Canada and the U.S., the quality of jobs as measured by value added per employee has been higher for the foreign owned group than the domestically owned group. On the other hand, for food and beverage manufacturing, value added per employee in the U.S. has been lower for the foreign owned group (Table 13). Nevertheless, there can be important differences in industrial composition in these data that can influence these figures. For instance, in Graham and Krugman's analysis of data for individual industries within U.S. manufacturing, they point out that the heavy concentration of FDI in high-wage, capital-intensive industries such as

Figure 10
Employment of U.S. Affiliates in Selected Regions,
Food and Beverage Manufacturing Industry,
1983 to 1992



⁽¹⁾Includes Africa and the Middle East.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Operations of U.S. Affiliates of Foreign Companies*.

petroleum refining and chemicals raises the average for the foreign group. They find no systematic difference: between-foreign and domestic firms in value added per employee for individual industries and they conclude that there is no support for the view that foreign firms typically keep high-value added activities at home.

With respect to compensation, for all manufacturing industries compensation per employee in the U.S. has been higher for the foreign owned group than its domestically owned counterpart, while for food and beverage manufacturing the group of foreign owned manufacturers has registered a lower rate of compensation per employee than its domestic counterpart (ibid). Studies in the U.S. have shown that there are substantial wage differences across sectors despite seemingly equivalent skills among workers,²⁰ possibly resulting from systematic market failures such as market power on the part of unions or firms and the inability of employers to adequately

- determine workers' potential effort resulting in wages that do not correspond to workers' marginal

²⁰ Shapiro and Stiglitz (1984) in Graham and Krugman (1991,p62).

Table 13
Value Added per Worker and Compensation per Worker,
Canada and the U.S., by Nature of Control,
Selected Industries,
1979, 1984, 1987

| | Value added per Worker | | Compensation per Worker | |
|--|---------------------------|------|----------------------------|------|
| | Canada | | U.S. | |
| | 1979 | 1984 | 1987 | 1987 |
| | \$thousands | | | |
| All Manufacturing Industries | 48.2 | 77.6 | 58.6 | 41.2 |
| Domestically-controlled | 41.9 | 66.0 | n/a | n/a |
| Foreign-controlled | 57.7 | 98.2 | 64.4 | 43.6 |
| Food & Beverage Manufacturing | | | | |
| All Firms | 52.6 | 86.5 | 62.6 | 36.6 |
| Foreign-controlled | n/a | n/a | 56.4 | 35.2 |
| Other Manufacturing | | | | |
| All Firms | n/a | n/a | 54.9 | 29.0 |
| Foreign-controlled | n/a | n/a | 58.5 | 29.1 |

Source: Alam, J., S. Li, and R. Oldenburg, "Analysis of Performance of Multinational Enterprises," Department of External Affairs and International Trade Canada, and Department of Industry, Science and Technology, Working Paper, October 1989. Graham, E. M., and P. R. Krugman, *Foreign Direct Investment in the U.S.*, Institute for International Economics, 1991, p7.

product.²¹ Whether foreign firms are in some way contributing to wage differentials is not clear. - However, as with value added per employee, Graham and Krugman found no systematic difference between compensation per employee of foreign and domestic firms for individual industries in the U.S.

4.2.4 Trade Balance

The degree to which foreign food firms contribute to Canadian exports of value-added food products is one of the issues at hand. The degree of foreign food firms' import propensity of raw agricultural inputs is also a pertinent issue because of the importance of the food processing industry as a market for Canadian production of agricultural commodities.

The export propensity of foreign food firms in Canada is relatively low, apparently due to the traditional structure of the multinational corporation as discussed in sections 2 and 3. In 1984, foreign food firms in Canada had a smaller export propensity than any other manufacturing group, foreign- or domestically-owned (Table 14).

²¹Based on economic theory, in a purely efficient labour market, workers would be paid their marginal product and therefore skilled workers would be paid more than unskilled workers regardless of the sector or activity.

Table 14
Import and Export Propensities in Canadian Manufacturing Industries,
by Nature of Control,
1979 & 1984

| Industry | Imports/Sales (%) | | | | Exports/Sales (%) | | | |
|----------------------------------|-------------------|---------|----------|---------|-------------------|---------|----------|---------|
| | 1979 | | 1984 | | 1979 | | 1984 | |
| | Canadian | Foreign | Canadian | Foreign | Canadian | Foreign | Canadian | Foreign |
| Food and Beverage ⁽¹⁾ | 3.9 | 11.5 | 3.7 | 10.3 | 10.1 | 5.3 | 10.6 | 4.3 |
| Rubber & Plastic | 6.7 | 26.9 | 7.1 | 30.4 | 9.0 | 15.6 | 10.5 | 20.9 |
| Leather, Textile & Clothing | 13.9 | 20.1 | 12.7 | 23.1 | 3.9 | 17.0 | 4.5 | 23.5 |
| Forestry, Wood & Paper | 3.0 | 5.1 | 3.4 | 7.4 | 34.5 | 55.1 | 31.5 | 47.8 |
| Automotive | 9.9 | 64.2 | 13.8 | 62.1 | 29.1 | 55.3 | 48.6 | 77.7 |
| Other Manufacturing | 7.0 | 20.4 | 8.2 | 25.0 | 8.4 | 14.7 | 7.4 | 19.9 |
| Total Manufacturing | 8.7 | 30.3 | 7.9 | 31.9 | 20.0 | 26.8 | 21.3 | 35.4 |

⁽¹⁾Includes tobacco.

Source: Alam, J., S. Li, and R. Oldenburg, "Analysis of Performance of Multinational Enterprises," Department of External Affairs and International Trade Canada, and Department of Industry, Science and Technology, Working Paper, October 1989.

In addition, the group of foreign food manufacturing firms in Canada has had a greater propensity to import than domestic food firms—a phenomenon present within all Canadian manufacturing industries (ibid). However with the exception of the forestry, wood and paper manufacturing industry, both foreign and domestic food manufacturers are generally less import intensive than other Canadian manufacturers.

We are not able to conclude from these statistics, however, that foreign-owned firms' imports substitute domestic agricultural production to a greater extent than domestically-owned firms' imports. First, a wide range of agriculture and food products may be imported including those indigenous products in short supply periodically or throughout the year or those not grown or manufactured in Canada, notably various fruits and vegetables, tropically-grown agriculture products and further-processed specialty food products. Second, these import data may include other kinds of inputs into production such as packaging materials and equipment.

