The Benefits of Foreign Business Activity in Canada

Main Conclusions

• Canadians would benefit from greater foreign business activity in Canada through lower prices, higher wages, greater choice, and better quality goods and services.

• Foreign business activity, which includes foreign direct investment (FDI), foreign ownership and foreign competition, is restricted by legislation in Canada. In fact, Canada has some of the highest restrictions on foreign business activity among industrialized countries.

• Foreign business activity in Canada is also expressly limited or controlled in several sectors, most notably in transport (airlines), telecommunications, banking, and financial services.

• Industries affected by restrictions on FDI and foreign ownership in Canada represent approximately 16.5% of total GDP for 2006. In other words, 1 out of every 6 dollars of economic activity in Canada is sheltered from foreign businesses.

• A number of studies have documented the positive impact of foreign business activity on the economy and highlighted the costs of restricting such activity. In fact, economic research shows that foreign business activity increases productivity, competition, innovation, and access to new technologies, which ultimately translate to significant benefits for domestic consumers through lower prices and increased choice.

• Canada should aim at creating a framework that encourages rather than restricts foreign business activity. In other words, recognition of the economic benefits of foreign business activity should play a critical role in shaping future investment and competition policy in Canada.
Introduction

There has been increasing interest in the broad issue of foreign business activity in Canada. This heightened interest has been facilitated by the purchase by foreign companies of several large Canadian firms including Falconbridge, INCO, Molson, Stelco, and Hudson’s Bay Company. To address concerns regarding foreign business activity in Canada, the federal government recently announced the creation of a Competition Policy Review Panel to evaluate domestic laws governing foreign investment and competition.1

This Alert explores the research on foreign business activity to enable readers to better understand the costs of restricting such activity. The Alert is divided into three sections. The first briefly discusses Canada’s regulatory framework regarding foreign business activity. It also identifies the key industries affected by these policies. The second reviews research on the economic impact of foreign business activity. The final offers some conclusions and recommendations.

I. Restrictions on Foreign Business Activity in Canada

In this Alert, the term “foreign business activity” includes foreign direct investment, foreign ownership, and foreign competition. Foreign direct investment or FDI refers to investment by foreigners in the assets (e.g. buildings, machinery, and equipment) of domestic companies. Foreign ownership is an extension of foreign direct investment (FDI) in that it entails the foreign firm gaining a controlling interest in the ownership of the domestic company. Finally, foreign competition, which is distinct from both FDI and foreign ownership, refers to the ability of foreign companies to compete with domestic companies for Canadian business. Essentially, this means that foreign businesses compete with domestic companies in the Canadian market without having a physical presence (through subsidiaries or foreign affiliates) in Canada. Such competition includes trade in goods and services for a share of the Canadian market. All three aspects of foreign business activity in Canada are restricted and limited by a series of Canadian laws.

Several important pieces of legislation affect foreign business activity in Canada. The broadest of these is the Investment Canada Act, which is administered by Industry Canada.2 The Investment Canada Act is the only domestic law that generally applies to all foreign investments in Canada. The purpose of this Act is “to provide for the review of significant investments in Canada by non-Canadians in order to ensure such benefit to Canada” (s. 2). In other words, under the Investment Canada Act, foreign investments are reviewed (screened) before they are approved in order to ensure that such investment will be of net benefit to Canada.

In addition to the Investment Canada Act, a number of federal laws that affect FDI and foreign ownership apply to specific industry sectors. For instance, the Canada Oil and Gas Operations Act limits FDI in the energy sector. The Bank Act, the Canada Transportation Act, the Telecommunication Act, and the Broadcasting Act have provisions that limit foreign ownership in the sectors where these acts apply. Specifically, the Telecommunication Act, which governs the establishment and operation of Canadian telecommunications common carriers, restricts foreign ownership to 20 percent. Similarly, the Canada Transportation Act not only restricts foreign ownership in Canadian airlines to 25 percent, but also allows only Canadian owned and controlled airlines to provide domestic scheduled air services. According to the Bank Act, financial institutions with equity above $5 billion must remain widely held, which means that individual investors, whether Canadian or foreign, may own up to 20 percent.3

Another important piece of legislation in Canada that applies to both foreign and domestic firms is the Competition Act. The Competition Act is Canada’s antitrust legislation; it governs most businesses in Canada and is administered by the Competition Bureau.5 The purpose of this act is to maintain and encourage fair competition in Canada, regulate trade and commerce activities, and monitor trade practices.

