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INDUSTRY CANADA'S FOREIGN INVESTMENT RESEARCH: MESSAGES AND POLICY IMPLICATIONS

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I. INTRODUCTION

Through its microeconomics research program, Industry Canada has been at the forefront of efforts to promote an understanding of the nature and effects of foreign direct investment, including both that by foreign firms in Canada and that by Canadian firms in other countries. Foreign investment is the subject of four volumes in the Industry Canada (and the former Investment Canada) Research Series, and of a number of Industry Canada working, discussion, and occasional papers. The purpose of this paper is to consider the policy implications of this body of research.

Since the focus is on policy, the paper skips lightly over those findings which are positive rather than normative. While the first chapter looks briefly at some of the factors underlying recent patterns of foreign investment, it does not purport to summarize the rich conceptual and empirical research in the Industry Canada (IC) papers. Moreover, the policy implications of these studies are clearer in some areas than others. While there is a high degree of consensus among researchers on most of the main issues, some of this paper's conclusions reflect the author's judgment on matters in which the findings of the IC studies are not fully consistent.

The next chapter of the paper discusses IC research that pertains to the role of foreign direct investment (FDI) and the factors underlying recent investment trends. Chapter 3 considers the policy implications of the IC research in the context of Canada's role as both a significant host and an important source of foreign investment. In addition to examining the need for government intervention in foreign investment markets, this section considers the implications of the studies' findings for general government policy. Chapitre 4 looks at foreign investment policy in an international context. The IC studies that examine foreign investment barriers and that have something to say about how to improve the international environment for foreign investment are discussed in this section. The paper's conclusions are presented in chapter 5.

2. UNDERSTANDING RECENT DEVELOPMENTS

Trends in FDI

Global Developments

The growth in FDI has been a major factor underlying the growing integration of world economies. The world stock of outward FDI stood at US$2.7 trillion in 1995, representing the investment of an estimated 40,000 parent firms in 250,000 foreign affiliates. The world's 100 largest corporations account for about one sixth of total world investment. The growth of world FDI stocks was particularly strong during the second half of the 1980s, but over the entire period since 1981 the rate of growth in FDI stocks has substantially exceeded that of world output and world exports. Foreign investment activity is concentrated in the Triad – the United States, the European Union, and Japan – and in 1995 these regions accounted for 81 percent of the outward stock and 61 percent of the inward stock of foreign direct investment.

Along with the growth in overall FDI, the recent period has witnessed some significant shifts in the pattern of world investment. The United States, which has long been the leading source of FDI, has also become the main recipient of direct investment: in 1995, it accounted for one quarter of the outward stock and over one fifth of the inward stock of world FDI. A second notable development has been the rising importance of Japan as a source of FDI. During the second half of the 1980s, Japan was the leading source of FDI outflows. Today, Japanese FDI flows are well below their 1989-91 peak levels, but at 11 percent, Japan's 1995 share of the world stock of outward FDI was still about three times its 1980 share.

A third significant trend has been the growing role of foreign investment in China and the more dynamic economies of Southeast Asia. Following the recent liberalization of China's foreign investment regulations, inflows of FDI have surged. The country's importance as a host economy has grown steadily over the past five years, and China now accounts for about 5 percent of the world stock of inward FDI. The newly industrializing economies (NIEs) of Southeast Asia – Hong Kong, Singapore, South Korea, Chinese Taipei – along with three of the members of the Association of South East Asian Nations (ASEAN) – Malaysia, Indonesia, and Thailand – have become increasingly important recipients of FDI. More notable, however, has been the evolution of the NIEs into important sources of FDI. In 1995, these countries accounted for about 5 percent of the total world stock of outward FDI. Most of this investment has occurred within Southeast Asia and, as Ahmad, Rao & Barnes (1996) have shown, it has supported the role of Japanese investment in integrating the economies of the region.

Canadian Developments

One of the most significant features of Canada's recent economic history has been the rapid growth of Canadian direct investment abroad. This has greatly outpaced the growth of foreign investment in Canada, with the result that net FDI liabilities declined from 11.7 percent to 1.2

percent of GDP between 1980 and 1996. It is also significant that, notwithstanding the growth of foreign subsidiaries in this country, Canada has lost its position as one of the world's most important host economies. In 1995, Canada accounted for 4.4 percent of the global stock of inward FDI – a figure that was less than that for China and well down from the 11 percent share recorded in 1980.

These developments have been accompanied by a number of changes in the pattern of foreign investment in Canada and Canadian direct investment abroad. The former is discussed in Knubley, Legault & Rao (1994) and Niosi (1994). The more significant changes affecting Canada as a host of FDI include the following:

- The United States has become somewhat less important as a source of FDI, although in 1996 it still accounted for 68 percent of all foreign investment in Canada. Recent trends reflect the increased focus of U.S.-based multinational enterprises (MNEs) on investment opportunities in other regions, notably the European Union (EU), and Mexico (as discussed by Unger, 1994).

- Investment from the European Union has become more important since 1980, reflecting the general growth in the global role of European MNEs. The relative importance of EU investment in Canada has declined somewhat in recent years, however, as a result of the drop in investment from Britain during the 1990s.

- Japanese FDI in Canada has also grown, although in 1996 it still accounted for less than 4 percent of all inward investment in this country. In contrast with U.S. investment, Japanese FDI is concentrated primarily in commerce.

- While it is not possible to identify the contribution of foreign acquisitions to the growth of foreign investment in Canada, data analyzed by Khemani (1991) suggest that foreign mergers and acquisitions became more important throughout the 1980s, contributing to the growth of foreign ownership and to higher levels of industry concentration.

The changing pattern of Canadian direct investment abroad is examined in a number of IC papers, including Knubley, Krause & Sadeque (1991); Knubley, Legault & Rao (1994); Rao, Legault & Ahmad (1994); and Chow (1994). The following are among the more significant findings:

- As with inward investment, the composition of Canadian FDI has shifted, with EU countries (other than the United Kingdom) playing a more important role relative to the United States. In 1996, however, the latter country still accounted for almost 55 percent of Canadian investment abroad, well above the European Union's 20 percent share.

- The industrial composition of Canadian investment has also changed over time, with finance and insurance growing in importance relative to primary industries and manufacturing. In 1996, finance and insurance represented almost 30 percent of the value of Canadian foreign direct investment assets.

- Canadian investment abroad is characterized by horizontal linkages, with most firms investing in industries with established expertise. Chow (1994) suggests that this may result in part from the presence of foreign trade barriers but that it also reflects efforts by Canadian firms to mine their comparative strengths more fully.

- Most of Canada's foreign investment is accounted for by a relatively small number of large firms. In 1991, 17 Canadian enterprises held direct investments of $1 billion or more, accounting for half of all Canadian investment abroad; 136 enterprises holding direct investments of $100 million and over accounted for almost 90 percent of total Canadian direct investment.

- While it is impossible to determine the role of acquisitions relative to other forms of direct investment abroad, Knubley, Krause & Sadeque (1991) find that, in the 1980s, Canada was relatively more active in cross-border mergers and acquisitions than many large countries. The majority of acquisitions were made in the United States and half were horizontal transactions.

Theories of FDI

Before attempting to identify the factors underlying recent patterns of FDI, one must understand what causes firms to invest in foreign markets in the first place. A number of IC papers contribute to the literature on this topic.

There is no agreed general theory of MNE investment, but as Eaton, Lipsey & Safarian (1994*b*) point out, there are important theoretical strands within analyses of firm behaviour based on transactions costs, locational factors, and business strategies. Transaction-cost theories point to various circumstances where "internal" transactions (i.e., within a firm) may contribute more than external, market-based transactions to maximizing the return on a firm's assets. This may result from the fact that the firm's competitive advantage is based on certain intangible assets – i.e., industrial property rights, unpatented know-how, product promotion, and product distribution capabilities – for which markets do not exist or are highly imperfect. While, for example, a firm could license a proprietary technology, it may not be able to receive a return that reflects the true potential of the technology or offers adequate compensation for the competitive risks that would accompany such a transfer. New, leading-edge technologies are especially prone to such problems.

Alternatively, the firm's competitive advantage may be tied to certain skills and routines that workers have acquired over time and that cannot be codified and sold. Cantwell (1991) accords particular importance to such tacit knowledge, which he regards as a critical element underlying the "technological competence" of firms. In other situations, market transactions may be problematic for certain tangible assets, such as an important raw material that is controlled by a single supplier. Direct investment allows the firm to avoid the risks associated with its dependence on a single source and to achieve greater predictability with respect to input costs and quality.

Company-specific advantages may also be the result of certain synergistic effects that cannot be marketed in externalized form. A particular operation may have greater value as part of an MNE, for example, because of the firm's greater ability to mobilize capital resources or to absorb risk.

The nature of a firm's foreign involvement depends partly on the interaction of such firm-specific assets with the location-specific advantages of different countries. The latter, in turn, depend on a range of elements, including factor costs, labour productivity, exchange rate variations, transportation costs, market size and growth, and public policies. Eden (1994*d*, Table 11) provides a comprehensive list of country-specific advantages, along with an assessment of their application to Canada, the United States, and Mexico in 1990. Historically, Canadian policies – and more specifically, protective Canadian tariffs – have been seen as an important element in the decisions of foreign firms to establish a subsidiary to serve the Canadian market.

Among the IC papers that shed light on the role of country-specific factors is a study by Rugman & Waverman (1991) that examines the pattern of acquisitions of Canadian firms by foreign interests between 1974 and 1990. The similar sector focus of investors from Japan, the United States, and the European Union suggests that opportunities in Canada were a key force behind foreign acquisitions over this period. The significant role of country-specific factors is also indicated in a study by Knubley, Krause & Sadeque (1991) of foreign direct investment by large Canadian firms. Survey results reported in this study indicate that among the main factors motivating the investments of Canadian firms were trade barriers, transportation costs, and (to slightly lesser extent) the availability of skilled labour and a favourable regulatory environment.

Business strategy, the third broad determinant of FDI patterns, will influence the way MNEs distribute and organize their activities so as to increase competitiveness and reduce other perceived risks, including the threat of adverse government policies. An MNE may establish a foreign subsidiary, for example, to prevent rivals from pre-empting markets or sources of supply. Vernon (1994) argues that the follow-the-leader strategy typically found in oligopolistic markets helps to explain the sudden surge in Japanese-based MNE networks in Mexico, the United States, the United Kingdom, and Germany during the 1980s and 1990s.

