FOREIGN DIRECT INVESTMENT IN CANADA: CHARTING A NEW POLICY DIRECTION [1]

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Introduction

January 1 marks two critical milestones in Canada-U.S. economic relations. Six years ago, on January 1,1989, we began phasing in the Canada-U.S. Free Trade Agreement (CUFTA), freeing up trade and investment flows across the 49th parallel. Last year, on January 1,1994, the North American Free Trade Agreement (NAFTA) began levelling the playing field for firms in the three North American countries. CUFTA and NAFTA have shaken up traditional trade and investment patterns. Canadian businesses have a more open door to the other markets in North America and other firms have a more open door to Canada.

The firms best placed to anticipate and take advantage of this regional integration process are large multinational enterprises (MNEs) which are already heavily involved in North America. These "insiders" are primarily U.S. multinationals, such as the Big Three auto firms, which already have distribution and production networks throughout North America.[2] This gives them an advantage over purely domestic firms and outsiders. These multinationals are adopting a North American focus to their structures and strategies, rationalizing production on a regional basis as tariff and non-tariff barriers within the region continue to fall. Thus regional integration offers both opportunities and threats to firms in Canada, challenges to which the insider multinationals are best able to respond.

Firms in Canada are not alone in facing these challenges. Other countries are also engaged in major policy reforms. For example, in the early 1980s, the European Community (EC) consisted of 12 countries with high internal non-tar

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1. This article is a revised and updated version of Lorraine Eden, *Multinationals as Agents of Change: Setting a New Canadian Policy* on *Foreign Direct Investment,* Industry Canada Discussion Paper Number 1 (Ottawa: Industry Canada, 1994). The earlier version also discusses North American trade and investment patterns and multinational responses to regional integration

2. Some Canadian MNEs are also recognizing this challenge. The Bank of Montreal has been in the United States and Mexico for several years and is now expanding these operations, hoping to become the first truly North American bank. Matthew Barrett, president of the Bank of Montreal, indicates that Canadian banks will "face a stark choice," adopt North American strategies or "resign themselves to becoming, over time, essentially regional banks" which would be open to takeovers by emerging, and potentially much larger, U.S. banks. Quoted in "Making a Break for the Border," *Business Week,* June 4, 1994, p.[104].

if barriers to trade and investment flows. Regional integration in Europe is now deepening (through the EC "1992" process) and broadening (through the addition of new member countries). Europe, as a result, is attracting large amounts of inward foreign direct investment (FDI) along with a rationalization of production by MNEs inside the European Union. Similar integration efforts are proceeding in Latin and South America *(e.g.,* Mercosur) and elsewhere.

The purpose of this article is to argue that Canada needs to initiate a new poiicy direction towards foreign direct investment. This new policy should take account of the opportunities and threats presented by regional integration for Canadian firms. The policy should also be sensitive to the opportunities and threats presented by policy innovations and technology changes going on around us in the rest of the world.

Our argument is organized in three parts. First, we briefly review the history of Canadian policy towards foreign investment, focusing in particular on the investment rules in CUFTA and NAFTA. Second, we situate Canada in the broader context of changes occurring in the global economy. Third, we suggest a new policy direction for Canada, one that builds on the potential offered by North American integration but is developed in the context of ongoing changes in the rest of the world. This new policy direction would be a shift away from the traditional Canadian focus on restricting inward foreign direct investment to a new focus on multinational enterprises as *market-making firms* that can serve as *investment bridges* to the global economy and as *agents of change* within the Canadian economy.

Looking Backward: A Brief History Of Canadian FDI Policy

We argue that Canadian policy can be broken into three time periods: 1960-85 (restricting inward FDI), 1985-94 (restriction and promotion) and 1994 to the present (nondiscrimination under the NAFTA).

Restricting FDI: 1960-1985

Canada has been a host country to foreign investment since Confederation. Regulating FDI has been an important policy goal of the Canadian government for many years.[3] Canadian policy, reflecting our status as a host country, has historically been a one-sided policy. The focus has been almost exclusively on inward FDI with little attention paid to outward FDI. The government has seen inward and outward flows of investment as unrelated economic phenomena and concentrated on regulating the former.

1. For a review see Robert Kudrle, "Regulating Multinational Enterprises in North America," in Lorraine Eden, ed., *Multinationals in North America,* Industry Canada Research Series Volume Three, (Calgary: University of Calgary Press, 1994).

Canadian public concern about high levels of U.S. ownership of the Canadian natural resource and manufacturing sectors started in the early 1960s. By the early 1970s, foreign controlled firms represented 58 per cent of Canadian manufacturing and 75 per cent of the petroleum and natural gas sectors. Over the 1965-72 period, three major reports on FDI (the Wahn, Watkins and Gray reports) were published by the government, each concerned about the high levels of foreign ownership, with the last recommending the creation of a specific agency designed to screen investments by foreign firms.

In 1974, the Foreign Investment Review Agency (FIRA) was established by the Liberal government of Pierre Trudeau. Takeovers (mergers and acquisitions) of established businesses and new business start-ups by foreign firms were both reviewed. FIRA was set up with the purposes of reducing the perceived adverse effects of foreign investment on Canada, such as transfer price manipulation and anti-competitive behaviour, and of securing commitments to increased benefits such as employment, value added and exports. The key criterion used by FIRA was that inward FDI should convey significant net benefit for Canada. Over the next ten years, FIRA's acceptance rate rose, many approvals included performance requirements (which were subsequently declared illegal under the General Agreement on Tariffs and Trade [GATT]), the threshold for investment review was increased, and the criterion for approval was reduced from significant benefit to net benefit.