Table 1 presents the key Canadian industries that are subject to restrictions on foreign business activity using data from Statistics Canada for 2006.6 The restrictions or limitations are either on FDI or foreign ownership. The affected industries are: mining and oil gas extraction; electric power generation, transmission, and distribution; air transportation; pipeline transportation; publishing industries; motion picture and sound recording...
Canadian consumers by keeping prices high, reducing choice, and slowing down access to new technology.

**II. Research on Foreign Business Activity**

A considerable amount of research highlights the benefits of foreign business activity. (For a comprehensive review of research on the economic effects of foreign business activity see Gorg and Greenaway, 2004; and Blomstrom and Kokko, 1998.) These studies shed light on the economic costs being borne by countries like Canada that restrict the activities of foreign firms.

**International comparison of restrictions on foreign business activity**

Most research that compares restrictions on foreign business activity across countries has been done by the Organisation for Economic Cooperation and Development (OECD). The OECD reports highlight the serious nature of Canada’s current restrictions on the

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**Table 1: Industries Affected by Restrictions on Foreign Direct Investment or Competition, by the North American Industry Classification System [NAICS], 2006 (millions of dollars, in 1997 $)**

<table>
<thead>
<tr>
<th>NAICS code</th>
<th>Industry</th>
<th>Limit on foreign ownership?</th>
<th>Limit on FDI?</th>
<th>GDP (2006), in 1997$</th>
<th>% of total GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>21</td>
<td>Mining and oil and gas extraction</td>
<td>Yes</td>
<td>Yes</td>
<td>40,173</td>
<td>3.7%</td>
</tr>
<tr>
<td>212291</td>
<td>Other metal ore mining</td>
<td>Yes</td>
<td>Yes</td>
<td>680</td>
<td>0.1%</td>
</tr>
<tr>
<td>2211</td>
<td>Electric power generation, transmission and distribution</td>
<td>Yes</td>
<td>Yes</td>
<td>22,867</td>
<td>2.1%</td>
</tr>
<tr>
<td>481</td>
<td>Air transportation</td>
<td>Yes</td>
<td>Yes</td>
<td>4,716</td>
<td>0.4%</td>
</tr>
<tr>
<td>486</td>
<td>Pipeline transportation</td>
<td>Yes</td>
<td>Yes</td>
<td>5,093</td>
<td>0.5%</td>
</tr>
<tr>
<td>5112</td>
<td>Publishing industries</td>
<td>Yes</td>
<td>Yes</td>
<td>9,020</td>
<td>0.8%</td>
</tr>
<tr>
<td>5123</td>
<td>Motion picture and sound recording industries</td>
<td>Yes</td>
<td>Yes</td>
<td>2,051</td>
<td>0.2%</td>
</tr>
<tr>
<td>5131</td>
<td>Radio and television broadcasting</td>
<td>Yes</td>
<td>Yes</td>
<td>2,694</td>
<td>0.2%</td>
</tr>
<tr>
<td>5132</td>
<td>Pay TV, specialty TV, and program distribution</td>
<td>Yes</td>
<td>Yes</td>
<td>2,287</td>
<td>0.2%</td>
</tr>
<tr>
<td>5133</td>
<td>Telecommunications</td>
<td>Yes</td>
<td>Yes</td>
<td>26,650</td>
<td>2.4%</td>
</tr>
<tr>
<td>524</td>
<td>Finance and insurance</td>
<td>Yes</td>
<td>Yes</td>
<td>66,551</td>
<td>6.0%</td>
</tr>
<tr>
<td>Total, all industries</td>
<td></td>
<td></td>
<td></td>
<td>1,100,363</td>
<td>16.5%</td>
</tr>
</tbody>
</table>

**Notes**

1 Includes uranium-radium-vanadium ore mining (NAICS 212291).
2 Includes newspapers, periodical, book, and directory publishers (NAICS 5111), and software publishers (NAICS 5112).
3 Includes motion picture and video production, distribution, exhibition, and post production services (under NAICS 5121), and record production and distribution, music publishers, and sound recording studios (NAICS 5122).
4 Although only financial services (banks and insurance companies) are affected by restrictions, this is a rough estimate of their impact on GDP since NAICS 52 also includes monetary authorities—central banks (NAICS 521). However, since the central bank is not subject to any restrictions, its impact is negligible in this calculation.