On balance, in Canadian food manufacturing, foreign firms imported more than twice that which they exported whereas domestic firms exported about three times that which they imported during the early 1980s : (ibid). Nonetheless, foreign -firms' Canadian; production would displace a substantial amount of imports from plants located in the United States and elsewhere.

There is evidence from firm interviews and the popular press that foreign food firms in Canada are becoming more outward-oriented. In part, this reflects an effort to rationalize existing North American production. In addition, it is associated with an effort to supply foreign markets with excess capacity or to find new export markets.

However, in supplying foreign markets, Canadian subsidiaries must compete with other companies including sister companies in the home country and other host countries. In terms of geographic positioning alone, Canadian sister companies can be at a disadvantage due to their relative distance from large and growing target markets outside of North America. Indeed statistics show that European affiliates of U.S. multinational food manufacturers are significantly more export oriented than their sister companies in Canada,²² most likely due to the many, large segmented markets on that continent.

In addition, while food firms are becoming more involved in international markets, multinational food manufacturers generally prefer local production as a means of supplying target markets while exports are typically used as a low-risk, short term means of building a market presence in foreign countries.

4.3 Conclusion

Potential benefits of FDI can be broken down into two broad categories. First, to the extent that FDI facilitates trade in goods and services, gains similar to those achieved from conventional integration through trade may be realized; these include gains from rationalization and increased competition. Second, positive externalities may arise that were not part of the motivation of the multinational, most notably spillovers of R&D to the host economy.

=¹ U.S. Department of Commerce, Bureau of Economic Analysis, US. *Direct Investment Abroad: Operations of U.S. Affiliates of Foreign Companies*.

On the other hand, host countries can potentially incur losses due to foreign ownership. These losses can result from, among other things, the "headquarters effect" of R&D, and transfer price manipulation. In addition, gains or losses may be realized from FDI in terms of employment and the trade balance of individual sectors of the host economy.

One can only presume net gains in efficiencies due to increased international exchange in terms of FDI, since no comprehensive data are available on cost comparisons of transacting through market channels versus a firm. One underlying argument is that multinationals magnify the gains from trade in tangible and intangible goods because of their ability to reduce transaction costs and more fully exploit firm advantages by engaging in intra-firm trade rather than arm's length transactions with unrelated parties. In terms of tangible goods, it is known that intra-firm trade accounts for a substantial portion of multinational food firms' overall trade.

Another argument is that to the extent that MNEs allow countries to specialize, international exchange in terms of FDI allows countries to benefit more from comparative advantage and economies of scale. No figures are available to indicate the magnitude of gains from rationalization resulting from multinational activity. However the pace of rationalization has been substantial, which could suggest that countries are benefitting more from comparative advantage and scale economies now than in the past. While multinational food firms tend to be diversified in the sense that they produce a wide range of food products, in Canada and elsewhere, there has been a movement toward consolidation and specialization within geographic regions in an effort to be more efficient. Indeed, while foreign food firms in Canada have had a very low propensity to export, one would expect this to change somewhat in the future.

Increased international exchange through FDI also can potentially widen the extent of market competition, by increasing the number of firms in a market, and thus reduce potential monopoly power of large firms in the host country. However, FDI could have the opposite effect. On the one hand, multinational food firms tend to enter a country more by acquisition than by greenfield investment, resulting in the same number of firms and possibly fewer plants. On the other hand, there are pressures to enhance competition; for instance, there are antitrust laws, private label products, and increasing imports resulting from trade liberalization. On balance, FDI may not have a significant effect on market competition. Nevertheless, smaller firms could have more difficulty competing as large firms rationalize production on a regional basis.

While empirical analysis of positive externalities is difficult to do, there are no doubt many favourable spillovers that accrue to host countries. A concern, however, is that FDI will result in a loss of spillovers resulting from foreign firms keeping activities, particularly those related to R&D, close to parents' headquarters in the home country. While foreign affiliates tend to be more R&D intensive than their domestic counterparts in the Canadian food and beverage industry, the so-called "headquarters effect" appears to be evident among the group of U.S. food firms (no analysis is done for the other foreign groups). This would likely be due to the proximity and similarity, in terms of culture, of the two countries. In addition, it could make more business sense to locate certain activities in the U.S. because of the numerous large markets there.

In summary, the large presence of foreign ownership in the Canadian food and beverage manufacturing industry suggests that potential gains and losses could be significant. On balance, FDI would appear to offer net benefits to the industry in terms of exploiting gains from international exchange, positive spillovers, and perhaps providing relatively high-skill jobs. Indeed, benefits from specialization in terms of lower costs and increased trade are increasing with trade liberalization and competitive pressures. However, there could be reason for concern with respect to: the ability of smaller firms to compete in markets dominated by large, multinational firms; and the ability of foreign affiliates to attract parents' resources to R&D efforts in Canada.

5. PUBLIC POLICY ISSUES

The analysis in this paper indicates that FDI provides benefits to the host country but also can raise some concerns. The public policy issue is what government can and should do to maximize the benefits of FDI and minimize the concerns. To put the potential advantages and concerns related to FDI in Canadian food and beverage manufacturing into perspective, the motivations behind and determinants of FDI in this industry need to be clear.

Multinational food manufacturers are motivated to access foreign markets primarily in an effort to realize growth and bolster or maximize company profits. Supplying foreign markets by means of foreign affiliates (rather than exports or arrangements with other firms) is typically the most preferred method of accessing foreign markets for multinational food firms since this method offers the most control over firm-specific advantages such as the development of branded products tailored for local markets. More generally, firms undertake FDI when their internalizable firm-specific advantages outweigh any disadvantages associated with operating in the foreign market and on balance the foreign country possesses location specific advantages. The notion that multinational food firms have established local production in Canada primarily in order to most profitably serve this country's local markets, rather than because of financial distortions, suggests that their *raison d'être* is much the same as that of domestic firms.

Nevertheless, as indicated, there is some evidence to support concerns about both unrealized potential contributions of foreign firms in Canadian food and beverage manufacturing and the possible negative effects of FDI on the industry. Therefore there is a need to consider the policy implications of FDI and whether multinationals should be treated as special characters in certain policy areas.

This section first discusses the implications of FDI for policies related to economic efficiency and growth, largely based on the results of the previous section. We then examine issues related to the distribution of income, FDI-specific policies, such as those concerning the right of establishment and national treatment, and proposals for a multilateral accord on FDI.

