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ASSESSING CANADA'S ABILITY TO COMPETE FOR FOREIGN DIRECT INVESTMENT

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Assessing Canada's Ability to Compete for Foreign Direct Investment

Abstract

The main purpose of this report is to assess Canada's performance in attracting foreign direct investment inflows. The study reviews the literature on the benefits of FDI, analyses global and Canadian trends in FDI, identifies various factors affecting the inflow of FDI, and details how Canada ranks relative to other major OECD countries on the most influential factors. Canada's share of world FDI has fallen markedly since 1980. The report finds that this development reflects the opening of other countries to FDI rather than a hostile climate for FDI in this country. Indeed, there is no one factor that can be identified as seriously impeding the flow of FDI to Canada. The report identifies a number of areas where Canada can potentially improve its attractiveness to FDI, including possible changes to FDI regulation, a more competitive tax regime, better infrastructure, and certain improvements in the human capital area.

Assessing Canada's Ability to Compete for Foreign Direct Investment

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Assessing Canada's Ability to Compete for Foreign Direct Investment

Executive Summary

The aim of this report is to assess Canada's ability to compete for foreign direct investment (FDI). It examines global trends in foreign direct investment, analyzes Canada's performance in attracting such investment, and suggests ways to make Canada a more attractive destination for foreign capital. Accordingly, section I discusses the theoretical underpinnings of the costs and benefits of FDI, and conditions necessary to maximize a country's gain from inward FDI. Section II provides an overview of global and Canadian trends in FDI, assessing Canada's relative performance in attracting foreign investment. The next section reviews the factors that affect inward FDI into a country. Section IV, the longest in the report, evaluates where Canada stands with respect to the factors influencing the decision of firms to undertake FDI. It does so by reviewing, among others, indicators of business environment and Canada's position in world rankings as well as by providing an overview of FDI regulations in Canada, comparing the level of restrictions to other G7 members. Finally, section V concludes with possible government action to build on Canada's existing advantages and develop new ones.

The report finds that the post-1980 decline in Canada's share of global FDI reflects the opening of other countries to FDI rather than a hostile climate for FDI in this country. Indeed, there is no one factor that can be identified as seriously impeding the flow of FDI to Canada. The report identifies a number of areas where Canada can potentially improve its attractiveness to FDI, including possible changes to FDI regulation, a more competitive tax regime, better infrastructure, and certain improvements in the human capital area.

Key findings are highlighted below.

Global and Canadian Trends in Foreign Direct Investment

- In 2006, global FDI inflows reached \$1,306 billion USD billion, the second highest level ever recorded and just \$135 billion USD short of the peak reached in 2000. Increased cross-border mergers and acquisitions (M&A) activity was responsible for much of the rise in global FDI. These transactions rose significantly, both in number and value, approaching the previous M&A peak in 2000.
- Canada performed rather poorly in terms of its long-term average annual growth rate of FDI stock over the period 1990-2006 compared to the U.S. and major country groups. As a result, Canada's share of world FDI stock has declined over the period, going from 6.3 per cent in 1990 (and 9.6 per cent in 1980), to 3.7 per cent in 2000, and 3.2 per cent in 2006.

- Canada's performance in attracting FDI looks much better when one considers FDI *inflows*, rather than *stocks*. Annual FDI *inflows* into Canada increased in absolute terms from 2002 to 2006, from \$22.1 billion USD to \$66.6 billion USD, representing a compound average annual growth rate of 31.7%, which was higher than the growth rate in many other countries.
- Foreign acquisitions in Canada have risen both in value and number since 2003. In 2006 the value of foreign acquisitions in Canada reached \$114 billion CAD – the highest value in the last decade.

Canadian Performance in the Most Influential Factors Affecting FDI Inflows

- Canada has the highest proportion of working-aged adults with post-secondary degrees among OECD countries, a positive factor for attracting FDI.
- Labour productivity growth in Canada, compared to other major OECD countries, has been weak. In addition, Canadian business R&D expenditure as a percentage of GDP is below average. It is however unclear how important this situation is for FDI location decisions. Foreign businesses can largely influence their own productivity and innovation performance since they organize the production process and control R&D spending.
- Although Canada stands in good stead in terms of its physical infrastructure, there are some indications that its position may have slipped compared to some other countries.
- The marginal effective tax rate on capital for large and medium sized corporations was 30.9 per cent in 2007. This is a high rate, although it is rapidly declining (down from 39 per cent as recently at 2005) and is expected to decline more in the near term.
- Canadian macroeconomic performance and public finances have been strong in recent years. Despite a market currency appreciation, the Canadian economy experienced solid growth in recent years, reflecting sound macroeconomic policies.
- The World Bank report *Governance Matters 2007*, taken together with the *Global Competitiveness Report 2006-2007* from the World Economic Forum, suggests that the problem with Canadian business regulation is not its level, but the time-consuming and bureaucratic nature of the process of compliance.
- The quality of life in a country is an important, though often implicit determinant of FDI location choice. Canada has consistently scored well in the UNDP's human development index, which combines social and economic well-being into a composite index.
- The World Economic Forum's *Global Competitiveness Report*, which takes into account international attractiveness of countries to foreign investors, ranked Canada 16th out of 125 countries in the 2006-2007 report, down from 13th in the 2005-2006 report. Among G7 countries, France and Italy performed worse than Canada.

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Assessing Canada's Ability to Compete for Foreign Direct Investment¹

Introduction

The global business environment is changing. Increased economic integration and trade liberalization have given rise to a business model in which trade is increasingly confined to intermediate inputs, and investments are made around the world to tap into location-specific advantages.² Improvements in information and communications technologies and lowering of transport costs allow for each stage of production to be located anywhere in the world where it can be conducted most efficiently. It is therefore not surprising that foreign direct investment (FDI) inflows reached the second highest level ever recorded in 2006, with developed countries, developing countries, and transition economies all registering growth in inflows. While Canada has recovered from its FDI inflow slump in the period 2002-2004, its global share of FDI stock has declined significantly over the long-term. On the other hand, developing economies in Asia and Latin America, and Southern Europe along with CIS countries have all increased their share of world FDI stock. A key issue is whether our falling share of world FDI represents a failing on the part of Canada or rather a natural development associated with the opening up of investment opportunities in other countries. In any case, the challenge for Canada is to adapt to this new economic environment, and become the destination of choice for high-value activities within global supply chains, which is essential for the long-term prosperity of Canadians.

The aim of this report is to assess Canada's ability to compete for foreign direct investment (FDI). It examines global trends in foreign direct investment, analyzes Canada's performance in attracting such investment, and suggests ways to make Canada a more attractive destination for foreign capital. Accordingly, section I discusses the theoretical underpinnings of the costs and benefits of FDI and the conditions necessary to maximize a country's gain from inward FDI. Section II provides an overview of global and Canadian trends in FDI, assessing Canada's relative performance in attracting foreign investment. The next section reviews the factors that affect inward FDI into a country. Section IV, the longest in the report, evaluates where Canada stands with respect to the factors influencing the decision of firms to undertake FDI. It does so by reviewing, among others, indicators of business environment and Canada's position in world rankings as well as by providing an overview of FDI regulations in Canada, comparing the level of restrictions to other G7 members. Finally, section V concludes with possible government action to build on Canada's existing advantages and develop new ones.

¹ The authors would like to thank Kellie Fong and Ron Hirschhorn from the Competition Policy Review Panel for comments on an earlier version of the paper and Alex Murray from the Centre for the Study of Living Standards for editorial assistance.

² A detailed discussion on the rise of global value chains is presented in DFAIT (2007).

I. The Impact of Foreign Direct Investment

The importance of foreign direct investment (FDI) for long-term development is widely accepted among economists. Both economic theory and empirical evidence suggest that FDI has a beneficial impact on host countries through the generation of employment, the rising of productivity levels, the transfer of skills and technology, and the increase of exports. In addition to benefits, a number of potential costs of FDI have been identified, including loss of head office and ancillary functions, loss of sovereignty, loss of national icons, and less research and development. This section discusses both the benefits and costs that are thought to be associated with FDI. The objective of this section is not to provide a comprehensive assessment of the benefits and costs of FDI, but only to highlight the issues involved.

A. Benefits of FDI

The benefits of FDI to host countries do not accrue automatically. An enabling domestic business environment, which encourages both domestic and foreign investment and provides incentives for innovation and skills upgrading, is essential to reap the maximal benefit from FDI. Factors that can hold back the realization of the benefits of FDI include low health and education levels in the labour force, weak competition, insufficient openness to trade, and inadequate regulatory frameworks in the host country. It is therefore useful to consider the potential benefits of FDI in the context of the environment that enable these benefits to be realized.

- **FDI and Growth:** Most empirical studies find that FDI improves factor productivity and income growth in a host country, beyond what would be otherwise possible. However, the magnitude of this impact is generally difficult to assess empirically. It is also unclear if the positive effects of FDI are dampened by a partial “crowding out” of domestic investment. Nevertheless, even when crowding out does take place, the net effect of FDI generally remains beneficial.
- **Trade and Investment:** FDI integrates the host economy more closely into the world economy. Trade and FDI tend to be mutually reinforcing channels for international trade, resulting in both higher imports and exports in the long-term. A country’s ability to attract FDI depends significantly on the abilities of multinational enterprises (MNEs) to engage in import and export activities. Host countries can attract FDI by following policies of regional trade liberalization and integration.
- **Technology Transfers:** According to economic theory, technology transfer is the main channel through which FDI boosts productivity, both directly by the impact of the superior technology of the foreign investor on the host country’s productivity and indirectly through externalities created by the foreign investor in a host country. Such externalities related to technology transfer and diffusion work through several channels: linkages of foreign firms with suppliers and purchasers in the host country (vertical spillovers), linkages with competing or complementary firms in the same industry (horizontal spillovers), migration of skilled labour, and internationalization of R&D.

Empirical literature finds stronger evidence for vertical spillovers than horizontal ones. A possible explanation for this may be the efforts by foreign enterprises to limit knowledge spillovers to competitors. It is important to note that for technology transfer to create positive externalities, the technologies need to be relevant to the host country business sector. Furthermore, evidence suggests that the ability of host-country enterprises to absorb the technology transferred via MNEs depends on their technological level not being substantially different from that of the foreign investors.

- **Human Capital Enhancement:** FDI affects human capital formation indirectly through host country government policies to attract FDI, and directly through the training opportunities provided by foreign enterprises. Foreign enterprises may also enhance the human capital in other enterprises with which they develop links. Investment in human capital is vital for creating an enabling environment for FDI. However, it should be noted that the beneficial effects of FDI on human capital are a supplement to, not a replacement for, the overall efforts of a country to enhance the skill levels of the general population. While empirical evidence shows that MNEs tend to provide more training and upgrading of workers than domestic firms, evidence of spillovers is much weaker.
- **Competition:** FDI can spur competition in domestic markets, leading to higher productivity, lower prices, and a more efficient allocation of resources. However, foreign investment taking the form of mergers and acquisitions (M&A) can increase market concentration, which can be anti-competitive. In addition, evidence suggests that the magnitude and dispersion of spillovers from FDI on competition are likely to be positively related to prevailing levels of competition in the country. Host-country governments should ensure that policies are in place to safe-guard a healthy degree of competition. Trade liberalization, competition laws, and enforcement agencies can ensure that sufficient competition exists in the market, thereby protecting consumers.
- **Enterprise Development:** FDI can promote enterprise development in the host country through efforts of MNEs to raise efficiency, reduce costs, and undertake new activities in the domestic enterprises they take over, as well as through synergies within the MNEs themselves. In addition, efficiency gains may occur in unrelated enterprises through spillovers. Foreign takeovers can lead to improvements in management and corporate governance, even in the privatization of government-owned enterprises, which have sometimes been politically controversial (usually due to short-run job losses as a result of restructuring).

The above discussion indicates that the potential benefits from FDI to host countries can be substantial, but policies are required to ensure that these benefits are actually realized. The magnitude of the benefits thus depends on host countries' efforts to put in place an enabling environment for FDI - i.e. raising their level of technological, educational and infrastructural achievement enables countries to accrue larger benefits from FDI. While the overall effect of FDI on enterprise development and productivity is usually positive, it may produce some adverse distributional and employment effects in the host country. These problems are usually temporary, and policies that encourage labour market flexibility, create macroeconomic stability, and provide adequate legal and

regulatory frameworks work to reduce the costs associated with these problems. In this sense, FDI can further serve to reinforce the prevailing conditions in the host country, whether or not these conditions are desirable. Therefore, sound policies that create an enabling domestic business environment are the key not only to mobilizing domestic resources, but also to maximizing the net benefit from FDI.³

B. Costs of FDI

Concerns are often raised about certain negative impacts of FDI on the host country. These concerns, which are generally more political and social than economic in nature, are much more associated with the foreign corporate takeovers than with greenfield investments by foreign firms.

It is often argued that foreign corporate takeovers are bad for the host country as they result in the “hollowing out” of the corporate headquarter functions and loss of the domestically-produced business and professional services supplied to corporate headquarters. With the large number of foreign corporate takeovers in Canada in 2006 and 2007, this issue has been prominent in public debate, and was a key factor leading to the creation of the Competition Policy Review Panel.

Many Canadians have expressed concern over the recent spate of takeovers of companies they consider “national icons.” Some argue that foreign ownership and control of these companies has a negative impact on Canada’s national identity, exerting an emotional toll on the Canadian psyche.

Critics of FDI often assert that increased foreign ownership of Canadian assets erodes national sovereignty. It is argued that the business decisions of firms controlled by Canadians will be more congruent with the overall national interest than decisions by firms operating in Canada but controlled by foreigners, even though such decisions are in principle motivated by the financial interests of the shareholders, not national interests.

An additional drawback of FDI often cited in the FDI literature is the propensity of MNCs to concentrate R&D in their home country. The classic example of such behaviour in the past has been the concentration of R&D undertaken by the Big Three auto makers in the United States. It should be noted however that there are examples of foreign-controlled firms that undertake significant R&D in host countries.

There is a vigorous debate about the merits of the above arguments. For example, a recent Conference Board of Canada (2008) study argues that the effects and extent of corporate takeovers are largely determined by the business decisions taken by the acquirer and that these decisions are driven by the business strategy considerations. Consequently, the nationality of the acquirer is less important to “hollowing out” than the rationale for the acquisition, particularly the business strategy context.

³ An elaborate discussion on the costs and benefits of FDI and a review of the empirical evidence is found in OECD (2002).

II. Recent Global and Canadian Trends in FDI

In the analysis of FDI,⁴ it is important to always make a distinction between FDI flows and stocks. FDI flows refer to the amount of FDI that enters a country during a certain period, generally a calendar year. FDI stocks refer to the amount or value of FDI at a certain point in time, generally December 31. FDI flows accumulate over time to determine the FDI stock.

It is also important to distinguish gross and net flows. Gross inflows refer to the total amount of FDI that enters a country in a given year. But multinational firms can also liquidate their FDI in a host country and repatriate the proceeds to the home country. This is called gross FDI outflows from a country. Net FDI flows are defined as the difference between gross inflows and gross outflows. As gross inflows normally exceed gross outflows, net FDI flows are generally positive. But in certain years when there are large repatriations of FDI, net FDI flows can be negative (as they were for Canada in 2004). In international discussions of FDI, the most widely used source appears to be the FDI data base maintained by the United Nations Conference on Trade and Development (UNCTAD). In this section, data are provided for FDI flow estimates on a net basis. For international comparisons, UNCTAD data are used while Statistics Canada data are the main source for inward and outwards flows of FDI in Canada as they provide more detailed breakdowns.⁵

FDI flows can be broken down into three distinct types: FDI arising from mergers and acquisitions, reinvested earnings by foreign-controlled firms, and “other,” which includes greenfield investments. The motivation and effects of the three types of FDI can differ significantly so it is always important to be aware of these distinctions in FDI investment. As a general rule, there is much more controversy about the relative benefits and costs from FDI inflows associated with corporate takeovers than from FDI inflows associated with the reinvestment of earnings and greenfield investments.

In order to identify Canada’s areas of strength and weakness in terms of FDI attractiveness, it is important to first assess Canada’s FDI performance in recent years. This section first provides an overview of global trends in FDI. It then focuses on trends in Canada by: (i) reviewing the recent evolution of FDI stocks and flows in Canada; (ii) assessing the importance of foreign mergers and acquisitions in Canada to recent FDI trends; (iii) identifying the major contributing countries and the sectors most targeted by FDI; and (iv) reviewing trends in Canadian direct investment abroad.

⁴ Statistics Canada defines FDI to include all investments of “resident entities” based in countries other than Canada obtaining a lasting interest in an enterprise resident in Canada. It notes that in practice direct investment is deemed to occur when a foreign company owns at least 10 per cent of the voting equity in a Canadian enterprise.

⁵ UNCTAD and Statistics Canada estimates on FDI are identical if appropriate PPPs conversion rates are used. UNCTAD data can be found in Tables 1, 2 and 3 while statistics Canada data can be found in Tables 4-13.

A. Global Trends

i. Trends in FDI flows

Since 2000, foreign direct investment flows have been at significantly higher levels than in any other period since 1970 (Table 1).⁶ In 2006, global FDI inflows, expressed in nominal prices, reached \$1,306 billion USD, the second highest level ever recorded and just \$135 billion USD short of the peak of \$1,441 billion USD reached in 2000 (Chart 1). All major country groups – developed countries, developing countries, and transition economies – saw strong growth in FDI inflows in 2006, the most recent year for which data are available.

The lion's share of FDI has always taken place within the developed world. For example, in 2006, the developed countries accounted for 66 per cent of FDI inflows, compared to 29 per cent for developing countries, and 5 per cent for transition economies (Southeast Europe and CIS). The EU remained the largest host region for FDI, accounting for 41 per cent.

Growth in FDI flows to developed countries has been particularly robust in recent years, up 16 per cent in 2004, 40 per cent in 2005 and 46 per cent in 2006. This follows consecutive falls in FDI inflows to developed countries in 2001, 2002 and 2003. Indeed, FDI inflows to developed countries in 2003 were down 75 per cent from the 2000 level. The United States was the world's largest FDI recipient in 2006, with a net inflow of \$175 billion USD, followed by the United Kingdom (\$140 billion USD) and France (\$81 billion USD). Canada had the fifth largest FDI inflow, at \$69 billion USD, after the three G-7 countries already mentioned and China.

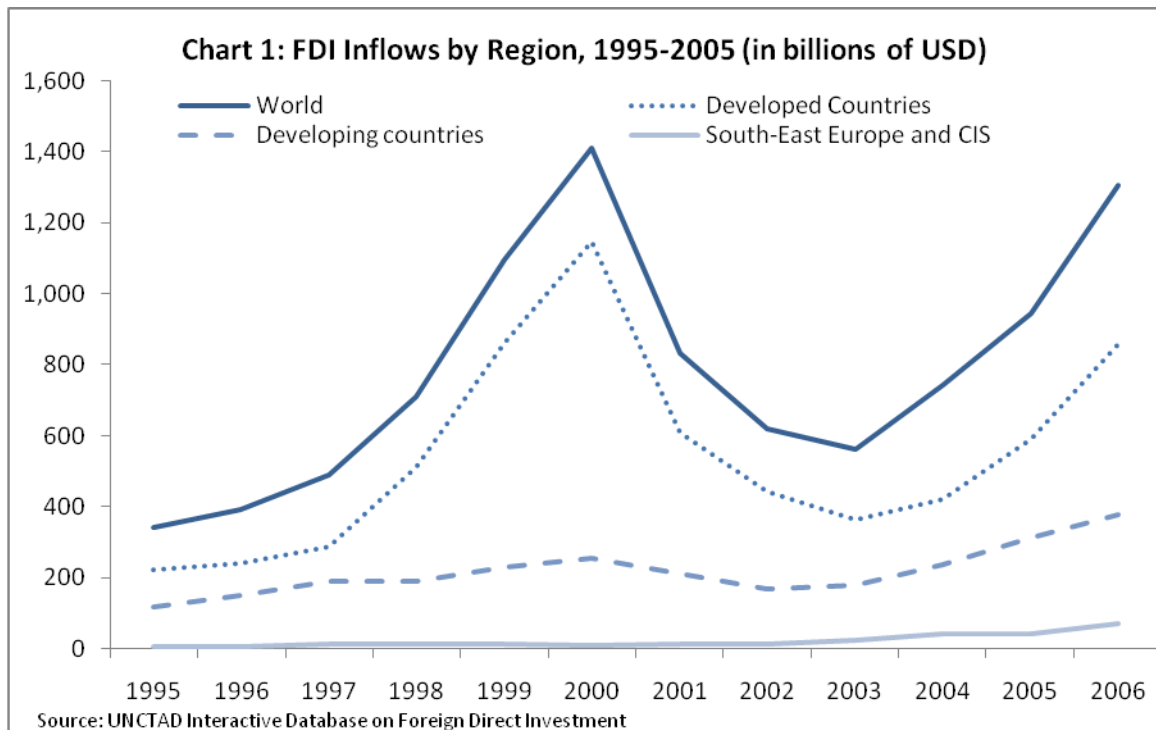
FDI inflows to developing countries have also been very robust in recent years, up 21 per cent in 2006, 22 per cent in 2005, and an astounding 48 per cent in 2004. Developing countries in Asia and Oceania maintained their strong attraction of foreign investment in 2006, garnering 72 per cent of total inflows to all developing countries since 2003.

But it is the transition economies, defined as Southeast Europe and the CIS countries, that have experienced the most rapid growth in FDI, admittedly from a small base. FDI to these economies increased over 400 per cent over the last four years, from \$13 billion USD in 2002 to \$69 billion USD in 2006.