An MNE's strategy is likely to be influenced by its country of origin. Encarnation (1994), for example, indicates that the establishment of majority-owned wholesaling subsidiaries, which can serve as distribution and purchasing agents, is central to the foreign-investment strategies of Japanese MNEs. Management and organizational differences between Japanese and western MNEs are also discussed by Westney (1994), and Kogut (1994) highlights the role of Japanese corporations in introducing lean production or “flexible specialization.” A different slant on the significance of country of origin is provided by Rugman (1994), who argues that differences in the scale of source and host markets can affect MNE strategy and that Canadian firms face a particularly formidable challenge in developing a “national responsiveness strategy” that will enable them to compete successfully within the much larger U.S. economy.

Sectoral considerations will also help to shape MNE strategies. In telecommunications, it is important for suppliers to establish a close relationship with the carriers that are major purchasers of telecommunications equipment. Amesse, Séguin-Dulude & Stanley (1994) show how, through

the decentralization of its manufacturing and R&D operations, Northern Telecom was able to forge close links with major carriers and successfully penetrate the U.S. market. The foreign investments of MacMillan Bloedel, as described by Vertinsky & Raizada (1994), were guided by a more diverse set of considerations that included the need to strengthen links with customers and sources of supply, and also to establish conglomerate linkages that would contribute to diversification and risk reduction.

As an alternative to undertaking foreign direct investment, firms may enter into strategic alliances. A survey by Magun (1996) finds that Canadian companies participate in alliances for many of the same reasons that they invest abroad – notably to gain access to new markets, to acquire new technologies or new resources, and to reduce financial risks. Alliances may be a response to host-government policies that constrain foreign investment or provide an advantage to local ownership. They provide a means for firms to take advantage of complementarities in situations where a merger or acquisition is not realistic or feasible. Also, as Globerman & Wolf (1994) point out, firms that lack product or geographic market knowledge may be attracted to a joint venture as an early-entry strategy into international markets undergoing rapid structural change.

Accounting for Recent Changes in FDI

While cyclical factors have an important influence on FDI – as evidenced by the slackening in world flows during the recession of the early 90s and the subsequent recovery in investment activity by the United States and, to a lesser extent, other Triad members – particular interest centres on the structural factors underlying the growth and changing pattern of FDI. The rapid growth of world FDI and the accompanying internationalization of business are partly a result of the pressures of increasing international competition and of the new opportunities created by the liberalization of state regulations and the privatization of state enterprises. The growth of MNEs has been facilitated by dramatic advances in computer and communications technology, which have reduced the costs and increased the possibilities for coordinating cross-border activities. As Rao (1993) points out, these developments have contributed to the evolution of global corporations in which production is rationalized on an international basis. This has involved situating discrete segments of the value-added chain where they can best contribute to corporate objectives such as cost minimization, innovation, market penetration or risk reduction; and it has also led MNEs to enter into alliances and other cooperative arrangements that can help them realize their objectives.

The general forces driving globalization have interacted with country-specific factors affecting the role of various economies as sources and hosts of FDI. The IC papers identify a number of factors that have been associated with recent changes in FDI patterns:

- Japan's development as a major source of FDI began with large investments in manufacturing and mining, following the removal of investment restrictions between 1969 and 1972. Much of this investment was in Asia and was prompted by the appreciation of the yen along with the desire for secure access to vital raw materials. In the 1980s, the United States became an increasingly important destination for Japanese FDI. Through FDI, Japanese firms protected themselves against the threat of U.S. trade restrictions. In addition, the rise in the value of the yen in the mid-80s made it desirable

to locate high-value-added production closer to major markets and to take advantage of the high returns on foreign investments in services and real estate (see Ries & Head, 1994; and Westney, 1994).

- The growing importance of Southeast Asia as a destination for FDI coincided with the strong economic growth in the region. More recently, the liberalization of China's foreign investment regime has opened up major new opportunities for foreign investment. Outward investment by the NIEs, beginning in the mid-1980s, was partly a response to currency appreciations and to labour shortages that necessitated a relocation and restructuring of activities (see Ahmad, Rao & Barnes, 1996; and Hirshhorn, 1996).

- The strong growth of investment abroad by Canadian firms during the 1980s reflected their high degree of responsiveness to growing investment opportunities in the United States and the European Union. This was, in turn, the likely result of such developments as the greater outward orientation of Canadian firms, the substantial need for foreign capital in the United States, and the threat of increased non-tariff trade protection both in that country and in "fortress Europe" (see Rao, Legault & Ahmad, 1994).

- The shift in the sectoral composition of FDI towards services corresponds with the growing importance of service activities in industrialized economies. Moreover, the relaxation of state controls affecting finance, communications, and transport have created new opportunities for MNE investment. In the case of Canadian investment abroad, the increasing importance of services corresponds with this country's significant comparative advantage in finance, insurance, and real estate (as noted in Knubley, Legault & Rao, 1994).

The forces driving the growth of FDI are also leading to increased trade. The complementary relationship between FDI and trade is indicated by Canadian trade elasticity estimates (with respect both to FDI in, and FDI from, Canada) developed by Rao, Legault & Ahmad (1994); by evidence for Japan gathered by Ries & Head (1994); and by empirical evidence for other countries reviewed by Graham (1994). In part, the observed growth in trade represents an increase in intrafirm trade. This, in turn, is a result of the growth of globalized production involving the integration by MNEs of specialized and geographically dispersed production processes. Eden (1994*a*) estimates that in 1990 intrafirm trade represented about 45 percent of Canada-U.S. merchandise trade, 50 percent of Canadian business service exports to the United States and two-thirds of Canadian business service imports from that country

While it is generally accepted that Canadian tariffs were a major factor in the initial decision of many foreign enterprises to establish miniature branch plants in Canada, the IC papers suggest that the response of MNEs to the removal of trade barriers depends on a complex set of factors. The Canada-U.S. Free trade Agreement (FTA) and the North American Free Trade Agreement (NAFTA) have created pressures for firms to reorganize and rationalize their activities within a North American context. These pressures are similar, although less pronounced, than those resulting from economic integration within Europe (Dunning, 1994). In reacting to these developments, North American MNEs are taking account not only of the potential for lower production and distribution

costs, but also of considerations such as relative market growth, the importance of sunk investment in existing facilities, and the implications of new, lean production technologies that increase the importance of locating activities close to customers (Vernon, 1994; Eaton, Lipsey & Safarian, 1994*a* and 1994*b*; Eden 1994*a*, 1994*b*, and 1994*d*). At the same time, firms outside North America have an incentive to position themselves within the newly created free-trade area – a factor that appears to have contributed to the growth of inward FDI in the United States rather than in, and possibly at the expense of, Canada (Globerman & Shapiro, 1997). Over time, the most important effect of agreements that provide more secure market access is to promote faster economic growth, which is favourable to both FDI and trade (Graham, 1994).

The growth in FDI has been accompanied by a growth in other transactions that support international production, including subcontracting, licensing, franchising, and alliances. These arrangements may be substitutes for FDI or they may be part of the strategy adopted by MNEs to improve international competitiveness. The significance of alliances in Canada and the United States is indicated by data compiled by Globerman & Wolf (1994) and Niosi (1994), while information on the use of R&D consortia – a specific form of alliance – is contained in Kumar & Magun (1995). In his study of strategic alliances, Magun (1996) identifies a number of factors behind the growth of alliances: globalization and the increasing interdependence of the world marketplace; technological trends that have resulted in shorter product cycles, increased fixed costs of product development, and greater interdependence between technologies; and the growing recognition that cooperation can help firms achieve innovation-led growth and contend with market risks. This is consistent with other studies cited by Globerman & Wolf (1994), which argue that technological and market changes are increasing the value of short-term, flexible arrangements for pooling resources and sharing risks. However, as Globerman & Wolf point out, there is only limited evidence documenting the presumed reasons for the growth of strategic alliances.

3. ISSUES FOR CANADA AS HOST AND SOURCE OF FDI

Canada as Host

General Considerations

An Evolving Policy

Inward FDI has been an important focus of Canadian policy over the years. In the early 1970s, following a decade of growing concern about the high degree of U.S. ownership in the Canadian natural resource and manufacturing sectors, the government created the Foreign Investment Review Agency (FIRA). FIRA screened foreign investment to ensure that both foreign acquisitions (which came under review in 1974) and new foreign businesses (which came under review in late 1975) conveyed "significant benefit" for Canada. Kudrle (1994) observes that the review process varied over time and that acceptance rates for proposed acquisitions became high in the agency's final years. In 1985, FIRA was replaced by Investment Canada and a more liberal foreign investment regime: the review of new businesses was discontinued (although notification was required), the threshold for review of acquisitions was set at $5 million in assets ($50 million for indirect acquisitions), and the approval criterion was relaxed so that transactions now simply had to convey "net benefits" for Canada. Investment Canada was also given the task of promoting FDI. In 1992, following assurances provided as part of the FTA, the threshold for review of direct acquisitions by U.S. investors was raised to $150 million, and export- and production-related performance requirements were abandoned.

Under NAFTA, these higher review thresholds were extended to Mexico and Canada's policy towards inward FDI was further liberalized. In exchange for similar commitments from the United States and Mexico, Canada agreed to treat investors from these countries no less favourably than it treats its own investors. The "national treatment" provisions were buttressed by a commitment to provide investors with "most favoured nation" treatment and to abide by the "minimum" standards for fair and equitable treatment under international law.

In 1994, Investment Canada was brought within Industry Canada. The threshold for reviewing foreign acquisitions, which is currently $172 million in assets, now applies to all investors from a member country of the World Trade Organization (WTO). Moreover, performance requirements placed on direct investments must adhere to national-treatment obligations included in NAFTA and to commitments contained in the recent WTO Agreement on Trade-Related Investment Measures (TRIMs).

The screening of foreign acquisitions now occurs within the context of Industry Canada's overall mandate for encouraging innovation and promoting industrial development. Industry Canada and the Department of Foreign Affairs and International Trade recently established Investment Partnerships Canada (IPC) as part of a new strategy to attract international investment. IPC employs campaigns aimed at encouraging new or increased investment by key multinational investors. The

new strategy also involves more focused marketing campaigns in major investing countries, an increased emphasis on helping small businesses establish investment partnerships, and the creation of new federal-provincial-municipal partnerships to attract investment.