Source: Statistics Canada (2007); calculations by the authors.
activities of foreign firms, particularly when compared to our competitors.

For example, a recent OECD report by Takeshi Koyama and Stephen Golub (2006) found that Canada has some of the greatest restrictions on foreign business activity among industrialized countries. The authors developed a measure of regulatory restrictiveness among 29 OECD countries and 13 non-member countries. The Index of Restrictiveness is a composite measure based on different types of barriers to foreign business activity in 9 sectors and 11 sub-sectors of the economy, including telecommunications, finance, transport, and electricity. Restrictiveness is measured on a scale from 0 to 1, where 0 represents no restrictions, and 1 represents a prohibition of foreign business activity. Overall, the results indicate that Iceland, Mexico, Australia, Austria and Canada have the highest levels of restrictions while those most open to foreign firms tend to be in Europe. In fact, Canada ranks 25th out of 29 countries in terms of openness to foreign business. In contrast, Belgium tops the list of OECD countries. More generally, European OECD countries dominate the top of the rankings with 8 countries in the top 10. Japan and the United States complete the list of the top-10 rankings.

Two consecutive surveys by the OECD on Canada have been highly critical of our restrictive policies on foreign business activity (OECD, 2006; 2007). The 2006 study ranked Canada amongst the most restrictive countries in many industrial sectors and identified key areas for improvement with respect to investment and competition. More specifically, OECD Economic Surveys Canada suggested that to increase competition and efficiency, Canada must lift restrictions on foreign businesses in heavily regulated sectors such as airlines, telecommunications, and broadcasting. In addition, the report also identified Canada as among the countries with the most regulations in major professional services such as law, accounting, engineering, and architecture. A previous OECD study by Maria Maher and Jay Shaffer (2005) also supports these findings.

Overall, these OECD reports suggest that by removing restrictions on foreign business activity, Canadians stand to gain in terms of greater choice, lower prices, and better quality goods and services in many sectors of the economy.

Foreign direct investment

A large body of research shows that foreign direct investment increases productivity, transfers new technology, and increases investment in the domestic economy. Productivity is the ability of a worker, firm, industry, or economy to convert inputs (raw materials, components, education, and skills) into outputs (goods and services). Improvement in productivity are highly desirable because they reduce production costs for firms and lower the prices of goods and services, create new jobs, increase earnings, and improve the standard of living for Canadians.

Foreign direct investment increases the productivity of domestic firms in several ways. First, FDI increases the competition that domestic firms face, which encourages them to become more productive to remain

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Many studies have found that FDI increases productivity in domestic industries. A study by Surendra Gera and colleagues (1999) from
Industry Canada estimated that from 1973 to 1992, FDI contributed to the productivity growth of Canadian industries by 0.5 percent per year on average. In addition, they found that a one percent increase in FDI in the Canadian energy, and finance and insurance sectors reduced firm costs by 0.5 percent and 0.16 percent respectively.

A study by Nigel Driffield (2001) also found that by increasing competition for domestic firms, foreign investment stimulated the productivity growth of the UK manufacturing sector. Using data for 1989 to 1992, the author found that foreign investment increased the productivity growth of the domestic sector by approximately 0.75 percent per year.12

There is also evidence that FDI transfers new technology to domestic firms. For instance, a recent study by Wolfgang Keller and Stephen Yeaple (2003) found that FDI increased the productivity of US manufacturing firms through the transfer of technology. In fact, they estimated that approximately 14 percent of the productivity growth in US manufacturing firms between 1987 and 1996 could be attributed to such technology transfers. (For related studies, see Branstetter, 2006; Keller, 1997, 2000, 2001, 2002a, 2002b; and Xu and Wang, 1999.)