Increased cross-border M&A activity was responsible for the more than doubling of global FDI since 2003 (UNCTAD 2007). These transactions rose significantly, both in number and value, approaching the previous M&A peak in 2000. This world M&A boom was driven by high stock market valuations, rising profits and favourable financing conditions. In North America, the value of M&A sales almost doubled in 2006, mainly due to high value deals concluded in the natural resources industry in Canada. In Europe the value of cross border M&A deals remained higher than in North America in 2006,

⁶ All tables are found at the end of the report.

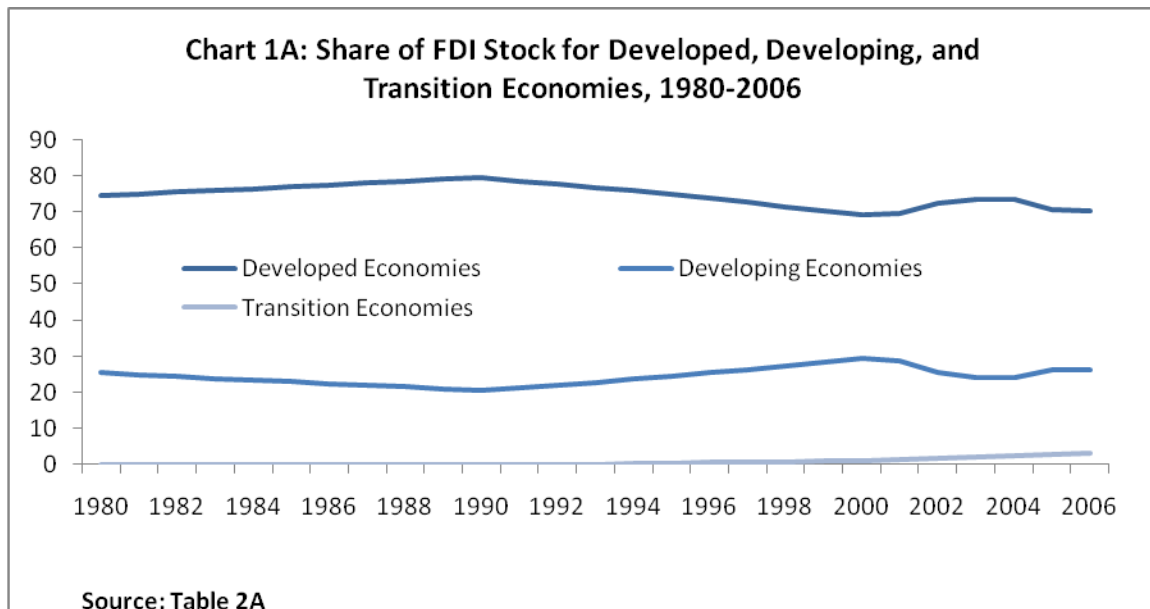
and grew by 9 per cent. The United Kingdom was the main target country in Europe, with 3 of the 5 largest cross-border M&A deals world-wide being acquisitions of UK companies by investors from continental Europe (UNCTAD 2007).



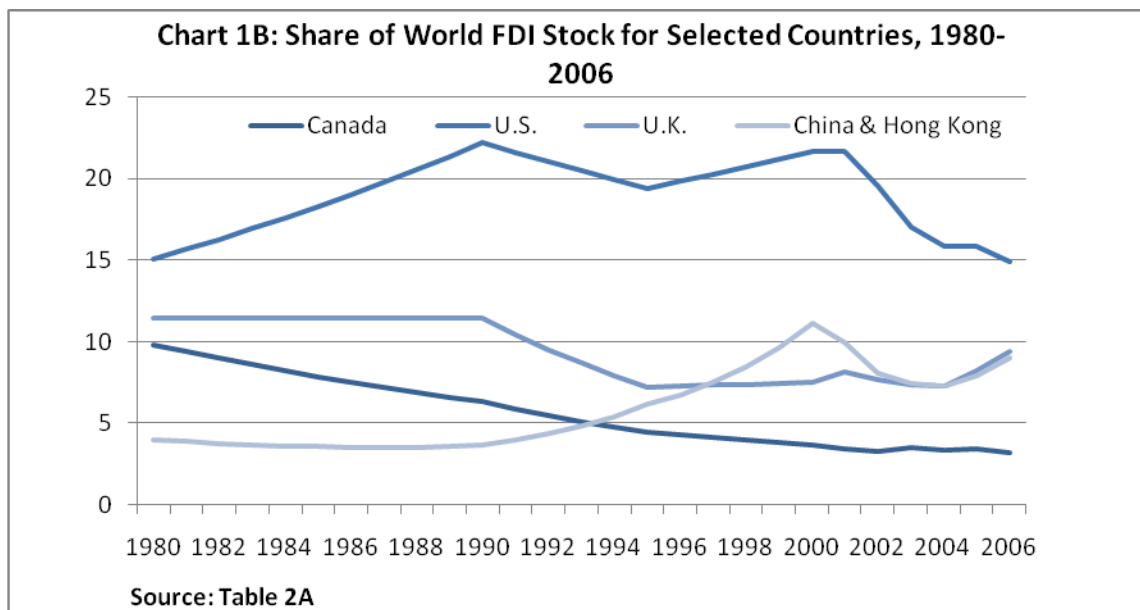
ii. Trends in FDI stocks

Following from the large increases in FDI flows, the world stock of FDI has ballooned in the past quarter century. Expressed in nominal US dollars, the world FDI stock more than tripled in the 1980s from \$551 billion USD in 1980 to \$1,779 billion USD in 1990; again more than tripled in the 1990s to \$5,810 billion USD in 2000; and more than doubled in the first six years of the 2000s to \$11,999 billion USD (\$12 trillion dollars) in 2006 (Table 2). The value of the world FDI stock in 2006 was around 22 times greater in 2006 than 1980, an average annual growth rate of 12.6 per cent. Growth in the world stock of FDI has been particularly strong since 2002, with annual increases of 21 per cent in 2003, 17 per cent in 2004, 5 per cent in 2005, and 19 per cent in 2006.

It is often thought that massive FDI flows to the developing world have been driving the growth in the world FDI stock. But in reality the developing countries' share of world FDI has been remarkably stable, at 25.5 per cent in 1980 and 26.3 per cent in 2006 (Table 2a and Chart 1A). The FDI share of the developed countries has fallen somewhat, from 74.5 per cent of the world total in 1980 to 70.5 per cent in 2006. But it has been the transition economies, defined as the Commonwealth of Independent States (CIS) and South-east Europe, but excluding China, who have largely made up for the fall in the developed country world FDI share. Their share increased from essentially zero in 1980 to 3.2 per cent in 2006.



World FDI shares for G-7 countries have been fairly stable over the 1980-2006 period, except for Canada. There were small increases in the world FDI share for France (from 4.8 per cent in 1980 to 6.5 per cent in 2006), Italy (1.6 per cent to 2.5 per cent), and Japan (0.5 per cent to 0.9 per cent). On the other hand, there were small decreases in shares for Germany (6.7 per cent to 4.2 per cent), the United Kingdom (11.4 per cent to 9.5 per cent), and the United States (15.1 per cent to 15.0 per cent). All these changes were minor compared to developments for Canada, whose world FDI share fell 6.6 percentage points, or by two-thirds, from 9.8 per cent in 1980 to 3.2 per cent in 2006 (Chart 1C). The factors behind this development will be discussed in the next section.



While the world FDI stock in the developing world was relatively stable between 1980 and 2006, there have been important shifts within the area. In particular, Africa has seen its world FDI share plummet from 7.2 per cent in 1980 to 2.6 per cent in 2006. This was largely offset by the rise of Asia's share from 11.9 per cent to 16.1 per cent. The share of Latin America and the Caribbean also rose from 6.4 per cent to 7.6 per cent. Within Asia, Hong Kong and China accounted for the rise in the Asian share of world FDI; Hong Kong saw its share rise from 3.8 per cent in 1980 to 6.6 per cent in 2006, and China experienced an increase from 0.2 per cent to 2.4 per cent (Chart 1B). Given the small size of Hong Kong, it is interesting to note that its stock of world FDI is more than double that of Canada!

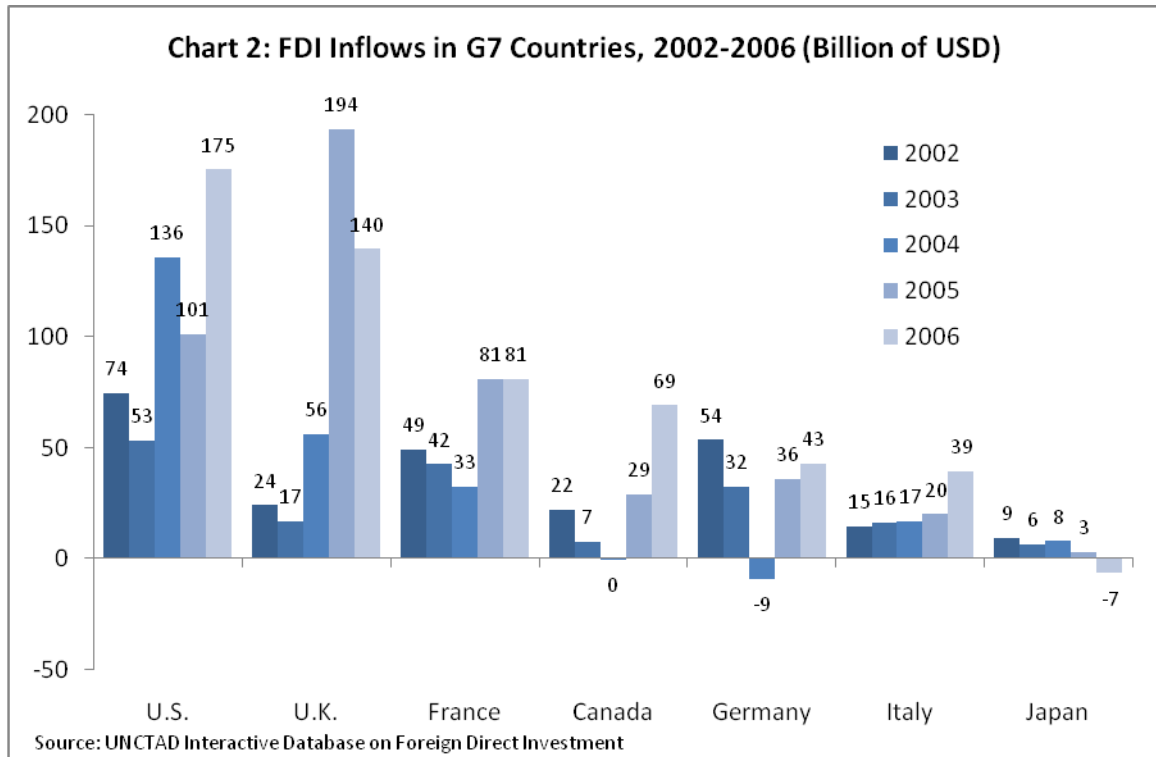
B. FDI Trends in Canada

Global trends in FDI clearly point to an unprecedented increase in cross-border investment. In this context, it is important to determine if Canada is playing a leading role in these worldwide trends or if it instead is a relatively minor player. Indeed, why has Canada's share of the world FDI stock been cut by two thirds over the last quarter century? For that reason, this section reviews trends in inward FDI to Canada from both historical and international perspectives.

i. Canada's FDI Flows and Stocks

As noted, FDI performance can be assessed in terms of both flows and stocks. While the former are a good indication of recent development in and/or changing incentives to foreign investment, the latter provide a longer term picture of incentives to invest in a given country. Given the volatility of FDI inflows, an assessment of Canada's ability to attract FDI is extremely sensitive to the period chosen. For example, based on developments since 2002, Canada's performance in attracting FDI flows appears impressive. Annual net FDI *inflows* into Canada increased threefold in absolute terms from 2002 to 2006, from \$22.2 billion USD to \$69.0 billion USD, representing a compound average annual growth rate of 32.9 per cent (Table 1 and Chart 2). Canada experienced much higher growth than most other G7 countries over that period, including Italy (28.1 per cent), the United States (23.9 per cent), France (13.4 per cent), Germany (-5.4 per cent) and Japan, which recorded negative net FDI inflows in 2006. Canada's growth over the 2002-2006 period was also well above the world average (20.4 per cent) and outpaced many developing countries such as China (7.1 per cent), India (31.6 per cent), Korea (9.9 per cent), Brazil (3.2 per cent) and Mexico (-0.4 per cent).

However, if one uses the year 2000 as a base, Canada has performed much less well, with FDI inflows in 2006 essentially unchanged from the year 2000, given the extremely high level of FDI inflows that year.

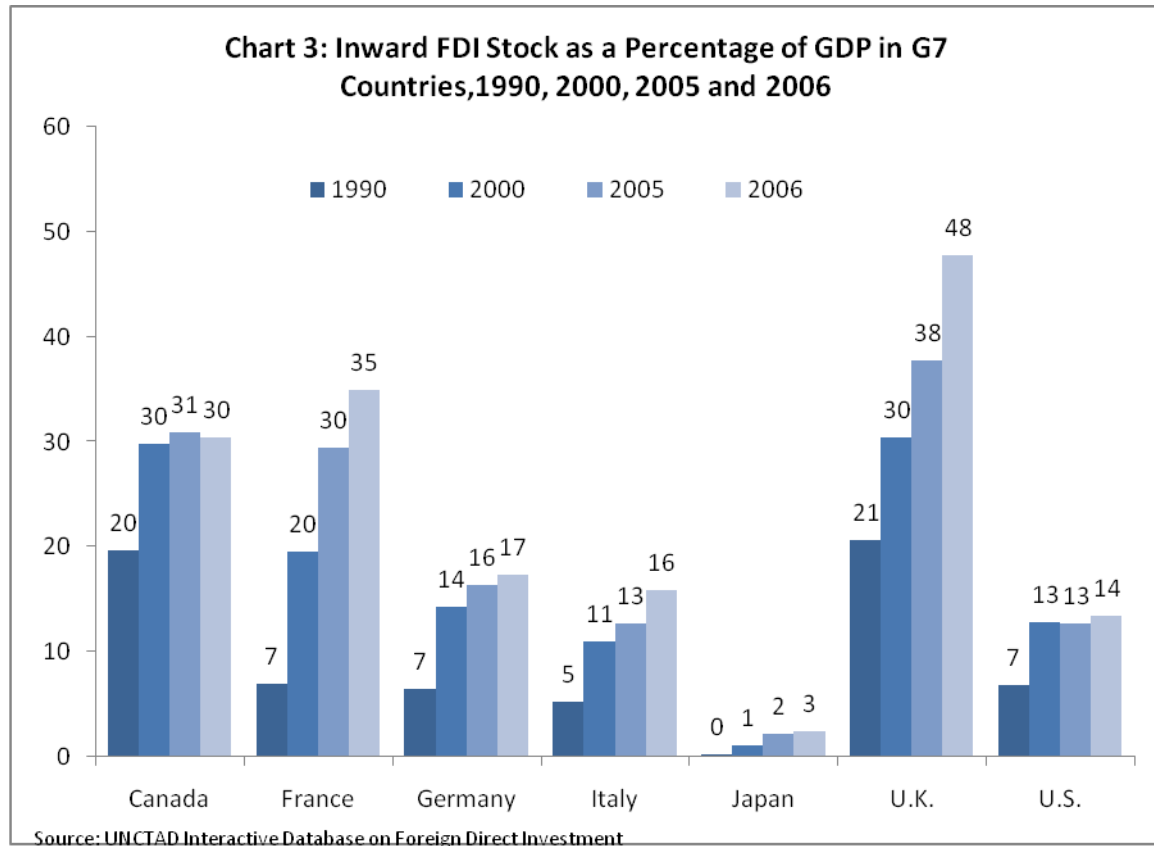


Recently released Statistics Canada data for 2007 show that the net flow of FDI into Canada, expressed in current Canadian dollars, jumped a massive 47 per cent in 2007, rising to \$115 billion from \$78 billion in 2006 (Table 4)

In terms of the absolute level of FDI inflows (not adjusting for the size of the economy), Canada's FDI performance in 2006 is far from poor in comparison to other countries. Canada ranked 4th among the G7 in the size of its FDI inflow despite having the smallest economy of the group, and recorded higher levels of net FDI inflows than all developing economies with the exception of China, which received an almost identical amount of FDI (\$69.5 billion USD).

Despite Canada's apparent strong performance in attracting FDI, the United Nations Commission on Trade and Development (UNCTAD) points out in its *World Investment Report 2007* that, in comparison to its potential, Canada is in fact underperforming. The report ranks countries' FDI progress by constructing two indices – the inward FDI performance index and the inward FDI potential index. The FDI performance index measures the extent to which a host country receives inward FDI relative to its economic size (calculated as the ratio of a country's share in global FDI inflows to its share in global GDP). The FDI potential index reflects country-specific structural variables which affect inward FDI and which do not generally change from year to year. In 2006, Canada ranked 79th out of 141 countries in terms of its FDI performance (based on the inward FDI index), while it ranked 4th in terms of its potential (Table 23). Thus, there is a significant gap between Canada's actual FDI performance and its potential FDI performance. Moreover, while Canada's absolute level of FDI

inflows is relatively high compared to other economies in the world, when its FDI inflows are adjusted for the size of its economy (share of world GDP) it ranks quite low.

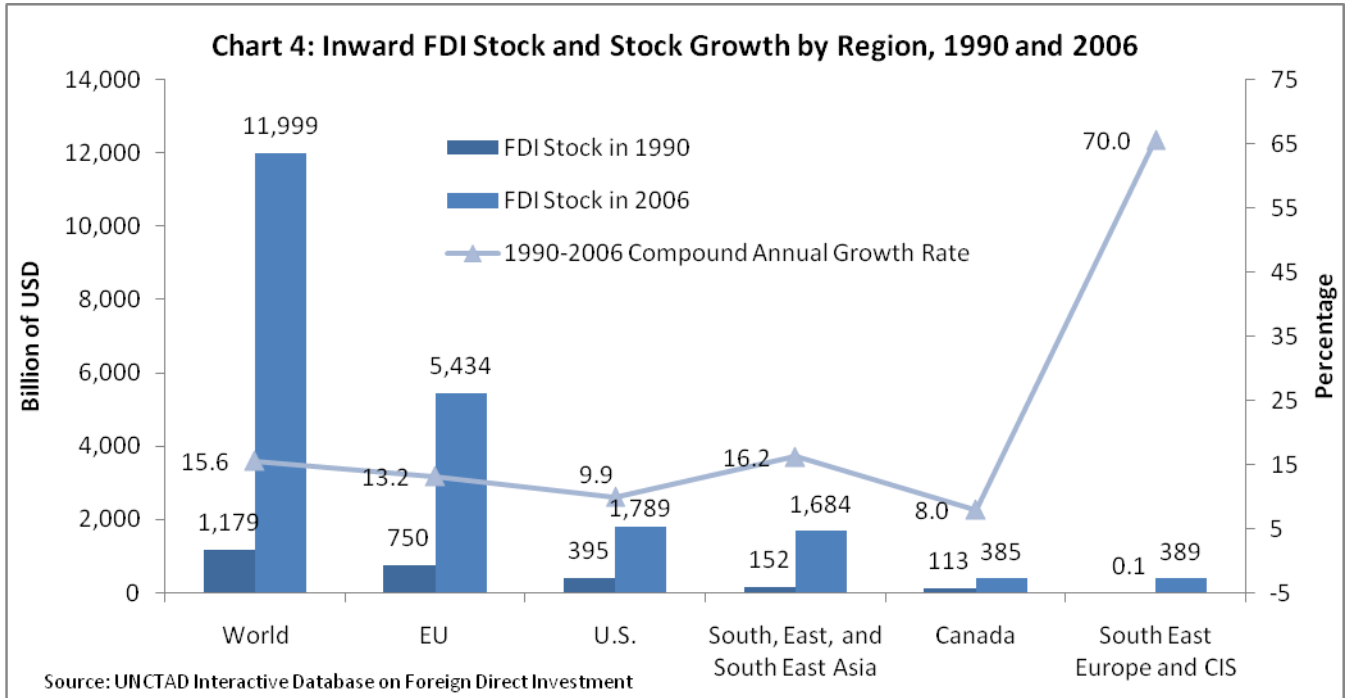


In terms of the absolute ability of Canada to attract and retain FDI, measured as the inward FDI stock/GDP ratio, Canada does fair well. Among G-7 countries, Canada in 2006 had the third highest FDI/GDP ratio at 30 per cent, below only the United Kingdom (48 per cent), and France (35 per cent).

But in terms of the relative ability of Canada to attract FDI, it appears that Canada has been losing ground. Indeed, even though Canada's inward FDI stock as a share of GDP increased 50 per cent over the 1990-2006 period from 20 per cent to 30 per cent of GDP (Chart 3 and Table 3), all other G-7 countries experienced larger increases in per cent terms and all other G-7 countries except the United States and Japan experienced larger increases in percentage point terms. Inward FDI stock as a share of GDP increased fivefold in France, three fold in Italy and Japan (admittedly from a very low base in this country), more than doubled in Germany and the United Kingdom, and doubled in the United States.

Canada poor performance in the growth of the FDI stock/GDP ratio over the 1990-2006 period was due to the relatively poor performance in terms of growth in FDI stock, with an average annual growth rate of only 8.0 per cent. Even if we do not consider South East Europe and CIS countries, where FDI inflows naturally took off after

the fall of communism, Canada still did poorly relative to Asia (16.2 per cent), the European Union (13.2 per cent), and the United States (9.9 per cent).