The Canadian government, particularly in the 1 970s and early 1 980s, was sensitive both to the general level of inward FDI and to its sectoral distribution. Certain sectors were considered *key sectors (e.g.,* banking, insurance, book publishing) and inward FDI either prohibited or restricted. The government also gave preferences to Canadian firms over foreign firms in terms of subsidies and preferential access to government contracts.[4] In the 1980 election, the Liberals pledged to expand FIRA's powers, but a combination of U.S. pressure and declining investment levels aborted that initiative. The government, however, did go ahead with the National Energy Program, which was (not surprisingly) widely disliked and protested by the U.S. oil industry.

However, since 1985, the policy focus has shifted from screening and restricting inward FDI to promoting more investment in Canada.

Trying to Do Two Things at Once: 1985-94

The Conservatives under Brian Mulroney came to power in 1984 determined to improve relations with the United States. Elsewhere we have called these policies *market Liberalism,* a package based on the commitments to liberalize, privatize, deregulate and downsize.[5]

As part of setting up a warmer climate for FDI, the Tories axed the National Energy Program and, in 1985, replaced FIRA with Investment Canada.[6]

4. These restrictions have been gradually lifted, particularly since 1984.
5. Lorraine Eden and Maureen Appel Molot, "Canada's National Policies: Reflections on 125 Years," *Canadian Public Policy,* Vol. 19, No.3, (1993), pp. 232-251.
6. They also substantially watered down compulsory licensing of pharmaceuticals (another policy disliked by U.S. multinationals).

Mandatory reviews of all new investments were eliminated and Investment Canada emerged with a new mandate: to promote foreign direct investment. Thus, for a period of time, Investment Canada had a double mandate: to screen FDI and to promote FDI, that is, an open door policy for most inward investments with a narrow screening window for sensitive areas like biotechnology (Connaught Laboratories) and cultural industries (book publishing). Officials inside Investment Canada were also actively involved in negotiating the investment sections of CUFTA and NAFTA (see below).

The situation changed in 1993, when the new Liberal government led by Jean Chrétien placed Investment Canada within the newly revitalized and enlarged Department of Industry. In the spring of 1994, Investment Canada disappeared as an independent agency. The screening function still exists, but is now subsumed under the broader departmental mandate of industry promotion and development. And now, with the staff at Industry Canada being significantly reduced in the wake of the 1995 federal budget, the cadre responsible for administering the Investment Canada Act probably numbers no more than ten persons.

Thus, like most countries, Canada has significantly liberalized its regulation of inward FDI over the past decade. FIRA, once the bane of the U.S. government and its MNEs, exists only as a memory for a few FDI scholars and government bureaucrats.

Nondiscrimination under the NAFTA 1994 and Beyond

Between May 1986 and October 1987 the Canadian and U.S. governments went through protracted negotiations resulting in the adoption of the 1989 Canada-U.S. Free Trade Agreement. Chapter 16 DFAlT with investment. The key commitment was *national treatment* — Canada and the United States were required to treat each other's investors in the same manner as their own domestic investors. Export and production-based performance requirements, such as those that FIRA in the past had imposed on foreign firms, were disallowed. Investment Canada's function as a screening agency was also several curtailed. Screening of new U.S. investments was eliminated; screening of acquisitions could still occur but the floor for screening was raised from five to 150 million dollars (with an inflation adjustment). This level still caught most U.S. investments, however, as the average size of an acquired firm in 1988 was $400 million.[7]

No sooner was the ink dry on CUFTA than the two governments began negotiations to extend the free trade agreement to Mexico.[8] NAFTA, which came into effect in 1994, has the most extensive regulations on investment of any free trade agreement, excepting perhaps those of the European Community, they are certainly much more rigorous than anything in the new *GATT* Uruguay Round package.[9]

7. Kudrle, "Regulating Multinational Enterprises," p.411.

8. Mexican President Carlos Salinas de Gortari approached U.S. President George Bush about a US.-Mexico ETA in June 1990; the three governments launched trilateral talks in early 1991. See Lorraine Eden and Maureen Appel Molot, "The View From The Spokes: Canada and Mexico Face the US," in Stephen Randall et al, eds., *North America Without Borders? Integrating Canada. the United States and Mexico* (Calgary: University of Calgary Press).

9. A short summary is provided in UNCTAD Division on Transnational Corporations and Investment, *World Investment Report 1993: Transnational Corporations and Integrated International Production* (New York: United Nations, 1993), pp.51-52.

The key commitment in the Investment Chapter is *nondiscrimination,* which is defined as national treatment (NAFTA partners must be treated at least as well as domestic investors) together with most-favoured-nation treatment (NAFTA investors must be treated at least as well as any foreign investor) for all North American investments and investors, including firms controlled by non-North Americans.[10] The agreement extends the list of proscribed performance requirements and mandates that most existing requirements be phased out over ten years. NAFTA forbids restrictions on capital movements, including all types of payments and profit remittances, except for balance of payments reasons. Expropriation is outlawed, except for a public purpose and on a non discriminatory basis, and full and prompt payment of fair compensation is required.

Investors can seek binding arbitration against a host government for violations of NAFTA obligations, using either the World Bank's International Centre for the Settlement of Investment Disputes (ICSID) or the United Nations Commission on International Trade Law (UNCITRAL). Thus, a new trinational dispute settlement process has been introduced into three countries. This is a major change since the governments have traditionally held that all disputes involving FDI should be settled in domestic courts.

The impact of nondiscrimination, as the NAFTA standard for regulating foreign investment in North America, on foreign investment in Canada is unclear. The standard makes it more difficult to discriminate between firms on the basis of ownership in areas such as trade, investment, intellectual property and business services. This should benefit Canadian MNEs investing in the United States. The rule works both ways, however. Recent Canada-U.S. disputes over items as disparate as cigarettes[11], country music specialty television channels[12] and Canadian investments in Cuba" suggest that the commitment to nondiscrimination may also affect Canada's ability to introduce policies that U.S. multinationals see as harming their interests.