The evolution of Canadian policy reflects changing public perceptions about the benefits and costs of inward foreign investment. The economic literature on FDI has supported this change in perspective. While it has long been recognized that FDI can help host economies acquire technology and other important assets, some of the earlier literature (notably Hymer, 1960) also fed concerns about the market dominance and potential political power of MNEs. More recent studies, by contrast, have noted the rivalry amongst MNEs themselves, along with the trend towards increasingly competitive global markets. Research on the economies of internalization has highlighted the role of MNEs as a vehicle for efficiently creating and transferring new technology. In addition, domestic research – especially the Macdonald Commission Report and studies – has drawn attention to the particular importance of an outward orientation for the continuing prosperity of a small developed country such as Canada.

The IC papers reinforce the conclusions emerging from recent research and support the direction of Canadian policy on FDI. They support the perception that Canada derives substantial net benefits from inward FDI and that the scope for government intervention to further increase the gains arising from individual transactions is limited. IC research suggests that the emphasis should be placed on creating a general policy environment that is favourable to inward FDI and to a fuller realization of technology transfers and the other benefits of foreign investment.

There is recognition – clearly expressed by Harris (1991) – that a mechanism (FDI) that is able to transfer technology and other benefits of foreign origin is also capable of facilitating the transfer of some "bad" or dubious goods. Concerns over the import of foreign ideas and influence, which were an important feature of Canadian policy debates throughout the 1960s and the early 1970s, still underlie the restrictive approach of Japan and certain other countries to inward FDI. The implications of the IC research, however, is that, except possibly in a few sensitive sectors, any accompanying "bads" are not likely to be of sufficient importance to detract from the overall benefits of inward FDI. In addition, there is doubt about the extent to which intervention can be successfully fine-tuned to capture the economic benefits and ward off the largely non-economic costs of foreign investment.

Costs and Benefits of Intervention

In assessing the role of transaction-specific intervention in an economic context, it is important, first, to consider whether a review agency such as FIRA or Investment Canada is likely to possess significant leverage. Where foreign firms are paying what they are prepared to pay for Canadian assets, performance requirements imposed by the government will cause foreign investors to either reduce their payment to Canadian shareholders and entrepreneurs or to redirect their investment to other countries. In the latter case, the economy will be denied the direct and indirect efficiency-enhancing benefits of the foreign investment.

It is also necessary to take account of the potential long-term economic costs of the foreign-investment regulations. If foreign MNEs perceive that the requirements imposed by the government are too costly or the approval process is too onerous, they may reduce their investment in Canada. Domestic investment could also be affected; as both Harris (1991) and Globerman (1994*a*) observe, by discouraging foreign acquisitions, government controls may reduce the expected payoff from investing in new high-technology ventures and thereby make it more difficult for new firms to acquire high-risk equity capital. Additional costs may be imposed on the economy if other countries react to Canadian controls by imposing requirements that discourage investment abroad by Canadian firms.

Evidence on the first issue pertaining to the policy leverage of a review agency is provided in a group of papers examining high-tech acquisitions. Globerman's (1994*a*) analysis of foreign acquisitions of Canadian high-technology firms, along with the accompanying discussion by Kierans, and Teece's (1991) study of acquisitions of U.S. firms in the Silicon Valley, suggest that international bidding markets are competitive and that foreign firms have generally paid around their reservation price for high-tech acquisitions. McFetridge (1991*a*) therefore concludes that R&D and other commitments that governments have secured from these firms were simply what was intended in any case; Canada's review agency did not bring about any incremental improvements in performance.

Evidence on the potential costs of FDI regulation is provided in a number of IC papers (Blomström, Teece, Baldwin & Caves; Baldwin & Gorecki, Bernstein, Preston, and Mcdougall) that document the benefits of inward FDI, and hence the losses from reductions in foreign investment. This evidence is relevant in assessing both the costs of potential miscalculations by the review agency that would lead foreign firms to abandon specific transactions and the more general costs of a regulatory regime that reduces the incentive for MNEs to invest in Canada.

Blomström (1991) discusses the benefits that host economies derive from technology transfers to MNE subsidiaries and spillovers to other host-country firms. The latter can occur through a number of channels: MNEs can increase the degree of competition, thereby forcing domestic firms to become more efficient; they may train labour and management, which will subsequently benefit other firms; and they can stimulate improvements in standards of quality and reliability by local input suppliers, as well as by local firms purchasing the products they introduce into the market. Blomström provides international evidence on the importance of these inter-industry and intra-industry spillovers. He also cites a number of studies suggesting that the more modern and complex the technology (and the greater the cost of leakage), the more likely MNEs are to transfer technology abroad using wholly owned subsidiaries. The implication is that FDI is a unique mechanism for gaining access to the latest technologies – one that is especially important for a country, such as Canada, that is heavily dependent on R&D undertaken in other countries.

Besides capital and technology, FDI may bring new management approaches and corporate governance arrangements. In his discussion of FDI in the Silicon Valley, for example, Teece (1991) observes how Japanese firms embedded in *keiretsu* structures have been able to adopt a longer time horizon than their American counterparts. As a consequence of their ready access to “patient” capital, along with their manufacturing skills and access to foreign markets, Japanese MNEs have

been able to add value to the high-technology enterprises launched by U.S. firms in the Silicon valley.

Specific evidence on the importance of FDI to Canada is provided in a study by McFetridge (1987) indicating that lags in transferring technology tend to be shorter when technology is transferred within a firm rather than through licensing and other external arrangements. Drawing on the history of the Canadian aircraft industry, De Bresson *et al.* (1991) illustrate how FDI can lead to technology transfers and spillover benefits to suppliers and other domestic firms. They observe that benefits have been more apparent where foreign entry occurred in the early stages of a technology cycle. Bernstein (1991) lends support to the view that MNE subsidiaries in Canada offer learning opportunities for domestic firms; he finds that intra-industry R&D spillovers generally lead to significantly greater cost reductions in foreign affiliates than in Canadian-owned firms.

Other evidence comes from studies of inward FDI in the form of mergers and acquisitions. While the results of U.S. research on the impact of mergers and acquisitions are ambiguous, evidence in the IC papers suggest that the effect of foreign mergers and acquisitions has been largely favourable when these are examined in an appropriate long-run context. The importance of a broad perspective is underlined in a study by Baldwin & Gorecki (1987) which suggests that, when they invest abroad, foreign corporations are less influenced by short-term profit expectations than with establishing a fit with their global operations. Baldwin & Gorecki (1991) find, in another study, that foreign takeovers increased productivity in Canadian high-technology firms over the 1970s, while Baldwin & Caves (1991) find that mergers and acquisitions, both foreign and domestic, have contributed to improvements in the performance of Canadian firms. Evidence analyzed by Mcdougall (1995) reinforces the importance of adopting a long-term perspective that takes account of the adjustment process through which foreign firms integrate the assets of the newly acquired enterprise. This adjustment tends to involve increased investment in physical and technological assets and often includes the sacrifice of short-term profitability.

A number of more general studies provide additional evidence. Data analyzed by Baldwin & Gorecki (1986) suggest that the prevalence of foreign investment has had a positive net effect on total factor productivity in Canada. The higher average productivity of foreign affiliates compared to Canadian-owned manufacturing firms is also indicated by the cross-section comparisons of Corvari & Wisner (1993). A comparison of foreign- and Canadian-owned establishments by Globerman, Ries & Vertinsky (1994) indicates that the superior performance of affiliates is not due to foreign investment in industries with above-average productivity growth rates; rather, the higher value added per worker of foreign affiliates is explained by their greater capital intensity and their larger scale of operations.

Preston & Saiyed (1996) demonstrate the positive impact that inward FDI can have on economic growth and jobs, using the WEFA Canada Macro Economic Model. Their study shows how the direct impacts of FDI are amplified through the responses that occur in the trade and domestic investment sectors of the economy and through the positive influence of foreign investment on total factor productivity. The authors' efforts to represent the highly productive nature of FDI in the model lead to the conclusion that additional FDI results in a substantial increase in economic growth at the margin and (even using more conservative assumptions) the creation of a substantial number of new jobs.

The potential contribution of FDI is also indicated by a study of R&D spillovers between U.S. and Canadian industries by Bernstein (1994). FDI is only one of a number of mechanisms through which Canada can capture the benefits of R&D spillovers, but it is a potentially important one. Bernstein's results indicate that R&D spillovers from the United States exert a greater influence on Canadian industries than do domestic spillovers and that they are the major contributor to total factor productivity growth rates in Canada. The study gives support to investment liberalization along with other policies that promote the transfer of knowledge from United States to comparable Canadian industries.

While some of these research findings are partial and tentative, the cumulative evidence points strongly towards the need for a policy framework that encourages inward FDI. The research results suggest that the downside risks from a regulatory regime that discourages inward FDI are likely to exceed the potential gains that can be extracted from commitments by individual foreign investors.

Two recent studies examine the relevance of these concerns to the foreign investment regime that existed in Canada under FIRA. Globerman & Shapiro (1997) find tentative evidence that FIRA restricted both capital inflows and capital outflows in manufacturing. Their results are not totally unequivocal, but the superior version fo their model suggests that FIRA may have acted as a modest protective barrier, making investment within Canada marginally more profitable for Canadian manufacturing firms and marginally less profitable for foreign firms. Suggestive (albeit weak) evidence of the deterrent effect of FIRA is also provided in a recent study by Kudrle (1995) examining U.S. FDI in Canada. Other findings from Kudrle's examination of FIRA lend support to those who question the ability of government regulators to effectively appropriate part of any rents earned by foreign investors.

While there may be situations in which, as Lipsey contends (1991), the government does have significant leverage and intervention can yield significant benefits – we consider some of these possibilities below – foreign investment policies must be applied with a sensitivity to the importance of ensuring a favourable environment for inward FDI. This has been recognized in the current Canadian approach to foreign investment review, where the emphasis on targeting the relatively small number of investment proposals that are seen to raise significant issues minimizes the potential for discouraging inward FDI. The IC research suggests, however, that government should now mainly turn its efforts to fashioning general policies that make Canada attractive to foreign investors and help Canadian firms better take advantage of FDI spillovers. These matters are discussed in the section entitled *Implications for General Government Policies.*

Specific Concerns

Securing the Gains from Innovation

Given the pressures that favour the centralization of R&D at the parent firm's headquarters, FDI could conceivably result in a reduction in R&D within Canada (Eaton, Lipsey & Safarian, 1994*a*). There is a trend towards greater dispersion of R&D as MNEs take advantage of advances in communication technology and respond to the competitive pressures to tap knowledge and

research skills in various countries. In 1992, however, according to the United Nations Conference on Trade and Development (UNCTAD, 1995), 87 percent of R&D expenditures by U.S. MNEs was still incurred in the United States.