5.1 *Implications for Selected Policy Areas*

The policies discussed in this section are not exhaustive. A number of policy areas are important in terms of the influence MNEs have on economic efficiency and growth in Canada. The policies covered here are considered the more relevant and, in the course of this research and interviews with multinational food firms, have emerged as the most noteworthy for the Canadian agri-food sector.

5.1.1 *Cost Competitiveness: Market, Technical, Labour, Environmental & Support Policies*

The increasing international integration of the food industries through FDI has focussed attention on the ways government policies can be developed or redesigned to improve Canada as a place to invest. Attracting foreign investment is a particular challenge for Canada's agri-food industry at this time, as like most developed countries many of its traditional markets are relatively mature. In addition, Canadian food markets are often small in comparison to those of other countries. At the same time, trade liberalization has increased both the threat of imports and opportunities for exports. This puts greater emphasis on the need to be a cost competitive country as a means of maintaining and attracting investment.

In addition to firms' internalizable advantages, firms decide to locate or remain in a country based on location specific advantages. Location specific factors that most strongly influence multinational food firms are economic in nature and often are associated with characteristics of the market, for example size of market, scale economies, delivery costs, input costs, market structure, and level of risk. Public policies are also locational factors considered by firms, for instance legislation concerning FDI, market regulation, import quotas and tariffs.

Based on comments from interviewed multinationals, however, public policies are generally not a decisive factor in multinational food firms' decisions to invest in local production. In certain circumstances, they can preclude or discourage firms from entering a country such as an FDI specific policy that restricts foreign ownership. However, public policies are most important in terms of the effect they have on the "competitiveness" of firms' production in only specific products in particular countries. In addition, firms are concerned about uncertainty associated with changes in government policies and- the effect this has on business planning as well as the time they have to respond to policy changes because of the long term nature of capital investment planning.

The range of policies that can influence investment decisions is broad. They include macroeconomic policies, horizontal policies such as FDI-specific rules, taxation, labour, environment and science and technology, and sectoral policies such as supply management and technical food regulation.

Interviewed multinational food firms consider Canada's policy environment relatively stable and attractive in terms of FDI. One U.S. firm commented that Canada was chosen as the first foreign market to access in part due to its relatively stable and favourable business climate. While this is the case, there are a few policy areas that raise concern about affecting firms' cost competitiveness and discouraging FDI. These are primarily agri-food sector policies related to market regulation and technical food regulation. A few firms hosed that, in general, they are not interested in operating in restricted markets. It was also noted that Canada's already small markets are fragmented by interprovincial trade barriers. However, it is apparent that in general government regulations need to have a substantial impact on cost competitiveness in order to influence firms' location decisions.

The cost and availability of raw ingredients is an important consideration for many food manufacturers and in some circumstances can influence production location decisions. In Canada, market regulation has the greatest influence on limiting or discouraging FDI in value-added production due to higher raw ingredient costs, particularly in the supply managed industries.²³ The higher cost structure can also limit exports of further processed products of these products. One U.S. firm noted that while it produces meat products in Canada, it does not produce further processed poultry products in this country for cost reasons and imports some product from the U.S. instead. The effect of market regulations on domestic production can be offset by limiting imports, however processors of products using ingredients based on these commodities are less

²³ U.S. sugar and peanut programs, on the other hand, favour production in Canada of value-added products containing sugar (e.g. confections) and peanuts (e.g. peanut butter) due to lower costs for these inputs in this count . Indeed, some Canadian production of these kinds of products is used to supply U.S. markets.

protected. Unrestricted imports of raw product or internationally competitive pricing could improve processors' cost competitiveness.

Multinational food firms in Canada are relatively import-intensive and their advantage in transferring raw inputs from one market to another emphasizes the importance of an internationally cost competitive domestic agriculture sector. This also raises the importance of a "level playing field" in terms of agricultural support.

A number of technical regulations and enforcement procedures were cited by interviewed firms as affecting their cost and product competitiveness in Canada, including regulations governing health and safety, product quality, and labelling. For example, some firms commented that Canada allows imports of products not meeting its labelling regulations, and that relative to the U.S. meat inspections are more rigorous and labelling regulations require added cost. In addition, a number of Canada's technical regulations are seen to have the effect of reducing trade, for example the difference in Canada's standard container size and colour/flavour regulations vis-à-vis the U.S. and Europe. Member countries of the GATT have agreed to address concerns regarding regulatory barriers to trade and the notion of harmonizing member-country regulatory standards. More consistent technical regulations across member-countries could eliminate some uncertainties and costs for Canadian firms and thus improve their competitiveness in domestic and international markets and in this way create a more attractive investment environment in Canada. ²⁴

Labour and environmental regulations were cited as factors that can influence plant location decisions; however, it would appear they are not generally major concerns for multinationals in terms of whether to produce in Canada. One interviewed firm mentioned, however, a labour issue regarding the length of the work week and overtime hours that would have affected its decision to keep production in Canada or move it to the United States if an agreement had not been reached. In addition, the burden of having to negotiate with a large number of unions in Canada was raised. In general, though, wage rates have little impact on multinationals' plant location decisions since labour costs account for a relatively small proportion of total costs in food manufacturing. A number of interviewed firms pointed out that higher wage rates in advanced countries are typically more than offset by higher productivity. On the other hand, aspects of employment such as skill level and reliability of the workforce are perhaps more important in influencing firms' production location decisions. In general, in Canadian food manufacturing, labour costs and characteristics of the workforce apparently do not significantly affect the business environment in an unfavourable manner.

A multinational in Canada commented that the U.S. provides more effective and GATT-proof policy support to food processors, through programs such as the Export Enhancement Program or Market Promotion Program. Notwithstanding, export support programs apparently would rarely affect multinationals' production location decisions. These kinds of programs are discussed in further detail in section 5.1.2. In addition, in a free trade environment, targeted support is becoming less acceptable internationally. No other types of government support or incentives

²⁴ In consultation with industry representatives, Agriculture and Agri-Food Canada carried out a review of regulatory policies and issues in 1992 with the objective of adapting the Canadian regulatory framework to enhance the competitiveness and marketability of Canadian products.

were mentioned; however the issue of government involvement in research and development is discussed in section 5.1.3.