How this will play out as the NAFTA is phased in, and as (if?) fourth countries such as Chile are admitted to the agreement, remains to be seen. One can hope that the commitment to nondiscrimination will constrain protectionist pressures

10. There are exceptions: investments in financial services are covered elsewhere in the agreement; many existing federal measures such as Canadian cultural industries are exempt; the states and provinces have two years to provide a list of exemptions; public procurement and investment incentives are not included, nor are FDI restrictions on national security grounds. See Gary Hufbauer and Jeffrey Schott, *NAFTA. An Assessment* (Washington:
Institute for International Economics), p. 82.

11. Last summer, U.S. tobacco multinationals argued that the Canadian government's attempt to force cigarette manufacturers in Canada to use plain packaging was tantamount to expropriation of intellectual property. They threatened to sue the government for damages under the NAFTA.

12. The CRTC's removal on January 1, 1995, of the license held by the U.S. Country Music Channel in order to replace it with the New Country Network has been protested by the U.S. cable networks. The U.S. government is investigating the CRTC decision. The law firm representing several U.S. cable companies is arguing that US. firms do not have equivalent investment access and protection,

13. The U.S. government has suggested that Canada, as a partner to the NAFTA, should not be trading with or investing in Cuba on the grounds that it is taking unfair advantage of U.S. restrictions on U.S. firms in Cuba. Two bills are currently going through the U.S. Congress that would retaliate against non-U.S. firms doing business in Cuba. See Graham Fraser, "EU Joins Canada in Resisting US Bills," *The Globe and Mail,* April 7, 1995, p. A8. This is extraterritoriality carried to a new height. (The U.S. government has always argued that U.S. subsidiaries in foreign countries are bound by U.S. laws such as the Trading with the Enemy Act; this proposal would restrict even Canadian-owned firms from engaging in practices the U.S. government found objectionable).

while still leaving room for countries to adopt distinctive, nationally responsive policies in other areas.

The Changing Global Economy

CUFTA and NAFTA, as important as they are, should be seen as nested within a period of widespread liberalization of economies, globalization of markets and technological change.

Liberalizing World Trade

Most governments, both developed and developing, have significantly liberalized their economic policies since 1980. Tariff and non-tariff barriers have fallen steadily. Developing countries have reduced their trade barriers, shifted from import substitution to export oriented development policies, and adopted macroeconomic adjustment policies sponsored by the International Monetary Fund. As we noted earlier, lower tariff and non-tariff barriers have also come from regional trading arrangements such as the European Union with its Single Market, Mercosur and Asia Pacific Economic Cooperation (APEC).

A third milestone, January 1, 1995, is symbolic of these external factors as Canadian and U.S. commitments under the GATT Uruguay Round begin to take effect and a new multilateral trade organization, the World Trade Organization (WTO), is born. The conclusion of the Uruguay Round brings with it the most significant changes in world trade liberalization that we have seen so far, according to international trade law expert, John Jackson.[14]

From Mass to Lean Production

At the same time, there has been a fundamental, long run shift in the underlying technology of production. Information technology; based on the microprocessor, has revolutionized product markets and manufacturing processes. Just as the first fifty years of the 1800s were known as the Industrial Revolution, so it looks like the period starting around 1980 (marked by the introduction of the personal computer) will be known as the *Information Revolution.*[15]

At the same time information technologies were being adopted throughout manufacturing, new ways of organizing production were being introduced by Japanese multinationals. In the 1970s, Japanese firms began to penetrate the U.S. market, first through exports and then by setting up distributor affiliates in North America. In the mid-1980s, the Japanese *keiretsu* began to move onshore, bringing with them new methods of production known as *just-in-time, flexible* or *lean production.*

14. Professor Jackson was speaking at a Centre for Trade Policy and Law conference on the Uruguay Round in May 1994 in Ottawa.
15. See Charles Jonshcer, "An Economic Study of the Information Technology Revolution," in Thomas Allen and Michael Scott Morton, eds., *Information Technology and the Corporation of the 1990s: Research Studies* (New York: Oxford University Press, 1994).

Lean production methods combine the activities of everyone – from managers to production workers to suppliers – in an integrated whole, with the goal of producing high quality; low cost output through a constant focus on cost reduction, zero defects and zero inventories. These new technology processes, led by the auto, steel and consumer electronics industries, are slowly diffusing throughout North America.

These international policy and technology-based changes are forcing major structural adjustments by businesses everywhere, as competition among firms for market share shifts from being national to being regional. In the automobile and consumer electronics industries, global competition is now the norm. The largest multinationals have been at the forefront of the process, reacting to these shocks by becoming leaner and meaner: they have been downsizing, rationalizing, out-sourcing, forcing in-house suppliers to seek new markets, and reducing the number and setting up pyramidal relationships with outside suppliers.

From Confrontation to Cooperation

A fundamental reorientation of the relationship between governments and multinationals is under way as a result. In the late 1960s and 1970s, MINE-state interactions were primarily conflictual, as governments sought to reduce anti-competitive behaviour by MNEs through heavy regulation and occasionally expropriation of inward FDI.

In the 1990s, however, MNE-state relations have shifted from confrontation to cooperation as states have come to see MNEs as the means by which national competitive advantage can be generated and sustained. Governments have moved from regulating to encouraging entry; from taxing to subsidizing, from opposition to FDI to partnership with multinationals. Governments now facilitate the competitiveness and innovation capabilities of their domestic firms, regardless of ownership, playing a positive and coordinating role in upgrading industry resources and capabilities. Inward and outward FDI are seen as complementary to domestic investment, so that governments are developing policies to encourage inward FDI and to improve the competitive advantages of their own MNEs in foreign markets.