R&D is a focus of policy interest because investment in R&D yields very high social rates of return. Bernstein (1994) estimates that Canadian social rates of return range from a low of 32 percent in transportation equipment to a high of 162 percent in nonelectrical machinery, and are between 2.5 and 10 times greater than private returns. Globerman (1991) argues that, given the high social rate of returns from R&D, the imposition of R&D performance requirements may be desirable even if foreign investors are paying their reservation price for Canadian assets; the social gains will exceed the losses from any associated reduction in payments to Canadian asset owners. This argument becomes less persuasive, however, when Bernstein's evidence on the importance of international R&D spillovers to Canada is taken into account. This latter evidence suggests that other Canadian firms will benefit from the positive externalities even if R&D is undertaken at an MNE's headquarters in the United States rather than at its Canadian subsidiary. It is far from clear that, even if MNEs could be induced to increase local R&D – a proposition challenged by Cantwell (1991) – the net gains from having R&D performed in Canada rather than the United States would exceed the costs (including the administrative as well as the longer-term costs discussed above) of government intervention.

A different case for government intervention arises from Cantwell's (1991) argument that FDI may hamper local innovation in sectors with an intermediate level of technological development. The concern is that MNEs will capture market share from local firms, which will then be weakened financially and forced to reduce their R&D. Both Safarian, in his comments on Cantwell's paper, and Lipsey (1991) question the evidence purporting to show the significance of this problem. Moreover, as Safarian points out, the requirements for a successful policy to protect local firms at this supposedly vulnerable stage of technological development are exceedingly demanding. Such policies, which would include discouraging MNE entry and restricting imports in specified sectors, would also conflict with Canadian obligations under various regional and international agreements.

Ensuring Competition

Another possible basis for intervention is to address concerns that FDI may create market power. While FDI often intensifies competition, foreign mergers and acquisitions may – just like domestic ones – be motivated by the desire to realize monopoly power, as indicated by Daniels (1991) and by Patry & Poitevin (1991) in their discussion of hostile takeovers. In some situations, the relevant concern may be the reduced competition in global markets. DeBresson *et al.* (1991), for example, warn about the potential anticompetitive effects in the international aircraft industry of takeovers of firms that have rival substitute models and designs.

The question is whether Canada's competition policy can adequately address these concerns. The analysis by Baldwin & Caves (1991) suggests that there is no reason for a policy bias against foreign takeovers. They argue that the economy benefits from the different skills that foreign enterprises bring as participants in the market for corporate control. This market is a particularly

important source of discipline for those producers who are subject to weak competition in product markets.

But while it may not be appropriate to place special hurdles in the way of foreign acquirers, foreign mergers and acquisitions do raise some distinct considerations. As Harris (1991) discusses, a foreign-owned domestic monopoly may entail economic costs for the country similar to those arising from a foreign monopoly exporting to Canada. Hence, in assessing a merger involving foreign control, it is not sufficient to ensure, as is done under Canadian competition law, that the resulting efficiency improvement more than offsets the impact of any lessening of competition. While efficiency improves, foreign owners may gain at the expense of Canadian consumers and Canadian welfare may decline.

On the other hand, the monopoly rents from a foreign takeover may primarily accrue not to foreign owners but to Canadian workers, so that efficiency gains do translate into an improvement in Canadian welfare. Alternatively, if the Canadian affiliate becomes a major exporter, it may be largely foreign rather than Canadian consumers who will support increases in Canadian wages and contribute to the increase in federal tax revenues arising from any resulting growth in affiliate profits. It would be extremely difficult to fine-tune the application of competition policy to take account of the welfare implications of transactions involving foreign ownership. Moreover, there may be little point in trying. If, as Lipsey (1991) contends, monopoly rents do tend largely to go to labour rather than capital, then, in practice, the welfare implications of foreign and domestic takeovers may not be very different.

Protecting the Interests of (non-shareholder) Stakeholders

Is a policy needed to protect the interests of Canadian employees, suppliers, customers, and creditors against the consequences of foreign takeovers? Changes in corporate management and control can clearly have important implications for the welfare of these groups. It is not clear, however, that foreign mergers and acquisitions are more harmful to stakeholders than domestic mergers and acquisitions or than a range of other events than can precipitate corporate reorganization and restructuring. Daniels (1991) finds that, although mergers and acquisitions generally (i.e., foreign and domestic) involve risks that stakeholders are unable to fully anticipate, the resulting harm is not a major or central feature of these transactions. He argues that there is no basis for a special policy to address the risks posed by foreign acquisitions. While there have been efforts to use the foreign-investment review process to extract commitments that protect stakeholders, binding commitments could prevent the rationalizations and restructurings that are needed to transform the organization into an international competitive operation.

Various provisions in corporate law and other legislation address the interest of stakeholders in major corporate changes. Daniels indicates that there may be possibilities for improving these safeguards. He argues that the best approach, however, lies in the development of adjustment programs aimed at helping employees and other stakeholders to get back on track, regardless of whether they are victims of an acquisition or of some other economic shock.

Limiting the Costs of Foreign Involvement in Sensitive Sectors

As Industry Canada (1994*a* and 1994*b*) and Kudrle (1994) show, all countries have limited foreign investment and/or applied special restrictions to the operations of foreign-owned firms in certain key sectors. The latter typically include finance, broadcasting, and cultural industries; telecommunications services; energy production and public utilities; transportation; and natural resource sectors. In addition, general legislation may allow the government to take action on national security grounds. In the United States, the Exon-Florio amendment to the *Trade Act* of 1988 allows the President to block an acquisition or takeover of a U.S. firm that threatens to impair national security.

While restrictions in Canada limiting the operations of foreign firms have been eased in some areas (telecommunications, transportation, energy, and finance), significant sectoral barriers to FDI remain. Canada is one of the few G-7 countries that does not allow foreign banks to establish branches on their territory, although the government has indicated its intention to introduce legislation that would allow foreign banks to branch directly (i.e., without establishing separately capitalized subsidiaries) in Canada and to review other aspects of its foreign-bank entry policy. While foreign investors are now permitted to own more than 25 percent of the outstanding shares in a Schedule 1 bank, the 10 percent ceiling on individual holdings, which remains in effect, effectively prevents control from being transferred to a foreign corporation. There is a 20 percent ceiling on foreign ownership of broadcast licences and a 33.33 percent limit on foreign ownership of the voting shares in Canadian cable and broadcasting holding companies. In the recent WTO Agreement on Basic Telecommunications, Canada agreed to remove foreign ownership restrictions in a few areas (global mobile satellite services, Teleglobe, and international submarine cable landings) but retained the direct and indirect limit of 46.7 percent on foreign ownership of the voting shares in Canadian facility-based carriers. The entry of foreign firms into book publishing and distribution is only likely to be permitted through a joint venture controlled by Canadian interests.

Such restrictions may have a significant impact on efficiency. For example, foreign purchasers may be in the best position to bring about the needed restructuring of a corporation. Alternatively, the free entry and unrestricted operation of foreign firms may be needed to inject some needed competition into an industry. A recent study by Globerman & Shapiro (1997) examines some of the impacts of policies restricting foreign ownership in the Canadian financial, oil and gas, and communications sectors. The authors' findings suggest that sectoral restrictions aimed at increasing domestic ownership in the oil and gas sector have limited the growth of the more productive foreign sector and reduced average industry productivity. They also find there is a "presumptive case" that restrictions on foreign ownership have helped to perpetuate an inefficient domestic insurance industry characterized by too many inadequately sized firms. In banking and telecommunications services, on the other hand, evidence suggests that domestic firms are highly competitive internationally, notwithstanding foreign ownership restrictions.

The IC papers offer limited guidance on how to assess the balance between the costs and benefits of sectoral restrictions. Both Globerman & Shapiro (1997) and Kudrle (1994), however, are sceptical that sectoral restrictions serve the national interest. Globerman & Shapiro emphasize

the difficulty of implementing policies that extract economic rent from foreign investors without, at the same time, discouraging foreign investment and thereby imposing a substantial cost on the economy. Kudrle takes particular issue with restrictions that (prior to the significant liberalization that took place in 1992) severely restricted foreign investment in the energy sector. He argues that activity in this sector can be easily monitored and there is little danger that a foreign enterprise could work against a host nation's interest "undetected and undeterred." The implications of past foreign ownership controls, Kudrle believes, is that Canada's energy production potential is less developed than would be the case with a more liberal investment regime.

The restrictions on foreign involvement in Canadian cultural industries raise complex issues that are not directly examined in the papers. Globerman & Shapiro (1997) note that the economic rationale for restrictions in broadcasting is to create rents that the broadcast regulator can then divert towards the support of domestic program content. These restrictions have traditionally been justified, however, not on economic grounds but in terms of the need to strengthen Canada's cultural and political sovereignty – although, as Globerman & Shapiro observe, the precise nature of the link between domestic ownership and sovereignty is far from clear.

Moreover, in reviewing sectoral restrictions introduced in the past, it is important to take account of the implications of globalization and advances in information technology. Policymakers must ask themselves whether, in the emerging environment of global economic activity and global information networks, investment restrictions continue to be effective and whether they still represent the most appropriate way to achieve specific social and cultural objectives.

While Canada has significant sectorial restrictions, unlike other G-7 countries it does not have general legislation that allows it to screen and, if necessary, block foreign investment on national security grounds. Frost & Graham (1994) argue that this omission needs addressing. There may be situations where it would be in Canada's interest to block foreign investment in defense-related activities. Another benefit, according to Frost & Graham, is that such legislation would help to ensure that Canada has input in the development of a harmonized North American policy regarding FDI and national security.