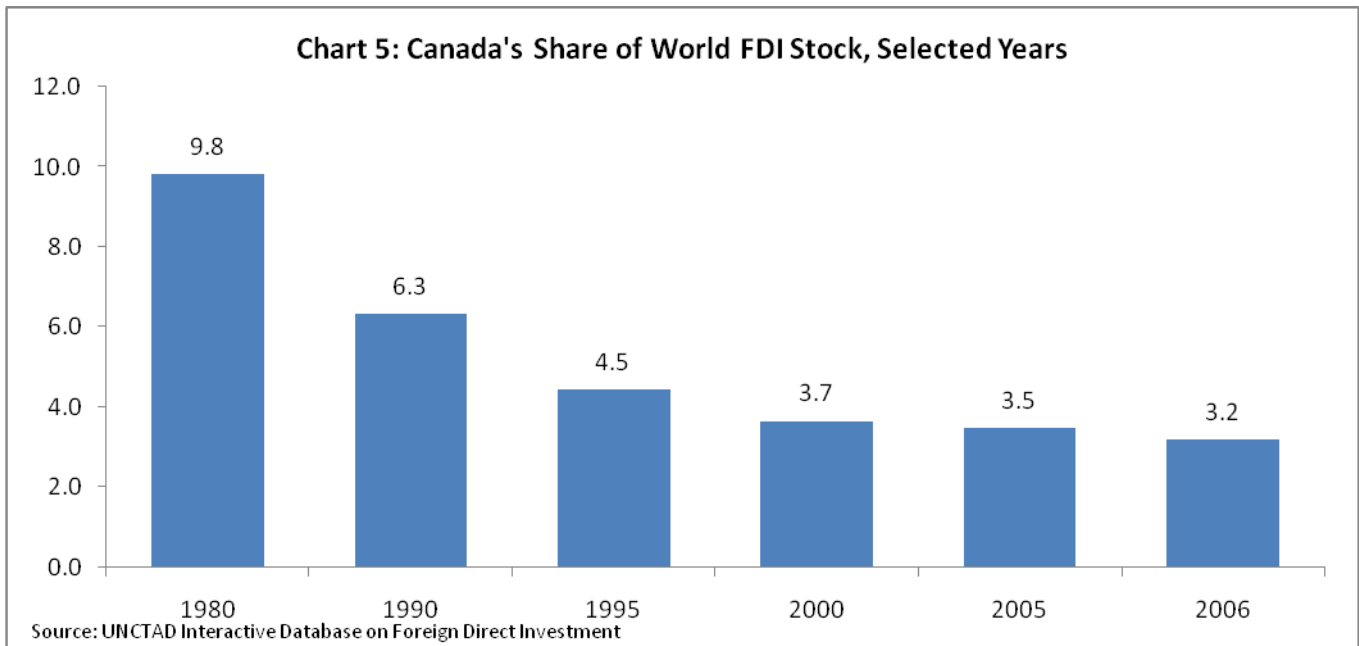


Canada's share of world FDI stock has also declined in the long-term, going from 9.8 per cent in 1980 to 6.3 per cent in 1990, 3.7 per cent in 2000, and 3.2 per cent in 2006 (Table 2, Chart 5). This should not be surprising, as Asia and Oceania, Latin America and the Caribbean, Southern Europe along with CIS countries and the European Union, all significantly increased their share of world FDI stock between 1990 and 2006.

The drastic fall in Canada's share of the world FDI stock since 1980 has received much attention in this country. Some see this development as a manifestation of Canada's declining ability to attract FDI and a major problem or challenge for the Canadian economy, although the factor that triggered this development is generally not specified. Others are more sanguine and see the decline as a more natural development. They note that it has not been the absolute level of Canada's FDI stock that has declined as FDI growth has averaged 8 per cent per year between 1990 and 2006. Rather it is that the FDI stock growth has been much faster in other countries. It is argued that this development reflected the massive growth of FDI to other economies as these economies opened to the world.

Already in the immediate postwar period Canada was a major destination of FDI, with this country's world FDI share well above its GDP share. Unlike many other countries at the time, Canada was open to FDI. After 1980 the rest of the world opened to FDI. The reduction of investment barriers in the EU meant EU firms invested more in other EU countries. The fall of communism opened up the former Soviet bloc to international capital. The adoption of more market-oriented policies in many developing countries, especially in Asia, led to large inflows of FDI to these areas.

From this perspective, it is unrealistic to have expected Canada to have retained its 1980 share of world FDI (9.8 per cent). Indeed, given the massive growth in the world FDI stock over the last quarter century, if Canada had retained its 1980 share of world FDI in 2006, its FDI/GDP ratio would have been 90 per cent instead of 30 per cent. The extent of foreign control of the Canadian economy would have been much greater. Indeed, Canada would have had the highest FDI/GDP ratio in the G-7 by a factor of two!



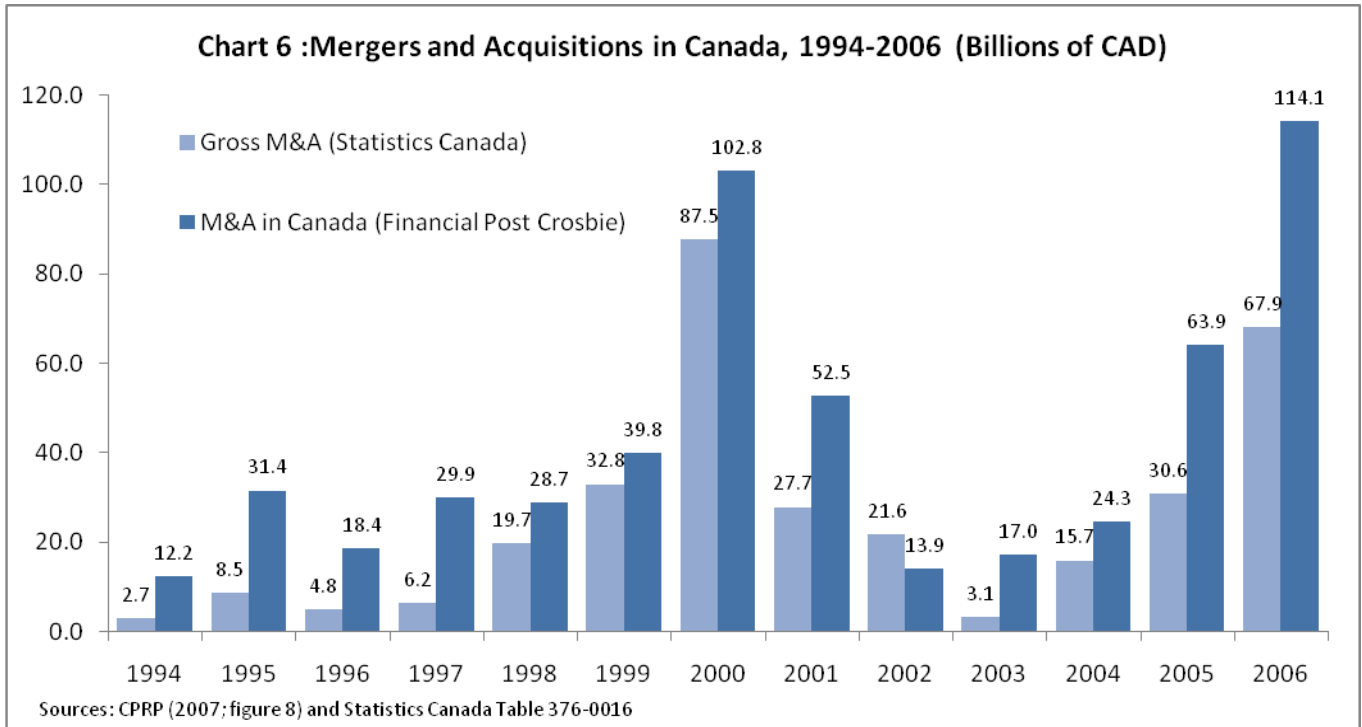
ii. Mergers and Acquisitions

FDI captures investments in the form of mergers and acquisitions (M&A), reinvested earnings and other investments including greenfield investment. Mergers and acquisitions are of particular interest because these investments are often the target of criticism; they raise fears of a hollowing out of Canadian businesses. According to the Financial Post Crosbie estimates, foreign acquisitions in Canada have risen both in value and number since 2003 (Chart 6, Table 6).⁷ In 2006, the value of foreign acquisitions in Canada reached \$114,091 million CAD— the highest value recorded over the last decade (Table 6).⁸ On the other hand, the number of transactions has declined compared to the last M&A peak in 2000, signifying an increase in high-value takeovers in Canada. According to data from Statistics Canada, the share of foreign acquisitions in FDI inflows has increased since the slump in 2003, going from 6.7 per cent of FDI inflows in 2003, to

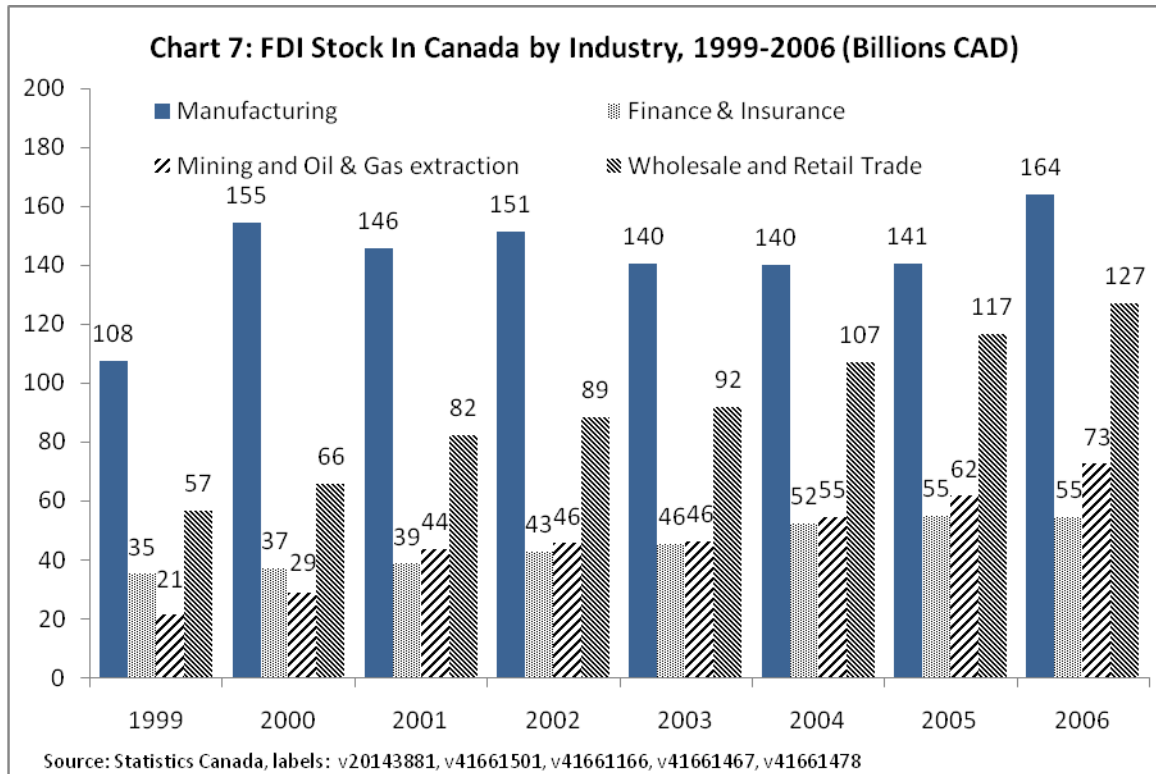
⁷ There exist two different sources for estimates of the value of M&A in Canada. The Financial Post Crosbie (FPC) publishes estimates of the number of deals and their value while Statistics Canada provides official estimates of FDI inflows broken into M&A, reinvested earnings and other FDI. While both sources show similar trends, FPC estimates tend to be significantly larger than Statistics Canada estimates. Table 5a shows that recent trends for M&A are similar for both sources. The Competition Policy Review Panel Consultation Paper (2007) *Sharpening Canada's Competitive Edge* uses both sources for assessing the level of M&A in Canada.

⁸ FPC preliminary estimates suggest another significant increase in 2007, with M&A deals in Canada easily in excess of 155 billion CAD.

approximately 58.1 per cent of FDI inflows in 2006 (Table 6). Over the 2001-2006 period, 36.5 per cent of all FDI inflows were accounted for by M&A. Canadian investment abroad has been slightly less driven by M&A activity, with M&A investments abroad accounting for only 31 per cent of the average outward FDI between 2001 and 2006 (Table 11). The difference was starker in 2006, with M&A accounting for 58.1 per cent of inward FDI flows but only 36.7 per cent of outward FDI flows.



The recent increase in FDI in Canada in the form of M&As, and foreign takeovers of prominent Canadian firms such as Falconbridge, Inco, and the Hudson's Bay Company, has fuelled debate over whether Canada is being disproportionately affected by the global increase in M&A activity. However, data from *Financial Post Crosbie: Mergers and Acquisitions* do not support this view, showing that between 2001-2006 Canadian companies acquired 1,993 foreign firms at a combined value of approximately \$300 billion CAD, and that over the same period, 864 Canadian companies were acquired by foreign firms at a combined value of \$286 billion (CPRP, 2007). It is also important to keep in mind that annual M&A activity tends to fluctuate sharply from year to year, and can be considerably affected by a few high-value transactions. The recent high profile takeovers in Canada do not necessarily signal a disproportionate hollowing out of Canadian businesses.



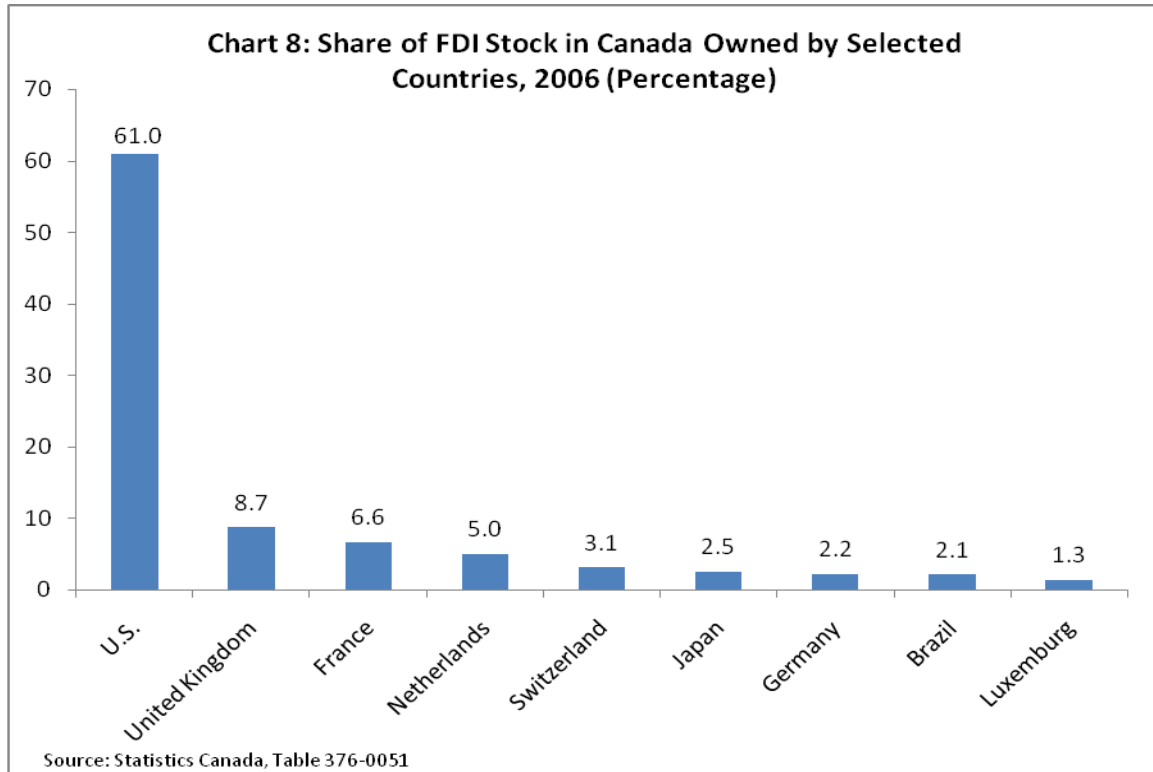
iii. Foreign Direct Investment by Sector and Country

There are significant differences across sectors in the prominence of FDI flows and stocks (Table 7-9, Chart 7).⁹ Overall, 36.5 per cent of FDI stock in Canada was in the manufacturing industry at the end of 2006, down from 48.4 per cent in 2000 (Table 8). The mining and oil and gas extraction industry increased its share of FDI stock from 15.1 per cent in 2005 to 16.2 per cent in 2006, and up from 8.5 per cent in 1999. The finance and insurance industry also held a significant portion of the FDI stock, 12.2 per cent in 2006. Over the period 2002-2006, both the finance and insurance industry, and the services and retailing industry registered strong annual growth rates of 6.2 per cent and 10.0 per cent respectively. The mining and oil and gas extraction industry posted the highest annual growth rate over this period, at 12.3 per cent. In 2006, the bulk of FDI stock in Canada still was in the manufacturing sector, followed by mining and oil and gas extraction, finance and insurance, and services and retailing. However, the manufacturing sector is declining in importance, with FDI in mining and oil and gas extraction, services and retailing, and finance growing rapidly.

While many countries have stakes in the FDI stock in Canada, a very large portion of it is accounted for by only a few countries (Table 10). As shown in Chart 8, the United States accounts for the bulk of the FDI stock in Canada (68 per cent). The U.S. FDI stock in Canada is fairly evenly distributed among sectors, with energy and metallic minerals

⁹ FDI stocks by industry are available from Statistics Canada on both a North American Industry Classification System (NAICS) basis and on a 1980 Standards Industrial Classification (SIC) basis. FDI flows are only available on a 1980 SIC basis.

and the “all other industries” category making up 27.6 per cent of U.S. holdings, followed by finance and insurance at 17.8 per cent, and then machinery and equipment at 12.1 per cent. Only three other countries, the United Kingdom (8.7 per cent), France (6.6 per cent) and the Netherlands (5 per cent) own more than five per cent of the FDI stock in Canada.



iv. Canadian Direct Investment Abroad

While not the focus of this study, it is interesting to note that Canada has been a net exporter of capital (in the form of FDI) since 1996 (Table 8 and Table 13). Indeed, from 1996 until recently, the overall stock of Canadian direct investment abroad has been higher than that of foreign direct investment in Canada. Between 1997 and 2006, the ratio of FDI stock in Canada to the stock of Canadian direct investment abroad has hovered between a trough of 81.9 per cent in 2002 and a peak of 90.6 per cent in 2003. At the end of 2006, the total stock of Canadian direct investment abroad was \$523 billion CAD whereas the total FDI stock in Canada was \$449 billion CAD. This situation represented a significant break with the historical reality of Canada as a net importer of capital since as late as in 1988 the stock of FDI in Canada was still 43 per cent larger than that of Canadian direct investment abroad. Yet, it must be noted that these developments are in large part the result of significant increases in Canadian direct investment abroad rather than that of a slowdown in FDI growth.¹⁰ The large FDI inflows in 2007 have resulted in Canada again returning to a position where FDI in Canada exceeds Canadian FDI abroad.

¹⁰ A more detailed discussion of Canadian direct investment abroad is found in the discussion paper produced by the Competition Policy Review Panel Consultation (2007).

III. Factors that Determine FDI

The factors that affect FDI can be broadly divided into two general areas: first, those that are fundamental drivers or rationales for FDI decisions and second, those associated with the environment that enables or facilitates FDI.

Three fundamental drivers or rationales for a firm to make a direct investment outside its home country can be identified: to take advantage of a local market; to exploit natural resources; and to make use of human resources in the host country in production processes. One or a combination of the following motives influences a firm's direct investment abroad:

- (a) **Market Seeking:** One motivation for firms to invest abroad is access to larger or faster-growing markets, or markets in which there is less competition than the home country. The existence of trade barriers has historically motivated firms to establish operations outside their home country to take advantage of local markets. For example, in the first half of the 20th century US firms such as the Big Three auto companies established production operations in Canada to get behind tariff barriers and sell their products in Canada. It should be noted that the market access sought by multinationals may go beyond the local market of the host country to include markets with preferential access from the host country. For example, Japanese auto companies have made direct investments in Canada to produce vehicles for the US market which is open to Canadian-based producers under NAFTA and US firms have invested in Ireland to gain access to the EU market. With trade liberalization, this motivation is of declining importance today.
- (b) **Resource Seeking:** Firms also invest abroad to exploit natural resources (usually for export markets) that are not readily or cheaply available in the home country. Manufacturing firms such as chemical producers that use natural resources may also invest abroad to set up plants close to the natural resources that are used in the production process. Canada has traditionally attracted FDI in the primary sector due to its rich natural resource base. Natural resources continue to be the driving force in inward FDI into Canada, and with the rise in commodity prices, this rationale for FDI is increasing.
- (c) **Efficiency Seeking:** Firms may invest abroad in order to take advantage of the relative strengths of countries in a way that minimizes their costs. For example, a firm's strategy may include taking advantage of cheap labour in one country for certain parts of the production process, and utilizing highly qualified workers in another country for different elements of the production process. Efficiency seeking is becoming an increasingly important determinant of FDI, evidenced by the rise of global value chains.

Summary Table 1: Determinants of Foreign Direct Investment

I. Fundamental Drivers (Economic Conditions)
(a) Markets: size, growth potential, income levels, proximity to important regional markets, urbanization, demand patterns.
(b) Resources: natural resources availability, location of resources, costs of exploring and exploiting resources.
(c) Competitiveness: labour costs, labour productivity, availability of skilled labour, scale of production, physical infrastructure, and level of technology, country comparative advantage
II. Enabling Factors (Government Policies)
(a) Macroeconomic Environment: price stability, growth, employment, exchange rates
(b) Promotion of Private Enterprise: tax system, efficiency of the financial sector, foreign trade zones, labour or capital subsidies.
(c) Trade Policies: openness in foreign trade, regional integration and access to regional markets
(d) Regulation: regulatory frameworks with respect to competition, financial reporting, IPR, labour market (EPL and labour tax wedges); regulatory burden in terms of time and cost.
(e) FDI Regulations: level of FDI restrictions, non-discrimination between foreign and domestic enterprise, transparent and stable policies.
(f) Good Governance and Quality of Life

Summary Table 1 provides a detailed listing of the host country determinants of FDI. These are grouped into two categories *Economic Conditions* and *Government Policies*. *Economic Conditions* essentially outline the three motivating factors for FDI discussed above. *Government Policies* outline the rules and regulations in a country, which provide an enabling environment for investment. Accordingly, the next section of the report discusses the most influential factors that affect the inflows of FDI, and assesses how Canada ranks relative to other major OECD countries with respect to those factors.