For example, bilateral investment treaties, signalling an open door policy to inward foreign direct investment, are expanding rapidly, with over 500 treaties among developed countries in existence in 1990. [16] Investment regimes in developing countries have also been liberalized in terms of FDI controls, key sector restrictions, FDI approval procedures, incentives and investment guarantees, as they have within the countries of the Organization for Economic Cooperation and Development (OECD). Even the GATT, which has traditionally ignored investment, in the Uruguay Round introduced new disciplines on trade-related intellectual property measures, trade-related investment measures and business services, all of which are expected to have significant liberalizing impacts on investment flows.[17]

16. UNCTAD Division on Transnational Corporations and Investment, *World Investment Report 1994: Transnational Corporations, Employment and the Workplace* (New York UNCTAD, 1994), p.28.
17. See UNCFAD Division on Transnational Corporations and Investment, *World Investment Report 1994,* Chapter VII.

Thus the politics of national economic competitiveness in the 1990s means that MNEs and nation-states must now be seen as partners in the race to engineer competitive advantage. What do these changes in policies in the rest of the world imply for Canada?

Looking Forward: Charting A New Policy Direction For Canada

Whither Canadian FDI policy in the late 1990s? We argue that it is time for a new policy on FDI in Canada, one that builds on the CUFTA and NAFTA but focuses explicitly on multinationals rather than trade flows. This new policy should focus on multinational enterprises as market-making firms creating investment bridges to the global economy and acting as agents of change within the Canadian economy. Our recommendation involves a fundamental shift away from the historical, macroeconomic focus on the benefits and costs of, and the need therefore to regulate, inward FDI, and its replacement by a new emphasis on:

- the positive effects of multinational enterprises as *market-making firms* in a globalized world, facing crosscutting pressures from their simultaneous involvement at the international level (linked through the MNE network to international markets and to affiliates and countries outside Canada) and at the domestic level (as firms involved in domestic markets with production, sales and employment in Canada), but with the ability to create value adding activities that can improve national competitiveness;

- the positive effects of MNEs as *investment bridges* between economies, as windows on what is going on in production, technology and marketing elsewhere in the world, bringing new ways of organizing production to Canada and carrying Canadian national organizing principles to other countries; and

- the positive effects of MNEs as *agents of change* within Canada, increasing the competitive pressures on domestic firms, and demonstrating and diffusing new techniques throughout the Canadian economy.

The specific policy directions we propose to implement this new policy on MNEs in Canada are the following: (i) a new national policy centred on strategic integration of Canada into the global economy (this is the broad, overarching policy umbrella for our other recommendations); (ii) getting the basics right, (iii) moving from confrontation to cooperation with MNEs in Canada; (iv) maintaining a minimalist screening role; (v) securing access to the U.S. market; (vi) reducing state aids to business; and (vii) upgrading to best practice technology. We discuss each briefly below.

A New National Policy. *Strategic Integration*

As a result of CUFTA and NAFTA, north-south economic linkages are creating a continental market. The country is fragmenting along regional lines in economic space with trade and investment flows increasingly north-south rather than east-west.

This same problem challenged the Fathers of Confederation and was handled by Sir John A. Macdonald through the First National Policy; *defensive expansionism* (1867-1940), based on three prongs: a high Canadian tariff to protect domestic manufacturing, a national railway system to provide the means to move goods across the country, and rapid immigration to populate the country. This national policy was later replaced by a Second National Policy, *compensatory liberalism* (1941-81), based on a commitment to the GATT postwar liberal trading order, Keynesian macroeconomic policies, and the construction of a domestic social welfare net. Our current national policy; *market liberalism* (1982-94), begun under the Conservatives, relies on continental free trade, market based policies and fiscal restraint. In 1995, under the Liberal Government of Jean Chrétien there is both a continuation of market liberalism, together with a renewed attention to employment, labour upgrading and social policies. Market liberalism, however, does not give sufficient attention to the enormous changes taking place around the world, such as globalization, the end of the Cold War, the rise of the Asia Pacific, the formation of regional blocs and the Information Revolution. Canada needs to develop a coherent set of policies that better position the country relative to its major trading and investment partners. We call this strategy *strategic integration* because it would be designed to strategically integrate Canada into the global economy. The policy would be based on dynamically engineering Canada's long-run competitiveness in a world of lean production and regional trading blocs. The three components of this national policy would be:

- *international and interprovincial free trade,* building on CUFTA and NAFTA *(i.e.,* the reversal of the original high tariff policy);
- *a national telecommunications network* based on development and diffusion of information technology and lean production techniques (the 1990s version of the coast-to-coast railway); and
- *human capital development* through a national education and retraining policy so that Canadian citizens and workers can fully participate in and benefit from the Information Revolution (a commitment not to more labour but to higher quality labour).

The goal of this national policy would be to achieve long run national competitiveness, defined as high and rising productivity levels, in a knowledge-intensive world.[18] A policy of strategic integration means a renewed emphasis on removing tariff and non-tariff barriers to trade and investment within Canada and within NAFTA; a commitment to the knowledge based economy with its focus on innovation, competition and sustainability and a focus on a national education policy that prepares our children for twenty-first century jobs.

18. Space prohibits more discussion of this topic. Note that we are sensitive to the financial and political constraints faced by the current government, but argue that nation building is an appropriate role for government policy. See Eden and Molot, "Canada's National Policies...".