Responding to the Actions of other Governments

How should Canadian policymakers respond to strategic actions by a foreign government intended to provide advantage to its home corporations or to place Canadian firms with activities in its territory at a disadvantage? As Lipsey (1991) suggests, a laissez-faire approach may not represent the optimal Canadian policy under these circumstances. The design of a successful counterstrategy, however, is likely to be highly problematic. By responding in kind, the Canadian government could find itself involved in a dangerous game. As is often the case when governments are engaged in a process of policy competition, the outcome is likely to be socially undesirable policies that either offset one another and have little or no effect on the allocation of FDI, or cause resources to be misallocated internationally. The latter will be the result if the new initiatives cause MNEs to structure their global operations differently than they would on the basis of production and organizational economies.

While it is conceivable that Canadian interests will be less harmed if the Canadian government reacts than if it does not react, this is not certain. The appropriate answer lies in bilateral and multilateral agreements that limit the scope for strategic policy actions and the danger of costly intergovernmental conflicts. We revisit this issue in the chapter 4 entitled *International Issues*.

Canada as a Source of FDI

General Considerations

In contrast to the extensive discussions and debates surrounding the development of Canadian policy on inward direct investment, there has been very little attention to outward direct investment. There is less scope for government to intervene in the outflow of FDI. A system for reviewing outward FDI that would mirror the approach applied to inward investment through FIRA would handicap Canadian firms and unfavourably affect the climate for investment in Canada. But while a regulatory approach would be untenable, the government can still play a significant role. If outward FDI is seen as beneficial to Canada as a whole and not just to the investing firms, the government can ensure that its general policies are appropriately supportive of the globalization of Canadian business activities. It can, if necessary, develop policies to address any negative side effects from outward FDI. And if there are opportunities that are not being realized, it can provide information and support to help firms take advantage of the gains from outward FDI.

The IC papers help to address the questions that underlie the choice of an appropriate policy approach. Drawing on this research, we first look at the contribution of outward FDI. Does the evidence confirm that the growth of outward FDI is in the public interest? This is followed by a consideration of two possible justifications for government intervention. The most significant concern about outward FDI relates to its consequences for Canadian workers. Is there a need for the government to intervene to address the labour market issues arising from foreign investment? Second, provided that outward FDI is socially beneficial, is there a need for government to help Canadian firms identify and take advantage of foreign investment opportunities?

Outward FDI and Canadian Growth

The IC research supports the view that outward FDI contributes to the growth of the Canadian economy. Besides the general benefits that it provides to home countries by enabling them to participate in the globalization of business, outward FDI plays a special role for a country like Canada that requires access to foreign markets to overcome the limitations of its small domestic market.

A number of IC studies document the linkages between outward FDI and a more competitive and dynamic economy. Rao, Legault & Ahmad (1994) observe that the income receipts from Canada's growing stock of outward FDI made a contribution to income growth and improvements in its current account balance during the 1980s. They also find that the growth, productivity, and profit performance of outward-oriented Canadian firms has, on average, been superior to the performance of domestically oriented firms.

Globerman (1994*a*) attributes the higher profitability of outward firms to their increased efficiency, which, in turn, is partly due to their enhanced ability to exploit economies of scale and scope. The study of Northern Telecom by Amesse, Séguin-Dulude & Stanley (1994) shows that the market growth achieved through outward FDI supported larger-scale domestic operations and stimulated increased R&D in Northern Telecom's Canadian research facilities. Along with providing a larger output over which a firm can spread the costs of R&D and other overhead activities (i.e., industrial design, marketing, and advertising), the sales generated through FDI may facilitate rationalization in production. Lower costs may be achieved through increased specialization by the firm's Canadian affiliate, combined with a greater reliance on intrafirm trade.

Calculations by Rao, Legault & Ahmad (1994) indicate that the elasticity of exports to direct investment is positive and relatively high. Other evidence suggesting that outward FDI stimulates home-country exports comes from a study on Sweden by Blomström & Kokko (1994) and a paper on Japan by Ries & Head (1994). After reviewing the complex factors influencing trade impacts, Graham (1994) finds that the international evidence largely supports the conclusion that outward FDI and exports are complements rather than substitutes.

For firms in high-technology industries, a major benefit of outward FDI may be that it facilitates access to foreign skills and foreign technologies. The potential importance of technology access as an incentive for outward FDI is illustrated by Teece's (1991) paper examining Japanese investment in the Silicon Valley.

Some of the gains associated with outward FDI may spill over to benefit non-affiliated domestic firms. The latter could reap some of the benefits from increased spending on R&D in Canada. They may also benefit indirectly from the Canadian affiliate's improved access to foreign skills and foreign technology. The substantial benefits that Canada derives from international R&D spillovers, as indicated by Bernstein (1994), are in part due to the technology inflows that occur as a result of Canadian investment abroad.

While outward FDI can also promote the transfer of Canadian technology abroad, this should not give rise to significant concerns. The transfer of Canadian technology may occur because FDI is accompanied by the relocation of R&D activities from Canada to a host economy; or it may simply reflect the reverse operation of some of the general spillover mechanisms that have benefited Canada as a host economy. McFetridge (1994) finds that foreign investment by Canadian firms is generally not in R&D-intensive sectors. While outward FDI has led to some decentralization of R&D, some of this has been knowledge-seeking R&D that will ultimately benefit home-country suppliers and employees. The broader issue, as McFetridge observes, is that "as foreign direct investors go, Canadians are not particularly R&D oriented." The implication is that concerns over technology transfer should not detract from the generally positive assessment of the contribution of outward FDI to Canadian innovation and technology access.

From his general review of the evidence, Globerman (1994*a*) concludes that the most important effect of outward FDI may be on the composition of domestic economic activity. By encouraging increased R&D in Canada, promoting increased geographic specialization of production activities, and increasing employment opportunities for more highly educated workers, outward FDI

contributes to efficiency gains that are related in part to shifts in activity within Canada. Taking these and other effects into account, both Globerman and Raynaud (1994) conclude that the strong increase in outward FDI since 1980 has been a favourable development for Canada.

Policy Issues

Labour Market Concerns

Concerns have been expressed about the impact of outward FDI on both the level and the composition of employment in the home country. Those who allege that FDI reduces home-country employment focus on the short term and assume, often incorrectly, that outward FDI substitutes for domestic production. Gunderson & Verma (1994) show that arguments about the labour-displacing effects of FDI lose much of their force when one adopts a long-term perspective that takes account of the investment income generated by FDI and of the contribution of FDI to exports and increased efficiency within the home economy. While outward FDI may substitute for exports in the short run, it is not a long-term substitute. Gunderson & Verma suggest that outward FDI is properly viewed in the context of the restructuring that is needed in dynamic economies to ensure competitiveness and create jobs that are sustainable over the long term.

On the other hand, there is a need to give attention to the implications of outward investment for the composition of employment. Gunderson & Verma find that there is a consensus in the literature that outward FDI is beneficial to higher-skilled, white-collar workers and harmful to lower-skilled, blue-collar workers. FDI therefore reinforces the pressures emanating from global trade markets towards increased labour specialization and greater skill development.

Although outward FDI may give rise to some significant adjustment problems, there is no reason to distinguish these problems from the economic hardships arising from a range of other economic events. As discussed above in relation to foreign takeovers, the solution should not impede any restructuring and rationalization that may be needed – or as Daniels (1991) puts it, policymakers must not "shoot the messenger." Rather, the focus should be on generic adjustment programs that help the workers affected to acquire the human capital they require to be reintegrated into the labour pool.

Facilitating Outward Investment

There remain significant international barriers to the free flow of foreign direct investment. As one element of an overall approach aimed at facilitating outward FDI, the Canadian government should continue to work with other countries to help achieve a more liberal environment for international investment. We discuss this issue more fully in chapter 4.

In the domestic sphere, the need for government involvement is less clear. On the one hand, the strong growth in the stock of Canadian outward FDI over the last decade and a half suggests that Canadian firms have come to recognize the opportunities for reducing costs or improving market access that are afforded through foreign investment. As noted previously, however, most of this investment is accounted for by a relatively small number of Canadian MNEs. While such high

concentration is not unique to Canada, it does raise the possibility that there are firms outside the relatively small circle of active investors that could benefit from investing abroad.

The appropriate role of government in this area is, at most, a modest one. Governments must refrain from using incentives that could encourage the wrong type of outward investment. The proper focus is on facilitating outward FDI by firms that are prepared to invest abroad or would be prepared to do so if they were well informed. The government could usefully provide information designed to make firms aware of investment possibilities in various countries. It can also facilitate outward FDI by maintaining current programs intended to help Canadian firms understand legal and regulatory requirements in different countries, as well as the relevant customs and cultural characteristics. Given that there are opportunities for influencing investment decisions, such government involvement is justified both by the public-goods nature of information and by the positive externalities from Canadian outward FDI.

As part of its role in facilitating outward investment, the government could help Canadian firms identify potential foreign partners for strategic alliances. As Magun (1996) notes, some Canadian trade commissions abroad have already implemented proactive programs in this area. The Canadian consulate general in Detroit, for example, offers a "matching service" for U.S. and Canadian businesses seeking cross-border strategic alliances. Respondents to Magun's survey of Canadian firms involved in alliances indicated that they favoured a facilitative role by government. Respondents think there is a need to improve the expertise of Canadian trade commissioners so they may be better able to feed Canadian firms the background information they require on potential partners and to effectively fill a brokerage function.

Implications for General Government Policies

The research pertaining to both inward and outward FDI suggests that there is limited scope for policy measures directed specifically at foreign investment. The message of the IC papers is that the main focus of government should be on establishing an overall policy framework that is conducive to Canada's full participation in an increasingly competitive global economy. As Eden (1994*a*) points out, with an emphasis on establishing a favourable overall environment for global commerce, there is no reason to differentiate between inward and outward FDI. The need instead is for an integrated approach that recognizes the role that MNEs play generally "as investment bridges to the global economy and as agents of change within the Canadian economy" (Eden, 1994*a*, p. 31).

The challenge that Canada faces in adapting its general policies to these realities is twofold: first, there is a need to ensure that the country's social and economic infrastructure helps Canadian firms and Canadian workers to take full advantage of the opportunities arising from inward and outward FDI; second, there is a need to ensure that economic framework policies promote Canadian interests in an environment of globally mobile investment. We elaborate on these challenges below.