5.1.2 Trade Policies: Trade Agreements and Export Development Programs

Canada, like many countries, has policies and programs aimed at increasing exports, they include trade agreements, market information, market promotion and export credit. Indeed, there is a goal to reach a level of \$20 billion in agri-food exports or 3.5 percent of world trade by the year 2000, about a 60 percent increase over current levels. In addition, the government would like to diversify among export markets. Presently, some 55 percent of agri-food exports and 70 percent of processed food and beverage exports are to the U.S.

The degree to which foreign food firms contribute to Canadian exports of value-added food products is an issue at hand because of the economic activity and foreign exchange that exports generate. The export propensity of foreign food firms in Canada is comparatively low; in the 1980s, this group had a smaller export propensity than any other manufacturing group, foreign or domestically-owned. This was largely due to the traditional, multidomestic structure of multinational food manufacturers.

Canadian affiliates of multinational food firms are increasingly seen as part of a regional or global operation and less as a miniature replica of their parents charged to supply only the domestic market. With increasing pressures to be more cost effective, multinational food manufacturers are rationalizing production of specific products within geographic regions in order to gain from specialization. While current data are not available anecdotal evidence suggests that foreign food firms in Canada are likely exporting more to and importing more from the U.S. now than a decade ago. This would also be consistent with the overall trend in Canada's food and beverage trade.

Foreign food firms in Canada also are becoming more outward-looking in terms of markets beyond the United States, however, only to the extent that their goals complement those of the parent and sister companies. The first responsibility of foreign food firms in Canada remains the need to supply domestic markets. After this, Canadian affiliates supply export markets with excess capacity or seek new export markets in competition with sister companies and unaffiliated companies.

Trade Agreements

The increasing tendency for MNEs to take a more integrated, less multidomestic strategy for serving global markets is in part a result of trade liberalization. The FTA and NAFTA have reinforced a move to regional plants, specialization of plants and more integrated management structures.

The North American perspective being adopted by the management of MNEs increases the need for Canadian subsidiaries to have reliable access to the U.S. market. Efforts to improve the functioning of current agreements, in terms of access, technical barriers and the dispute settlement mechanism, are needed to attract investment to Canada and expand Canadian exports.

A few interviewed firms in Canada voiced concern that the FTA has been less effective than anticipated in reducing border irritants and producing a "level playing field." Specific concerns were the uncertainties created by meat inspection at the border and the threat of reduced access for sugar containing products. Because of the relatively small size of Canadian markets, the need for continued investment in Canada is increasingly dependent on minimizing these kinds of risks. While technical working groups established under the FTA have had some success in resolving outstanding border irritants, continued efforts are needed to improve the functioning of the Agreement.

Export Development Programs

The success of export development programs in generating economic growth is influenced by the way international trade fits into firms' production location strategies. In this regard, the relevant findings of this study and their policy implications are as follows:

- Multinational food firms take into account numerous factors when determining the optimum strategy for supplying foreign markets. Based on the firm, interviews, the- primary factors favouring the use of exports are most often purely economic ones: whether a target market is too small to support local production, whether delivery cost is too great relative to the value of the product, etc. If the conditions are right, exporting can be a relatively low-risk means of establishing a foothold in a foreign market.
- In an effort to most successfully access a foreign market, multinational food firms often progress from exporting to local production; though exports can be used as long term strategies for supplying foreign markets in some cases, for economic and political reasons. Successful export development programs thus could lead to outward FDI. Indeed, for multinational food firms, the most preferred method of supply is local production since it offers the greatest control over the development, marketing, and delivery of firms' products.
- Export development programs might assist or influence MNEs in their decision to enter a foreign market, however they would not typically be a deciding factor. MNEs participate in export programs and most likely benefit from information provided by governments on foreign markets.
- Export programs could influence the allocation of production among countries. For example, a company might produce a product in the U.S. to take advantage of the export promotion and subsidy programs in that country.
- Compared to their influence on smaller firms' decisions, these programs would typically have less influence on the decisions of larger MNEs, foreign- or domestically-owned, given their international expertise, distribution systems and resources. The contribution of export development programs to Canada's overall export performance, therefore, might be enhanced by putting more emphasis on the needs of small and medium sized firms.
- Export programs that encourage the combined efforts of firms, of all sizes, in accessing foreign markets could generate synergies and thus greater success. This could involve partnerships between firms in Canada or between firms in Canada and other countries.

5.1.3 Science and Technology Policy

Foreign-owned food firms are typically more R&D intensive than their domestic counterparts. However, as a group, Canadian affiliates of U.S.-controlled multinational food manufacturers are less R&D intensive than their sister companies in other industrialized nations; Canadian affiliates presumably import proportionately more R&D from their U.S. parents.

These phenomena reflect the outcome of the most desirable distribution of multinational resources across many countries from firms' perspectives. MNE research is typically done in the home country to maintain control or in regional centres. Affiliates of multinational food manufacturers in Canada are most responsible for ensuring product quality and that products are tailored to the Canadian market, though a few affiliates perform a number of innovative R&D activities beyond these basic requirements. A desire to capture economies of scale in R&D favours establishing facilities in larger U.S. markets to service all of North America. Canada and the U.S. share a common geographic region and some of the same customs and tastes, which lowers the cost of transferring R&D from the U.S. to Canada.

However, it is in Canada's interest to have policies in place that allow Canadian affiliates of multinational food firms to best compete with sister companies for parents' scarce resources in order to develop processes and products for both domestic and worldwide markets. While food manufacturing is not a "high technology" industry, there are numerous opportunities in food science and technology (technical processes, packaging, product development), food marketing, and so on, which firms can take advantage of. Realistically, affiliates in Canada likely are best suited to niche-type endeavours that complement parents' efforts. It is also important that Canadian manufacturers embrace new technologies and reach for an internationally competitive level of productivity by modernizing production facilities, in order to offset the country's relatively high cost structure compared to some countries.

The vertically- and horizontally-integrated nature of the multinational enterprise gives foreign affiliates in Canada excellent potential opportunities to quite readily transfer technology, expertise, etc., across a wide range of outlets, from industrial inputs through to the food service sector, and to markets around the world. They also have the advantages of the relatively high level of skill and post-secondary education among the ethnically-diverse Canadian society, as well as the relative availability of higher technologies, and capital and natural resources in Canada.