The first prong, free trade, we have discussed above under CUFTA and NAFTA. In addition, the federal government should continue to pressure the provincial governments to implement the Canadian economic union. The recent federal-provincial accord is a step in the right direction, but north-south trade is still freer under NAFTA than east-west trade is within Canada. Unless the large number of remaining domestic internal barriers to trade are removed, the north-south pattern will continue to strengthen and more firms will be induced to close their plants and move south. Cross-border economic regions such as Cascadia in the west and the Golden Triangle linking New York, Michigan and Ontario in the centre of the country will grow stronger as agglomeration benefits coincide with removal of north-south trade barriers. High interprovincial trade and investment barriers can only exacerbate this tendency.

The second prong, transportation infrastructure, will be as important in the twenty-first century as it was one hundred years ago when the national railway was established. However, the twenty-first century equivalent will be based on the marriage of computers with telecommunications. Canada has no national program for an information technology infrastructure, but should develop one or be left behind. For example, the United Nations is already encouraging the setting up of infoports or *teleports* as central nodes for exchange and transmission of information around the world. (Columbus, Ohio, is one of the United Nations-designated world info-ports). A teleport performs an entrepot function in the knowledge-based economy; it "is like an airport or seaport but transports a new economy weightless cargo: voice, data, text and video" using broadband facilities, satellites, fibre-optic networks and microwave hubs.[19] Over 100 teleports are in operation or under development worldwide, many setup as export processing zones with no duties or taxes.

The third prong, labour policies, implies a renewed commitment to labour quality and productivity. The knowledge-based economy creates high demand for skilled labour but structural unemployment for unskilled workers, widening the wage differential between them. Canadian labour policies (particularly high school and adult retraining programs) must prepare both new and older workers to function effectively in the new economy.

Get the Basics Right

MNEs are worried about the economic and political insecurities in Canada. dislike risk, particularly policy risk, Japanese MNEs dislike policy risk more than most multinationals. CUFTA and NAFTA were supposed to reduce policy risk and encourage investment. Unfortunately, recent outside events have overwhelmed the beneficial impacts of regional integration and created significant uncertainties that are discouraging investment in Canada.

Instability in the Canadian dollar has risen due to investor fears about Canadian public debt levels, the possibility of Quebec secession, and recent declines in the U.S. dollar and Mexican peso. First, total debt for all three levels of

19. Rod McQueen, "The Crusade to Convert our Cities to Teleports," *The Financial Post,* July 9, 1993, p.7.

government now approximately equals Canada's Gross Domestic Product (GDP) and a significant proportion is held by offshore investors, causing Moodys in February 1995 to raise the issue of downgrading the federal debt.[20]

The possibility of Quebec separation is a second factor discouraging inward FDI. For example, a 1994 study by DRI Canada Ltd. suggested that the Canadian dollar would fall and interest rates rise substantially, costing the country 20,000 jobs due to lost investment, during a Quebec referendum.[21] Many private think-tanks *(e.g.,* the C.D. Howe Institute) have released similar studies showing large financial losses to both Quebec and the rest of Canada should Quebec separate.

And third, the collapse of the Mexican peso in December 1994 and the rapid downward spiral in the U.S. dollar *vis-à-vis* the Japanese yen are having spillover effects on other currencies, including the Canadian dollar. Currency volatility has increased together with greater downward pressure on the Canadian dollar. Canadian businesses *(e.g.,* banking, manufacturing, real estate) with investments in Mexico are also suffering large financial losses from the peso collapse and curtailing their Mexican investment plans. The financial losses, if large enough, could have second-round, harmful impacts on investments in Canada.

We conclude that these factors, regardless of any explicit Canadian policy towards MNEs, will discourage MNEs from expanding their operations in Canada. These problems are already having a negative impact on investment in Canada. Oxford Analytica noted in 1994 that "[a] growing lack of investment interest in Canada itself has created a net outward flow of funds....Canada will run a deficit in direct investment likely to exceed $3-billion (4 per cent of GDP) in 1994." [22] Oxford Analytica attributed the weakness in investment to: (i) the small Canadian market with its restricted provincial trade; (ii) unfavourable corporate income tax rates, especially on export earnings; (iii) high capital costs due to high real interest rates; (iv) low after-tax returns to capital due to government overheads in the form of tax and regulatory compliance costs and higher import costs due to devaluation of the Canadian dollar; (v) growing concerns about the inability of the federal and provincial governments to lower budget deficits without large tax increases; and (vi) about the political future of Quebec and Canada. The consulting group's conclusions – that the net deficit on investment would continue in 1994 and 1995, so that overall investment growth would remain weak – have been borne out over the past year.

During this period of political and economic instability, the federal and provincial governments should not lose sight of the fundamental proposition: *get the basics right.* This means a commitment to reducing the federal and provincial debt overhangs and keeping a focus on a sound macroeconomic policy for the long run. The 1995 federal budget is a step in the right direction, with its promise to cut the federal deficit to three per cent of GDP by 1996-97. However, the budget did not include deficit or debt targets for subsequent years, and investors are understandably wary of government promises to cut "down the line."[23]

20. The net federal debt has risen to 73 percent of GDP; when coupled with provincial government net debts, the total is over 90 percent. See Greg Ip, "Dangers of High Debt Remain," *The Financial Post,* March 1, 1995, p. 8.
21. Bruce Little, "Study Bleak on Referendum," *The Globe and Mail,* June 4, 1994, p. B4.
22. Oxford Analytica, "Investment Shifting Outward," *The Globe and Mail,* July 18, 1994, p. B9.
22. Ip, "Dangers of High Debt Remain," p. 8.

