



# Straight Talk

## Laura Dawson on Foreign Direct Investment

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As a small, open economy that receives a significant amount of its income from trade with other countries, Canada depends on accessing markets and fair trading rules. The more open foreign markets are, the greater the opportunities for Canadian exports. And yet one area of trade, specifically investment in Canada by foreigners, has long been a contentious issue even though the benefits to Canadians are considerable. This instalment of *Straight Talk* explores Canada's historical and current experience with foreign direct investment.

**MLI:** Canada prides itself, in principle, in having an open economy. Foreign direct investment is part of an open economy. Can you explain the basic concept of FDI?

**Dr. Dawson:** Foreign direct investment (FDI) refers to the acquisition of assets by a foreign entity. The debate over FDI tends to flare up when a foreign entity is seeking to acquire controlling interest or ownership of a Canadian asset. We are less concerned about "portfolio investment," when someone simply buys shares in a Canadian public company. FDI raises questions about whether foreigners will follow Canadian laws, respect Canadian resources, and uphold the best interests of Canadians and the Canadian economy.

**MLI:** Didn't we debate these issues in the 1960s and 70s?

**Dr. Dawson:** Yes, growing foreign – particularly U.S. – ownership in those years prompted fierce debates about whether Canada was becoming "a branch plant economy" and whether important economic decisions were being made outside our borders. In the 1960s and 70s there were grounds for concern because manufacturing tended to be "vertical", that is, almost all stages of production occurred within a single factory. Foreign companies would locate in Canada so they could sell locally without paying the high import tariffs we placed on manufactured goods. Because almost everything was done in-house, this investment created few spinoff benefits to the larger economy beyond local employment.

**MLI:** But production methods have changed.



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**Dr. Dawson:** Absolutely. With the advancements in communications and shipping technology, production now takes place in a “supply chain” model in which a finished product is produced by lots of independent companies. Their efforts, production schedules and so on, are closely coordinated but they are separate firms, so when a factory locates in Canada it does business with local suppliers.

**MLI:** So has Canada’s view of FDI changed along with the changing conditions?

**Dr. Dawson:** Yes. As the world has changed, so is Canada now aggressively promoting itself to foreign investors. Since tariffs tend to be quite low now, investors locate in new markets for other reasons. Canada provides investors with access to markets and natural resources, a skilled workforce, relatively good infrastructure, and a stable business environment. But, there are lots of other desirable markets in the world so Canada has to continue to provide location advantages to potential investors.

**MLI:** You say Canada is a lot more open to FDI than it used to be. What changed and when?

**Dr. Dawson:** The policy changes began in the 1980s when we realized that if Canada was going to be a global player we needed more competition and a greater volume of trade and capital flowing through our economy. Canada was struggling with high unemployment and low growth and the Trudeau-era foreign investment review policies were simply too slow and cumbersome. The Mulroney government streamlined the process with the 1985 Investment Canada Act (ICA). Now, only high-value investments are automatically reviewed by the Industry Minister. The threshold (size of the investment) that triggers a review has gradually been increased since 1985 and stands today at \$312 million for most types of investment.

**MLI:** If a review is initiated, what is the key criterion?

**Dr. Dawson:** The review focuses on whether an investment provides a ‘net benefit’ to Canada such as increased production, employment or technology transfer. Advocates of investment liberalization suggest that the test should be reversed to weed out harmful investments but let the market decide whether an investment ultimately provides a net benefit or not.

Nowadays, unless an investment is particularly large or in a sensitive sector, federal authorities just have to be notified about the intended investment and provided some information about the potential investors. Implementing a more streamlined review mechanism has made Canada a more predictable (and attractive) place to invest because it reduces the scope for political and interest group interference in the process.

**MLI:** So are we more open now to FDI due to these changes?

**Dr. Dawson:** We are definitely more open to FDI than we used to be but, unfortunately, future improvements will proceed by inches. We have already gotten rid of the most obstructionist policies that didn’t serve any public policy purpose. Now, we have to make difficult decisions about how much we are willing to open sensitive areas such as the cultural industries, banking, as well as sectors related to security or “strategic” interests.

**MLI:** What do you mean by “strategic” interest?

**Dr. Dawson:** Strategic interest doesn't refer to national security. Instead it's a somewhat nebulous term that seems to have been invented by folks opposed to BHP Billiton's acquisition of Saskatchewan's Potash Corporation last year. Since then, it has been tossed around regarding the intellectual property assets of high tech firms, access to the Canadian wireless market, and management of the Toronto Stock Exchange.

The Investment Canada Act doesn't mention anything about strategic interests but it does specify that investments must be compatible with national, industrial, economic and cultural policies. To me, this seems to be a sufficient basis to make case-by-case decisions but others are pushing to apply the "strategic" label to sectors they want to shield domestic firms from foreign competition.

**MLI:** For some reason foreigners investing in Canada often worries people, as though they were going to buy all our good stuff and leave with it. What does FDI do for Canada?