Establishing an Infrastructure that Enhances the Gains from Inward and Outward Investment

The IC papers indicate that the benefits the country derives from inward and outward FDI depend on a variety of factors, including the education and skills of its labour force, domestic managerial talents, the efficiency of capital markets, the strength of competition, and the adequacy of the mechanisms in place to facilitate economic adjustments. These factors will help to determine whether Canada is well positioned to attract investment – in particular, in high value-added, knowledge-intensive activities that offer high remuneration and tend to have significant spin-offs; whether Canada is realizing the potential benefits from FDI spillovers; and whether Canadian entrepreneurs and Canadian workers are likely to play a significant role in developing new ventures into successful global enterprises.

Economic and political stability are prerequisites for creating an environment that is conducive to MNE activity. As Eden (1994*a*) notes, multinationals dislike risk and there is, thus, a cost to excessive levels of government debt, inappropriate macro-economic policies, and political conflicts that raise questions about the future of Quebec and Canada. General policies designed to improve Canada's appeal to foreign investors must also address the trade barriers limiting access to the U.S. market. Despite the FTA and NAFTA, protectionist U.S. trade practices continue to be a problem, and there is anecdotal evidence that the resulting concerns have been influential in a number of decisions by major firms to locate new plants in the U.S. rather than Canada.

The role of government policy in establishing an environment that is conducive to R&D is discussed by Harris (1991). He observes that if R&D is scale-intensive, as well as intensive in the use of capital and labour, policies should be directed towards 1) keeping foreign markets open (to address the scale problem); 2) ensuring capital availability through low real interest rates and efficient capital markets; and 3) ensuring that workers meeting the high-skill requirements of today are available and that appropriate labour market practices are pursued. While Harris is concerned with how Canada can benefit from inward FDI, the policies he proposes would also encourage Canadian firms investing abroad to locate managerial and research activities in Canada – a subject that is a particular focus of concern in Brean (1994).

A different perspective on this issue is provided by Birkinshaw (1995 and 1996), who looks at the factors associated with mandates in Canadian subsidiaries. Mandates, in which a subsidiary undertakes a range of activities for the North American or the world market, are critical to subsidiaries' long-term growth prospects. Birkinshaw (1996) finds that mandates are earned and "it is the entrepreneurship and leadership of the subsidiary, and its underlying capabilities, that are the drivers of success" (p. 24). In terms of policy, what the studies underline is the importance of investment in the development of managerial capabilities and the creation of an entrepreneurial business culture.

The question of how a host economy can foster spillovers and continuing technology transfer is addressed explicitly by Blomström (1991). Based on a range of evidence, he points to the benefits of policies that support education and training in local firms and that promote competition. Competition forces the MNE to import more advanced technology, thereby increasing the potential

for spillovers, while education and training improve the absorptive capacity of domestic firms. These policies would also enhance this country's enjoyment of spillovers from the activities of Canadian-based MNEs. While Blomström's position on the role of domestic competition differs from that of Birkinshaw, it is consistent with other studies, including the research by Porter (1990), as well as the finding by Amesse, Séguin-Dulude & Stanley (1994) that inadequate competition in the domestic telecommunications service industry has hampered the development of world-class Canadian telecommunications equipment suppliers.

The suggestion that a country may be handicapped because it lacks the infrastructure needed to nurture world-scale enterprises is made by Teece (1991) in connection with foreign takeovers in the Silicon Valley, but it corresponds with concerns that have been voiced from time to time within Canada. Patel & Pavitt (1991) find that a comparatively high proportion of technological activity in Canada is accounted for by small firms and by individuals, as distinct from large firms. The concern is that the technological strength of small firms is not providing Canada with a corresponding advantage in the development of innovative global enterprises because of deficiencies in other areas. Possible problems include: the inadequate availability of high-risk equity capital; deficiencies in entrepreneurial and managerial talent; limitations in organizational arrangements and labour practices; and skill shortages along with an inadequate commitment to continuing education and retraining, a point emphasized in Wolf and Taylor (1991). Capital market inefficiencies are documented in *Financing Growth in Canada* (1997), an Industry Canada study edited by Paul J. N. Halpern. As Lipsey (1991) points out, the answer to concerns in this area is not to restrict foreign investment; it is to focus on policies that will improve the quality of Canada's economic infrastructure.

Promoting Canadian Interests in a World of Mobile Investment

In a world of highly mobile investment, Canada cannot design its tax and regulatory policies in isolation from those of other countries. Along with all the other considerations that go into the choice of an optimal tax or regulatory regime, policymakers must take account of the potential cost of tax or regulatory differences that reduce Canada's appeal as a business location.

The nature of this constraint is discussed by Gunderson & Verma (1994) as it applies to labour policy and by Mayer (1994) as it applies more generally to labour, environmental, and other social policies. As Gunderson & Verma point out, harmonization pressures do not apply to labour regulation that is aimed at improving the efficiency of labour markets; they primarily apply to regulations that reduce efficiency and protect rents. The latter regulations can be a problem if they lead to labour costs that are significantly higher than in other countries and FDI is responsive to labour cost differentials; the empirical evidence about the importance of these impacts is unclear, however.

Mayer similarly finds that concerns about the influence of regulation on business location decisions are difficult to substantiate. He observes that regulatory costs are a very small component of total costs for most industries; even in the more pollution-intensive industries, the cost of pollution control has been in the range of only 1 percent to 2.5 percent of total costs.

Both studies confirm that governments must take account of how their regulatory policies impact on corporate costs and thereby on plant location and investment decisions, but they also suggest that in this respect policymakers have more room for manoeuvre than is commonly appreciated.

The influence of corporate tax policies on investment location decisions is discussed by Halpern & Mintz (1991) and Brean (1994). The important factor in corporate location decisions, as Globerman (1994*a*) notes, is the effective burden of domestic taxes, net of the value of government services being provided. While Halpern & Mintz indicate the difficulty in measuring the influence of various tax differences between Canada and the United States on cross-border transactions, empirical evidence cited by Brean suggests that (given generally similar government services) differences in corporate tax policy do influence foreign investment decisions. Given the responsiveness of corporate decisions to tax differentials, policymakers are challenged to establish a tax system that is competitive internationally but that provides proper fiscal compensation for Canadian-based contributions to MNE profits and that, at the same time, is not overly complex to administer.

With respect to outward FDI, Canada, like most other nations, does not tax foreign-source corporate income. While Brean believes this is reasonable, he argues that there is a need to identify that portion of MNE income which is attributable to home-based activities, including headquarters activities and R&D. Currently such costs tend to be arbitrarily allocated to various products and places and to be written off. Brean believes that Canada is entitled to proper fiscal compensation for foreign-source rents generated by Canadian technology, much of which is developed with government assistance. He supports the use of R&D tax incentives, however, based on the evidence that they are effective in encouraging activities with a high social return. Indeed, Brean suggests that it may be reasonable to raise and/or broaden the R&D tax credit base.

The transfer pricing issues identified by Brean are one aspect of a larger problem that relates to the complex financial strategies that MNEs employ to lower their marginal effective tax rates. The efforts of MNEs to shift deductible costs to higher-tax jurisdictions and report income in lower-tax jurisdictions are also of concern to Canada as a host economy. Bilateral treaties have reduced the scope for conflict between governments in this area, but further international efforts are needed to establish fair rules to govern the determination and allocation of MNE profits.

4. INTERNATIONAL ISSUES

One of the more general conclusions to be drawn from the IC research is that some of the most important changes that are required in the policy framework governing foreign investment depend on action at the international level. In this chapter, we first review the evidence on the significance of formal and informal investment barriers in major industrialized nations. This is followed by a discussion of approaches for improving the international environment for FDI through rule-making and other measures.

Formal and Informal Investment Barriers in the G-7

Industry Canada (1994*a* & 1994*b*) provides a comprehensive analysis of formal and informal investment barriers among the members of the Group of Seven Industrialized Countries (the G-7). This is updated in Rao & Ahmad (1996). These papers indicate that, despite the progressive liberalization of formal rules applying to foreign investment, significant informal barriers within the G-7 continue to impede and distort foreign investment activities. The elimination of these informal barriers, which are associated with well-entrenched structural and organizational features within different economies, poses a formidable challenge.

Formal Barriers

The legislation of G-7 countries includes the following restrictions on inward FDI.

- *Prior authorization requirements.* Requirements for prior authorization of investment have been eliminated in Japan and reduced in France and Canada. France now only requires prior authorization when an investment might pose a threat to law and order or to public health and safety, or when it pertains to military technology or equipment. Canada has raised to C$172 million its review threshold for proposals from investors in WTO member states to acquire direct control of a Canadian business. The threshold for non-WTO investors is C$5 million.

- *Pre- or post-investment notification requirements.* Canada, France, Japan, and the United States maintain pre- or post-investment notification or verification procedures. In the last three countries, this process could lead to refusal or modification of the proposal. In Japan, prior notification is mandatory for FDI in most primary industries and other specified sectors, including those which have some relevance to national security. In the United States, notification requirements are related to the broad powers given the president under the Exon-Florio amendment to suspend or prohibit transactions that threaten national security.

- *Statutory powers to block FDI.* Germany, Italy, and the United Kingdom, which do not review inward FDI, have broad statutory powers to block inward FDI that is judged to

be a threat to national security or contrary to national interests. In Italy, these powers lie with the competition authority. In Germany and Britain, governments have not as yet exercised their broad powers to prohibit transactions.

- *Sectoral restrictions.* All G-7 countries have restrictions that limit the activity of foreign firms in various sectors. These apply mainly to service sectors – notably, financial services, transportation, telecommunications, and public utilities. While some sectors are largely closed to foreign investors (e.g., rail transportation in all countries except Japan; mining, and oil and gas in Japan), entry into other sectors is subject to reciprocity considerations (e.g., banking in all countries; oil and gas in Italy), and foreign involvement in a third group of sectors is conditioned by various ownership and/or operational restrictions (e.g., broadcasting, aviation and maritime transport in most countries). The financial services sector has experienced significant liberalization in all G-7 countries. On the other hand, restrictions applying to the transportation sector and to the mining, oil, and energy sectors have remained largely intact over the past decade.

Informal Barriers

In the category of informal barriers, Industry Canada researchers include a range of factors that impede mergers and takeovers by foreign investors. Significant informal barriers include:

- *Limited role of stock markets.* France, Germany and Italy have fewer listings on their stock exchanges than other G-7 countries. In addition, the market capitalization of listed companies is low in relation to the size of these economies. Hence it is more difficult for foreign investors to acquire control through stock purchases.