Other studies have also found that FDI increases productivity and transfers technology to domestic firms. Xiaming Liu and colleagues (2000), using data from 48 UK manufacturing firms from 1991 to 1995, found that FDI has a positive impact on the productivity of domestic firms. In addition, they found that the extent to which domestic firms benefited from the introduction of advanced technology by foreign firms depended largely on their own technology capabilities (see also Hejazi and Safarian, 1999; and Barrell and Pain, 1997).

In addition, research also shows that FDI increases overall investment in an economy. In an early study on this issue, Frances Van Loo (1977) concluded that FDI has positive effects on Canadian investment. Specifically, he found that a $1 increase in FDI resulted in a $1.43 increase in total Canadian investment. The additional increase in investment, over and above the initial increase in FDI, results when FDI increases economic activity and stimulates further investments by domestic firms.

More generally, Leonardo Bartolini and Allan Drazen (1997) found that countries that lifted restrictions on capital (investment) flows experienced sharp increases in foreign investment, especially from private sources.13 They concluded that government policy towards capital flows acts as a signal to investors: restrictive regimes discourage capital inflows, whereas more open regimes encourage capital inflows since investors are more willing to invest in a country that allows them to withdraw their investments in the future.14

Foreign ownership

A number of studies have found that foreign ownership increases firm performance (i.e., the productivity and wages of workers) and speeds up innovation.15 In a recent study on Canada, John Baldwin and Wulong Gu (2005) from Statistics Canada found that foreign-owned firms are more productive than domestic firms. Specifically, they found that of the 1.7 percentage point increase in annual labour productivity between the periods 1980-1990 and 1990-1999, foreign multinational companies contributed 1.1 percentage points to the increase, while domestic forms contributed just 0.6 percentage points. They also found that domestic firms tend to be more productive when foreign-owned firms account for a larger share of total employment in the industry. Their estimate implied that a 10 percentage point increase in the share of foreign-owned firms is associated with a 0.3 to 0.5 percentage point increase in the annual labour productivity growth of domestic firms.

Similarly, Steven Globerman, John Ries, and Ilan Vertinsky (1994) compared the economic performance (productivity and wages) of foreign-owned and Canadian-owned enterprises using manufacturing data for 1986. Their results showed that worker productivity is substantially higher in foreign-owned firms. They also found that foreign-owned firms tended to pay higher wages to their employees, partly due to their higher productivity. The authors concluded that foreign ownership improves efficiency and income levels in Canada.17

Studies for other industrialized countries have also found that foreign ownership is associated with increased productivity. A recent study by Martin Conyon and colleagues (2002) analyzed the impact of foreign ownership on labour productivity and wages in the UK manufacturing industry for the...
period 1989 to 1994. The study found that labour productivity tends to be higher in foreign-owned firms by 13 percent on average. Additionally, foreign firms paid 3.4 percent more in wages to comparable workers in domestic firms. Similarly, Sourafel Girma and his colleagues (2001) found that labour productivity in foreign firms is almost 10 percent higher than in domestic firms, while overall firm productivity is greater by nearly 5 percent. Partly owing to this productivity gap, foreign firms pay on average 5 percent more in wages than domestic firms (see also Haskel et al., 2002).

In addition to increased productivity, research shows that foreign ownership is associated with greater innovation and transfer of new technology to domestic firms. Most recently, Sourafel Girma and colleagues (2007) found multinational companies transferred new technology to newly-acquired subsidiaries in foreign countries. Using data for UK manufacturing export firms from 1988 to 1996, the authors compared the productivity growth of firms after acquisition by multinational companies. They found that firms with above average productivity benefited the most from an acquisition. Specifically, firms with a productivity level 10 percent above average in the year of acquisition experienced an additional productivity growth of 1.27 percentage points in the same year. However, the authors also found that firms with below average productivity had much to gain from a foreign acquisition. Specifically, a firm with a productivity level 10 percent below average in the year of acquisition experienced a 1.37 percentage point increase in productivity growth two years after acquisition. The authors attributed the increased productivity of acquired firms to the transfer of technology and other advantages (e.g., better management and training) from the multinational to the newly acquired domestic firms.

...foreign ownership creates significant benefits in restricted sectors of the economy.

