THE CANADIAN EXPERIENCE WITH FOREIGN DIRECT INVESTMENT*

MELVILLE H. WATKINS†

The extent of foreign ownership of Canadian industry is unique among the industrialized nations of the world. At the end of 1964, the last year for which comprehensive statistics are available, long-term foreign investment in Canada stood at $27 billion. Sixty per cent of this long-term investment was foreign direct investment carrying with it foreign ownership and control. Eighty per cent of the foreign direct investment represented ownership and control by Americans. Foreigners owned over one-half of Canadian manufacturing, and more than two-thirds of mining and smelting, and of petroleum. Foreign ownership approached 100 per cent in such major industrial sectors as automobiles and rubber. The only key sectors of the economy largely immune from foreign control are agriculture, banking, and the media, the last two being specifically protected by public policy. In the words of a 1965 Twentieth Century Fund study:

> a very large and strategic part of Canada's industrial assets are owned and controlled by non-residents, much of them being directly controlled *via* the foreign parent-domestic subsidiary relationship. In addition such concentration tends to be in the larger enterprises and in industries whose growth prospects appear to be among the most dynamic in the whole economy. Indeed, the concentration is extremely heavy in various key export areas as well as important sectors of domestic secondary manufacturing both of which tend to be prime movers of the Canadian economy. To a very large extent therefore it appears that Canada's economic growth is increasingly dominated by nonresidents and will be strongly conditioned by decisions made by companies located in the United States and subject to U.S. laws, customs and attitudes.[1]

Foreign direct investment is not a new phenomenon in Canada. At least as early as the 1850s, American entrepreneurs had penetrated the eastern Canadian lumber industry. An American drug company established a branch factory in Canada in 1860, and a file manufacturer did the same in 1870. The flow of direct investment picked

---

* This paper is adapted from an address to the Washington Conference on Trans-Atlantic Direct Investment and the Balance of Payments, Institute for International and Foreign Trade Law, Georgetown University, Washington, D.C., Sept. 26, 1968.

† The author is an Associate Professor of Economics at the University of Toronto. He headed a Government of Canada Task Force which prepared a report, *Foreign Ownership and the Structure of Canadian Industry*, which was tabled in the Canadian House of Commons in February 1968; see REPORT OF THE TASK FORCE ON THE STRUCTURE OF CANADIAN INDUSTRY, FOREIGN OWNERSHIP AND THE STRUCTURE OF CANADIAN INDUSTRY (1968). The author does not speak for the Government of Canada nor for the seven other economists who constituted the Task Force.

[1] G. WILSON, S. GORDON & S. JUDEK, CANADA: AN APPRAISAL OF ITS NEEDS AND RESOURCES 197-98 (1965).

up with the high protective tariff of 1879. The 1920s saw a major spurt in both primary products, such as newsprint, and manufacturing, such as automobiles. There has been another major round of expansion by direct investment firms in the years since World War II. These successive waves of foreign capital have been associated with rapid growth of the Canadian economy and large scale immigration.

Nor is any end in sight. Those Canadians who think the Canadian economy is at last mature enough to get along without further increases in foreign ownership have a long list of predecessors who have been wrong in the past. The Twentieth Century Fund study pointed to "the steady increase in non-resident, especially U.S., control, which is seemingly unaffected by depression, boom, war, or peace."[2] Indeed, there is a specific reason to anticipate further increases in the near future. It is well-known that the United States is currently passing through a major merger movement associated primarily with the spread of the conglomerate firm. This movement can be expected to spread across the undefended border in the form of increasing U.S. takeovers of Canadian firms; presumably, it is already happening and waiting official measurement.

The extent of U.S. investment that has taken place in Canada can be explained, in very broad terms, by a number of interrelated factors which constituted the so-called Second Industrial Revolution of the late nineteenth century—a revolution in chemicals, electrical goods, and a broad range of commodities. There is evidence that at this point Canadian entrepreneurs began to lag seriously behind the advanced countries of the world. The late nineteenth century saw the growth of big business in the United States when U.S. firms based in the eastern United States went national. In the process they tended more or less automatically to go continental, to spill over the border into Canada, partly because it is not a very visible border, making it hard to believe that Canada was really a foreign country.