IV. Where Canada Stands with Respect to the Factors that Affect FDI Inflows

This section of the report discusses the current state of Canada's attractiveness as a locus for foreign direct investment in terms of both fundamental drivers and enabling factors. To facilitate presentation, the factors have been divided into two sets: factors where Canada is doing well and factors where Canada is doing less well. It should be stressed that the factors lie on a continuum and the boundary between the list of factors where Canada is doing well and less well is arbitrary. In terms of the factors where Canada is doing less well, the assessment is made relative to other factors and not other countries. Compared to other countries, Canada may be doing well. Moreover, even for the factors where Canada is assessed to be doing well, there is still room for improvement.

The areas where Canada is assessed to be performing well are: natural resource base; human resources; governance; macroeconomic performance; labour market flexibility; government finances; general business environment; and quality of life.

The areas where Canada is assessed to be doing less well from the point of view of attracting FDI are: productivity performance; innovation performance; exchange rate; infrastructure; taxes; and FDI regulation.

A. Canada's Relative Strengths

i. Natural Resource Base

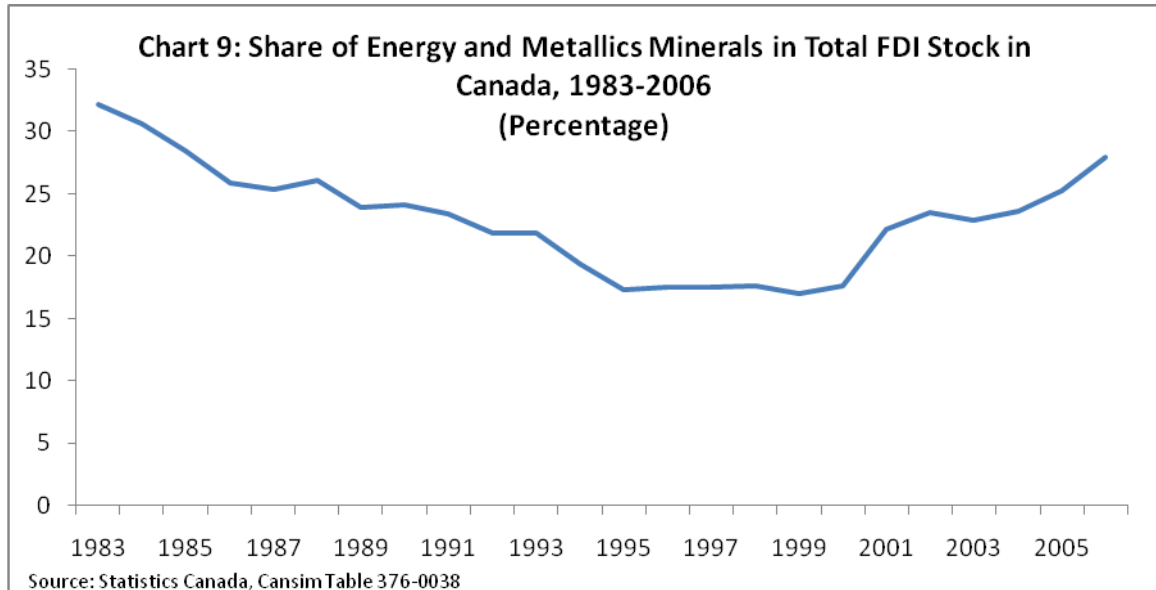
Canada's traditional advantage in attracting foreign direct investment has been its rich natural resource base related to our extensive land mass, the second largest in the world. With the rise in world commodity prices related to growing demand for commodities in developing countries, particularly in Asia, this relative advantage has become even more important.

As noted earlier in the report, the surge in FDI inflows to Canada since 2004 has been mainly driven by investment in the natural resource sector, a trend which is likely to continue in the foreseeable future (DFAIT, 2007). In 2005, net FDI flows in energy and metallic minerals totaled \$21.9 billion CAD (Table 7). This increased to \$46.5 billion in 2006 and \$65.2 billion in 2007. Energy and metallic minerals FDI, defined on the 1980 SIC basis, accounted for 62.5 per cent of net FDI inflows in 2005, 59.4 per cent in 2006, and 56.5 per cent in 2007 (Table 7a).

Canada is and remains a choice location for mineral exploration, much of it done by foreign-controlled firms. The Prospectors and Developers of Canada estimates that in 2007 Canada accounted for 19-20 per cent of worldwide exploration spending (Koven, 2008), well above its share of world land mass and mineral production.

It should be noted that Canada is a world leader in mining technology and that Canadian firms such as Inco, Noranda, Falconbridge, and Alcan have operations throughout the world. The inward FDI associated with the takeover of these Canadian natural resource companies by foreigners thus includes the acquisition of the Canadian-controlled assets abroad of these corporations as well as the assets located in Canada.

Following from the increased FDI inflows in the natural resource sector, the share of energy and metallic minerals in Canada's total FDI stock has also risen markedly. It reached 25.2 per cent in 2005 and 27.9 per cent in 2007 (Table 9a, Chart 9).

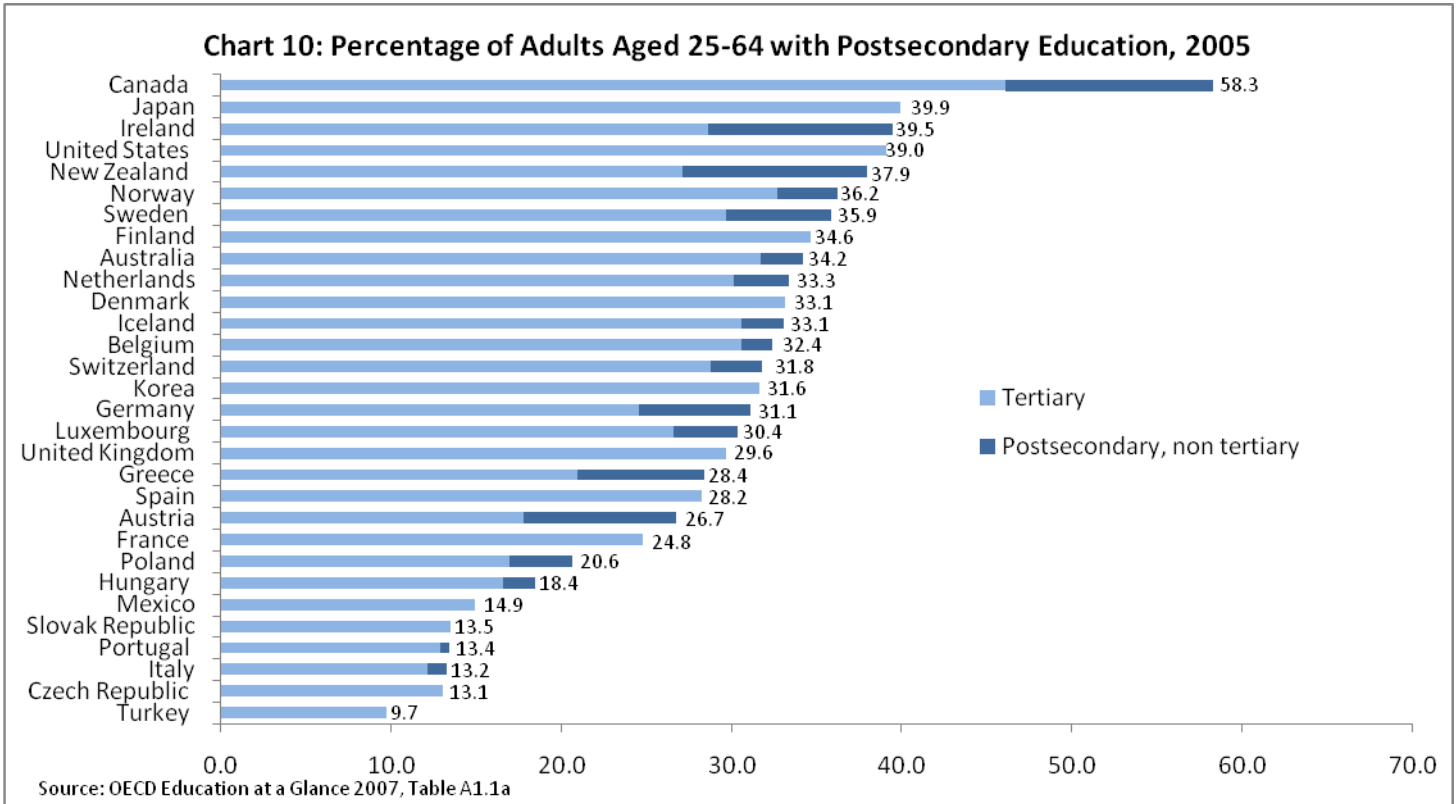


Despite the attractiveness of Canada as a location for FDI in the natural resource sector, it should be noted that this advantage is not absolute and can be eroded. The cost of exploring for and developing new natural resource deposits in Canada has increased significantly in recent years (Conference Board of Canada, 2004). The cost overruns in oil sand projects are an example of this trend. Developing natural resources in Canada can also be difficult given the unsettled nature of many Aboriginal land claims and stringent environmental regulations. Other countries also have great potential for natural resources development, and at lower costs. Canada should not take for granted its attractiveness as a location for FDI in the natural resource sector.

ii. Human Resources

An important OECD study on FDI found that a high level of human capital tends to attract inward FDI (Nicoletti *et al.*, 2003:44). The quality of Canadian human resources is in general high, which makes Canada an attractive location for FDI that needs a well-educated workforce. Indeed, Canada's greatest competitive advantage in the human resources area is the proportion of working-aged adults (25-to-64 year-old population) with tertiary education. At 46 per cent in 2005, this proportion was highest among OECD countries (see Summary Table 2 below), although these estimates do suffer from

definitional issues.¹¹ If we focus on all postsecondary education, Canada's advantage on the second place country grows to almost 20 percentage points (Chart 10).



Canadian students have also done extremely well in the PISA International Student Assessment tests (OECD, 2007c). In the most recent survey conducted in 2006 (Table 14), Canadian students ranked second among 30 OECD countries in science (after Finland), and third in reading and mathematics (after Korea and Finland).

Canada did quite well in the International Adult Literacy Survey conducted between 1994 and 1998 (OECD, 2000). For the 22 jurisdictions for which results are

¹¹ The 1997 International Standard Classification of Education (ISCED) used by the OECD divides post-secondary education into three levels, i.e. Level 4, Level 5 and Level 6 (UNESCO, 1997). Level 4 refers to post-secondary, non tertiary education and captures programmes that straddle the boundary between upper-secondary and post-secondary education from an international point of view, even though they might clearly be considered as upper-secondary or post-secondary programmes in a national context. Level 5 includes tertiary education programmes which do not lead directly to the award of an advanced research qualification. It includes both programmes which are theoretically based/research preparatory (history, philosophy, mathematics, etc.) or giving access to professions with high skills requirements (e.g. medicine, dentistry, architecture, etc.), and those programmes which are practical/technical/occupationally specific. The first type is classified as Level 5A while the second is classified as Level 5B. Finally, Level 6 is reserved for tertiary programmes which lead to the award of an advanced research qualification and are therefore devoted to advanced study and original research and are not based on course-work only. For many countries including Canada, Level 6 data are not recorded separately but instead included in Level 5A. In Canada, the Labour Force Survey does not allow for a clear delineation between Level 4 and Level 5B which, according to the OECD, leads to inflated estimates for Level 5B estimates. One must therefore be careful when comparing Canadian data on tertiary education (Level 5 and Level 6) with that of other countries. This problem can be avoided by comparing data on overall postsecondary educational attainment (Levels 4, 5 and 6) or by focusing on what is commonly called university level educational attainment (Level 5A and Level 6).

available, Canada ranked 5th in terms of prose literacy in mean score, 8th in document literacy, and 9th for quantitative literacy (Table 15). In terms of the proportion of the population at the top literacy level (level 4/5), Canada ranked second in prose literacy, 4th in document literacy, and 8th in quantitative literacy of 22 countries (Table 15a).

Summary Table 2: Educational Attainment in 2005 for Selected OECD Countries and Regions

	Percentage of Working-Aged Population (25-64 years)		Percentage of University Graduates (20-64 years old)	
	Tertiary Education	University Degrees (Tertiary Type A and Advanced Research)	Science Graduates	Engineering Graduates
Canada	46	23	12	11
Japan	40	22	n/a	14
United States	39	30	n/a	n/a
United Kingdom	30	21	18	11
France	25	15	15	10
Germany	25	15	8	22
Italy	12	12	12	n/a
EU 19	24	17	n/a	n/a
OECD	26	19	11	14

Symbol n/a denotes missing data

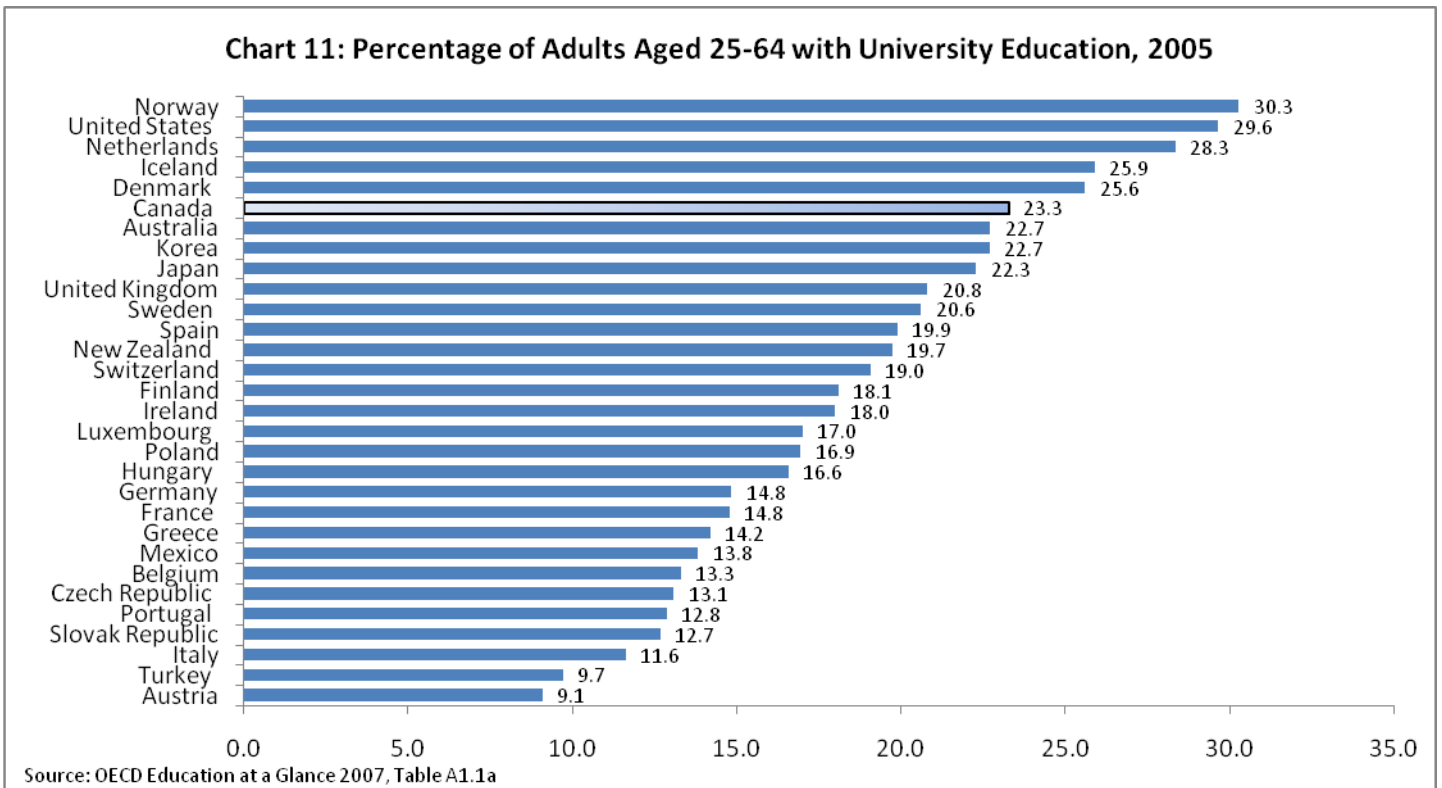
Source: Education at a Glance: OECD Indicators 2007

In recognition of Canada's record in delivering a high quality of education to children and youth outlined above, the Conference Board of Canada (2007) in its report card of Canada's performance gave Canada an A in education and skills.

Of course, there are aspects of human resources where Canada performs less well. For example, the distribution of university graduates in Canada is generally skewed towards social sciences, arts and humanities rather than towards science and engineering. Indeed, Canada had a lower proportion of its university graduates in science and engineering than many European countries (such as Finland, Belgium, France, Germany, Ireland, Italy and the U.K.), and also had a much lower proportion of working-aged adults with university degrees than the United States (Summary Table 2). In fact, Canada only ranks sixth in the OECD in terms of university graduates with 23.3 per cent of working-aged adults with university degrees, 7.0 percentage points behind first place Norway (30.3 per cent) and 6.3 percentage points behind second place United States (29.6 per cent) (Chart 11). Workplace training also appears to be less developed in Canada than in other countries.

Because of these deficiencies, some have suggested that Canada lacks the level of competencies required to be an attractive destination for the production of high value-added elements in the global supply chains of MNEs, although this is a moot point.

The *Global Competitiveness Report 2006-2007*, produced by the World Economic Forum, ranked Canada 17th out of 125 countries in higher education and training, behind countries such as Finland, Denmark, Sweden, Belgium, Norway, United States, Singapore, United Kingdom, France and Japan, to name a few. The composite indicator was based on eight sub-components. In terms of these variables, Canada ranked 15th in the gross secondary enrolment rate; 27th for tertiary enrolment rate; 14th in the quality of the educational system, defined as the ability to meet the needs of a competitive economy; 22nd in terms of the quality of math and science education; 4th in the quality of management schools; 13th in the local availability of specialized research and training services; 24th in the extent of staff training; and 9th in the quality of public schools. All these assessment are based on survey data except the first two which are based on hard data. This may account for Canada's poorer showing compared to OECD data on post-secondary education and PISA data on school achievement.



iii. Governance

Governance has been defined as "rules, processes and behaviour that affect the way in which powers are exercised.... particularly as regards openness, participation, accountability, effectiveness and coherence" (European Commission, 2001). There are a number of international studies of governance indicators and Canada does well on all of them.

For example, the World Bank report *Governance Matters 2007* identifies six dimensions of governance and develops empirical estimates for 212 countries (World Bank, 2007):

- *Voice and accountability* - measures the extent to which the citizens of a country are able to participate in selecting their government, including freedom of expression, freedom of association, and free media;
- *Political stability and absence of violence* - measures the perceptions of the likelihood that the government will be destabilized or toppled through unconstitutional or violent means, including terrorism;
- *Government effectiveness* – measures the quality of public services, the quality of civil service and its degree of independence from political pressure, the quality of policy formulation and implementation, and the credibility of the government’s commitment to those policies;
- *Regulatory quality* - measures the ability of the government to formulate and implement both sound policies and regulations that promote private sector development;
- *Rule of law* – measures the confidence of a country’s citizens in the rule of law and the extent to which they abide by it, with particular emphasis on the quality of contract enforcement, courts, police, and the likelihood of crime and violence;
- *Control of corruption* – measures the extent to which public power is used for private gain. It includes petty and grand forms of corruption, as well as the capture of the state by elites and private interests.

Canada scored very well in all six dimensions of governance. Among G-7 nations, Canada ranked first in three areas (government effectiveness, the rule of law, and the control of corruption) and second in three areas (voice and accountability, regulatory quality, and political stability and absence of violence). Canada was among the top 10 per cent of 212 countries in all dimensions, except in political stability and the absence of violence, where it ranked among countries in the 75th to 90th percentile.

In contrast to the stellar performance in the World Bank report, Canada did not rank quite as high in the governance measures contained in the *Global Competitiveness Report 2006-2007*, produced by the World Economic Forum. It ranked 21st out of 125 countries in institutions, a broad measure of governance. A total of 29 sub-components or variables make up this index, with all indicators derived from survey data. In terms of these variables, Canada’s ranking ranged from 9th to 74th.¹² Canada’s relative poorer

¹² Canada ranked 9th in centralization of economic policy making; 10th in freedom of the press; 11th in the protection of minority shareholders’ interests; 14th in the reliability of police services; 14th in the ethical behaviour of firms; 14th in the efficacy of corporate boards; 14th in the effectiveness of law-making bodies; 15th in the strength of auditing and accounting standards; 17th in irregular payments in public utilities; 17th in

performance in the area of governance in the Global Competitiveness Report relative to the World Bank report may be linked to the survey nature of the results. The World Bank study is to a greater extent based on hard data. Indeed, Canada appears to do less well in international rankings based on surveys of employers than those based on hard data. Canadian respondents seem to be more critical of their home country than respondents in other countries.