**Dr. Dawson:** FDI fills domestic gaps in capital, expertise, and technology transfer. Foreign investment also increases competition that, in turn, increases productivity. When a Canadian firm becomes part of an international supply chain, that company has to meet the efficiency challenge of greater competition. In turn, Canadian consumers benefit from better products, lower prices, or both and the Canadian labour market benefits from firm longevity and stable employment.

It's important to remember that even though we have a huge land mass and the 10th-largest economy in the world, Canada has a small population and a fairly small domestic market. We can't become globally competitive without outside stimulus. Just like you couldn't become an Olympic track star if you never competed outside your own neighbourhood. It's good for all of us to strive to be global players and not hide behind investment barriers that make us weaker in the long run.

**MLI:** How much foreign direct investment is there in Canada and how has that changed over time?

**Dr. Dawson:** In 2010, Canada took in \$562 billion in FDI. That's equal to about 36 percent of GDP compared to 1970 when FDI was equal to about 28 percent of GDP. The ratio of FDI to GDP has declined somewhat from a high of 44 percent in 2010 but there is no reason to sound the alarm bells yet since the decline coincides with the global economic downturn and the slowing U.S. economy.

Today, more than half of Canadian FDI comes from the United States. It is ironic that in 1970 we were worried about too much U.S. investment and now we're worried that there's not enough. However, a sign of healthy participation in global supply chains is Canadian investment abroad. Our outbound FDI has been on the upswing in recent years, especially to emerging markets in Latin America, Asia and Eastern Europe.

**MLI:** What about the negative impacts of foreign investment?

**Dr. Dawson:** Sure, not all foreign investors are boy scouts but the same is true of Canadians. Generally speaking, the behavior of investors – foreign and Canadian – is only as good as the laws that govern them. Fortunately, Canada has strong environmental and labour protections so we don't attract companies that seek to exploit local resources with impunity. Generally speaking, with strong rule of law, a functioning courts system, fair taxation, moderate red tape and good infrastructure, Canada is able to attract high quality foreign investors who will stick around and generate "net benefits" to the long-run health of the economy.

We have a built-in bias that Canadian companies always have the best interests of the country at heart but there are many examples of factories that have declined under Canadian ownership only to be resuscitated by foreign investors. Sault Ste. Marie's Algoma Steel went from bankruptcy protection in 2002 to record profits today as a result of capital and know-how from Indian, Argentinean and Italian companies. As long as we have good rules and good enforcement, most of the concerns people imagine will not manifest as serious problems.-

**MLI:** Most? Is there an important exception you have in mind? For instance, the Chinese are trying to buy up major energy assets when they are a major source of greenhouse gases and strategically they are not always our friends.

**Dr. Dawson:** The thing is, if a Canadian asset is legally on the market, we can't discriminate and say, "Hey, we are only willing to sell Canadian energy to New Zealanders because they are good at conservation and have a low carbon footprint." These are commercial transactions between willing buyers and sellers. As long as they are following the laws of the land, there is not much a government can do. Canada's laws are pretty specific about the sectors where investment is permitted and under what conditions.

The real problem with China is their size, their newcomer status in global disputes, and the fact that so many Chinese commercial enterprises are state owned. Even though we have pretty good international tribunals for settling foreign investment disputes, if a major grievance arose with a Chinese company, there's a very real danger that it would escalate to the diplomatic level. Unlike a dispute between, say, a privately owned British firm and the Canadian government, where British government involvement would be at best secondary, this would be a confrontation between the much larger Chinese government and ours.

**MLI:** Provided we deal sensibly with the concerns you raised earlier, what are the main FDI restrictions we still have in place and what sorts of harm do they do?

**Dr. Dawson:** The greatest deterrent to investment is uncertainty, especially when rules are not clearly spelled out or when politics leads the government to backpedal on a decision. While not specifically an ICA matter, the Wind Mobile/Globalive case shows how costly these reversals can be. In 2008, Industry Canada deemed that Wind Mobile – a company with Canadian directors but Egyptian financial backers - was Canadian enough to participate in an auction for wireless spectrum rights. But, when Wind tried to enter the Canadian wireless market with the spectrum rights it purchased, the CRTC deemed that the company's Canadian directors were not sufficiently independent of the foreign financiers and it excluded Wind from the market. The Industry Minister then got Parliament to overrule the CRTC and let Wind back in. Meanwhile the company has been spending considerable sums to establish a Canadian market presence. In early 2011 the parliamentary decision was overturned in court and Wind's spectrum rights removed and now that decision is under appeal. This is a case where a foreign investor got mixed, and very costly, messages from the Canadian government. Other foreign investors are guided by cases like this when considering the merits of investing in Canada.

**MLI:** OK, where should the government go in terms of FDI policy and what's the best way of getting there?

**Dr. Dawson:** As I mentioned earlier, we've taken care of the most obvious stuff. What we need to do now is look at sensitive areas where until now we've made an exception to our general policy of openness.