In an earlier study, John Baldwin and Wulong Gu (2004) found that foreign-owned firms have a rate of innovation that is, on average, 10 percentage points higher than their domestic counterparts for the period 1989 to 1991. The authors attributed the superior performance of these firms to larger firm size, higher exports, better technology capabilities, and past innovation activities.

Finally, research also shows that foreign ownership creates significant benefits in restricted sectors of the economy. A case in point is the banking industry which is heavily protected from foreign firms in many industrialized countries. In an interesting study, Stijn Claessens and Luc Laeven (2003) found that foreign-owned banks increased the competitiveness of a country’s banking system. Greater competition in the financial services sector is beneficial since it can increase the efficiency of service provision, the quality of financial services, and the degree of innovation in the sector. Using an index of competitiveness for 50 countries for the years 1994 to 2001, the authors estimated that greater foreign bank presence and fewer restrictions on the activities of banks increased the competitiveness of the banking sector. An earlier study by Claessens and colleagues (2001) also confirmed that foreign-owned banks increase competition for domestic banks.

Foreign competition

A highly debated aspect of foreign business activity in Canada is the impact of foreign competition. Foreign competition, defined as the ability of foreign firms to compete in the domestic economy, is often treated with hostility by some groups due to fears of domestic job losses and loss of business. However, research shows that foreign competition, which includes trade in goods and services, provides significant benefits through increased productivity, lower prices, and a wider range of goods and services for consumers.

Several studies have found that foreign competition raises the productivity of domestic firms. A recent study by Juann Hung and colleagues (2004) estimated that due to lower priced imports, foreign competition increased the productivity of domestic manufacturing firms. In fact, they found that for the US, foreign competition accounted for a 32 percent growth in labour productivity in the manufacturing sector between 1996 and 2001 (see also Mann, 1998).
At the same time, a study of the Canada-US Free Trade Agreement (FTA) by Daniel Trefler (2004) found that there were long-term benefits from lowering restrictions in the form of tariffs (taxes) on goods and services traded. Using data from 1980 to 1996, the author found that the FTA was associated with an up to 15 percent increase in labour productivity in those Canadian industries most affected by import competition. In other words, the 15 percent increase in labour productivity translated to an annual growth of labour productivity of 1.9 percent.

The importance of foreign competition in providing benefits to domestic consumers was recently highlighted by economist William Baumol and his colleagues (2007) in an influential book entitled Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity. They point out that foreign competition through trade “… gives importing countries products that manufacturers in other lands can produce more economically in exchange for items made by less costly producers in the exporting countries” (Baumol et al., 2007, p. 254), allowing consumers to reap the benefits of a variety of goods and services at cheaper prices. Instead of placing restrictions on trade, the authors argue that the right response by industrialized nations is to “innovate more rapidly, developing ever-better and cheaper products” (Baumol et al., 2007, p. 254).

An excellent example of the benefits to consumers of the removal of restrictions on foreign competition is in air transport. For instance, a recent study by the Brattle Group researchers James Reitzes and colleagues (2002) on behalf of the European Commission found significant benefits associated with fully removing restrictions on competition in the transatlantic airline industry. Specifically, the report quantified the impact of eliminating all commercial restrictions on EU-US aviation. The most conservative estimates revealed that passenger traffic would increase annually by 9 to 24 percent in total transatlantic travel and by 5 to 14 percent in intra-EU travel. The report also found that consumers would gain immensely from increased competition through lower fares. In fact, the total benefit to consumers would range from €5.1 billion to €5.2 billion annually. In addition, the report estimated that industries directly related to the airline industry such as suppliers of aircraft and computer equipment would experience increased output ranging from €3.6 billion to €8.1 billion a year.

Similarly, studies on Canada also found evidence of benefits to consumers from the signing of the US-Canada Open Skies Agreement in 1995. A Statistics Canada article by Dubey and Gendron (1999) found that by the end of 1996, just a year after the agreement was signed, 59 new routes were created allowing greater access by Canadian passengers to US air traffic hubs and outbound international flights. Dubey and Gendron also found that the share of total travelers choosing Canadian carriers increased markedly, from 40 percent in 1993 to 44 percent in 1997. (For other studies on the Canadian airline industry, see Gillen et al., 2002; and Dresner and Oum, 1998.)