The World Bank report on governance, taken together with the *Global Competitiveness Report*, suggests that a problem may not be the level of regulation, but the time-consuming and bureaucratic nature of the process of compliance. For example, according to *Doing Business 2008*, the hours per year necessary to prepare, file, and pay corporate taxes, sales taxes, and labour taxes in Canada were higher than in Australia, Ireland, Luxembourg, Norway, Switzerland, United Kingdom, and New Zealand, among OECD countries. This is corroborated by the findings in the *Global Competitiveness Report's* survey of foreign investors, which reveals that paying taxes and inefficient government bureaucracy are considered the most problematic factors for doing business in Canada.

A third indicator of governance is the Index of Perceptions of Corruption produced by Transparency International. This index is available for most countries of the world (200 countries in 2007) and is based on surveys of businesspeople. Canada does very well in this governance measure, suggesting that corruption is not perceived as a significant problem in this country. In 2007, Canada ranked 9th out of 180 countries and first in the G-7 (Table 16). Over the ten year period from 1998 to 2007, Canada's average ranking was tenth.

To conclude, both the World Bank and Transparency International rank Canada high in terms of governance, in the top 5 or 10 per cent of countries. The World Economic Forum places Canada at a somewhat lower rank, in the top 20 per cent. While there is always room for improvement, poor governance is unlikely to deter FDI from locating in Canada.

the business cost of corruption; 17th in irregular payments in tax collection; 18th in irregular payments in public contracts; 18th in judicial independence; 19th in irregular payments in exports and imports; 20th in protection by the law of property rights; 20th in irregular payment in judicial decisions; 27th in bribes for influencing laws, policies, regulations, or decrees; 28th in the impact of nepotism; 29th in the public trust of politicians; 29th in the business costs of crime and violence; 31st in favoritism of decisions of government officials; 33rd in the diversion of public funds due to corruption; 34th in wastefulness of government spending; 34th in the quality of information regarding changes in policies and regulations; 36th for the costs imposed on business by organized crime; 36th for pervasiveness of illegal donations to political parties; 38th in the burden of government regulation; 47th impact of legal contributions to political parties on public policy; and 74th in the business costs of terrorism.

iv. Macroeconomic Performance

Canadian macroeconomic performance has been strong in recent years, among the best in the OECD.¹³ Despite a very large exchange rate appreciation, the Canadian economy experienced solid GDP growth in recent years (Table 24). The unemployment rate, at 6.0 per cent in 2007, is the lowest in since the mid-1970s, reflecting sound macroeconomic policies (Table 25). Canada's economic success in large part reflects high commodity prices, which have resulted in improved terms of trade, fuelling incomes and domestic demand. Inflation has remained under control (Table 26), and current account balances are in surplus. Good macroeconomic conditions contribute to a favourable climate for foreign investment, and the strong macroeconomic performance will contribute to Canada's ability to attract FDI.

v. Public Finances

Canada's public finances are very sound, being among the best, if not the best, in the OECD. In the 2007-08 fiscal year ending March 31, 2008 the federal government and provincial-territorial governments, in the aggregate, are projected to each be in a surplus position equivalent to around 0.5 per cent of GDP (Chart 12). In addition, all individual provinces and territories are projected to be in a surplus position, as they were in 2006-07.

Canada is expected to have the strongest budgetary position in the G-7 over the 2007-2009 period (Chart 13). In contrast to the G-7 average of a budgetary deficit equivalent to nearly 3 per cent of GDP in 2007, Canada recorded a surplus of over 1 per cent of GDP. The contrast between the fiscal position of Canada and the United States in 2007 is particularly striking given the many similarities between the two economies: a 1.2 per cent total government surplus versus a 2.9 per cent deficit.

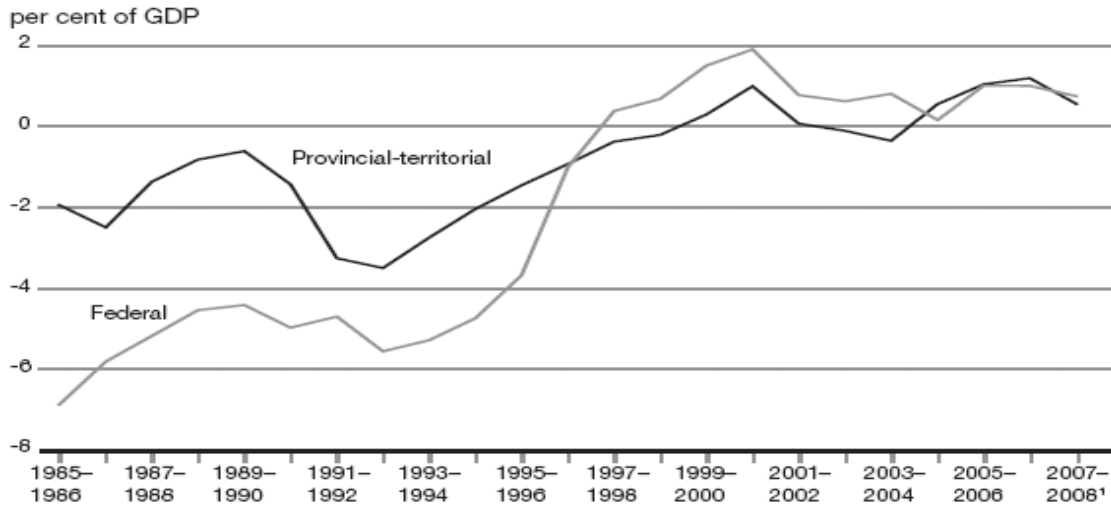
The Canadian government has been in a surplus position since the 1996-97 fiscal year. This situation has resulted in a massive fall in the debt/GDP ratio, plummeting from nearly 70 per cent in 1995-96 to 30 per cent in 2007-2008 (Chart 14). The provincial-territorial debt/GDP ratio has also fallen from nearly 30 per cent in 1999-2000 to less than 20 per cent. Canada now has by far the lowest total government net debt/GDP ratio in the G7 on a national accounts basis (Chart 15) and ranks in the top half among OECD countries behind countries such as Norway, Finland, Sweden and Australia. At around 20 per cent of GDP in 2008, it is less than half the G-7 average of 49 per cent. The debt-

¹³ Details on recent Canadian macroeconomic performance are provided in OECD (2006b) and IMF (2008). The OECD in its 2006 country report on Canada (OECD, 2006:9) states "The Canadian economy has continued to deliver excellent results in nearly all respects." The recent IMF Article 4 report on Canada (IMF, 2008) "commended Canada's impressive macroeconomic track record since the mid-1990s, which has been underpinned by sound monetary and fiscal policies and favorable external conditions. They welcomed, in particular, the strong GDP growth and declining unemployment, low and stable inflation, and consecutive fiscal surpluses with attendant reductions in the federal debt-to-GDP ratio achieved during this period."

GDP ratio of the G-7 country with the second lowest ratio is around 40 per cent, double that of Canada.

To the degree that a firm seeking to make direct investments abroad is influenced by the fiscal position of the host country, Canada is a very attractive location for FDI.

Chart 12: Federal and Provincial-Territorial Budgetary Balances (Public Accounts Basis)

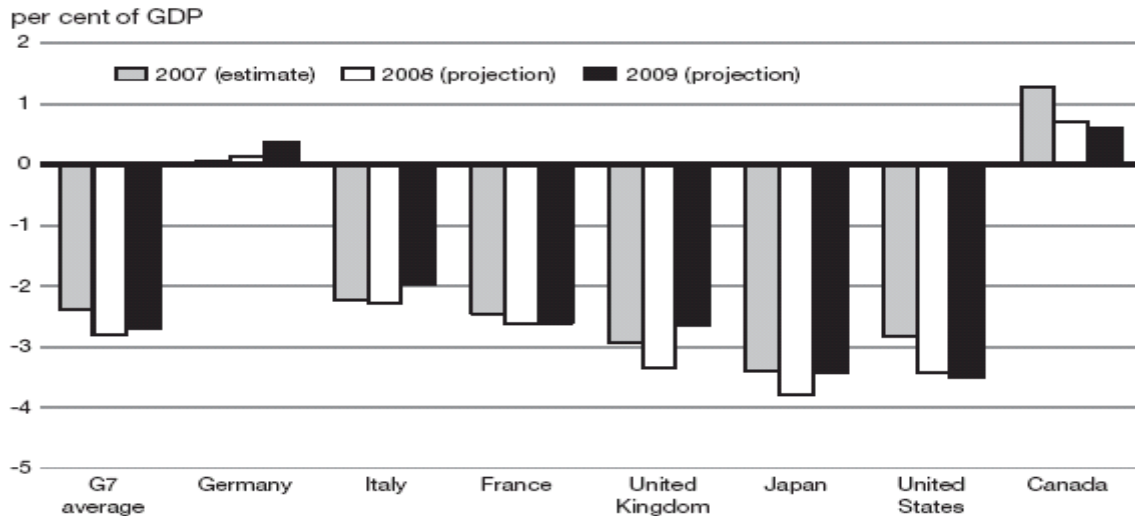


¹Projection.

Sources: Federal and provincial-territorial Public Accounts and budgets.

Source: 2008 Federal Budget, Chart A1.1

Chart 13: Total Government Financial Balances¹ (National Accounts Basis)

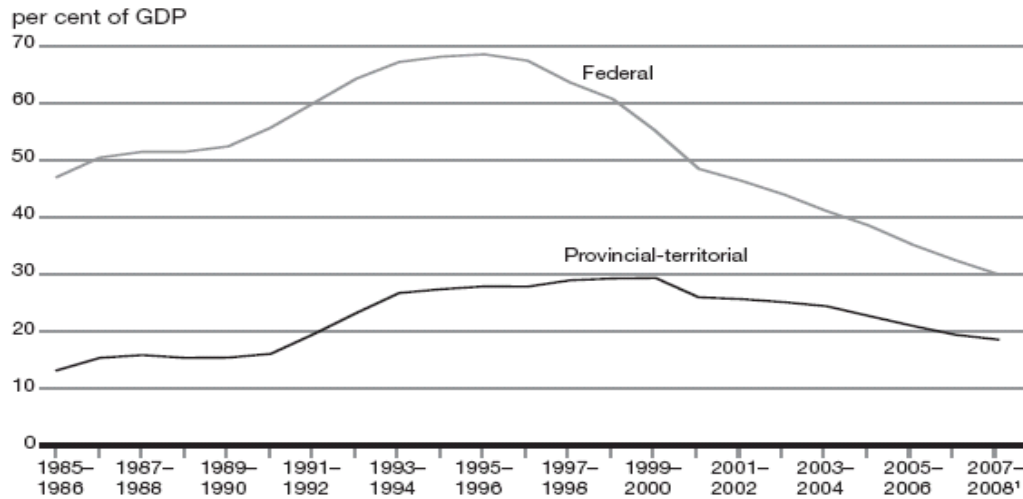


¹The OECD uses the term "financial balance" to mean "budgetary balance."

Source: *OECD Economic Outlook*, No. 82 (December 2007).

Source: 2008 Federal Budget, Chart A1.7

Chart 14: Total Government Financial Balances (Public Accounts Basis)



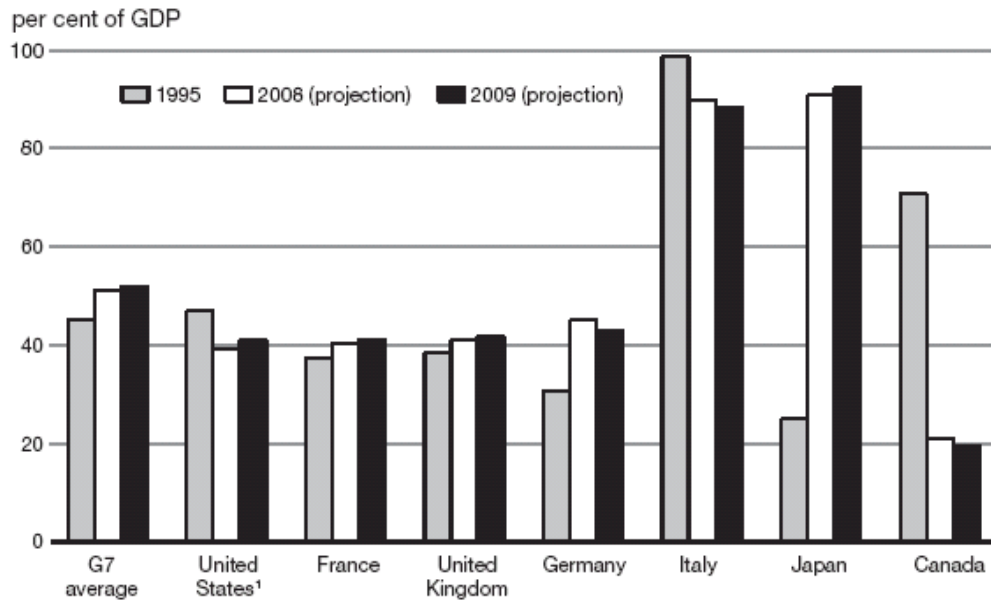
¹ Projection.

Sources: Federal and provincial-territorial Public Accounts and budgets.

Source:2008

Federal Budget, Chart A1.5

Chart 15: Total Government Net Debt (National Accounts Basis)



¹ Adjusted to exclude certain government employee pension liabilities to enhance comparability with other countries' debt measures.

Sources: OECD Economic Outlook, No. 82 (December 2007); U.S. Federal Reserve Board, *Flow of Funds Accounts of the United States* (September 2007); Department of Finance calculations.

Source: 2008 Federal Budget, Chart A1.8

vi. Labour Market Flexibility

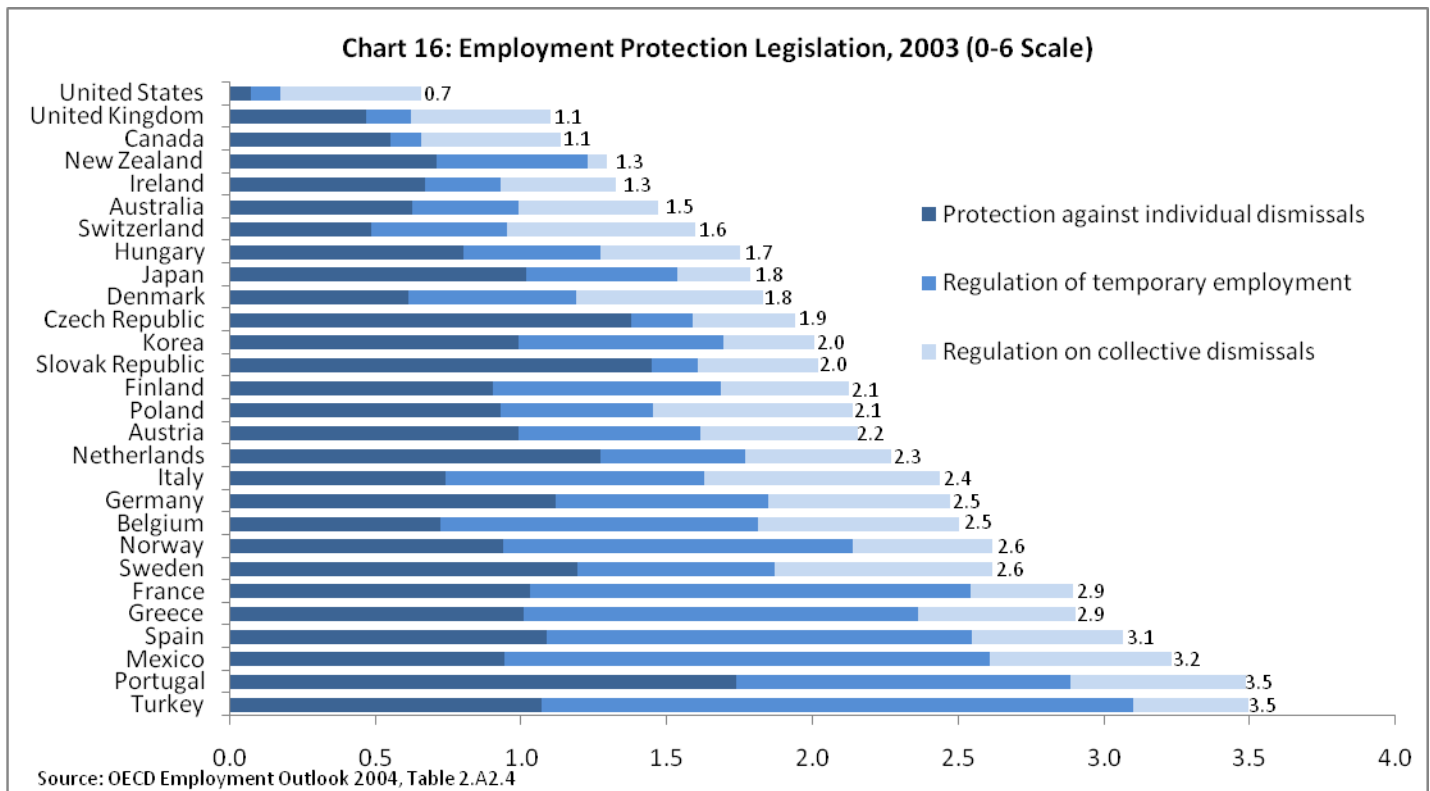
Everything else being equal, firms prefer a flexible labour force over a non-flexible labor force as it facilitates the reallocation of workers and lowers costs. A country

with a high degree of labour market rigidity therefore may be a less attractive location for FDI than a country with a flexible labour market.¹⁴

Both the World Bank and the OECD have developed methodologies to estimate a country's degree of labour market flexibility. Both measures show that Canada's labour market is relatively flexible compared to that of other countries.

The World Bank, in its annual report *Doing Business*, produces an index of the ease of doing business in 177 countries. One of the ten components, or domains, of the index is entitled "employing workers." This sub-index can be considered a measure of labour flexibility.

In the 2008 report Canada ranked 19th out of 177 countries on this variable, 6th among OECD countries, and 3rd in the G-7 (Table 17). The "employing workers" domain is composed of three components: firing costs (cost of advance notice requirements, severance payments, and penalties for terminating a redundant worker, measured in weeks of salary); nonwage labour costs (social security payments and payroll taxes associated with hiring an employee, expressed as a percentage of the worker's salary); and the rigidity of employment index (composed of three sub-indices – difficulty of hiring, rigidity of hours, and difficulty of firing). It is the latter index that is particularly relevant for international comparisons of labour flexibility



¹⁴ Nicolletti *et al.* (2003) found that host countries in which employment protection legislation is stricter than in their investing partners tend to attract significantly less FDI.

Canada ranked 2nd among G-7 nations and 3rd in the OECD in the overall rigidity of employment index. For the difficulty of hiring sub-index, Canada received a score of 11 on an index from 0 to 100 (0 reflects no rigidity and 100 complete rigidity). This placed Canada 7th among OECD countries (along with eight other countries) and 3rd in G-7 (equal with the United Kingdom). For both the rigidity of hours index and the difficulty of firing index Canada scored 0 on an index from 0 to 100, placing Canada first (4 other OECD countries also received this score for the rigidity of hours index and 2 countries for the difficulty of firing index.)

Canada ranked 3rd in non-wage labour cost of salary in the G-7 and 7th in the OECD. Canada performs well in terms of overall labour market flexibility, beating the United Kingdom, Germany, Italy and France. Among OECD countries, only the United States, Australia and Denmark, New Zealand and Japan performed better than Canada in this category.

Work done at the OECD is consistent with the World Bank results that Canada's labour market exhibits a high degree of flexibility.¹⁵ The OECD index of employment protection legislation ranked Canada third out of 30 OECD countries in 2003 (Chart 16). Only the United States and the United Kingdom scored higher. Canada's index was 1.1 based on 0-6 scale where 0 is no protection and 6 is complete protection. Canada scored well in all three components of the index: protection against individual dismissals, regulation of temporary employment, and regulation on collective dismissals.