Getting the basics right also means reducing the paperwork and regulatory barriers that discourage investment, avoiding waste and duplication of activities within the three levels of government, and eliminating unnecessary spending. The "Watson test" for deciding whether the federal government is serious about expenditure reduction *(i.e.,* what has happened to federal funding for five-pin bowlers?) suggests that there is room for further cutting.[24]

The Bank of Canada has responded to high federal deficit and debt levels and recent pressures on the Canadian dollar through a combination of high interest rates and slowly letting the currency slide *vis-à-vis* the U.S. dollar; a policy designed to keep inflation low. High interest rates can discourage outflows of short-term portfolio capital (thus propping up the dollar), but they depress domestic demand and discourage long run productive investments. Thus the needs of public capital (federal and provincial bonds) crowd out private investment. Getting the basics right therefore also means selecting monetary and fiscal policies that work in tandem towards the goal of low inflation, combined with high levels of investment, output and growth.

Practise "From Confrontation to Cooperation" at Home

Most countries historically treated inward and outward FDI flows as unrelated economic phenomena, and set up policies designed to lessen the adverse effects of inward FDI. This was also true in Canada where FIRA, key sector policies and preferential procurement policies were biased against foreign investors. However, recent policy and technology shifts have forced governments to reconsider their policies *vis-à-vis* multinationals and foreign direct investment. This positive, proactive attitude towards multinationals as agents of change should be a fundamental component of a new Canadian policy towards foreign direct investment, one that focuses on cooperation, not confrontation. This means seeing MNEs as potential contributors to Canada's long-run competitiveness. Government policy should attempt to attract firms that will build upon and upgrade Canada's competitive advantages. Such a policy should also concentrate on removing internal barriers to trade and investment that discourage inward and outward FDI, and on encouraging access to foreign markets for firms in Canada.

In addition, in order to promote a country internationally as an investment location most countries now have an investment promotion agency. These agencies act as central locations, providing information about doing business, setting up firm-to-firm contacts, streamlining the investment process for the new entrant, and so on. With the demise of Investment Canada the mandate to promote inward FDI is now diffused within the broader departmental objectives of Industry Canada. A single agency has visibility potential investors know where to go, and the staff are trained. Setting up an agency – or revitalizing Investment Canada – to promote Canada as a "one stop shopping" investment location should be considered. This would re-establish the second half of Investment Canada's "screen and promote" double mandate of the 1985-94 period.

24. William Watson, "Ottawa May Be Close to Passing the Watson Test," *The Financial Post,* April 7, 1995, p. 15.

Maintain a Minimalist Screening Role

In terms of the first half of Investment Canada's mandate, it should be clear from our brief review of Canadian FDI policy that the traditional Canadian focus on restricting inward FDI is now (thankfully, in our opinion) mostly gone. In a world where countries are scrambling to attract MNEs, a policy of discouraging foreign entry is a clear signal for firms to take their business elsewhere.

This is not to suggest, however, that Canada should totally give up its right to screen inward FDI. There may be industries or particular firms which the Canadian public deems as strategic, in the sense of *being in the national interest,* where the government may decide to block a takeover or prohibit entry by a foreign-owned firm. No OECD country has given up this right.[25]

The least likely case for screening inward FDI should be the latter *(i.e.,* blocking entry) since new or *greenfield investments* increase the number of firms in the industry, reduce concentration levels and encourage domestic firms to become more competitive. Thus we agree with Michael Porter's view that firm rivalry is a source of competitive advantage and should be encouraged.[26] Giving a single, Canadian-owned firm a monopoly over a product market in Canada is a sure-fire recipe for inefficiency and mediocrity

On the other hand, there may be economic *(e.g.,* anti-trust) or non-economic arguments *(e.g.,* culture, national security) for blocking foreign takeovers or brownfield investments. That right should be protected, but monitored so that it is not abused. A careful weighing of the economic and non-economic costs and benefits, by the staff at Investment Canada (or by the Competition Tribunal in the case of anti-trust actions), should be sufficient to protect this tight.

Our minimalist role for screening should not be interpreted as support for the recommendation by Frost and Graham that Canada should pass an explicit law giving the federal government the power to block entry or takeovers on the grounds of *national security.*[27] The U.S. government has such legislation and a committee to enforce it, the Committee on Foreign Investment in the United States (CFIUS). Even though most Group of Seven (G7) countries have similar legislation, in our view, the Investment Canada Act is already broad enough to protect Canada's national interest without further complicating matters by passing additional — and probably fuzzy — legislation on national security.

Secure Market Access

For most Canadian firms, access to the U.S. market is critical for their long-term success. We take it for granted that the hub and spoke economy[28] within North

25. See Chapter VII of UNCTAD Division on Transnational Corporations and Investment, *World Report 1994.*
26. See Michael Pester, "Towards a Dynamic Theory of Strategy," in Richard Rumelt, Dan Schendel and David Teece, eds
Fundamental Issues in Strategy: A Research Agenda (Boston: Harvard Business School Press, 1994).
27. See Ellen Frost and Edward M. Graham, "Multinationals and North American Security," in Lorraine Eden, ed., *Multinationals in North America* (Calgary: University of Calgary Press, 1994).
28. Trade and investment patterns in North America are in the shape of a hub and spoke, with the U.S. economy as the dominant hub and the much smaller Mexican and Canadian economies as spokes. Most trade and investment flows between the hub and the north or south spoke. Canada and Mexico engage in little trade or investment with one another that is not mediated through the United States.

America is *a fait accompli.* Canadian firms are inexorably tied to the U.S. economy and no "Third Option" is going to change this. We can diversify our trade patterns somewhat – for example, the West Coast can develop its Asia Pacific links – but the key economic relationship in Canada is south of the 49th parallel. Canadians should therefore see access to the United States as an advantage, not a threat (after all, most businesses would be delighted if their country were next door to the U.S. market).