- *Concentrated ownership.* The highly concentrated pattern of stock ownership in France, Germany, and Italy is a significant barrier to contested takeovers. Concentrated ownership is also a feature of Canadian equity markets; it has been estimated that, in 1990, only 16 percent of the companies on the TSE 300 Composite Index were widely held.

- *The role of institutional investors.* In Japan, banks, insurance companies, manufacturers, and other institutional investors in 1990 held 72 percent of the shares of publicly owned companies, which is well above the level of institutional holdings in the United States and most other countries. As part of the *keiretsu* structure, groups of firms, generally including a financial institution, are linked to one another through cross-shareholdings, buyer-supplier arrangements, interlocking directorates, and worker interchanges. It is virtually impossible for foreign companies to complete a hostile takeover of a firm that is part of a *keiretsu* group. Institutional ownership is also important in Germany, where the banks have significant equity holdings that they can use to block foreign acquisitions. It is an issue as well, in Quebec, where the Caisse de dépôt et placement uses its considerable influence to ensure that important provincial enterprises remain in the province.

- *Restrictions applying to privatized firms.* A number of ownership and other restrictions have accompanied recent privatizations. For example, France placed a significant share of the equity of privatized companies in the hands of selected companies. The U.K. government established limits on foreign shareholdings of privatized companies and created "golden shares" that can be used to prevent changes in control. In Italy, the government holds golden shares in privatized corporations in telecommunications, defense, transportation, and other strategic sectors.

- *Authorized restrictions in voting rights.* Under company law in some counties, corporations can issue equity that eliminates or dilutes the voting rights of certain shareholders. In Canada, for example, many companies issue non-voting or subordinate-voting equity that allows effective control to be held by a group representing a relatively small proportion of all shares. In Germany, some companies have introduced clauses in their bylaws that cap the voting rights of a single shareholder to a certain percentage, irrespective of the number of shares held. In the United States, a number of state anti-takeover statutes have been passed which incorporate restrictions on the voting rights of any individual or group.

- *Use of antitrust policy to vet FDI.* In some countries, merger legislation has been used to review and, if required, block takeovers by foreign enterprises. The British government has used its merger law to block foreign takeovers on a variety of social and economic grounds. Investors from a non-EU country may be blocked from acquiring a British company because, as a result of the absence of reciprocity in that country, the transaction is deemed to be contrary to the public interest.

- *Lax administrative procedures.* The administration of foreign investment rules may be problematic because of a lack of transparency and the high degree of discretion accorded officials. In Japan, for example, foreign investors often learn about the terms and conditions under which their proposal is likely to be approved through informal "pre-notification discussions" with relevant ministry officials. In the United States, there are indications that takeover reviews under the Exon-Florio regulations are used to impose performance requirements on foreign firms. In France, the government has, on occasion, used its review powers to delay foreign takeover bids in certain key sectors in the hope that a French buyer would come forward.

While some of these informal barriers arise from the discriminatory application of public policy, some pertain to policies in which discrimination against foreign investors is not an issue. Other informal barriers are a product of corporate practices that are viewed within individual countries as being entirely consistent with the public interest. The latter two categories comprise more subtle barriers and raise issues that may be a matter of contention at the technical, as well as the political, level.

The difficulties in addressing informal barriers are illustrated by the issue of the Japanese *keiretsu* system. In Bergsten's (1994, p. 393) view, the "collusive behaviour among Japanese firms that make up the keiretsu system" are at the core of "the Japan problem." Bergsten recognizes that

keiretsu are not aimed primarily at foreigners. He also acknowledges the efficiency-enhancing benefits of some *keiretsu* practices, such as the cross-shareholding which helps to foster patient capital. His concern is with what he regards as anticompetitive and inefficient aspects of *keiretsu* behaviour – for example, upstream vertical integration that excludes suppliers outside the corporate family and downstream integration that may block the access of manufacturers to major parts of the Japanese distribution system.

The concerns raised by Bergsten are appropriately addressed through competition policy, and the United States has tried on a number of occasions to reach an agreement that would lead to the required reform of Japanese antitrust laws. It is not clear, however, to what extent the non-price vertical restraints used by keiretsu would be in violation of competition laws when they are evaluated, as in Canada, on a case-by-case basis using tests that allow broad scope for the consideration of potential efficiency gains. Ostry (1994) contends, more generally, that problems of investment access that are rooted in the nature of corporate governance will not be solved by competition policy. For the solution of these issues (which also arise, for example, because of the role of banks in Germany), what would be required is the harmonization of corporate governance systems along Anglo-Saxon lines, a development that Ostry regards as highly unlikely.

Improving the International Environment for FDI

Alternative Fora

Countries have attempted to establish a more favourable environment for foreign investment through a variety of bilateral, regional, and multilateral agreements. All existing arrangements fall well short of what is required.

The bilateral route is generally recognized to be the least satisfactory because of the costs and difficulties of negotiating a multitude of agreements with a large number of countries and of the potential for conflicts and inconsistencies between agreements. This approach is nonetheless highly popular. By mid-1997, there were more than 1,300 bilateral investment treaties (BITs) in existence. In addition, investment provisions are contained in bilateral trade agreements such as Canada's free-trade agreement with Chile. Foreign Investment Protection Agreements (FIPAs), as Canadian BITs are termed, delineate the respective rights and obligations of the signatories with respect to the treatment of foreign investment. The parties are generally obligated, for example, to list exceptions to the general rules of the agreement and to refrain from adopting new, more restrictive foreign investment measures that are not specifically allowed for in the document. FIPAs formalize the standard of treatment (i.e., minimum, national, or most-favoured-nation) to be afforded investment from the other country, and they establish conditions to govern expropriation.

Regional agreements may be a vehicle for the development of more general investment rules addressing the needs of countries with a common set of interests. One example of a regional approach is the Investment Code recently adopted by the Asia Pacific Economic Cooperation (APEC) group to promote the progressive dismantling of investment barriers by members and to support the increasing regional economic integration documented in Ahmad, Rao & Barnes (1996).

The investment principles, however, are non-binding, and the tentative way in which they are drafted allows member countries significant scope to pursue their objectives through restrictive policies.

Chapter 11 of the NAFTA represents a much more substantive attempt to reduce regional investment barriers. It incorporates national-treatment rules that prohibit most performance requirements and that apply to states and provinces as well as to national governments; it outlaws expropriation without internationally generous compensation; and it disallows nationality restrictions for managers. In addition to the provisions for intergovernmental dispute settlement, the agreement contains rules to provide for investor-state dispute settlement. While the agreement contains many exceptions to the right of national treatment, these are made transparent through the use of a "negative list," and the parties are committed not to expand the list in the future. Although it is in some respects a model of rule-making, the NAFTA still only focuses on a limited range of the issues that impede international investment.

Multilateral fora for the discussion of investment issues include the Organisation for Economic Co-operation and Development (OECD) and the World Trade Organization, specifically the WTO Working Group on Trade and Investment. Most industrialized nations are currently signatories to the OECD Code of Liberalisation of Capital Movements, the Code of Liberalisation of Current Invisible Transactions, and the National Treatment Instrument, which promote non-discrimination and investment liberalization. However, as Rao & Ahmad (1996, p. 179) observe, "the `reservations' and `derogations' to the codes and `exceptions' and `transparency items' under the National Treatment Instrument allow OECD countries formally to restrict the investment activities of nonresident firms and already-established foreign-controlled firms within their jurisdictions." As a result of the Uruguay Round negotiations, two new investment-related agreements came into force in 1995. The General Agreement on Trade in Services (GATS) addresses foreign investment restrictions in service activities but is limited in its requirements and coverage. The Agreement on Trade-Related Investment Measures (TRIMs) emphasizes the need for performance requirements imposed by host governments to comply with various WTO obligations, including especially "national treatment."

Current interest focuses on the proposed Multilateral Agreement on Investment (MAI) currently being negotiated by Canada and the 26 other members of the OECD. A MAI could serve as an example for the subsequent negotiation of a WTO investment agreement that would be subject to WTO enforcement procedures and dispute resolution mechanisms. Efforts to establish a comprehensive multilateral framework are based on a recognition of the advantages of "a stable, predictable and transparent" system in "facilitating the growth of investment flows and their contribution to development" (UNCTAD, 1996, p. 166). The UNCTAD report also states (p. 166) that "a global economy requires a global policy framework, including a set of rules that is consistent for trade and investment issues." Moreover, as Ostry (1994) points out, a multilateral approach avoids the dangers that investment rules will be worked out by powerful countries through bilateral arrangements that take little account of the interests of smaller nations.

Issues to be Covered

What issues need to be addressed in a reasonably comprehensive multilateral or regional investment agreement? The IC papers offer some guidance in answering this question.

Basic Rules

The basic principles that should form the core of an investment accord have received a considerable degree of attention over the years, and they have been a focus of recent deliberations among OECD members over the proposed MAI. It is generally accepted that an investment agreement should be based on: 1) the right of "national treatment" for foreign investors; 2) guarantees that assure foreign investors that their investment interest will be protected according to a clear set of rules; and 3) dispute settlement mechanisms that provide for the settlement of not only intergovernmental disputes but also, as in the NAFTA, investor-state disputes. These principles are central to the current MAI negotiations, which are scheduled to conclude in May 1998.

Some observers have pointed to the need for broad national-treatment guarantees that would prevent countries from discriminating against new investors through performance and operational requirements (e.g., laws restricting the residency of directors or impeding the entry of foreign executives). Under the MAI, countries will be allowed to lodge exceptions to the basic rules regarding, for example, the right of entry or the right of existing foreign investors to be treated equivalently to domestic firms. There is considerable support, however, for having these exceptions transparent and defined as precisely as possible. As Ahmad & Rao (1996) point out, it is important to avoid vague and broadly defined exceptions, such as the national-security provisions in the United States under the Exon-Florio authority. Wilkie & de la Mothe (1996) emphasize that a broad national-security "carveout" could provide a "smoke screen" to hide exclusionary investment policies and undermine the achievements in other parts of the investment accord.