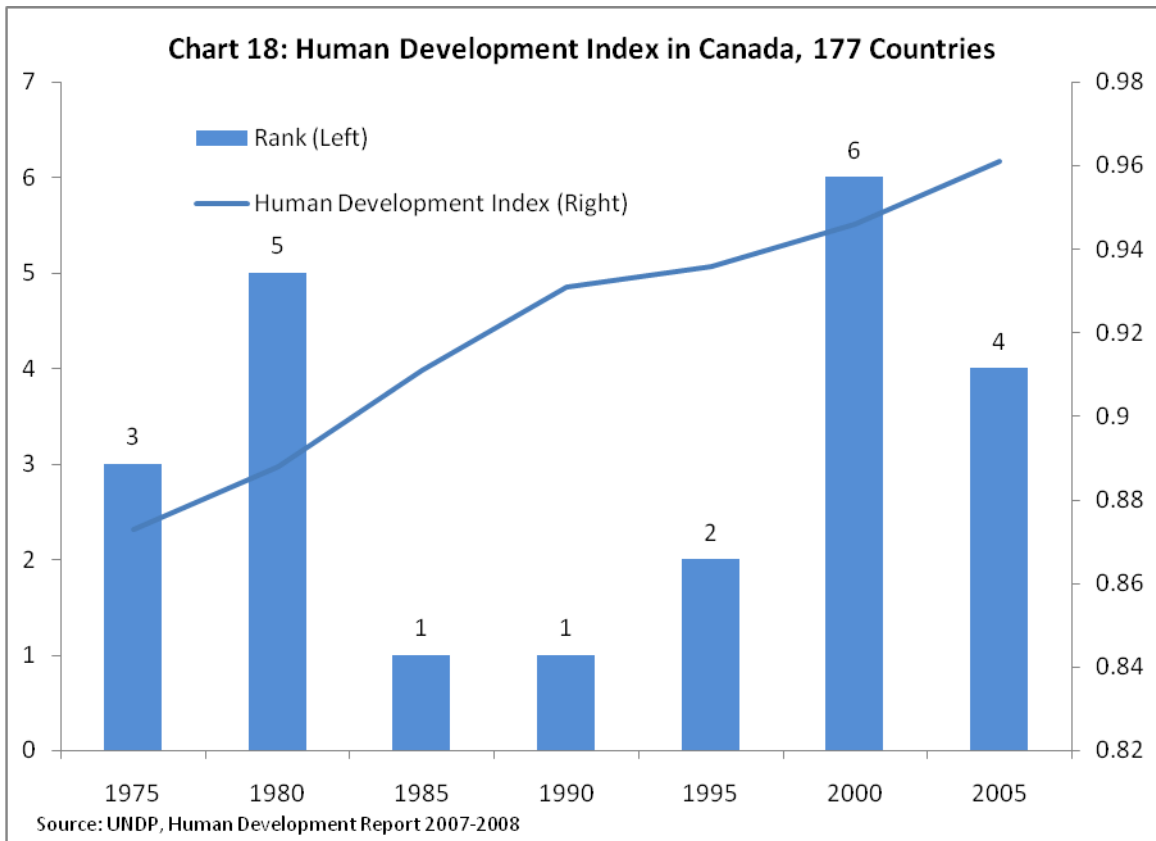
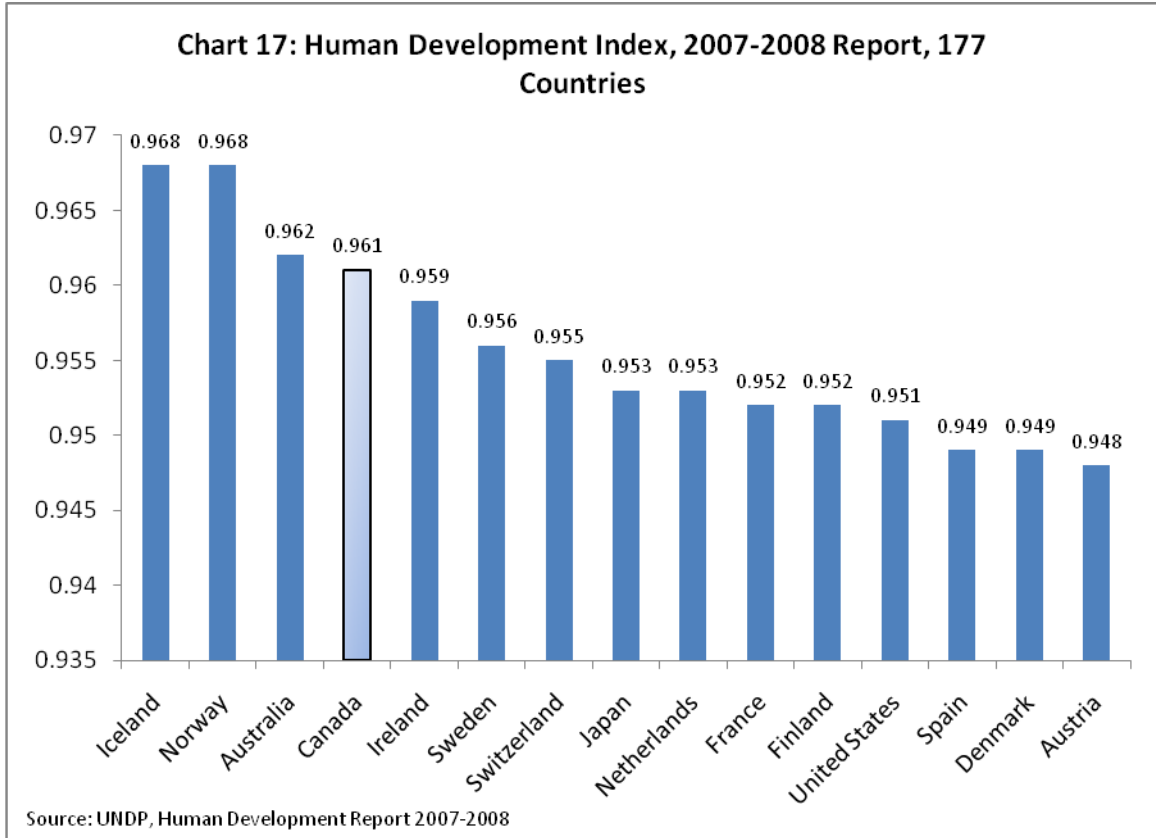
To conclude, Canada has been and remains an attractive country from the point of view of firms who place a high value on labour market flexibility in their decisions on the location of FDI.

vii. Quality of Life

The quality of life in a country is an important, though often implicit, factor influencing FDI location. Naturally, foreign investors are concerned not only about the performance of their businesses, but also about the quality of expatriate life. Lifestyle factors may therefore tip the balance in favour of one country over others perceived to have similar investment conditions.

The most widely known measure of well-being is the United Nation's Development Program's Human Development Index (HDI). This measure combines social and economic well-being into a composite index that measures countries' achievements in health, knowledge, and standard of living (GDP per capita). In the most recent report (UNDP, 2007) based on data for 2005, Canada ranked 4th among 177 nations in the Human Development Index (Chart 17). Canada has consistently ranked at or near the top in the HDI since 1975 (Chart 18).

¹⁵ The IMF (2008) has also concluded that the Canadian labour market exhibits a high degree of flexibility.



The HDI captures objective measures of quality of life or well-being. Subjective rankings of quality of life across countries are also needed for a comprehensive assessment of both aspects of well-being. Canada also ranks high in international subjective measures of quality of life. For example, the first world map of happiness created by Adrian White (2007) ranked Canada 10th in the world and 1st among G7 nations in terms of the happiness of its citizens (Table 18).¹⁶

Finally, it is worth noting that the perception of quality of life in a country according to its own inhabitants might greatly diverge from that of potential foreign investors. In Canada's case, anecdotal evidence might suggest that our harsh winters are detrimental to a foreigner's positive perception of the quality of life in Canada, even though most Canadians consider ice and snow part of the Canadian identity.

viii. Overall Business Environment and Climate for Entrepreneurship

Decisions on direct foreign investment are ultimately made by executives in multinational corporations, taking into account not only the fundamental drivers of FDI, but also the overall business environment or climate in which the FDI will operate. Foreign firms prefer a country with an environment favourable to business to one where the climate is not favourable.

A number of organizations publish reports on the overall attractiveness of a country's business climate to foreign investors. These reports include the *Global Competitiveness Report* produced by the World Economic Forum, the *World Competitiveness Yearbook* produced by IMD Business School, the *Global Entrepreneurship Monitor 2007* compiled by researchers at Babson College and London Business School, *Doing Business 2008* produced by the World Bank, *Competitive Alternatives* produced by KPMG, and the *FDI Confidence Index* compiled by the consultancy A.T. Kearney Ltd.

The rankings contained in these reports must generally be viewed with caution, as they incorporate perceptions of foreign investors, which may be subject to quick revision based on new information or gut feeling. Not surprisingly, Canada receives a wide range of scores in these international rankings.

The *Global Entrepreneurship Monitor (GEM) 2007* provides insight into international trends in entrepreneurship and factors that affect the rate of new business formation for 42 countries. The key indicator used is early-stage entrepreneurial activity rate (TEA rate) – i.e. the prevalence rate of people who are involved in entrepreneurial activity as nascent entrepreneurs or the owners of new businesses.¹⁷

¹⁶ The report was based on a meta-analysis of the findings of over 100 different studies around the world, which questioned 80,000 people worldwide to map out subjective well-being.

¹⁷ New business formation rates exhibit a U-shape, with low-income countries exhibiting high early-stage entrepreneurial activity, middle-income countries exhibiting lower early-stage entrepreneurial activity, and early-stage entrepreneurial activity rising again for high-income countries.

The overall level of early stage entrepreneurial activity in Canada was relatively high, with Canada ranking 7th out of 21 high income nations. Australia, Iceland, the United States, Ireland, Norway and Spain were the only high-income countries ranking higher than Canada in terms of TEA rates. Canada also displays a healthy entrepreneurial attitude compared to other countries studied, ranking fourth among high income countries in terms of high-growth expectation entrepreneurial activity (measured as the prevalence of new and nascent entrepreneurs who expect their business to employ at least 20 people in 5 years time). Moreover, Canada ranked fifth among high-income countries in terms of innovation-oriented entrepreneurial activity (measured as the percentage of early-stage entrepreneurs who believe that they offer a product or service that is new to some or all customers, and that there are few or no businesses offering the same product).¹⁸

The *Global Entrepreneurship Monitor's* Red Tape Index ranked Canada 21st out of 42 countries in terms of regulatory burden for starting a business. This index was based on the survey of experts about the regulatory regime for starting a business in their country, and revealed that experts in Canada, Australia, and New Zealand considered their regulatory regimes to be negative, even though these countries were among those with the lightest red tape according to the World Bank Report noted earlier. It is difficult to reconcile these divergent results.

The World Bank report *Doing Business 2008* provides international comparisons of the ease of doing business based on hard data for 178 countries. Quantitative indicators of regulations that enhance business activity, and those that constrain it, are provided, spanning regulations in 10 stages of a business's life: starting a business, dealing with licenses, employing workers (discussed earlier), registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and closing a business.

In 2008, Canada ranked 7th in the overall "ease of doing business," behind Singapore, New Zealand, United States, Hong Kong, Denmark, and the United Kingdom (Table 19). Canada performed particularly well in the category "starting a business" (which considers all standard procedures that a small- to medium-size company needs to complete in order to start operations legally), in which it was ranked 2nd, behind Australia. Canada also did well in three other indicators: closing a business (fourth), protecting investors (fifth), and seventh in getting credit (seventh).¹⁹

The World Bank's *Doing Business* series, produced annually, is generally more reliable than the *Global Entrepreneurship Monitor*, as they are based on actual regulations and processes rather than relying on the opinions of experts alone (although to some extent, the World Bank rankings do reflect the opinions of experts in the fields).

¹⁸ The GEM results should be viewed cautiously, as there are some methodological issues. For example, sampling methods vary greatly from country to country. The United Kingdom has a reasonable sample size, the United States has a very small sample for the size of its economy, and the Canadian sample is drawn 80 percent from the province of Quebec and is therefore not indicative of the country as a whole.

¹⁹ In the other six indicators Canada's ranking ranged from 19th to 43rd: employing workers (19th), paying taxes (25th), dealing with licenses (26th), trading across borders (39th), and enforcing contracts (43rd).

In its *FDI Confidence Index*, the consulting firm A.T. Kearney publishes the results of an annual survey of major companies regarding their foreign direct investment intentions and their views on candidate countries. In 2005, Canada dropped from 16th to 21st place in the index (out of 68 countries), which was its lowest recorded ranking (Table 20). The only reasons provided were (1) a drop in Canada's attractiveness among U.S. investors, who ranked Canada their 8th most preferred FDI location in 2005, down from 4th place in 2004, and (2) a general decline of interest in the Canadian market among global manufacturing and financial services investors. The A.T. Kearney rankings appear to be quite volatile, affected by short term factors, and do not provide much insight into the reasons for Canada's changes in the rankings. The results should therefore be viewed very cautiously.

The Economist Intelligence Unit rates the business environments of 82 countries on the basis of 91 indicators including indicators of macroeconomic stability, labour market flexibility, the quality and quantity of infrastructure, and the regulatory environment. The scores take values between one and ten and allow countries to be ranked according to the overall attractiveness of their business environments to potential investors. In the 2008 rankings, Canada places fourth with a score of 8.72. (Denmark's score of 8.78 places it first, while Finland and Singapore rank second and third.) Canada's rank represents an improvement over its fifth-place rank in 2003.

The most comprehensive analysis of business environment is found in the annual publication *The Global Competitiveness Report 2006-2007: Creating an Improved Business Environment*, produced by the World Economic Forum. The Global Competitiveness Index groups factors that determine productivity and competitiveness into nine categories – institutions, infrastructure, macroeconomy, health and primary education, higher education and training, market efficiency, technological readiness, business sophistication, and innovation. It defines the first four categories as basic requirements; the fifth, sixth, and seventh as efficiency enhancers; and the final two categories as innovation factors. The study is largely based on survey responses of domestic and foreign investors to capture qualitative aspects of the business environment, but it also relies on some hard data to compile its country-rankings.

Overall, Canada ranked 16th out of 125 countries in the 2006-2007 *Global Competitiveness Report*, down from 13th in the 2005-2006 report. For the four basic requirement categories Canada ranked 13th overall, placing 21st in institutions, 13th in infrastructure, 32nd in the macro-economy, and 2nd in health and primary education. For the three efficiency enhancers Canada ranked 15th, placing 17th in higher education and training, 7th in market efficiency, and 17th in technological readiness. For the innovation factors Canada ranked 16th, placing 18th in business sophistication and 13th in innovation.

A second comprehensive assessment of overall competitiveness is provided by the *World Competitiveness Yearbook* published by the IMD Business School in Geneva. Canada's overall ranking was 10th out of 55 countries in 2007 (Table 22). Of the four

components of the index, Canada ranked 11th in government efficiency, 12th in infrastructure and business efficiency, and 13th in economic performance.²⁰

KPMG's *Competitive Alternatives: 2008 Edition* provides model-based comparisons of business costs across nine affluent countries and Mexico, a newly industrialized country. The comparisons rely on data collected from 136 cities and seventeen industries within four industry sectors: manufacturing, research and development, software, and corporate services. Using this data, KPMG's cost model produces, for each country, estimates of various location-sensitive business costs including the costs of labour, transportation, utilities, and taxes. The United States is used as a baseline; its business costs are assigned a value of 100.0, and costs in other countries are indexed to that base. Since firms prefer to invest in locations with low costs rather than high costs, all else being equal, these business cost measures provide information about the relative attractiveness of countries' business environments from a cost perspective.

Summary Table 3 contains the business cost index values for all countries in the KPMG study, for four industry sectors and for the overall national economies in 2008. In each case, Canada compares favourably to most of the other countries. Overall, Canadian business costs take an index value of 99.4, on par with costs in the United States and Australia and lower than those in all the other affluent countries. Only Mexico has lower overall business costs than Canada, which is no surprise; Mexico is a newly industrialized country with low labour costs, and labour costs (including wages and salaries, statutory benefits, and fully employer-provided benefits) make up 58 to 74 per cent of location-

Summary Table 3: Business Costs by Country and Industry Sector, 2008

	Manufacturing	Software	Research and Development	Corporate Services	Overall
Mexico	83.9	69.5	68.9	69.3	79.5
Canada	99.9	96.5	96.3	105.8	99.4
United States	100.0	100.0	100.0	100.0	100.0
Australia	99.5	99.7	100.5	109.6	100.2
France	102.3	105.0	100.4	121.2	103.6
United Kingdom	104.9	111.4	107.5	123.2	107.1
Netherlands	105.5	109.6	102.1	132.2	107.3
Italy	104.8	113.9	109.1	129.8	107.9
Japan	111.1	109.3	117.6	159.9	114.3
Germany	111.9	127.2	121.7	141.9	116.8

Note: Business costs are reported as an index with US = 100.0.

Source: KPMG (2008)

²⁰ See Table 23 for Canada's ranking for the different variables in each component.

sensitive costs for manufacturing firms and 79 to 88 per cent for non-manufacturing firms. Canada also ranks second behind Mexico in terms of business costs in the software and R&D sectors. Within the R&D sector, Canada has particular advantages in biotechnology and product testing, with cost index values of 98.6 and 94.2—both placing Canada in second place behind only low-cost Mexico.

Canada ranks third in the manufacturing sector, although the differences between Canada and the second- and fourth-place countries, Australia and the United States, are negligible. In the particularly important automotive industry, Canada's cost index value is 100.2; this ranks Canada fourth in the industry with costs once again essentially the same as those in the United States.

In the corporate services sector, Canada's index value of 105.8 is good enough for a third-place ranking, although it is 5.8 points higher than the second-place United States.

Since 2006, Canada's cost competitiveness has decreased relative to the United States but increased relative to the rest of the affluent countries. Canada's cost index value increased by 4.9 points over the two-year period, from 94.5 to 99.4, but this was the smallest increase experienced by any of the countries; the next smallest was Japan's 7.4 point increase. These trends reflect the influence of exchange rates in the business cost measurements. The US dollar has depreciated against the Canadian dollar, the UK pound, and the Euro since 2006 and the costs of doing business have therefore declined in the United States relative to the rest of the world. Since the long-run value of the Canada-US exchange rate is estimated to be about \$0.80-\$0.85 USD per \$1.00 CAD, there is reason to think that Canada's cost competitiveness should improve in the future as the Canadian dollar returns to its long-run value.²¹

While there is always room for improvement, the KPMG study does not identify any particularly problematic aspects of Canada's business cost environment. Canada is ranked third in total labour costs per employee. In terms of the percentage of a firm's payroll that goes toward statutory plans and other benefits, Canada ranks first and second, respectively. Canada ranks second in both electricity costs and telecommunications costs, behind only the United States. Canada has a lower effective income tax rate for manufacturing firms than any of the other affluent countries in the study. Neither the federal government nor most of the provincial governments impose capital taxes. Environmental regulation is becoming an increasingly important factor in investment decision-making, and Canada ranks first in terms of the impact of environmental laws on cost competitiveness. One potential area of concern is property taxes; Canada ranks seventh in the cost of property tax per square foot of building space. On the whole, however, the cost of doing business does not appear to be a major impediment to FDI inflows into Canada.

Indeed, based on the above rankings, it seems fair to conclude that Canada does not have a major problem with respect to its overall business environment, although there may be room for improvement in some areas.

²¹ For estimates of the long-run Canada/US PPP exchange rate, see OECD (2008).

Exhibit 1

**Canada's Performance on OECD Product Market Regulation Indicators
(0 to 5 from least to most restrictive)**

	Score		Ranking out of 28 OECD Countries	
	1998	2003	1998	2003
State Control	1.8	1.7	4	8
Barriers to Entrepreneurship	1.0	0.8	1	1
Barriers to Trade and Investment	1.3	1.1	13	22
Overall Product Market Regulation	1.4	1.2	4	8

Note: The state control domain includes sub-domains on public ownership and involvement in business operations; the barriers to entrepreneurship domain includes sub-domains on administrative barriers to start-ups, regulatory and administrative opacity, and barriers to competition; the barriers to trade and investment domain includes explicit barriers to trade and investment and other barriers.

Source: Conway, Janod and Nicoletti (2005: Tables 21-24).

One specific aspect of the business environment is product market regulation (Sharpe and Currie, 2008). OECD research has found that these regulations curb competition and have a negative and significant effect on FDI.²²

Exhibit 1 shows Canada's performance on OECD product market regulation indicators, which include state control, barriers to entrepreneurship, barriers to trade and investment, and overall product market regulation. In 2003, Canada ranked 8th among OECD countries in terms of overall product market regulation, down from 4th in 1998. In absolute terms, however, product market barriers were low and on a downward trend. On a scale of 0 to 5 where 0 is the least restrictive and 6 the most restrictive, Canada registered below 2 in all three policy domains as well as for the overall indicator. In all three policy domains, Canada moved slightly to a less restrictive product regulatory environment between 1998 and 2003.

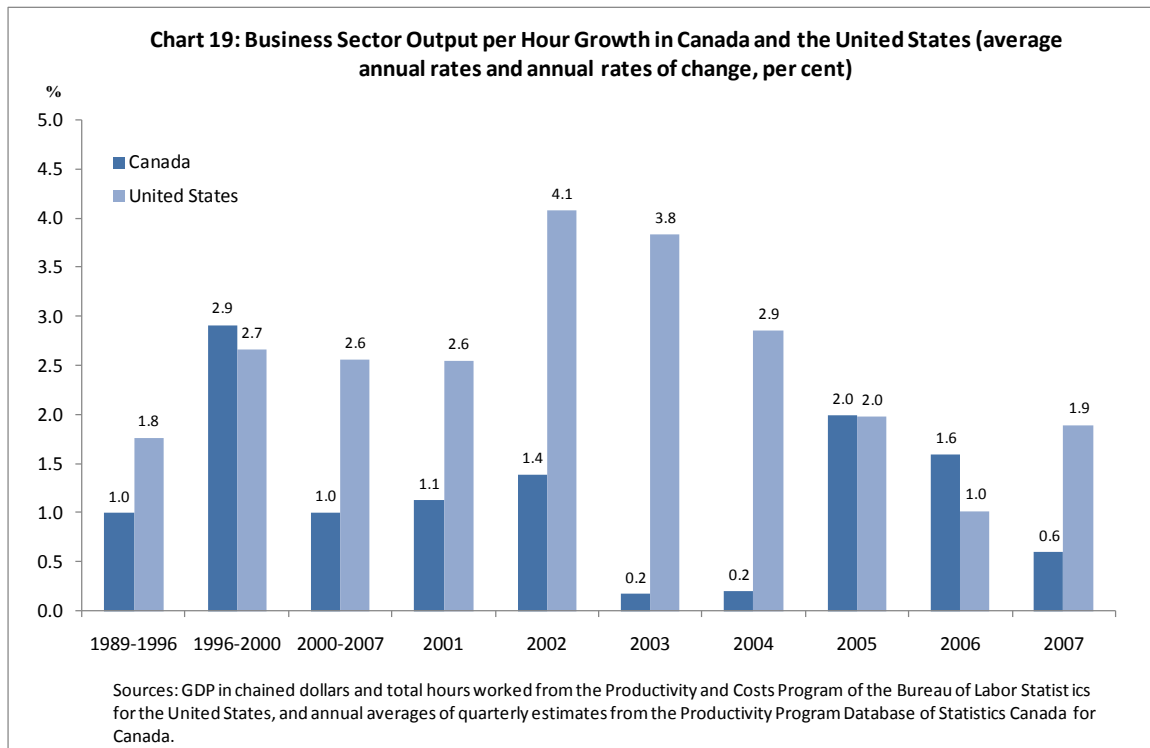
²² Nicoletti *et al.* (2003:55) find that as product market regulation in the host country becomes more restrictive than regulation in the home country, outflows of the latter decrease. In other words, product market regulations make the host country less attractive to international investors located in countries where regulations are less restrictive.