Conclusion
The studies summarized above provide compelling evidence that foreign business activity provides significant benefits to the domestic economy in terms of lower costs of production, increased productivity, and the transfer of new technology to domestic firms. Ultimately, these benefits translate into lower prices, higher wages, better quality goods and services, and increased choice for consumers.

III. Conclusion
Economic research shows that foreign business activity increases investment, competition, innovation, new technology, and consumer choice. Although established to protect certain domestic interests, policies that restrict foreign business activity eventually harm the majority of economic participants and impede the development of a healthy and adaptable economy. In light of the evidence presented, Canada should aim to create a framework that encourages rather than restricts foreign business activity to increase its competitiveness relative to other industrialized countries. In other words, recognition of the economic benefits of foreign business activity should play a critical role in shaping future investment and competition policy in Canada.

Notes
1 The Panel’s core mandate is to review two key pieces of legislation, the Competition Act and the Investment Canada Act. The Panel will also examine Canada’s sectoral restrictions on foreign direct investment.
However, for investments that relate to Canada’s cultural heritage or national identity, the act is administered by the Department of Canadian Heritage. For examples of such investments, see Schedule IV of the Investment Canada Regulations.

See APEC (2007) for a comprehensive review of foreign ownership restrictions in telecommunication, broadcasting, and banking. In addition, industry experts and government agencies have also reviewed restrictions on foreign business activity in Canada in sectors such as telecommunications, broadcasting, and banking. For further details on these reports, see Standing Committee on Industry, Science and Technology (2003), Transport Canada (2003), and the Conference Board of Canada (2000).

These restrictions are mostly related to licensing requirements in professional services. Around 50 occupations and 100 trades are regulated in Canada.

Loosely, a worker has more and better tools with which to work.

Although this increase might appear small, the cumulative effect of productivity growth over the years would be substantial. For additional studies on FDI and productivity, see Girma and Wakelin, 2001; Xu, 2000; and Nadiri, 1991.

Examples include Italy, New Zealand, Uruguay and Spain in the 1970s and 1980s.

In a related study, Stein and Daude (2001) concluded that institutional factors like government regulation have a significant impact on FDI flows. Using various measures, they found that improvements in institutional quality increased FDI.

Other economic benefits of foreign ownership include increased exports by domestic firms. See Kneller and Pisu, 2007; Greenaway et al., 2004; Aitken et al., 1997; and Ruane and Sutherland, 2005 for further details.

The report also noted that highly regulated provincial electricity markets should be opened to competition in order to “boost productivity and efficiency in electricity generation and distribution as well as to provide clear price signals for investment” (OECD, 2006, p. 54). In addition, industry experts and government agencies have also reviewed restrictions on foreign business activity in Canada in sectors such as telecommunication, broadcasting, and banking. For further details on these reports, see Standing Committee on Industry, Science and Technology (2003), Transport Canada (2003), and the Conference Board of Canada (2000).

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over domestic firms determines how much domestic firms can benefit from new technology from foreign firms. See Cantwell (1989) for further details.

20 For further details, see Baumol et al., 2007. For more information on the benefits of trade, see Edwards, 1992; Dollar, 1992; Ben-David, 1993; Sachs and Warner, 1995; Frankel and Romer, 1999; Dollar and Kraay, 2004; and Wacziarg and Welch, 2003. Winters (2004) presents a comprehensive summary of the key studies on trade and economic performance.

21 The most recent Open Skies Agreement negotiated in Washington DC on April 30, 2007, further removed existing restrictions in the US-EU transatlantic airline industry.

22 These figures exclude the potential benefits to the tourism and leisure industries. For further reports on the impact of Open Skies Agreements, see Micco and Serebrisky (2006) and U.S. Department of Transport (2000, 1999).

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Legislation

Bank Act, 1991, c. 46

Canada Oil and Gas Operations Act, R.S. 1985, c. O-7

Canada Transportation Act, 1996, c.10

Competition Act, R.S. 1985, c. C-34

Investment Canada Act, R.S. 1985, c.28

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