A policy environment in Canada that encourages firms, in all industries and of all nationalities, to adopt new technologies and maintain and expand R&D activities, with a keen eye on growth areas, both for domestic and export markets is important for Canada's success in a global economy. Governments need to ensure that food manufacturers be in the best position to strategically build on this country's strengths and develop expertise that can be exploited at home and abroad. This might be largely achieved by using tools already in place and more aggressively stimulating private sector interest and investment in value-added food research and development. The Food Technology Industry Centre at Guelph and the B.C. Food Technology Centre, a joint effort of the University of British Columbia and the B.C. Institute for Technology, are examples of government and industry working together to stimulate product development and commercial activities in the food industry.

5.1.4 Industrial Policy: Employment

There is no evidence foreign affiliates in Canadian food manufacturing offer noticeably better or worse jobs than their domestically-owned counterparts. An industrial policy to encourage the development of high-wage jobs in all manufacturing industries would seem appropriate rather than one that would discourage FDI on the basis of "good jobs" being replaced with "bad jobs." There has

been concern about loss of employment among multinational food firms in the past several years particularly in North America and Europe in connection with the wave of acquisitions and mergers, trade liberalization and the recent recession. Many of these jobs may never be regained, however others have been created. In Canada, despite challenges from the latest recession and trade liberalization, foreign food firms generally have maintained a strong presence in the food industry.

5.1.5 Competition Policy

FDI can enhance economic efficiency in terms of competition by increasing the number of firms in a market and putting downward pressure on prices. However multinational food firms often access foreign markets through acquisition rather than greenfield investments. In addition, larger foreign firms hold a large share of industry sales in some Canadian food industries. Where market competition might be a concern, the fact that foreign owned firms are involved could have implications for competition policy or at least for how it is applied.

The main issue is whether current antitrust laws and pressure from competitors can effectively moderate market power if the same few MNEs share regional/world markets. With the increasing integration of markets within Canada and the U.S. and elsewhere in the world, the task of governments to promote competition within the boundaries of individual nations is becoming more complex. Governments realize they cannot effectively carry out their mandates exclusive of the international activities of MNEs. Ultimately the coordination of national policies would be necessary to accomplish internationally efficient competition policies. This kind of international effort is beginning to be addressed in discussions concerning a multilateral accord on FDI.

5.1.6 Taxation Policy: Transfer Pricing

The cursory analysis in section 4.2.2 was not conclusive in providing evidence that suggests the role of transfer pricing in reducing government revenue is a problem in the Canadian food industry. Transfer pricing is a general concern for all countries that host multinationals and continues to be monitored by governments and the academic community.

Trade agreements could help alleviate problems in the area of transfer price manipulation that arise from "grey areas" in which interpretations of tax regulations might differ between countries.

The standard cost-benefit analysis used in public finance and international trade policy distinguishes between the redistributive effects of policies and their efficiency effects. This analysis determines the effect of a policy change on the redistribution of income among three domestic groups—consumers, producers and the government—and on the efficiency gains or losses resulting from production and consumption distortions. A working assumption could be that in the aggregate the redistribution among the three groups is netted out, since everyone is a producer of something and a consumer of something else.

Therefore the net effect of a policy change on national welfare could be measured by comparing the net gain or loss resulting from production and consumption distortions on the one hand and the benefits derived from the policy objective on the other. However if there is foreign ownership in some part of the domestic industry, from a national point of view, redistributions cannot be netted out since those benefitting from or hurt by a policy may be foreign instead of domestic residents. Graham and Krugman (1991,p87) cite three possible implications of the redistributive effects of policies involving foreign-owned factors.

First, the cost or benefit of a policy to the nation implementing it may be larger because of foreign ownership of factors than it would be otherwise. For example, a tariff or a subsidy to an industry in which foreign ownership is high would impose substantial national costs since the benefits would be drawn away from domestic firms. On the other hand, a policy of deregulation or of import liberalization of a largely foreign-owned industry may produce national gains beyond any efficiency consequences.

Second, if foreign capital moves into a country because of distortional policies, such as a tariff, the foreign investors may receive earnings that exceed the true contribution their capital has made to national product.

Third, to the extent that foreign owners of factors of production can influence the domestic political process in their favour, net national costs will tend to be higher, not because foreign-owned firms behave any differently but simply because domestic residents would not appropriate the gains. In principle, therefore, a foreign firm that influences national policy in its own interest is more likely to have a negative effect on national welfare, other things equal, than a domestic firm with the same influence.

From a domestic point of view, the issue is how much do losses resulting from policies that redistribute income to foreign-owned firms matter and thus should foreign firms be given special treatment when setting public policies?

From a world point of view, the redistributive effects are again different. In this case gains to foreign-owned firms represent a redistribution rather than a loss. A policy that redistributes income toward foreign-owned factors is a cost for the host country but not from the global point of view, and a policy that reduces foreign firms' income benefits the home-country but not the world.

²⁵ This section is based on a discussion in Graham and Krugman (1991,p86).

For all countries to be better off as a whole, international investment needs to take place under rules that limit the extent to which individual countries take a parochial view that looks upon income earned by foreigners as a pure loss. To the extent that a country is a home nation as well as a host nation for multinationals, it may prefer to use rules that prevent other countries from being too concerned about international redistributive effects, even if these rules restrict its own actions.

For a country such as Canada, whose inward foreign investment has been historically high but whose outward foreign investment is becoming more substantial, the existing international code of right of establishment and national treatment (that is, a neutral policy whereby foreign affiliates are established virtually unimpeded and receive the same treatment as domestic firms) could be beneficial on balance.

5.2.1 Strategic Trade Theory

Strategic trade theory proposes that in imperfectly competitive markets it is sometimes possible for foreign firms to earn above-normal profits at the expense of domestic firms, if foreign governments intervene in the market.²⁶ While this theory was developed within the context of international trade, it can be applied to foreign direct investment as well.²⁷

The theory has three basic assumptions and when they are adapted to FDI they are as follows. First, because of economies of scope in multinationals there is room for only a few MNEs to operate profitably in a domestic country; second, a domestic government must either not offer foreign multinationals national treatment and/or in some way close its market to foreign multinationals; and third, while the domestic government effectively closes its market, firms from that country are allowed to operate freely in other countries.

While strategic trade theory has established the possibility of a country raising its national income at another country's expense, it does not offer a general proposition that the country with the aggressive trade policy will benefit. Helpman and Krugman (1989) show that attempts to quantify this cost indicate that it is small. Nevertheless, the strategic issue brings priority to an effort for countries to establish similar treatment where asymmetric FDI policy presently exists.

2e Brander and Spencer (1985)

²⁷ See Graham (1992) in Graham and Krugman (1991,p66).