B. Canada's Relative Weaknesses

i. Productivity Trends

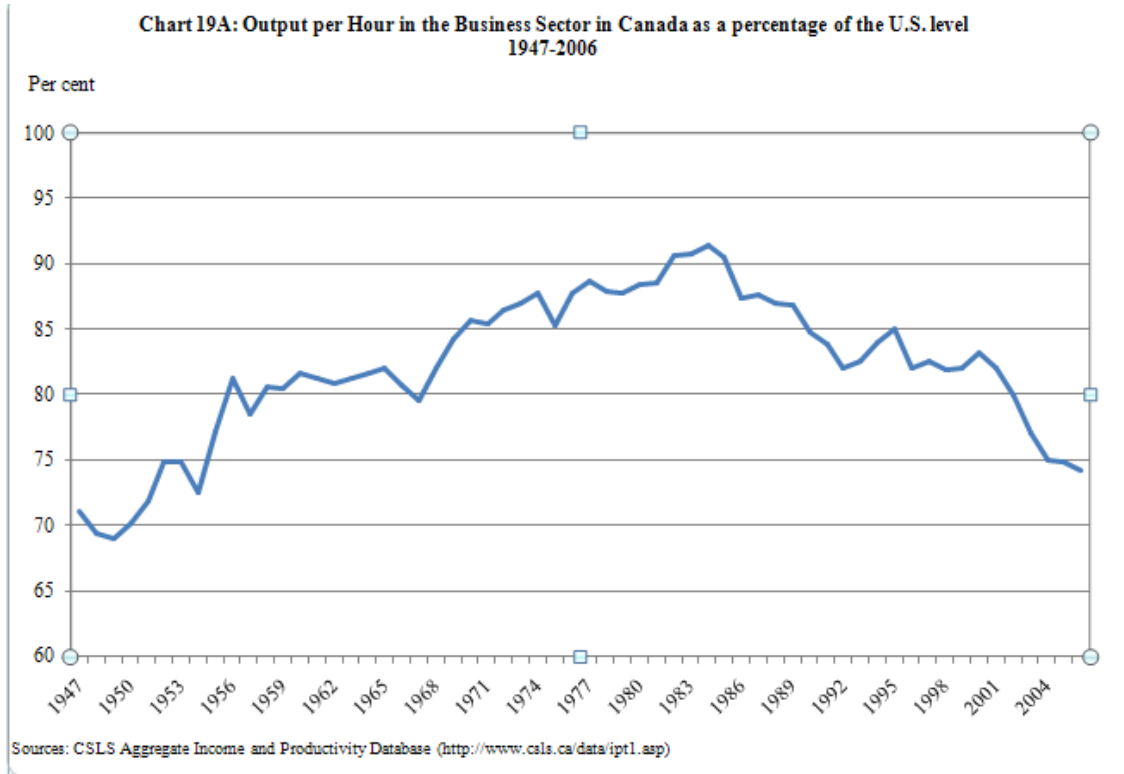
As noted earlier in the report, the Canadian economy has performed well on almost all economic indicators. The one area where Canada has performed poorly, from both historical and international perspectives, is productivity growth. Ironically, as discussed above, productivity growth is of paramount importance for international competitiveness and future living standards. Not surprisingly, both the OECD and IMF reports highlight this area of weakness and recommend policies to rectify it.²³

Canada's productivity growth has also been very weak relative to that experienced in the United States. The growth rate of business sector output per hour in Canada has been 1.0 per cent per year since 2000, only around 40 per cent of the 2.6 per cent rate recorded south of the border (Chart 19).²⁴ Based on Industry Canada benchmark labour productivity level estimates (Rao, Tang and Wang, 2004), Canada's lagging labour productivity growth has resulted in the widening of the business sector labour productivity gap from 17 percentage points in 2000 (83 per cent the US level) to 26 points in 2006 (74 per cent the US level) (Chart 19A).

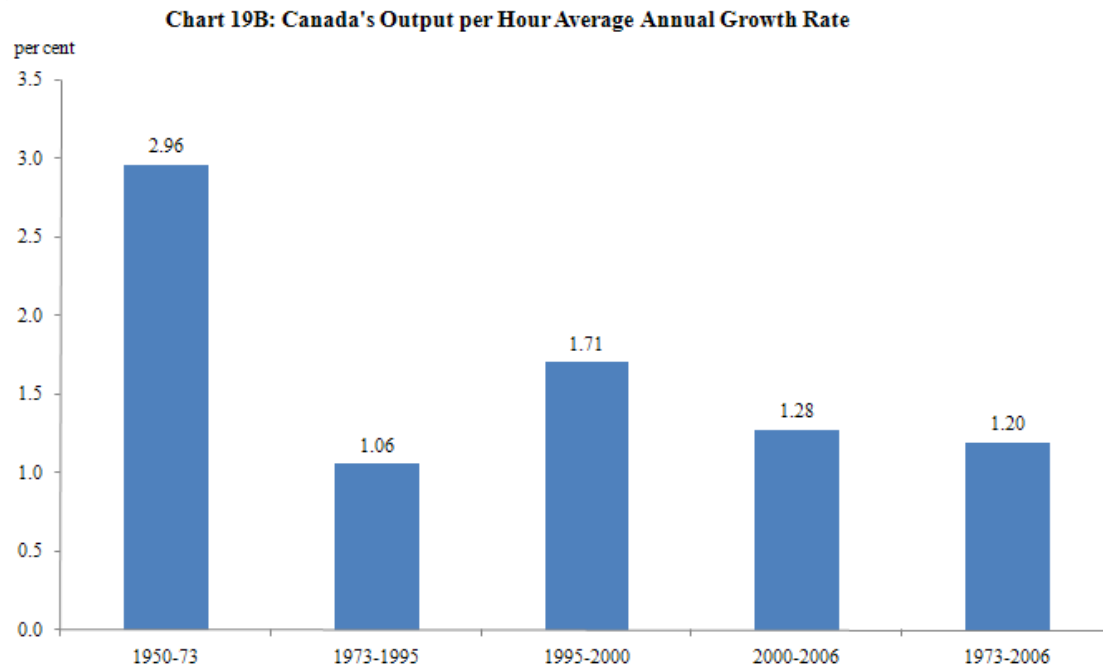


²³ The OECD country report (2006:10) says that a challenge for all levels of government is to raise productivity and that boosting productivity growth depends on improving the overall business environment. For an OECD perspective on Canada, also see Cotis (2006).

²⁴ For a detailed recent analysis of the causes of weak productivity growth in Canada since 2000, see Sharpe and Arsenault (2008).

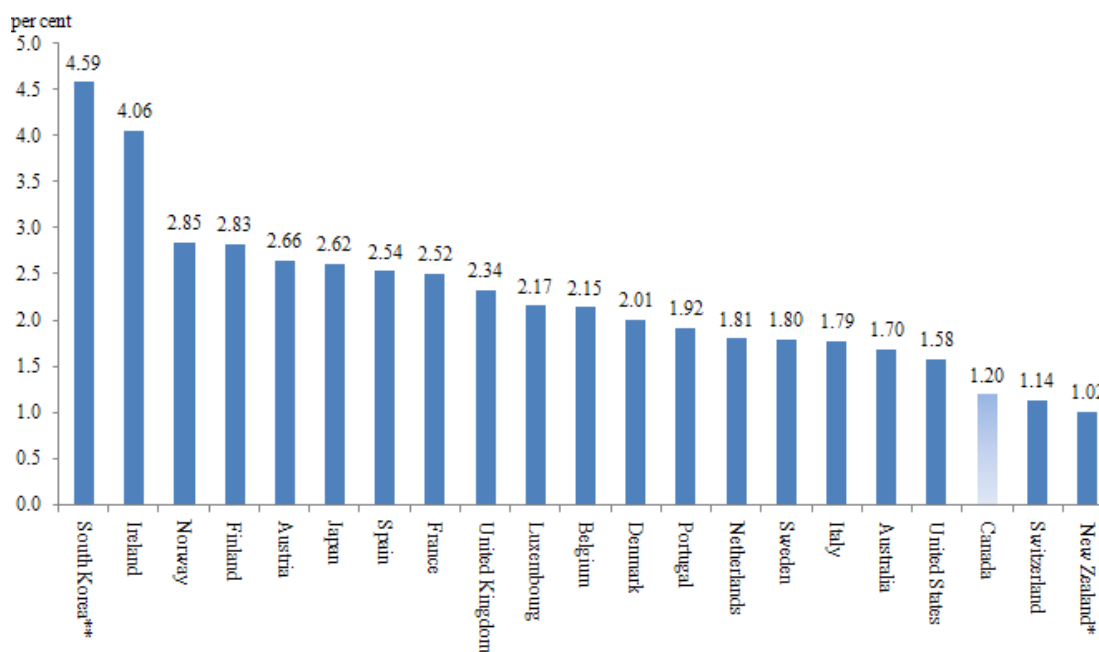


From a historical perspective, Canada's relative productivity performance has been very weak. Over the 1973-2006 period, output per hour in Canada advanced at only a 1.2 per cent average annual rate (Chart 19B and Table 26), down from 3.0 per cent in the 1950-73 period, a drop of nearly two thirds.



Source: Groningen Growth and Development Centre and the Conference Board, Total Economy Database, June

Chart 19C: Output per Hour Growth Rates in Selected OECD Countries, 1973-2006



Source: Groningen Growth and Development Centre and the Conference Board, Total Economy Database, February, 2007, <http://www.ggdc.net>.

Since 1973 Canada has had the third lowest rate of growth in output per hour among 23 OECD countries, with only New Zealand and Switzerland doing worse (Chart 19C). This resulted in Canada's level of output per hour falling from third highest in the OECD in 1950 and in 1973 to 16th in 2006.

The causes of the fall-off in labour productivity growth in Canada after 2000 are still poorly understood. Possible explanations include measurement problems; weak productivity growth in resource industries exploiting poorer quality resources such as the oil sands; weak ICT investment; a failure to exploit advanced technologies; and weak wage growth leading to a slower rate of substitution of capital for labour (Rao, Sharpe and Smith, 2005 and Sharpe and Arsenault, 2008). There is no evidence that trends related to FDI have been responsible for the weakness of labour productivity growth.

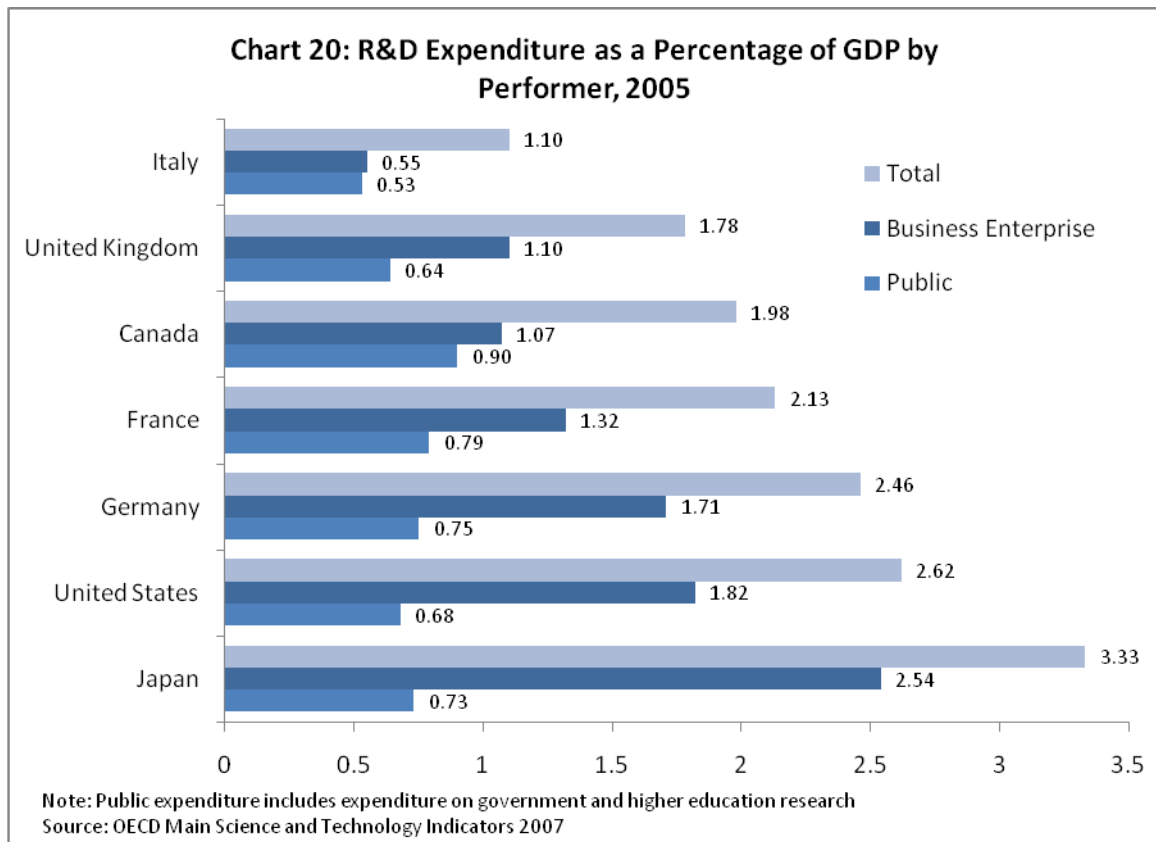
This inability of productivity analysts to provide a definitive account of the reasons for Canada's poor productivity growth makes the development of policies to reverse this situation more difficult. If we knew what was wrong, we could take action to rectify the problem. But we do know that technological change and investment are fundamental drivers of productivity growth. Thus policies that focus on these two areas can be expected to have a positive impact on productivity growth.

The importance of productivity for FDI attraction is unclear. Foreign firms considering investing in a host country normally would be expected to assume responsibility for the productivity performance of their operations since they control all aspects of the production process. From this perspective, they may not be particularly concerned by a country's poor productivity growth as they feel they will not be affected.

But if the productivity performance is directly linked to certain negative aspects of the business environment, such as an excessively adversarial labour relations climate or negative worker attitudes to productivity, then FDI may indeed be deterred. Fortunately, Canada's mediocre productivity performance has not been linked to specific business environment factors that are harmful to productivity.

ii. R&D and Innovation

The level of R&D in a country is a key determinant of innovation and an innovative economy is attractive to FDI. Indeed, an OECD study on FDI found that the overall level of R&D expenditure in the host country increases its attractiveness for total inward FDI (Nicoletti *et al.*, 2003:48). While Canada had the highest public R&D expenditure as a percentage of GDP among G7 nations in 2005, Canadian business R&D expenditure as a share of GDP was 6th amongst the G7 countries (Chart 20), and down from 5th place in 2004.



Canada's performance in attracting foreign R&D expenditures also lagged in comparison to other countries in the G7. Expenditures on R&D of foreign affiliates (adjusted for inflation) in Canada were the 2nd lowest among G7 countries in 2003 (the most recent year for which data are available), although expenditures on R&D by foreign affiliates as a percentage of total R&D expenditures by enterprises was the 2nd highest.²⁵

²⁵ Data on R&D expenditures are from OECD (2007b).

Moreover, India and China are making rapid progress in the area of R&D and are likely to be major players in the future. For example, in 2005, China became the 3rd largest R&D spender world-wide (in purchasing power terms), after the United States and Japan (OECD 2007d). In addition, with its large pool of scientists and engineers, China could become an attractive location for FDI in R&D if its WTO membership pushes it to develop a secure intellectual property rights regime and legal framework. While R&D expenditures in India are not significant in the world stage, it is high among developing nations. India has become a major player in computer software development, and is attracting some R&D in IT with its large pool of computer engineers and lower pay scales (Conference Board of Canada 2004). Both countries are strong competitors to Canada for attracting FDI in R&D-intensive industries.

The 2006-2007 *Global Competitiveness Report* ranked Canada 13th out of 125 countries in innovation, noting that Canada's comparative advantages in this category lie in the availability of scientists and engineers, utility patents, quality of scientific research institutions, and university/industry research collaboration, while its comparative disadvantages lie in government procurement of technology products and company spending on R&D. Though Canada performs well on innovation in the 2006-2007 *Global Competitiveness Report*, it is interesting to note that its ranks in technological readiness (i.e. the quickness with which an economy adopts existing technology to increase the productivity of its industries) and business sophistication (measured by the quantity and quality of local suppliers, well-developed production processes, and the extent to which companies produce the most sophisticated products) are 17th and 18th, respectively, out of 125 countries. For Canada to build its attractiveness as a destination for investment, it will have to effectively deal with increased competition for foreign investment (in R&D and otherwise), and issues pertaining to technological readiness and business sophistication.

In contrast to the relatively high ranking in innovation provided by the *Global Competitiveness Report*, the Conference Board of Canada (2007) gave Canada a grade of D for innovation, ranking it fourth to last in a 17 country comparator group.

As was the case for productivity, the importance of innovation, and particularly business sector R&D, for FDI location decisions is unclear. Foreign firms considering investing in a host country normally would be expected to assume responsibility for their own innovative activities including R&D. From this perspective, they may not be particularly concerned by a country's poor business sector R&D performance as they feel they will not be affected by it. They control their own R&D budget. They might be more concerned with the overall level of public R&D and the potential spillovers from this type of R&D to the business sector, and the supply of highly skilled labour. As noted, Canada does well on both of these indicators.

iii. Infrastructure

The availability of quality infrastructure positively affects inward FDI, as it lowers transaction costs, in turn facilitating international specialization and the location choices of MNEs.²⁶

The *Global Competitiveness Report 2006-2007* ranked Canada 13th out of 125 countries in this category, taking into account the availability and quality of energy, transport, and telecommunication services infrastructure. There are indications that the quality and quantity of Canada's physical infrastructure are slipping compared to some other countries. For example, Germany, France, Denmark, Japan and Netherlands, which ranked behind Canada in 2000 according to the OECD study "*The Influence of Policies on Trade and Foreign Direct Investment*," fared better than Canada in the *Global Competitiveness Report*.²⁷

Based on surveys of investors, the *Global Competitiveness Report* ranked Canada 14th in terms of railroad infrastructure development, 16th in the quality of port infrastructure, 17th in the quality of air transport infrastructure, 18th in the quality of electricity supply, 16th in the quality of roads, and 16th in the quality of telephone/fax infrastructure, out of 125 countries world-wide.

A slightly older survey of global investors conducted by the Conference Board of Canada in 2003/2004 revealed that 80 per cent of those surveyed thought that the overall business infrastructure in Canada had a negative or strongly negative impact on their decision to invest. It is important to keep in mind that all surveys are subjective and represent opinions that may be quickly revised based on new information. However, the overarching message from the analysis of various sources is that Canada's traditional advantage in the quality and quantity of infrastructure is slipping.

iv. Taxes

High business taxes reduce the return on investment, which in turn reduces domestic and foreign investment in a country. Based on a survey of the literature, de Mooji and Enderveen (2006) find that a one percentage point reduction in the corporate tax rate raises foreign investment by 2.1 per cent. Their focus is on the effect of taxes on the amount of investment rather than firms' decisions to locate in a specific country.

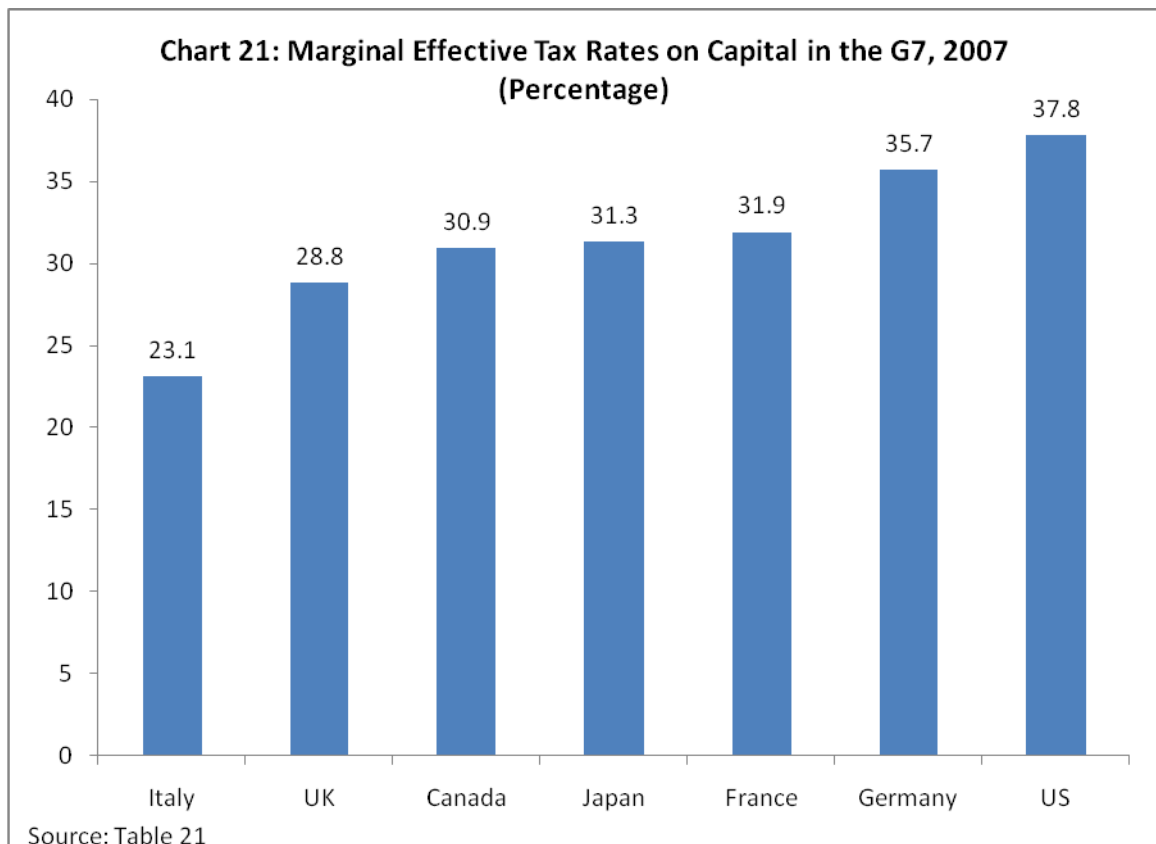
Statutory income tax rates on individuals and businesses are relatively high in Canada according to international standards. Historically, tax revenue as a percentage of

²⁶ Nicoletti *et al.* (2003:58) found that infrastructure improves the overall attractiveness of a host country for international investors when the potential endogeneity of FDI is controlled for.