The Canada-U.S. free trade negotiations were designed to secure, protect and enhance such access. While both CUFTA and NAFTA phase out tariffs, reduce non-tariff barriers, cover goods, services and factor markets, and develop a farsighted investment policy regime based on nondiscrimination, it is still true that secure access to the U.S. market has not been achieved. U.S. firms continue to harass Canadian exporters through requesting countervailing duties, anti-dumping duties and temporary safeguard measures on the grounds that Canadian firms are causing material injury to U.S. producers.[29] The NAFTA dispute settlement procedures continue to be based on national laws that focus on subsidies and/or dumping by foreign competitors, while ignoring subsidies and dumping by domestic firms. In addition, the procedures are cumbersome, expensive and time consuming; their principal beneficiaries so far have been trade lawyers and the firms launching the complaint. Thus, as Eaton *et al* argue, policy risk still exists and market access, while improved, is not secure.

How can we secure this access? Two solutions are possible. One is to renegotiate the NAFTA rules to substitute a trilateral system of dispute settlement, based on continental rules that take account of the *net* subsidies available within North America; i.e., asking the question: how level is the playing field? For the United States to cede sovereignty in this manner to its much smaller Canadian and Mexican partners does not appear likely, so we do not offer much hope for this solution.

Competition policy offers another alternative. It includes the regulation of market monopolization (anti-trust policy) and state aids to industry (state aids policy). In North America, each of the three governments has its own antitrust policy but not a formal state-aids policy. NAFTA requires each country to have its own competition laws and the countries to cooperate in enforcement of domestic laws.

Graham and Warner argue that NAFTA should explicitly contain competition policy provisions, and that MNEs strengthen the case for such a policy.[30] The authors provide five reasons: (i) bafflers to trade can offset the gains from NAFTA (ii) some competition policy issues, such as continental mergers and acquisitions, have a North American dimension that will be ignored by national competition policies; (iii) national competition laws in the three countries are not fully harmonized, so there are potential conflicts between the regulations; (iv) a trilateral competition policy would replace the CUFTA/NAFTA rules on anti-dumping duties, countervailing duties and safeguard measures,[31] that are now disguised "back door"

29. The last extraordinary challenge, this time in softwood lumber, is an example of the lengths U.S. firms will go
to protect their market from Canadian competitors.
30. Edward M. Graham and Mark A. A. Warner, "Multinationals and Competition Policy in North America," in Eden, ed., *Multinationals in North America.*
31. As competition policy rules have replaced countervail and anti-dumping rules within the European Community.

protectionism particularly for U.S. firms; and (v) a trilateral competition policy could be used to regulate government subsidies to business, both at the federal and sub-federal levels. The authors recommend a North American Competition Commission (NACC) be established in this regard, and this is also our policy recommendation.

Province/State Aids to Business

An institution such as the proposed NACC could also have the advantage of regulating provincial and state aids to business. Given the size of the federal and provincial debt levels, Canadian governments cannot compete with the location subsidies offered by U.S. states.[32] Such government largesse can be a way of attracting assembly firms, which then generate a second round inflow of parts suppliers, such as has happened with the Japanese and European auto investments in the middle and late 1980s. As a result, although the up-front costs in subsidies and tax holidays may be high, the net benefits to the local economy may exceed these costs – at least governments tend to assume there are net benefits and to rationalize the subsidies in this manner.

The problem, as is well known, is one of *tax competition:* if the investment would have been placed there anyway, the subsidy does not affect location and simply represents a transfer from taxpayers to the firm and its shareholders. If the investment would have been placed somewhere else but within national boundaries, one region gains but at the expense of another, and resources are misallocated at the national level. In addition, competition among states for investment has also significantly upped the ante. The size of grants to new investments has risen sharply since 1980, thus reducing the possible net gains to the region.[33] Thus there would be benefits to North America as a whole if governments could constrain state aids to business, and, in the case of Canada, the benefits are high.

In addition to straightforward tax holidays, firms in the United States can take advantage of various cost-reducing government policies that are not available to firms in Canada. One example is the creation of a *foreign trade zone,* now heavily used in the United States as a location subsidy.[34] This federal policy allows designated regions to declare themselves as a special area for the purposes of importing parts for assembly, with the final product being exported. In the United States, tariff rebates, tax holidays and subsidies can all be part of the package; most U.S. auto plants now enjoy these privileges. Canada has a few international banking centres *(e.g.,* Montreal, Vancouver), but no other equivalent.[35] The United States also gives its MNEs a tax break on export profits under the Foreign Export Sales Corporation program. Such profits are taxed at a lower rate than profits earned on domestic sales.

32. The provincial governments, however, have often fried with marked effects on their treasuries. Preferential procurement policies have much the same effect as subsidies.
33. James Rubenstein, *The Changing US Auto Industry: A Geographical Analysis* (New York: Routledge, 1992).
34. *Ibid.,* Chapter 8.
35. Another somewhat similar program was the duty drawback and remission schemes available to designated auto and auto parts firms under the Auto Pact. Under NAFTA these are being phased out, except for the Big Three, over the next few years.

As part of the CUFTA negotiations, the U.S. and Canadian governments agreed to address the issue of subsidies. These negotiations were postponed until Prime Minister Chrétien secured a commitment from the U.S. and Mexican presidents to discuss the subsidy issue, as part of Canada's agreeing to sign the NAFTA treaty in December 1993. Since a three-part subsidy code (green, yellow red) is part of the Uruguay Round package, it is likely that these talks, which are now ongoing, will result in the adoption of the GATT subsidy code, or some modification, as part of NAFTA. It is imperative that the Liberal Government obtain a U.S. commitment to restrain such subsidies since this is a game that only governments with deep pockets can win.