5.3 National Policies on FDI

With a few exceptions, there has been a general movement among developed countries toward the liberalization of formal barriers to foreign investment—at least those related to screening and performance requirements.²⁸ Some advanced nations, such as Canada, Japan and France, have had legal machinery that in principle would allow more extensive screening of inward foreign investment than others, such as the United States; however, since the early 1980s this machinery has rarely been used and there is little *de facto* difference among the advanced nations in their legal openness to inward FDI.²⁹

Formal aspects of foreign investment regimes may involve a number of rules and policy areas. Some examples of these are: a screening process which may be used to accept, modify or block foreign investments (by means of evaluations based on, for instance, net benefit to a national economy, or on grounds of national interest or national security); disclosure requirements; corporate taxation policy; competition policy; the provision of investment incentives; and a number of government performance requirements. Investment incentives (which may include subsidies) tied to performance requirements are, offered by a number of countries including European countries.³⁰ In general, Canada's current investment regime does not involve tying incentives to performance requirements, however specific project proposals, most likely those attempting to promote technology transfer, may incorporate both instruments.

Performance requirements vary widely among countries and may apply to all investment or to specific industries. The following is a comprehensive though not exhaustive list of such requirements: economic performance requirements such as location in development areas; local content requirements; technology transfer considerations; restriction of foreign investment in certain areas; encouragement of FDI in priority sectors; limitations on foreign acquisitions of domestic firms and limitations on size of new investment projects; financial performance requirements such as foreign firm required to put up certain amount of own capital; local equity participation requirements; limitations on borrowing and limitations on remittances abroad; manpower performance requirements such as job retention, registration and/or limitation of foreign employees, training of local employees and management participation; balance-of-payments requirements such as level of exports, import substitution considerations, and general effect on balance of payments; and other performance requirements such as language, health and safety, environment, and real estate and construction requirements.³¹

²³ Investment Canada (1991b,p28) and Ahmad and Knubley (1993) cited in Investment Canada (1992a).

²⁹ OECD (1987), U.S. Department of the Treasury (1988), and Tanzi and Coelho (1991) from Graham and Krugman (1991,p136).

³⁰ Graham and Krugman (1991,p137).

³¹ U.S. Department of Commerce (1978) in Gordon and Lees (1986,Table 1.4).

Despite a general relaxing or disuse of overt legal barriers to foreign investment among developed nations, a myriad of informal barriers cloud the international investment environment. For instance³² the disproportionately high ownership of German corporations by domestic banks combined with highly interlocking management structures in Germany can bar foreign investors from purchasing firms in this country, except when deemed "friendly". While Japan has made some significant progress in removing restrictions on foreign investment since the 1970s, the foreign presence in Japan remains far below that in other advanced nations and there still remain serious informal barriers. These range from business cultural constraints, such as the keiretsu system (whereby the cross-hauling of equity among Japanese firms in the system constitutes a barrier to acquisition by foreign investors), to more direct impediments such as the government's use of "administrative guidance" to dissuade potential investors from their plans if they conflict with local business interests. Also, while France has relaxed administrative requirements to expedite the investment screening process, domestic firms have been allowed a variety of defensive tactics to resist hostile foreign acquisitions.

In 1985, Canada replaced the Foreign Investment Review Act (FIRA) with the Investment Canada Act in order to reduce the regulation of inward foreign investment largely by substantially relaxing screening requirements, and to increase its effort to attract foreign capital into Canada.³³ Under FIRA, approval of foreign investments could be conditional on various performance requirements such as the trade-distorting minimum levels of local purchasing in Canada and import substitution.³⁴ In addition both foreign acquisitions and the establishment of new foreign-owned firms were screened. Under the new Investment Canada Act, Canada retains the right to screen inward investment however there are no formal performance requirements and all new business establishments by foreign investors: as well as acquisitions by foreign investors less than \$5 million are not reviewable.

Canada's review process takes into account the following factors: the effect on the level and nature of economic activity, including its effect on employment, resource processing, on the use of parts, components, and services produced in Canada, and on exports from Canada; the degree and significance of participation by Canadians in the Canadian business; the effect on productivity, industrial efficiency, technological development, product innovation and product variety in Canada; the effect on competition; the compatibility of the investment with national industrial, economic, and cultural policies; and the contribution of the investment to Canada's ability to compete in world markets (Investment Canada, 1992b, p5). The review process also involves an assessment of the likely effect of the investment on competition in the relevant industry.

³² See Ahmad and Knubley (1993) for a discussion of formal and informal barriers to foreign investment in G-7 countries.

³³ In 1993, the regulatory responsibilities of Investment Canada were assigned to the new Department of Industry Canada however the investment review procedures remain the same.

³⁴ McLachlan, Apuzzo, and Kerr (1988, p27).

In addition, the Canadian government's mandate is to promote investment in Canada by Canadians and non-Canadians, undertake research and provide policy advice, and as fulfillment of its screening requirements, determine whether an investment application is likely to be of net benefit to Canada. To facilitate investment promotion, the government offers a range of services to investors and has worked in partnership with counsellors in foreign embassies.

Since about the time that the Canadian government relaxed its position on incoming foreign investment, Canadian investors have stepped up their own foreign investment abroad and there has inevitably been an increasing awareness of investors' concerns rather than those of a host country exclusively. Canada's institutional and attitudinal changes concerning foreign investment have been reinforced by the further liberalization of investment rules toward the United States under the FTA. The FTA formally commits both countries to recognize the principle of neutrality with respect to foreign ownership in future regulations, with the exception of a few specified industries.

A neutral policy implies the right of establishment and national treatment whereby foreign affiliates may be established unimpeded and receive the same treatment as domestic firms. Traditionally, U.S. policy toward FDI has been based on the general principle of neutrality, though there have been occasional lapses and the federal government has potentially extensive authority to screen and block foreign investment on grounds of national security (Graham and Krugman, 1991, p138). Various investment incentives at the state level, however, may undermine a federal commitment to a policy of neutrality. Canadian policy toward FDI under the Investment Canada Act also may be characterized as espousing the principle of neutrality with possible qualifications pertaining to investment incentives and the performance requirements, discussed above for large acquisitions.