The Canadian tariff facilitated the process, but it may also be explained by apparent deficiencies within the Canadian business class. In turn, these deficiencies may have been intensified by foreign ownership. Entrepreneurship can be seen as a learning process for society. When astute foreigners move in and undertake to do the work that nationals are neglecting, the incentive to learn tends to be lessened.

In spite of its long history, direct investment has only become politically controversial in Canada in the past fifteen years. The issuance of official statistics on foreign ownership and control in the mid-1950s triggered off a political debate—indicating that statisticians are not as apolitical as they appear. This was followed by a Royal Commission on Canada's Economic Prospects chaired by W. L. Gordon, which commissioned an official study of foreign investment and which, in spite of the blandness of the latter, warned Canadians, in its Final Report in 1957, of the costs of foreign ownership. In the early 1960s, Mr. Gordon, as Minister of Finance, led a personal crusade for a stiffer Canadian policy on foreign ownership. His attempts

[2] *Id.* at 196.

at policy making proved largely abortive, but in early 1967 he persuaded the Government to appoint a Task Force of academic economists to advise on the whole issue of the economics and politics of foreign ownership. The original intent, to issue a White Paper, was abandoned for reasons of party politics, and, in early 1968, the Task Force Report, entitled *Foreign Ownership and the Structure of Canadian Industry*, was published without Government endorsement. Mr. Gordon retired from politics, and the Report, in need of a short title, was dubbed the "Watkins Report."

The Report attempts to analyze the Canadian experience and prescribe policy. It is written around the major theme of the harmonies and tensions between the multi-national corporation and the nation-state. Explicitly, it insists that Canadians must recognize the existence of the multi-national corporation and talk of foreign ownership less in terms of the importation of capital and more in terms of the operation of large foreign-based corporations. Implicitly, it insists that Americans need to admit to the reality of nation-states other than their own. The point of view, exhibited by Mr. George Ball when he calls the nation-state old-fashioned in contrast with the futuristic multi-national corporation,[3] needs to be challenged—and by Americans as well as Canadians.

The policy of the Report is *simpliste* and is predictable as the product of a Task Force consisting only of economists: maximize net benefits from foreign direct investment—that is, increase the benefits and decrease the costs.

Let us take the two elements of this strategy in turn, beginning with increasing the benefits. Foreign investment clearly contributes to the economic growth of the host country. The relevant questions are: how much? why not more?

Economic research on the Canadian case suggests that the benefits, while substantial, are not as large as is perhaps imagined. There appear to be few significant differences in the performance of foreign-controlled and Canadian-controlled firms, though there are some special problems peculiar to foreign ownership such as the limited opportunity for Canadians to participate as shareholders in the Canadian operation, the export restrictions within some international firms, and the extraterritorial application of American law and policy via the medium of the parent-subsidiary relationship. But if Canadian subsidiaries are as efficient as their domestic counterparts, they are definitely less efficient than their parents. Performance in the area of research and development spending, with its obvious importance for the rate and character of economic growth, is a relevant case in point. Foreign-controlled firms out-perform Canadian-controlled firms in research and development spending, but the differences in performance between subsidiary and parent strikingly favour the latter and are suggestive of the limitations of a branch-plant economy.

From one point of view, then, we can say that foreign firms perform as well in Canada as domestic firms and that Canadians should stop worrying about foreign ownership; this is the interpretation popular in the Canadian business community.

[3] Fortune, June 1967.

From another point of view, however, we can say that foreign firms perform as badly as domestic firms, since many Canadians outside the business community are not particularly impressed by the performance of the latter. The question can be left standing: why should the political costs that are known to inhere in foreign direct investment be borne when the foreign firm creates only the same economic benefits as the domestic firm?

The similarity of performance appears to be attributable to the nature of the Canadian environment which is common to all firms: the oligopolistic structure of the economy and Canadian industrial policy, specifically, the high tariff and a weak anticombines (or antitrust) policy. The structure of Canadian industry, that is, secondary manufacturing industry, is frequently one of too few and too small firms —too few for effective competition yet too small to reap full economies of scale. The combination of the willingness of American firms to move to Canada and of the Canadian tariff's segregation of the Canadian market, has produced an industrial structure in Canada which is a "miniature replica"[4] of that in the United States— whereas the American market is twelve times larger than the Canadian market.