The main reason for restricting foreign investment is because it would harm national interests, national security being the obvious example. For instance, we wouldn't allow North Korea to acquire a Saskatchewan uranium mine. Similarly, we have decided it is in the national interest to retain Canadian control of cultural industries so we don't allow majority foreign ownership of bookstores or radio stations.

**MLI:** The last thing is how our rules about intellectual property (IP) affect our attractiveness for FDI.

**Dr. Dawson:** The presence of strong rules to protect patents, trademarks, and copyright is an important incentive to foreign investors. Incidentally, it's about more than just having strong rules, it's also about having reliable enforcement mechanisms. Are authorities empowered to seize counterfeit goods at the border? Can pirated IP be removed from the internet and violators dealt with appropriately? Some of the world's largest bit torrent sites are hosted in Canada but, unlike in Sweden and the Netherlands, law enforcement here has been unwilling to shut down servers and punish operators. Canada's new copyright legislation, if passed, will be a good first step to reassure foreign investors that Canada is not a pirate haven. Foreign investors will not be willing to put their IP on Canadian servers unless they know that their material is protected by laws that are enforced.

The second area where IP and foreign investment overlap is the recurring question of whether IP developed in Canada should be kept out of the hands of foreigners. We've seen both ends of this argument play out recently. When Nortel began selling off its assets in 2009, Canadian tech giant RIM argued that Nortel's IP was a Canadian natural resource that should not be allowed to leave the country. Meanwhile, Nortel's beleaguered shareholders and pensioners believed their interests would be served getting the best price possible for Nortel's assets. Ironically, RIM did end up with a share of Nortel's more than 6000 patents but RIM was part international bidder consortium that included Microsoft and Apple so foreign capital was ultimately key to their success.

**MLI:** Looking forward, what will happen if RIM's fortunes continue to decline and their estimated \$4 billion in IT assets end up on the auction block? Will RIM shareholders – many of whom are Canadian – insist on selling to the investor with the maple leaf on his backpack or will they hold out for top dollar, regardless of investor nationality?

**Dr. Dawson:** The pessimistic view says that Canada should guard its domestic IP because we may never be able to reproduce it. The optimistic view says that Canada has proven itself to be a high tech innovator and this is proven by international demand for our domestic IP product. If we did it before we can do it again. The genealogy of the Mitel, Newbridge, and Corel companies is a great illustration of success begetting success in the high tech world.

There is no easy answer but factors to consider are how much taxpayer resources went into the development of the IP in the first place? Would retaining the IP in Canada deliver clear benefits to Canadian shareholders, workers and pensioners? Would losing the IP have negative implications for national security or other areas of critical importance? Does foreign investment really result in a hollowing out of domestic capacity? Many foreign investors choose to retain Canadian production and head offices. This is the decision by US-based Sterling partners in its recent acquisition of Ottawa's Mosaid Technologies.

**MLI:** Where do we go from here?

**Dr. Dawson:** In 2008, the federal government commissioned a study entitled *Compete to Win* that sought to balance public policy concerns with Canada's need for FDI to bolster its competitiveness in the world. The

report recommended increasing the FDI review threshold to \$1 billion, providing greater transparency when reviewing investment in the cultural industries and greater liberalization of controlled sectors such as financial services, telecommunications, air transport, and uranium mining. The government seems to be incrementally rolling out these recommendations and the pace may accelerate with a parliamentary majority.

As we move ahead, we need to reconsider the public policy rationale for keeping certain sectors closed to foreign competition in the context of Canada's competitiveness in a global economy. We need to ensure that the new measures on security and sovereign wealth funds help us to stay out of unwinnable disputes. Most importantly, we need work to have clear rules that are consistently applied in order to maximize certainty for businesses and minimize the leeway for political interference in commercial transactions.

#### **Conclusions and Recommendations:**

Foreign direct investment provides a range of direct benefits such as filling domestic investment gaps, financing increased production, increasing and enhancing employment opportunities, and facilitating technology transfers.

Canada struggled through a difficult debate in the 1960s and 70s regarding the efficacy of protectionist policies. As a nation, we grew up economically and realized the many benefits of competing in the global market.

Canada's well-educated workforce, stable economic environment, competitive business tax regime, and access to natural resources make us an attractive destination for foreign investment. The key to our long-term success is to have a predictable, stable environment for investment and business development.

Recent flip-flops like Wind Mobile and government intervention in the case of Potash Corp. have led many to question Canada's commitment to foreign investment and the stability and predictability of Canadian laws. These decisions reduce Canada's competitiveness and ability to attract investment.

A growing area of concern where the Canadian government may soon be tested is foreign acquisition of companies with Canadian intellectual property. The most visible example of this may well be future investments in RIM. The Canadian government must provide a consistent, clear set of policies if we are to repair and renew our position as a leading destination for foreign investment.

Finally, the federal government should heed recommendations from its own recent report, including increasing the FDI review threshold to \$1 billion, providing greater transparency when reviewing investment in the cultural industries, and greater liberalization of controlled sectors such as financial services, telecommunications, air transport, and uranium mining.



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