²⁷ Indeed, Nicoletti *et al.*, (2003:39) find that in 2000 Canada ranked 6th out of 28 OECD countries in the quality and quantity of infrastructure in transport, telecommunications and electricity. Only Norway, Sweden, the United States, Iceland, and Switzerland ranked higher than Canada.

GDP in Canada has consistently been over the OECD average. Recognizing the importance of a competitive business tax system in creating a healthy business environment, the long-term trend in developed countries has been to reduce statutory corporate income tax rates.²⁸ Despite a general downward trend, statutory corporate tax rates in Canada during 2006 were much higher than the OECD average. However, this does not say much about how taxes affect specific investment decisions of businesses. The extent to which taxes impinge upon investment decisions is better understood through the marginal effective tax rate (METR) – i.e. the share of pre-tax return on capital that would be required to cover taxes.

According to the CD Howe Institute (2007), the marginal effective tax rate on capital for large and medium-sized corporations in Canada in 2007 (taking into account corporate tax rates, and other capital-related taxes) was 30.9 per cent, the 11th highest among 80 countries (Table 21). Relative to G-7 countries, Canada was fifth. The United States, Germany, France, and Japan had a higher METR (Chart 21). Canada's METR has dropped dramatically in the past two years. It was 39 per cent in 2005 and 36.6 per cent in 2006.

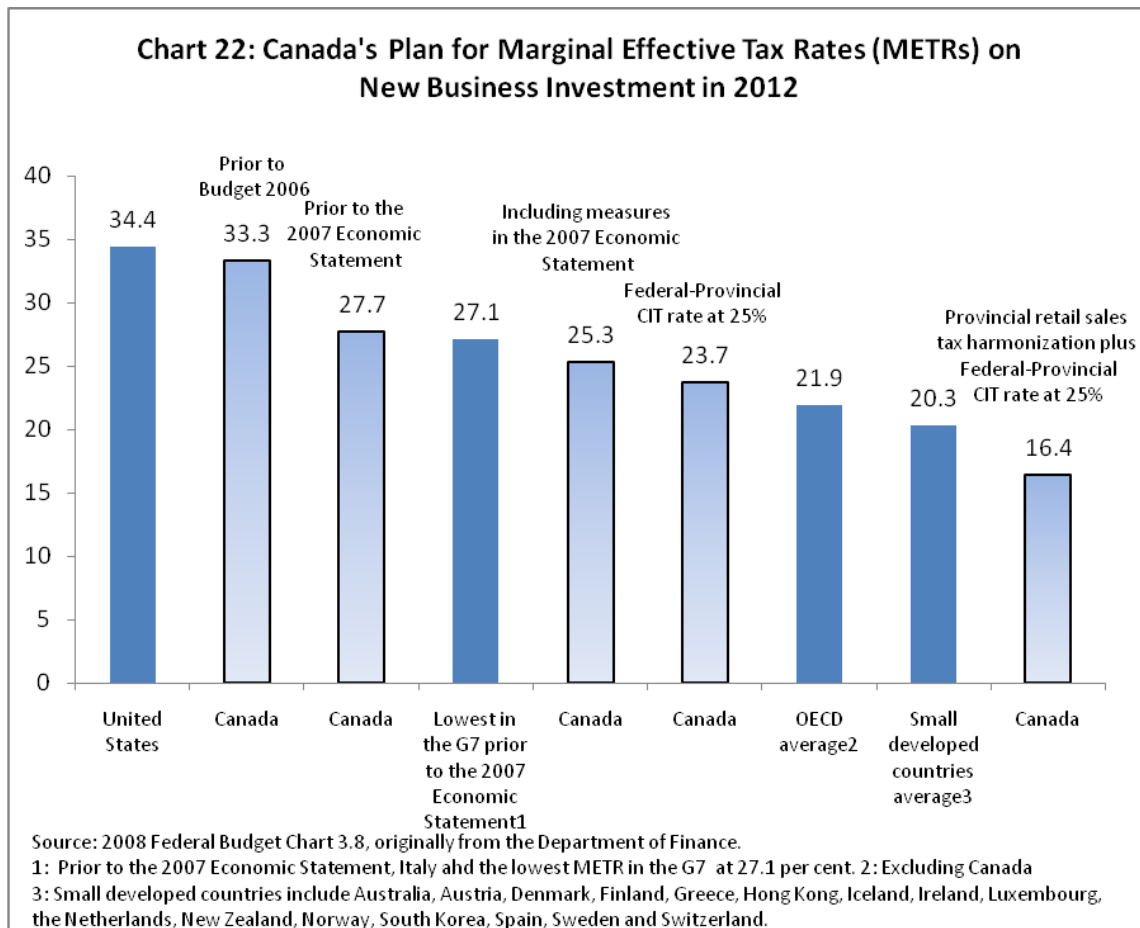


To improve Canada's business tax competitiveness, improvements in the structure of the tax system will have to be made. Some examples of structural improvements are: harmonizing provincial retail sales tax with GST in the five provinces where they are not

²⁸ The analysis of statutory corporate tax rates is from Department of Finance Canada (2006:73-74).

harmonized—Ontario, B.C., Saskatchewan, P.E.I. and Manitoba—so as to effectively eliminate retail sales taxes on business inputs and capital goods; eliminating provincial capital taxes on productive investment; reviewing capital cost allowance rates so as to ensure a fair tax burden on investment; and making the tax system more neutral across firm size. The Canadian government has already announced a business tax relief plan in its 2006 budget and in its long-term economic plan Advantage Canada, released in the fall of 2006. Advantage Canada aimed at gaining an METR advantage for Canada over the United States by 2011, and establishing the lowest METR among G7 countries in the future by ensuring that capital cost allowance rates reflect the useful life of assets, and by encouraging provinces to eliminate capital taxes and harmonize provincial retail taxes with the GST.

Chart 22 shows the planned level of the METR in Canada in 2012, reflecting developments up to the February 2008 budget and given the government's future objective related to GST harmonization with the provinces and future cuts to the corporate income tax. The rate is 16.4 per cent, around half the current rate. The attainment of this objective would certainly be a boon for FDI that is tax-sensitive.



The World Bank also publishes an indicator of the total tax rate (TTR) paid by businesses in 178 countries as part of its *Doing Business* project (World Bank, 2008a). For the most recent survey, the standardized business was assumed to be located in the largest city in each country (Toronto in Canada) and 2006 tax rules were applied. The study found that Canada's TTR stood at 45.9 per cent, 12th among the 24 OECD countries covered and 99th among the 178 countries under study (Table 22). The TTR can be divided into three components: profit taxes, labor tax contributions and other taxes. In 2006, Canada still had relatively high profit taxes, with provincial and federal profit taxes adding up to 26 per cent in 2006, ranking only 18th among 24 OECD countries. While Canada had relatively low labour taxes at 7.6 per cent (ranking 7th in the OECD), this advantage was offset by other taxes such as property taxes (6.5 per cent) and fuel taxes (0.9 per cent) (Table 22a). In the "Other Taxes" component, Canada (7.6 per cent) ranked second to last just before the United States (9.5 per cent) among the 24 OECD countries surveyed.

v. Exchange Rates

Theoretically, the effect of nominal exchange-rates on FDI involves two opposing effects (Nicoletti et al, 2003:48). For given relative prices, an exchange-rate depreciation in the home country reflects a pure valuation effect, with the US dollar value of assets held by home country in the host country increasing. It also creates an asset effect, reducing the attractiveness of investment in the host country as its assets become more expensive. A second factor affecting FDI is exchange-rate volatility, which may increase the risk premia on the returns to FDI. The effect of exchange-rate volatility on FDI depends on whether a firm sells its output in the host country or abroad, and whether it finances its capital at home or abroad. Ultimately, the effect of exchange rates and exchange-rate volatility on FDI is an empirical question.

The OECD study *The Influence of Policies on Trade and FDI* by Nicoletti et al. (2003) finds some evidence that reduced bilateral and multilateral (import weighted) exchange-rate volatility positively affects inward FDI position of host countries. The effect of exchange rates on FDI is ambiguous, with estimated effects changing sign according the bilateral FDI specifications. Recent literature analyzing Canada's FDI position barely touches on the issue of the recent exchange rate appreciation and its effect on FDI stocks and inflows.

One might have expected that the strong appreciation of the value of the Canadian dollar vis-a-vis the US dollar since 2002 would have dampened FDI inflows, particularly from countries whose currencies are closely linked to the US dollar. This does not appear to have happened. As noted earlier in the paper, FDI inflows into Canada since 2002 have soared, including inflows from the United States. There appears to be little link between FDI and the exchange rate.

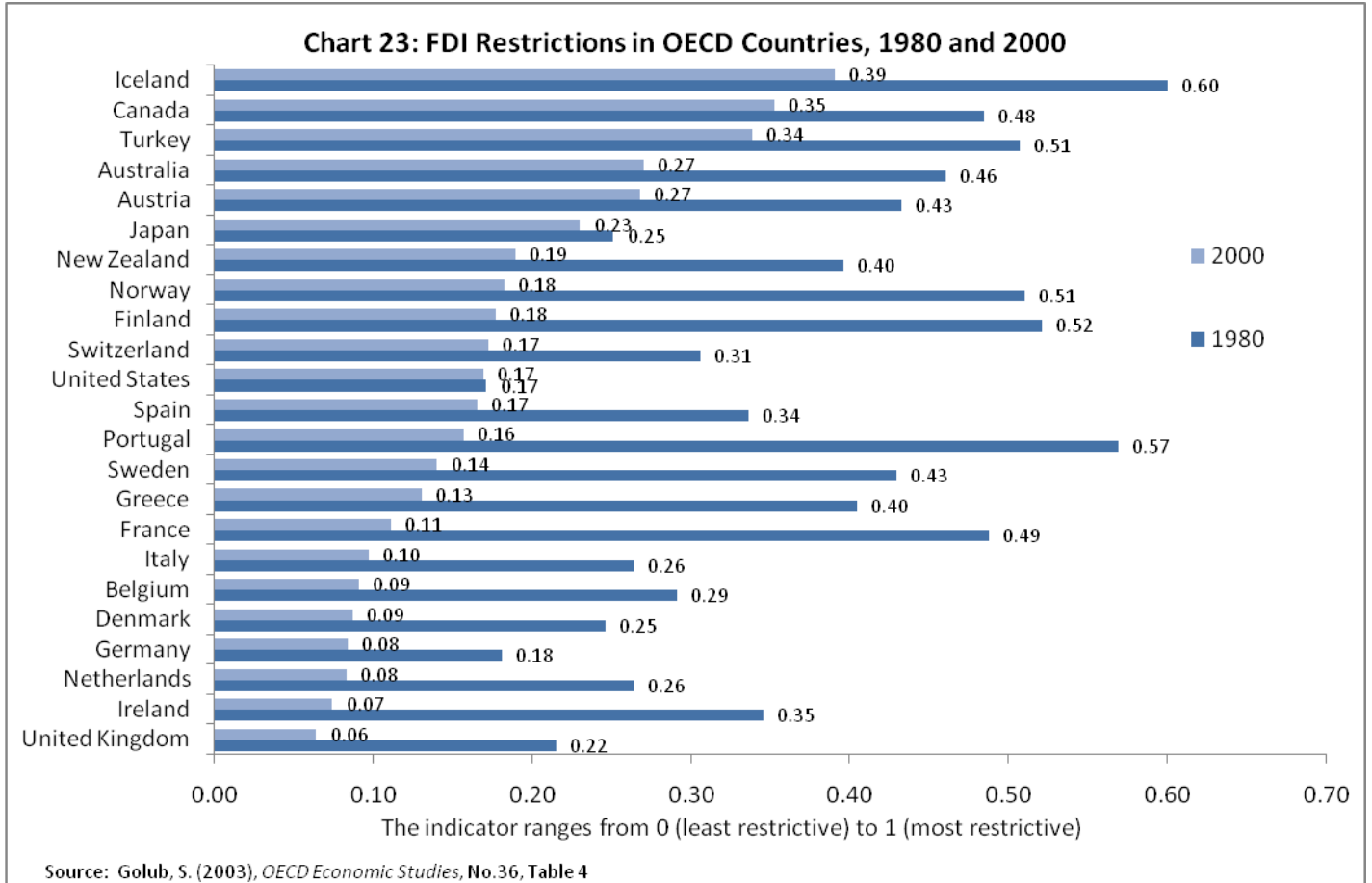
vi. FDI Regulation

The Investment Canada Act (ICA) is the regulatory framework used by the government to review large-scale foreign investments in Canada which exceed a certain financial threshold. Review of foreign investments at a lower threshold is required in financial services, transportation services, uranium and culture. A prospective foreign investor must demonstrate to the government that the intended transaction is of net benefit to Canada. The criteria used are: 1) effect of the investment on the nature and level of economic activity in Canada, 2) degree of participation by Canadians, 3) factors related to productivity, efficiency, technological development, innovation and variety, 4) competition in Canada, 5) compatibility with national industrial, economic and cultural policies, and 6) Canada's ability to compete in world markets.²⁹

There is no specific weighting to the above-mentioned factors in the net benefit test, providing the Minister of Industry with discretion to decide if the FDI serves Canadian interests as they change over time. This brings up issues of the *lack of predictability* about how the net benefit test will be applied and what conditions have to be met, and the *lack of transparency* about the undertakings of foreign investors to meet net benefit tests (due to reasons of commercial confidentiality). In addition, Canada has sector-specific policies on foreign investment in certain sectors. For example, regulation placing limits on foreign ownership are present in telecommunications, transport, broadcasting, cultural industries, and uranium production. Restrictions on operational freedom are also present in protected sectors, such as length of stay of non-resident executives, and regulation in the financial sector, wherein residents are required to form a majority of the board of directors of a domestic financial institution, and must form one half of the board of directors of a financial institution that is a subsidiary of a foreign parent. According to the OECD, Canada's level of formal restriction to inward FDI in the ICA and sectoral investment legislation/policies impede Canada's ability to attract FDI.

Unsurprisingly, OECD research has found that FDI restrictions have a significant negative impact on FDI stocks, with estimates implying that such barriers could be depressing FDI stocks between 10 and 80 per cent depending on the restriction considered (Nicoletti *et al.*, 2003:49). While Canada has eased its overall level of FDI restrictiveness over time, it still has the highest level of restrictions among the G7, and the 2nd highest among original OECD members, after Iceland (Chart 23). The OECD study *The Influence of Policies on Trade and FDI* by Nicoletti *et al.* (2003), estimates that the effect of bringing FDI restrictions down to the level of the United Kingdom (the least restrictive country) could increase Canada's inward FDI stock by 70 per cent of the average FDI stock over the 1990s.

²⁹ An overview of FDI Regulation in Canada is presented in Competition Policy Review Panel Consultation Paper (2007).



Some observers question the validity of OECD measures of FDI restrictiveness, and whether they are a true reflection of reality. There are certain limitations acknowledged by the OECD in its calculation of FDI restrictions. For example, hidden institutional or behavioural barriers and the extent of enforcement of statutory restrictions to FDI are difficult to identify and quantify, and are ignored. It is also possible that some countries are more transparent in reporting restrictions than others. In that case, transparent countries receive higher score, not because they are actually more restrictive, but because they report restrictions more completely. All of these factors may contribute to an upward bias in the calculations of FDI restrictiveness in Canada.

While FDI regulations in Canada are broadly consistent with the regulations of other countries, where electricity, transport, telecommunications and finance are generally the most controlled, it is nonetheless an issue of concern. FDI brings with it many benefits, such as new technologies and competition, which help drive productivity growth in Canada. With productivity being the long-run determinant of economic growth, and Canada's productivity performance lagging behind most OECD countries, re-evaluating Canadian FDI regulations to ensure that they support clear policy objectives, with a minimum of negative effects on the economy, could be part, albeit a small part, of a solution to boosting Canadian productivity levels.

V. Conclusion: How Can Canada Improve Attractiveness to of Global FDI?

Canada's share of world FDI has plummeted over the last quarter century. This development has not been due to policies or a business environment in Canada that has been hostile to FDI. Rather it was due to the opening of many closed parts of the world to international capital flows. Canada was an early player in the game of allowing unimpeded access to foreign capital, but now other countries such as China are catching up. It is not at all clear that this fall in world FDI share is a problem. Canada's FDI share is roughly comparable with its world GDP share and is third highest in the G-7.

An assessment of how Canada stands on both the fundamental and enabling factors influencing FDI location decisions reveals that there is no obvious area where Canada is doing particularly poorly. The one area where Canada excels is the quality of its natural resources base, as FDI inflows in this area have been very large in recent years.

Despite the overall positive assessment of Canada's ability to attract FDI, one should not be complacent. More FDI, particularly greenfield FDI, would be positive for Canada, including a potential contribution to better productivity performance through technology transfer. And there are certainly steps Canada can take to make the country more attractive to FDI.

In addition, NAFTA has not proved to be of much help to Canada in attracting the foreign direct investment it hoped for. Canada now faces increased competition from faster-growing developing economies in Asia, where the size and growth of markets, and lower labour costs are proving to be a clear draw for foreign investors. Canada is not yet well positioned to fully benefit from the large flows of FDI in today's global, knowledge-based economy, or from the increased focus of MNEs on global supply chains. In order to become a major player in inward FDI, Canada will have to develop its potential comparative advantages, maintain its existing ones, and most importantly, communicate these advantages in the face of increased global competition.

A. Improving the Business Environment

If Canada is to become a better destination of choice for foreign direct investment, it must improve its already favourable business environment. The analysis in this paper reveals the following areas of improvement:

- **Taxes:** A competitive tax environment is an important factor in attracting foreign investment. While traditional variables such as resource endowments, market size, and agglomeration economies have always been recognized as the main factors influencing the flows of FDI, economic integration and falling trade barriers have increased the importance of taxation in location and sourcing decisions of MNEs. The federal

government has already taken steps to improve the business tax environment in Canada, although concerns remain about provincial governments reversing this process.

- **Overall Regulatory Environment:** There is an indication that business concerns about regulation in Canada stem from the cost of compliance, rather than the level of regulation per se. Improvements need to be made in the administration of regulation, so that they can be enforced with minimum cost to businesses. The federal government's "smart regulation" initiative is an encouraging step in this direction.
- **FDI Regulation:** Canadian FDI regulation appears to be extremely high, according to OECD calculations. As discussed previously, evidence suggests that Canada could substantially increase its stock of FDI by adopting a less stringent regulatory regime, similar to that of the United Kingdom. A review of FDI regulation in Canada is required to ensure that the current regulatory regime protects Canadian interests efficiently, with minimum damage to its world competitiveness. Of course, one must consider the reasons why these regulations were first put into place and assess whether or not these reasons continue to be valid.
- **Labour Productivity:** Foreign investors may see weak productivity growth in Canada as indicative of an underlying problem or malaise that would affect them if they chose to invest in Canada. To rectify this negative image Canada must improve its labour productivity substantially. Suppliers will need to enhance their technological readiness (i.e. the quickness with which they adopt existing technology to increase productivity of their employees) and upgrade the skills of their workforce. The government can support this by tax incentives such as income tax credits for employers and workers to offset training costs, and government financial support for technological upgrades.

Trade: It is in Canada's interest to successfully manage the frequent problems in the Canada-U.S. trade relationship, and ensure that FTA/NAFTA provides foreign investors with the North American market access it promised

B. Honing Existing Competencies

Other measures that build on Canada's existing comparative advantages could be taken to improve the country's performance in attracting foreign investment. These include:

- **Enhancing Skills and Education:** Canada already has the highest proportion of working-aged adults with post-secondary degrees among OECD countries. Canada could deepen this advantage by ensuring that skills and competencies are developed in technical fields, and increasing the proportion of adults that have university degrees. In this regard, caution must be exercised in focusing on enrolment rates (quantity) alone. Quality of education must be given the highest priority so that there is no quality/quantity trade-off. Government programs that support stay-in-school initiatives, provide career counselling, offer incentives to Canadian employers and workers to upgrade their skills, and improve

immigrant credential recognition processes, would enable Canada to increase its pool of highly educated workers with skills that are rewarded in the global marketplace.

- **Improving Infrastructure:** While Canada was among countries with the highest levels (quality and quantity) of infrastructure in the OECD as of 2000, its position has been slipping in recent years. Modernizing physical infrastructure in urban regions, highways, airports, ports, and along borders, including maintenance to keep pace with normal wear and tear is indispensable to the free flow of goods and services. Sizeable public investments in infrastructure will be required if Canada is to maintain this traditional advantage.
- **Finding Niche Markets:** In the absence of advantages of market size, scale of production, and labour costs, Canada will have to define and develop its advantages in the context of what it can produce efficiently within global supply chains. The analysis of existing and potential advantages in Canada points towards a possible specialization in high-value, knowledge and technology intensive products and services. Another area of specialization could be emerging technologies such as biofuels, genetics, environmental technologies, and artificial intelligence.

Finally, increased global competition for foreign direct investment means that Canada will have to effectively communicate its strengths to the world. Being a small economy, Canada may be easily overlooked by foreign investors making location choices among countries the world over. While honing and developing strengths is important, Canada must let the world know what it has to offer.

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