The development of international rules that effectively limit the use of costly and distortionary subsidies constitutes a particularly challenging issue. The WTO Agreement on Subsidies and Countervailing Measures focuses on trade subsidies but, as Wilkie & de la Mothe (1996) point out, it is also makes a start in addressing subsidies that are of concern in an investment context. An expanded set of rules could build on the efforts of the OECD, through its *Industrial Subsidies Reporting Manual*, to classify subsidies and promote a high degree of international transparency.

In addition to the other basic requirements of an investment accord, some observers have emphasized the importance of a commitment by signatories to roll back sectoral and other restrictions that are part of an "exceptions list" according to a specified timetable. For Canada, this would mean going beyond its commitments in the NAFTA, where specific safeguards were included to address concerns about foreign ownership of Canadian cultural, transportation, energy, and other sectors.

Competition Policy

A number of the private barriers to investment that are discussed in the section below entitled *Formal and Informal Barriers in the G-7* are appropriately addressed through competition policy. An agreement on competition policy would have other benefits: it would help to eliminate frictions between governments arising from differences in the substance and implementation of competition law; it would allow countries to cooperate in addressing issues relating to MNE activities that affect them jointly; and it could help to ensure that trade remedy laws, notably antidumping duties, do not become disguised forms of protection for domestic firms.

Policy concerns in this area can be addressed through an international agreement on competition policy principles or, as in the European Union, through the establishment of a supranational competition policy commission. In relation to APEC, Hirshhorn (1996) believes that the most that could reasonably be hoped for in the foreseeable future is an agreement on principles. Members could be encouraged to achieve a consensus on the purpose of competition policy and on the major issues to be addressed; to adhere to the principles of non-discrimination and transparency; and to accept that enforcement must be subject to due process and the rule of law. The agreement should also cover the procedures that countries would follow to minimize conflicts and to facilitate a cooperative approach on competition matters with impacts that extend beyond national boundaries. An agreement on competition policy principles is also a reasonable long-term objective at the multilateral level.

In the case of the NAFTA, Graham & Warner (1994) believe that the establishment of an independent competition policy commission is feasible and desirable. Unlike the EU competition authority, their proposed North American Competition Commission (NACC) would not have judicial powers on antitrust matters; it would be confined to issuing court-enforceable decrees based on its findings. But like the EU Commission, it would have extensive powers to regulate state subsidies, including subsidies at the subnational level, which, as Brean (1994) notes, have become an increasingly important form of investment distortion. If a supranational authority could be established with the power to prevent bidding competitions that tend to make all countries worse off, it would be a major accomplishment.

Technology Issues

Intellectual property. Significant progress has been made in reducing policy frictions in the area of intellectual property (IP), partly as a result of the recent TRIPs agreement signed within the Uruguay Round. Hirshhorn (1996) observes that although the relation between the strength of a country's IP protection and its inward FDI is unclear, MNEs are less likely to transfer or license advanced technology to firms in economies with less effective IP protection. Hence the recent improvement in IP policies in developing and newly industrializing economies should influence FDI patterns.

TRIPs, however, did not achieve consistency in IP laws. Ostry (1995) argues that there is a need to try and reduce the growing transaction costs faced by high-tech firms in dealing with a number of different national IP systems. She sees harmonization as desirable because it would

greatly simplify international business and also because it would force the resolution of some significant outstanding issues that could be a source of future conflict.

R&D consortia. Government-private research consortia, which have become increasingly popular vehicles for promoting research on "pre-competitive generic technologies," have become a source of friction because of the different rules that countries have established regarding the participation of foreign subsidiaries in domestic projects. Membership in EU projects is negotiated on a case-by-case basis, and foreign subsidiaries must comply with certain "unofficial" conditions (Ostry, 1995). In the United States, foreign participation in government-sponsored technology programs depend, in part, on how the U.S. government views the openness and fairness of the policies adopted by the subsidiaries' home government. While these problems would be resolved by an agreement guaranteeing foreign investors the right of national treatment, Ostry (1995) is doubtful that a suitably comprehensive accord can be achieved. She therefore opts for a two-stage process involving, first, the development of a comprehensive inventory of rules governing membership of foreign subsidiaries in government-sponsored research consortia; and second, the negotiation of an international code that would harmonize rules in this area.

International cooperation in basic research. Ostry (1995) believes that the combination of intense global competition and the diminished ability of firms to shield their research findings from rivals is driving companies out of the basic research business. She sees pre-competitive generic research moving closer to the market phase of innovation. As well, in the United States there is increasing pressure on universities and government laboratories to shift their research towards projects with foreseeable commercial benefits. Ostry proposes that efforts be devoted to documenting the extent of this potential negative spillover of globalization and the increased rivalry among high-tech firms. If there is indeed a significant problem that has implications for global welfare, it will become necessary to work out rules and mechanisms to promote basic research and govern the international sharing of costs and benefits.

Taxation

As well as using subsidies to attract investment, governments may compete for foreign investment through their tax policies. International agreements can help to reduce investment distortions arising from tax policies and contribute to a more stable environment for international investment. Cooperative arrangements can also reduce transfer-pricing manipulations and help to ensure that governments receive their proper share of tax revenues.

The potential for tax conflicts has been reduced thanks to the adherence of most industrialized economies to the OECD's model tax conventions and to the existence of a large number of bilateral tax agreements based, in part, on the OECD principles. However, there remain many issues that are not adequately addressed by bilateral agreements or by regional agreements such as the NAFTA. Vernon (1994) believes that by contributing to the increased integration of North American economies, the NAFTA is, in fact, likely to exacerbate some tax problems, such as the valuation of intracorporate transactions and the determination of which unit of a multinational enterprise should be credited with a given sale to an outside buyer.

Investment agreements need to incorporate mechanisms that promote transparency and contribute to a more consistent international approach for addressing transfer-pricing issues and related problems. As regional economies become more integrated, however, some observers believe there may be merit in explicitly recognizing their interdependence by harmonizing tax policies. Tax harmonization by the NAFTA members could facilitate efficient decision-making by North American MNEs. It would also result in a cooperative approach to policymaking that could conceivably enable Canada to exercise more influence over the setting of tax policy than would otherwise be possible in a highly integrated North Mexican economy.

Environmental, Labour, and Social Regulations

As the NAFTA experience illustrates, investment agreements leading to increased economic integration are likely to be accompanied by pressures for the establishment of minimum standards with respect to environmental, labour, and social regulation. In the NAFTA, concerns about the impact of differing regulations and the possible erosion of environmental and labour standards were addressed by the creation of a new regional regulatory regime. The establishment of a political infrastructure at the regional level can be seen as part of an attempt by the North American governments to respond effectively to business activities that are highly integrated at the regional level.

In contemplating the possibility of “a deeper and broader regional infrastructure,” Mayer (1994, p. 522) argues that those who worry about the impact on national sovereignty may be missing the larger point. He notes that “national sovereignty has been undermined for some time.” Broad-based agreements such as the NAFTA may provide an opportunity to correct the balance:

> Rather than contributing to the further empowerment of private actors it may, in fact, be the beginning of a recapture of power by states, either by facilitating greater cooperation among them or by creating supranational institutions capable of addressing social issues on a regional basis. To the extent that economic activity – trade and investment – becomes increasingly regional, rather than national or global, what may develop is a political architecture more coincident with the economic landscape.

5. CONCLUSION

The IC research papers provide substantial evidence documenting the benefits for Canada from the growth of foreign investment and the increasing globalization of business activities. Since Canada could not realistically isolate itself from those trends, it is reassuring to know that the growth in inward and outward investment has been consistent with Canada's needs as a small economy that is highly dependent on foreign capital, foreign skills, foreign technology, and foreign markets.

The research suggests the gains from policies aimed specifically at foreign investment are likely to be limited. It supports the evolution of Canada's general policy on inward FDI towards the current flexible and highly selective regime in which there is a recognition that efforts to extract concessions from foreign investors must not significantly discourage or distort foreign investment. From the research, one might also expect that programs aimed at promoting inward investment and facilitating outward investment, along with strategic alliances between Canadian and foreign enterprises, have a useful role – although the studies did not provide evidence that major opportunities are being overlooked by foreigners investing in Canada or Canadians investing abroad. While the sectoral limits on inward FDI, which are the remaining highly restrictive aspect of Canada's foreign investment regime, are not fully assessed, the research does give rise to questions about the benefits of these restrictions and whether they justify the costs from reducing foreign investment. These costs need to be considered, as well, in assessing the role of investment restrictions as part of a strategy designed to counter the actions of other governments and increase Canada's leverage in bilateral and regional negotiations.

For the future, the government should concentrate on setting appropriate general policies and on working with other governments to create a more favourable international environment for foreign investment. With respect to general government policies, two challenges need to be addressed.

The first involves the creation of an economic infrastructure that enhances the economy's ability to benefit from inward and outward FDI. Important factors include the education and training available to workers and managers, the efficiency of capital markets, the existence of competitive domestic markets, secure access to the U.S. market, and the availability of mechanisms to facilitate economic adjustments.

The second challenge involves the design of tax and regulatory policies that will promote Canada's interest in a world of mobile investment. In developing environmental, labour, and social regulations, policymakers are not constrained to follow the lead of other countries, but they must consider how their decisions affect the relative costs and benefits of doing business in Canada. In the case of tax policy, the challenge is to design a regime that will recognizes the responsiveness of investment decisions to intercountry differences in net tax burdens while also taking account of Canada's interest in realizing proper fiscal compensation for the contribution of domestic factors. Based on these considerations, the research raises questions about current provisions that allow Canadian-based multinationals to write off headquarters costs and the costs of R&D undertaken in

Canada. Attention also needs to be devoted to transfer-pricing problems that apply to inward foreign investment and that affect Canada's tax revenue as a host economy.

Internationally, the movement of foreign direct investment has been impeded by a wide range of formal and informal barriers. Current deliberations could lead OECD members to adopt a MAI that would incorporate recognized rules relating to such matters as right of entry and right of national treatment. A MAI, however, will not lead to the “deeper integration” that is needed to get at some troubling indirect and informal investment barriers. Therefore, as well as contributing to current multilateral efforts, Canada must continue to work with other countries to develop rules covering relevant issues in the areas of competition policy, technology policy, taxation, and environmental and labour regulation. The focus should be on pursuing opportunities both regionally and multilateral to reduce intergovernmental frictions and create an environment that fosters efficient international investment decision-making.

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