The policy implications of this line of reasoning seem clear: American-style antitrust and free, or freer, trade. This is certainly the conventional wisdom of North American economists and, understandably, is reflected in the Report.

It is possible to have some doubts. Any revision of Canadian anticombines legislation should be such as not to inhibit mergers within Canada that would permit large Canadian-controlled firms to emerge. Canadians should read Servan-Schreiber[5] and consider the force of his argument that the economic independence of countries may require that they nurture their own giant firms capable of challenging existing American-based giant firms. Any rationalization of the Canadian tariff structure should not be such as to cause each Canadian subsidiary to be more closely tied to its American parent, for that would further reduce the already limited extent to which decision making in the private sector takes place within Canada. The case for lowering the Canadian tariff stands, but there is a need for selective policies and for a strong Canadian government presence.

An important over-all point to be learned from the Canadian experience with foreign direct investment is that host countries do not necessarily get the full economic benefits therefrom unless they pursue appropriate national policies.

Policy should be directed to increasing not only the benefits but also the Canadian share of the benefits. Economists argue that the most obvious benefit from foreign direct investment is the taxes collected from foreigners. The tax authorities should be vigilant in limiting any tendency for the multi-national corporation to shift profits and taxes in a manner harmful to local taxpayers and in dis-

[4] The term is H. E. English's. H. ENGLISH, INDUSTRIAL STRUCTURE IN CANADA'S INTERNATIONAL COMPETITIVE POSITION (1964).

[5] J. SERVAN-SCHREIBER, THE AMERICAN CHALLENGE (1969).

couraging special tax treatment of industries predominantly controlled by foreigners; Canada does have a problem at least in the latter regard as is evident from the 1966 *Report of the Royal Commission on Taxation.*

Canadians can also share in the benefits as shareholders. As is well known, a number of multi-national corporations are most reluctant to permit a minority participation in their subsidiaries. The prevalence of the wholly-owned subsidiary in Canada has resulted in a shortage of equity shares in Canada and an increasing flow of Canadian funds into American securities. While recognizing that minority participation is a contentious issue, the Task Force regarded the present state of the Canadian capital market as being such as to support a recommendation for stronger incentives, as through the tax system, to encourage share issue.

An alternative vehicle for Canadian participation is a Canada Development Corporation (CDC). The latter idea was first put forth some time ago by Mr. Gordon, and the Corporation has had a stormy nonexistence. The Task Force felt that a well-conceived and well-financed CDC would enable Canadians to get a greater share of future action than they have been able to get of past action. The Government has recently indicated its intention to proceed with the setting up of the CDC.

The proposed CDC could provide Canadian participation in new ventures too large for Canadian private capital which might otherwise come under foreign ownership and control. It could play a leading role in Canada's business and financial community, in close cooperation with existing institutions. Its size and quasi-public character would enable it to make a unique contribution in organizing consortia of investors, domestic and foreign, for the purpose of carrying out large projects, as in the resource field, which are beyond the capacity of a single institution. The capacity of the CDC to draw on the expertise of the business, financial, and professional community and to provide a focal point for the mobilization of entrepreneurial capital would help to meet what is at present a major flaw in the Canadian capital market—rising Canadian ownership of equity securities not matched by rising Canadian control. The existence of the CDC would furnish an additional opportunity for the investment of Canadian savings with the assurance of Canadian participation in decision making.

Let us now turn to the strategy of decreasing costs. Most people sense that there are costs which result from foreign direct investment, but economists have not been particularly successful in articulating a frame of reference in which such costs can be analyzed and evaluated. The Task Force had some success in this regard. Foreign direct investment results in foreign control, which might be defined as a shift in the locus of decision making in the economy to outside the host country. In principle, this would not matter under conditions of perfect competition, where all firms are fully disciplined by the market. Nationality of ownership ought then to be irrelevant to the performance of firms, while attempts by one government to interfere with its firms abroad would cripple them in the long run. But if industries are oligopolistic, then firms have power and discretion. Who makes decisions, and where they are made, can matter. The firm does have discretion in responding to government policy, particularly when it faces different policy directives from different governments. Liberal societies have long accepted the need to countervail private monopolistic power. The case is simply strengthened when the private power is foreign-based because of the additional dimension of susceptibility to foreign government policy.