The most specific and immediate step in the FTA contributing to increased freedom for bilateral Canada-U.S. investment flows was to raise the threshold beyond which the Canadian government screens acquisitions by U.S. firms from \$5 million to \$150 million. The Agreement also stipulates that prospective changes to future legislation are to provide for repatriation of capital and earnings, however both partners retain some freedom to tax national and foreign-owned firms at different rates. The Agreement goes well beyond existing multilateral agreements in several respects. The most important of these are: 1) Both countries are precluded from imposing new performance requirements on investments that affect trade between the two countries, such as local purchasing or import substitution, though other types of performance requirements such as those relating to product mandates, transfer of technology and ROD may still be negotiated, and; 2) Disagreements over investment policy can be brought under the Agreement's general dispute settlement mechanism which is designed to act as an impartial judicial proceeding.³⁵

³⁵ See McLachlan, Apuzzo and Kerr (1988, p29) and Graham and Krugman (1991, p130) for discussions concerning provisions for foreign investment in the FTA.

5.4 Multilateral Accord on FDI

There are policy areas associated with the many markets that are affected by multinationals which host governments should consider when addressing national welfare. Traditional welfare economics offers rules for these policies based on the goal to maximize the income of a country. A dilemma that emerges from this economic analysis, however, is that policies maximizing the incomes of host countries, home countries and the world as a whole are not identical and therefore conflict can be expected (Caves, 1982, p298). Hence, if countries fail to recognize the interdependent effects of their policies, the national policies consistent with maximum global welfare from multinationals' activity will diverge from those that appear to maximize national welfare. Furthermore there is no guarantee in the theory of bargaining and retaliation that recognition will bring consensus on policies that maximize joint (global) welfare (Caves, p295).

Caves emphasizes this point with a comparison to the GATT. He suggests that an idealized agenda for international cooperation of policy toward MNEs could be similar to an international forum like the GATT and would bargain toward the global-welfare-maximizing arrangements toward MNEs such as corporation income-tax treatments consistent with capital-import and -export neutrality, internationally efficient competition policies through the coordination of national policies, and internationally efficient policies toward the creation and dissemination of technology. Apart from the economic conflicts, arrangements would also have to be made to arbitrate cases in which the MNE of one country is perceived to be invading the sovereignty of another country; however international political arrangements usually are zero-sum and offer no basis for bargaining toward a global optimum.

There would be difficulty in executing such an agenda, Caves suggests, since no globally efficient change in economic policy that is not neutral between source and host can claim to spread its benefits equitably without side payments being made. Finally, a package of globally optimal policy changes may contain net benefits to both source and host countries, but there is no guarantee that there would be an overall balance. This difficulty is avoided in multilateral trade negotiations under the GATT since general rounds of coincident tariff reduction presumably lead to global gains that are spread fairly evenly among participating nations since no nation's trade balance has undergone much change when calculated at ex-tariff prices.

Finally Caves comments that while there may be a need for international regulation to address the power of MNEs relative to governments and that an economic case can be built for collective international commitments on policy toward MNEs, because of the conflict between policies maximizing national welfare and global welfare, in reality such regulation may be unrealistic.

More recently, and in accordance with Cave's views on the subject, Graham and Krugman (p92) suggest that in general world income would be maximized when foreign- or domestically-owned factors of production were treated the same and if MNEs were given national treatment by all countries. They seem to be somewhat more optimistic than Caves, however, in their assessment of the possibility of a multilateral investment accord. Indeed they have proposed an international accord on investment and multinational enterprises among the world's largest industrial nations, including a dispute-settlement mechanism to address deviations from the rules.

Graham and Krugman claim that a larger group of nations is not needed and in any case would be impractical because the goals among major industrial nations with respect to FDI are different from those of developing nations. However they suggest that outside nations should be allowed to enter the core group latter on. They provide more insights on this topic than can be presented here and cite a forthcoming paper by Bergsten and Graham (1992) which is to provide details concerning a proposed multilateral accord for foreign direct investment and multinationals.

5.5 Conclusion

Canada's policy environment is considered relatively attractive to foreign food firms and in general public policies are not a major factor in multinational food firms' decisions to invest in Canada. Public policies are most important in terms of the effect they have on the competitiveness of producing specific products in Canada.

Based on the results of this study, there are a few areas in which changes to public policies would make Canada a more attractive place for foreign investment in the food and beverage industry. These changes would also draw benefits through potential investment from domestically owned firms, and, in general, improve the competitiveness of the Canadian agri-food sector.

- 1) Market regulations in the agri-food sector discourage FDI, especially in the Canadian

poultry industry. A more market responsive approach would likely attract more FDI to the agri-food sector.

- 2) Continued efforts on the part of the government are needed-to improve the functioning of

trade agreements, especially in the areas of market access, technical barriers and the dispute settlement mechanism. Multilateral reductions in non tariff barriers to trade such as technical regulations, fewer uncertainties and improved export-opportunities could create a more attractive investment environment in Canada.

- 3) R&D policies must encourage firms to adopt new technologies and apply their "special

Canadian" expertise to niche-type endeavors, with a keen eye on growth areas, both for domestic and export markets. Expanding R&D efforts might be largely achieved by using tools already in place and more aggressively stimulating private sector interest and investment in value-added food research and development. Foreign affiliates in Canada must focus on areas that complement parents' worldwide efforts, however the vertically and horizontally-integrated nature of the MNE can give affiliates in Canada the opportunity to explore many applications.

In addition, two policy issues emerge from this study concerning potential benefits and costs of MNEs in the agri-food sector. First, a concern is whether imports and current antitrust laws effectively moderate market power if the same few MNEs share the world market. Coordination among governments will be necessary to accomplish internationally efficient competition policies. This effort is beginning to be addressed in terms of a multilateral accord on FDI.

-Second, MNEs benefit from information provided by governments on foreign markets, however export development programs have less influence on their production location decisions than economic factors. Export programs would also have less influence on larger MNEs, due to their international expertise and resources, than on smaller firms. The contribution of export development programs to Canada's overall export performance, therefore, might be enhanced by

putting more emphasis on the needs of small and medium sized firms. Export programs should encourage the combined efforts of firms, of all sizes and nationalities, in accessing foreign markets in order to generate strategic synergies.

While there are domestic policies that might redistribute income to foreign-owned firms or fall short of deriving the maximum benefits from foreign-owned firms, for all countries to be better off as a whole, international investment needs to take place under rules that limit the extent to which individual countries take a parochial view that looks upon income earned by foreigners as a pure loss.

Strategic trade theory has established the possibility of a country raising its national income at another country's expense. However this theory does not offer a general proposition that a country will benefit from restrictive FDI policies or aggressive trade policies. This reinforces the priority for countries to establish similar treatment where asymmetric policies exist.