Move Up to Best Practice Technology

In the knowledge-based economy of the twenty-first century, Canadian firms will only be competitive on world markets if they operate at international standards of quality and best practice technology. For example, ISO 9000 standards are now required by the European Union for many imports; the standards are widely diffusing through the auto industry and the need for quality control in lean production is causing manufacturers to insist on their first tier suppliers also meeting the standards. Unless Canadian firms can satisfy international quality standards, whether ISO 9000 or some other benchmark standard, their products will be blocked from the U.S. and foreign markets.

In addition, technology levels are continually upgrading. Firms without a window on foreign competition lack the information necessary to benchmark their performance against international levels. Without the motivation or knowledge to upgrade their activities, best practice technologies diffuse slowly throughout the economy.

A policy of attracting "best practice" multinationals to Canada would change this. Japanese MNEs, with their process and product technologies, currently offer the best investment bridges to, and windows on, lean production techniques. An aggressive policy of seeking out Japanese multinationals, attracting them to Canada, and encouraging them to set up strategic alliances and joint ventures with Canadian firms is recommended. More Asian investment in Canada would diffuse these best practices among Canadian firms through competition, the demonstration effect and supplier networks (as Kenney and Florida demonstrate has occurred in the U.S. auto parts industry).[36]

Given the Japan-bashing attitudes in the United States, it may be possible to attract Japanese investments, which are destined for North America, to a Canadian instead of a U.S. or Mexican location. The rapid rise in the yen over the past 24 months suggests that another round of outward investment by Japanese multinationals is likely as the *keiretsu* again move offshore to lower cost production locations. Canada could be a location for this new round of transplant production; Canadian costs are low and access to the U.S. market, while not secure, is

36. See Martin Kenney and Richard Florida, *Beyond Mass Production: The Japanese System and Its Transfer to the US* (New York: Oxford University Press, 1993).

significantly improved compared to the mid-1980s. Weighing against this, however, are the deep pockets of U.S. state governments, the Japanese perception that investing in the United States can be used to offset the U.S.-Japan trade balance, and the lack of a clear sense of Canada by Japanese MNEs. [37]

We suggest that an "inviting and open door" policy towards Japanese MNEs be adopted so that these firms are encouraged to see Canada as a good place to do business, a place where they are welcome. The west coast, with its trade and investment links to the Pacific Rim, is a natural location for such firm-to-firm contacts. The technology spillovers to Canada are critical and the window of opportunity is now.

Of course, Japanese firms are not the only MNEs that can offer lessons to Canadian business. In the retail sector the entry of U.S. firms such as Wal-Mart Stores, Inc. is already shaking up the hidebound Canadian retail sector. Canadian consumers should benefit from better service at lower prices as U.S. techniques diffuse through Canadian businesses.

The inflow of U.S. and Japanese MNEs to Canada in the wake of CUFTA and NAFTA is both a benefit (better technology, lower prices, more choice) and a threat (more competition, domestic firms going out of business). The most common response has been is a short run one of cost cutting, downsizing and out-sourcing (perhaps to Mexico), rather than the needed technological upgrading. Domestic firms need to be encouraged, perhaps through loans (not subsidies), to take the long run approach of learning from these new competitors and moving up to best practice technologies.

In addition, Canadian firms should be encouraged to invest abroad and to strategic partner with best practice firms. Their foreign affiliate activities can be diffused through the parent firm to other Canadian firms. Outward investments should also be seen as investment bridges and windows on foreign competition, as ways of accessing the global marketplace. Some of this is already happening as a result of CUFTA and NAFTA; mergers and acquisitions by Canadian firms in the United States are expected to set a five year record in 1994[38]; much of the activity occurred in the financial services and communications and media sectors.

Conclusions

The adjustment of Canadian firms to CUFTA and NAFTA is occurring with-tin a rapidly changing international environment. Since 1989, we have witnessed EC "1992" and Maastricht in Western Europe, the disintegration of the Soviet Union, the boom in China, and the collapse of the speculative bubble in Japan. We live in a world where multinationals are the key non-state actors, where almost half of all Canadian goods and services are traded inside related businesses and where more products are sold through foreign affiliates than through exports.[39] What does this mean for policymakers in Canada?

37. In particular, we do not anticipate any large Asian investments in Canada at least until after the issue of Quebec separation is addressed, although smaller investments may occur.

38. Scott Haggett, "Canadian Firms on a US Buying Spree," *The Financial Post,* July 5, 1994, p. 1.

39. Dennis Encarnation, "Intra-firm Trade in North America and the European Community," in Eden, ed., *Multinationals in North America.*

In this article we have proposed a new direction for Canadian foreign direct investment policy. Historically, Canada has screened and restricted inward FDI flows. Our proposed new direction focuses on multinationals as market-making firms and as agents of change, acting as investment bridges to the global economy and as diffusers of technology within Canada. A new FDI policy should, in general, not differentiate between inward and outward FDI, but seek to maximize the gains to Canada from NINE activities in both directions.

There is a well known quotation about the linkage between foreign policy and trade policy in Canada. Eaton *et al.* phrase it this way:

> For the United States, as a super power, trade policy has always been an instrument of foreign policy ... For small countries such as Canada, however, foreign policy is an instrument of trade policy. [40]

In this article we have shown that a fundamental rethinking of Canadian foreign policy is required. It is not sufficient to focus on trade policy. Canadian foreign policy must also be an instrument of investment policy.

40. Curtis Eaton, Michael Lipsey and A.E. Safarian, "The Theory of Multinational Plant Location in a Regional Trading Area," in Eden, ed., *Multinationals in North America,* p. 71.