This way of looking at costs is real in two senses. First, most foreign direct investment is accounted for by a relatively small number of giant firms. Hence, the relevant economic theory is that of oligopoly, not of perfect competition, and public policy must be tailored appropriately. Statistical investigation shows that many foreign-controlled firms in Canada are oligopolists and, conversely, many oligopolistic firms in Canada are foreign-controlled. Second, American-controlled firms in Canada are, in fact, subjected to American law and policy, and the latter sometimes differs in important ways from Canadian law and policy.

The resulting problems of extraterritoriality manifest themselves for Canada in three specific areas, that is, there are three sets of circumstances where the United States government uses the direct investment subsidiary as a medium for the application of U.S. law and policy. These are American law and policy with respect to freedom to export, antitrust policy, and balance of payments policy.

United States law and policy—the Trading with the Enemy Act,[6] Foreign Assets Control Regulations,[7] and Cuban Assets Control Regulations[8]—in effect forbid American firms and their subsidiaries to trade with Mainland China, North Vietnam, North Korea, and Cuba. While Canadian foreign policy is typically pro-American, Canadian policy in trade with Communist countries is much more lenient than American policy. Given this difference, periodic flare-ups in Canadian-American relations have become inevitable. An attempt was made to alleviate these tensions by the so-called Eisenhower-Diefenbaker Agreement of the late 1950s permitting trade where the order was important to the Canadian economy and there was no non-American-controlled supplier from Canada.[9] The limitation of this agreement from the Canadian point of view is evident when it is realized that the right to decide when American restrictions will be lifted is held unilaterally by the United States.

The Task Force proposed that the Agreement be institutionalized on the Canadian

[6] 50 U.S.C. App. §§ 1-6, 7-39, 41-44 (1964).

[7] 31 C.F.R. §§ 500.101-.809 (1969).

[8] 31 C.F.R. §§ 515.101-.501 to 515.809 (1969).

[9] Prime Minister Diefenbaker announced in Parliament on July 11, 1958, that President Eisenhower had agreed not to bar Canadian subsidiaries of American firms from selling to Communist China under the U.S. Treasury's foreign assets control regulations. Diefenbaker said that in cases where rejection of such orders by Canadian subsidiaries "might have any effect on Canadian economic activity," the United States "would consider favorably exempting the parent company from the regulations." *See* N.Y. Times, July 12, 1958, at 1, col. 2.

side so as to strengthen the Canadian hand in negotiations with the United States. Specifically, the Report recommends that Canada create a government export trade agency to oversee Canadian trade with relevant Communist countries and, as a last resort, require American-controlled firms to fill bona fide orders which would otherwise be lost to Canada. This is stiff medicine, and the proposal has been consistently disowned by the Canadian government. The imminent creation of such a trade agency is therefore improbable, to say the least.

An analogous problem results from the extraterritorial extension of American antitrust law. Basically, the Sherman Act and the Clayton Act apply the reach of law to American firms operating anywhere in the world.[10] Hence, in the 1950s, Canadian firms with U.S. parents were required to withdraw from a radio patent pool which was legal in Canada. There should be general recognition of the need for harmonization of Canadian and American antitrust policy. It is sometimes alleged that such harmonization already takes place under the so-called Fulton-Rogers Agreement,[11] but, in fact, all that is really involved is consultation, with the United States reserving the right to act unilaterally. Again, the Task Force recommended strengthening the Canadian hand. The most important recommendation in this regard was to enact legislation to prohibit Canadian compliance with foreign antitrust orders, decrees, or judgments, on the presumption that American parents would then be relieved by American courts from obeying decrees which would place their Canadian subsidiaries in the position of violating Canadian law. While cases of extraterritoriality on the antitrust issue have been infrequent in the past, the issue may turn out to be more important in the future should the Canadian government press for rationalization of industries and should American firms be reluctant to cooperate because of fears of violating American law. The moral is that the Canadian government should act now to clarify the Canadian interest.

The issue of the application of U.S. balance of payments policy to the subsidaries of American corporations has been very much alive in recent months. While the United States had been applying voluntary controls for some time, it issued new mandatory controls on direct investment early in 1968—just as the Report was being completed. The result was a major exchange crisis in Canada, requiring Canada to plead for, and to be granted, special exemption.[12]

The exemption was, under the circumstances, clearly a welcome development, but that is not to say that there is not an important lesson to be learned from the sequence of events. The Canadian Minister of Finance found that he could communicate with Canadian firms—that is, American-controlled firms resident in Canada which chose

---

[10] *See* Fugate, *Trans-Atlantic Investment—Antitrust Aspects*, in this symposium, p. 135.