To the extent that a country is a home nation as well as a host nation for MNEs, it may prefer to use rules that prevent other-countries from being too concerned about international distributive effects. For Canada, whose inward FDI has been historically high but whose outward FDI is becoming more substantial, the current neutral policy toward foreign affiliates could be beneficial on balance. Indeed most industrialized countries have been moving toward more liberal foreign investment rules, and since the early 1980s, there has been little difference in the legal openness toward FDI of advanced nations.

The dilemma that emerges from the analysis of government policy and the maximization of benefits from FDI is that policies that maximize the incomes of host countries, home countries, and the world as a whole are not necessarily identical and therefore conflict can emerge. Caves suggests that an idealized global-welfare-maximizing arrangement toward MNEs would include internationally efficient policies in competition, corporate taxation and the creation and dissemination of technology. While the feasibility of such an agenda has been raised, work is ongoing in the area of a multilateral investment accord. Ultimately, countries that can effectively meet internal policy goals at the least cost to government and industry will be best able to attract and retain investment and be competitive in international markets.

6. CONCLUSIONS AND IMPLICATIONS

This study analyzes the theory and potential benefits and costs of FDI and draws from comments of interviewed multinational food firms to provide implications of FDI for the agri-food sector and highlight policy areas in which the Canadian government might maximize the benefits and minimize the concerns of foreign ownership in food manufacturing.

The theory of FDI proposes that firms undertake FDI when their internalizable firm-specific advantages outweigh any disadvantages associated with operating in the foreign market and on balance the host country possesses a locational advantage for the firm. In the food industry, the major determinants of FDI are the internalization of intangible assets, such as trademarks, technology and skills, especially in order to maintain control over and fully exploit these advantages. Certain location advantages are also dominant, such as the size of a target market relative to the minimum efficient scale, the cost of delivery relative to the value of the product, the availability and cost of raw ingredients and market and political risks. Government policies can also influence FDI, however they tend to be less important than economic factors.

Multinational food manufacturers are best characterized as traditional multinational firms with subsidiaries oriented toward domestic markets rather than globally integrated with subsidiaries oriented toward export markets. In the food business, local production is often required to successfully exploit intangible assets and hence food firms are constrained to being more multidomestic than globally integrated. However, with trade liberalization and increasing competitive pressures, multinational food firms are becoming less of a collection of companies acting domestically and increasingly following integrated international strategies whereby they can exploit benefits gained in one market for use in another. This has led to the rationalization of management and production on a more regional basis and increased trade within major economic regions. In North America, in product-specific cases, more Canadian production is being exported to the U.S. as substitutes or supplements to U.S. production, and vice-versa. -

This characterization and the structural changes occurring in international food manufacturing is reflected in statistics for FDI and trade. Both worldwide FDI and trade in processed food products are increasing, however international commerce remains by far dominated by direct investment. Sales of foreign affiliates account for about US\$1 trillion of the total US\$1.5 trillion in international commerce while exports account for about US\$325 billion and sales through licenses and joint ventures the remainder. In North America, while bilateral Canada/U.S. trade in processed food products is increasing, sales of U.S. food manufacturers in Canada are about three times the value of U.S. exports of food products to Canada, and sales of Canadian food manufacturers in the U.S. are at least 50 percent more than the value of Canadian exports of these products to the U.S.

Potential benefits of FDI can be derived from gains similar to those achieved from conventional integration through trade, such as gains from rationalization and increased competition, and through positive externalities such as spillovers of R&D to the host economy. Host countries can also potentially incur losses due to foreign ownership, for example losses resulting from the "headquarters effect" of R&D and transfer price manipulation. In addition, gains or losses may be realized from FDI in terms of employment and the trade balance of individual sectors of the host economy. The large presence of foreign ownership in the Canadian food and beverage manufacturing industry suggests that potential gains and losses could be significant.

On balance, FDI appears to offer net benefits to the industry in terms of exploiting gains from international exchange, positive spillovers, and perhaps providing relatively high-skill jobs. However, there could be reason for concern with respect to the ability of smaller firms to compete in markets dominated by large, multinational firms and the ability of foreign affiliates to attract parents' resources to R&D efforts in Canada.

Canada's policy environment is considered by multinational food firms to be relatively attractive and in general public policies are not a major factor in multinational food firms' decisions to invest in Canada. Instead, public policies are most important in terms of the effect they have on the competitiveness of producing only specific products in Canada. Nevertheless, attracting new foreign investment is a challenge for Canada's agri-food industry as many of its traditional markets are relatively mature and demand is often small in comparison to that of other countries.

Changes to public policies which could maximize benefits of FDI in Canadian food and beverage manufacturing include: 1) more market-oriented marketing institutions in the agri-food sector 2) improved functioning of trade agreements and 3) better ability of affiliates to attract parents' R&D resources.

Two policy areas emerge which might raise concern about multinationals, of any nationality: 1) whether current antitrust laws effectively moderate market power if a only few firms hold a significant share of regional/global markets, and 2) whether the contribution of export development programs to overall export performance might be enhanced by putting more emphasis on the needs of smaller firms.

While there are domestic policies that redistribute income to foreign-owned firms or fall short of deriving the maximum benefits from foreign-owned firms, for all countries to be better off as a whole, international investment needs to take place under rules that limit the extent to which - individual countries take a parochial view that looks upon income earned by foreigners as a pure loss. To the extent that a country is a home nation as well as a host nation for MNEs, it may prefer to use rules that prevent other countries from being too concerned about international distributive effects. In terms of FDI-specific policies, for Canada, whose inward FDI has been historically high but whose outward FDI is becoming more substantial, the current neutral policy toward foreign affiliates could be beneficial on balance. Indeed most industrialized countries have been moving toward more liberal foreign investment rules, and since the early 1980s, there has been little difference in the legal openness toward FDI of advanced nations.

In general, countries that can effectively meet internal policy goals at the least cost to government and industry might be best able to attract and retain investment and be competitive in international markets. However the international community still faces a dilemma which emerges from the analysis of government policy and the maximization of benefits from FDI; that is, policies that maximize the incomes of host countries, home countries, and the world as a whole are not necessarily the same and thus conflict can emerge. Work is ongoing in the area of a multilateral investment accord which could allow countries to move toward more internationally efficient policies in areas such as competition, corporate taxation and technology.

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