[11] The United States' agreement to consult with the Canadian government before bringing antitrust actions against firms operating in Canada was announced January 29, 1959, by U.S. Attorney General William P. Rogers after a Washington meeting with Canadian Justice Minister E. David Fulton. 1959 FACTS ON FILE YEARBOOK, at 38, col. 3.

[12] OFDI Reg. §§ 1101-07, 33 Fed. Reg. 8665, as amended, *id.* at 8776, 11713 (1968).

to respond, if not overrespond, to U.S. directives, thus driving the Canadian dollar to the wall—only through Washington. Just for a moment the continental power grid was lit up. For some Canadians, what they saw was disturbing, even humiliating. Admittedly, there is limited scope for independent Canadian action at a time of crisis, but a case can be made for action along more fundamental and structural lines so as to reduce dependence in the long run. Certainly pleading for exemptions from U.S. policy and cultivating a special relationship are not manifestations of independence but rather admissions of dependence.

There is yet one more "cost" of foreign ownership that merits mention. Wholly-owned subsidiaries of foreign parents are permitted, under Canadian law, to avail themselves of the status of private companies, thereby evading disclosure to the Canadian public and even to Canadian public officials other than the official statistician and the tax collector. Such were the limitations of existing data that, in spite of a prodigious effort, it was impossible for the Task Force to determine precisely the number of large private companies in Canada. The Report understandably insists that the Canadian government should get more information out of large corporations in Canada—whether foreign-owned or Canadian-owned, though most of the large private companies are foreign-owned—by company law or by some other means. Failure to do this in the past must be attributed to the government; certainly corporations do not like to disclose, but there is no doubt they will do so if required by law.

The major recommendations of the Report are based on the assumption that much could be done to increase the economic benefits and reduce the political costs of foreign direct investment. There remains some room for maneuver by Canada, perhaps not a great deal but more than recent governments have been prepared to use. The tone of the Report is positive in calling for an active program of industrial rationalization and general economic development so as, it is hoped, to facilitate Canadian growth without requiring further reductions in the level of domestic ownership.

If all of the proposals were put into effect, Canada would still have one of the most liberal policies toward foreign direct investment in the world. Foreign corporations should still find Canada a profitable place to invest. Indeed, it could be presumed that, with a better set of industrial policies on the part of the Canadian government, they might earn higher returns on their investments. And Canadians should find themselves deriving larger economic benefits and enjoying more political independence.

In conclusion, we might pose the question of the relevance of the Canadian experience with foreign direct investment for other countries. For the United States, the moral would appear to be that Canadian nationalism, though weak, is real. There is reason to expect continuing tension and periodic crises in Canadian-American relations associated with the extent of American ownership of Canadian economic activity. Some action by Canada is quite possible, though any substantial change in policy is improbable.[13]

For other host countries, the lessons of the Canadian experience are unclear because of the special relationship of Canada to the United States growing out of geography and history—though this is something of a chicken-egg problem insofar as foreign ownership has cemented the special relationship. Two points might be hazarded. First, a national economic policy is needed if citizens of the host country are to benefit fully from foreign direct investment. No policy, or the wrong policy, means bearing political costs from foreign ownership with no assurance of full economic benefits. Second, policies must be formulated which come to grips with the reality of the political costs of foreign ownership. The costs must be specified, and then specific policies must be tailored to minimize each specific cost. While in the long run that may mean international policy, in the foreseeable future there is no alternative to positive national policies by individual host countries.

[13] "The 'expropriation of the expropriators' could not be successfully carried out in Canada much in advance of a similar event in the United States." H. MARSHALL, F. SOUTHARD, JR. & K. TAYLOR, CANADIAN-AMERICAN INDUSTRY 291 (1936). They continue in a more serious vein: "[A] country that is dependent to a considerable extent on foreign borrowing must, if it is to borrow economically, follow social, economic, and political policies that commend themselves reasonably well to the relatively small group that controls the money market in which it borrows." *Id.*