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Canadian Foreign Investment Policy

*Roberto Gualtieri**

Because the topic of this afternoon's panel is trade and investment liberalization in selected industries, I am going to try to demonstrate that the Canadian policy to control foreign investment is in fact a liberal policy. However, we shall see whether I prove my point.

For the sake of completeness, let me add to Dr. Dickey's comprehensive list of the areas in which the American presence in Canada exists. One other issue that is of concern to Canadians has been coming to the fore in the last year or so and will be the subject of a meeting of the prime minister of Canada and the provincial premiers later this month. I am referring to the foreign acquisition of recreational land, particularly on the West Coast and in the Atlantic provinces but also in Quebec and Ontario. This is another area in which Canadians will have to examine the problems of foreign ownership in order to determine whether some public policy measure should be introduced.

I would like to confirm what our moderator told us about the distribution of nationalist sentiment in Canada. I was quite surprised when I came across two polls which indicated that the hotbed of nationalism was in fact British Columbia and even more amused by the description of the archetypal nationalist by one of the polls studying the nationalist phenomenon in depth. The personification of the nationalist in Canada is apparently the single, under 25, unionized, pessimistic, female member of the New Democratic Party residing in British Columbia!

Dr. Dickey gave us an excellent overview of the whole of Canadian-American relations and the historical context into which they should be placed. I would like to add just two other points. One is the problem of foreign direct investment which has a long history in Canada. The first subsidiaries of foreign corporations were established in Canada in 1879 shortly after the introduction of the National Policy by Sir John A. MacDonald. The National Policy was basically a policy of tariff protection, and subsidiaries were set up in order to overcome the added cost of the tariff. The first governmental measure of which I am aware was a section in

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the Bank Act of 1871 which required all directors of banks to be British subjects. Supporting a point that Dr. Dickey made, I recall that while this is a problem of long standing, it really crystallized in the post-war era with large investments from the United States particularly in the resource industries. Since the 1950's this investment was continued, as Dr. Dickey indicated, financed largely from internal sources, that is, retained earnings generated by subsidiaries in Canada, capital cost allowances, and capital drawn from Canadian sources.

A number of steps dealing with the foreign investment issue have been taken in recent years. Identification of certain key sectors among the financial institutions (banks, trust and loan companies, insurance companies) was made. Steps were taken to restrict foreign investments in broadcasting, newspapers, and periodicals. An attempt was made to induce foreign controlled subsidiaries to issue equity to Canadians by giving complying subsidiaries a tax break. But in my view, and I believe this is also the government's view, the most important measure by far is the bill presently before Parliament which would give the government the power to establish a review agency to examine future take-overs of Canadian business, any establishment of a new business in Canada by a person not already doing business in Canada, and any establishment of a business in an unrelated line of activity by a foreign controlled company already doing business in Canada. For example, if General Motors of Canada wanted to go into the peanut butter business, the review agency could examine the establishment of the peanut butter line. These transactions, assuming that the bill is passed, will be subject to screening by the government, which will attempt to ensure that the proposed investments are, in the language of the bill, likely to be of significant benefit to Canada. Clearly this is the core concept, but the bill does not elaborate precisely what the concept means. Rather, five factors are identified which will guide the government in determining whether or not a proposed take-over or a proposed establishment of new business is of significant benefit to Canada. The first of these factors is the impact of the proposed investment on the nature and level of economic activity in Canada (including employment). The second factor is the impact on efficiency, productivity, technological innovation, and product variety. The impact on competition is the third factor but not in a negative sense. A negative impact on competition is a matter for anti-combines policy or the competition law, whereas

a positive impact on competition would be recognized as a benefit in assessing foreign investments. The fourth factor is the degree and significance of Canadian participation in the industry; i.e., is this an industry in which there should be a Canadian presence for national interest reasons in which foreign takeovers should be prohibited? The fifth factor is the compatibility of the proposed investment with national economic and industrial policies, including any economic and industrial policy objectives enunciated by the province affected.

With respect to the provinces, I want to emphasize that I am not familiar with any piece of legislation in the area of economic policy which will rely as heavily on federal-provincial consultation and cooperation as this bill. This has, of course, been an essential element in the policy because some provinces of Canada are deeply concerned with the possibility that the review agency could be used to block needed foreign investment in Canada. These provinces want to ensure that they have their day in court. There will be a great deal of emphasis in this legislation on federal-provincial consultation.

Mr. Kilpatrick mentioned the degree of concern that exists in Canada with the foreign investment issue. That concern, however, does not necessarily mean that there is a consensus in the country with respect to any particular solution. I have been amused at the absolutely contradictory descriptions of this proposed legislation. One wonders whether the critics are really talking about the same bill. On the one hand, nationalists like Mel Watkins call the bill a complete cop-out, a nothing. The Conservative party spokesman on the issue, the spokesman for the official opposition, called it a pitifully inadequate response (though obviously for different reasons). The New Democratic Party said that the proposed legislation is not a law to control foreign investment, but a welcome wagon! You have that whole range of criticisms on the one side, that the bill is too little or incomplete. On the other hand, some people are talking about a bureaucratic nightmare and the beginnings of a police state. One Toronto lawyer referred to the bill as "a storage tank of serpents," which I thought was a very novel description. However, my friends who are better versed than I in classical mythology tell me that I should take some heart from the metaphor because a serpent is a sign of life and vitality in classical mythology. Given these very disparate views of the government's policy and the differences that exist regionally within the country,

one can, I think, draw an important conclusion, namely, that the policy must be a moderate one, both in legislative form and in administration. Otherwise, there will be no national consensus, no basic agreement to make the policy an effective operating instrument.

Having described the policy as a basically moderate one, let me outline what I think are some of the kernel elements in the policy. These elements are reflected in the significant benefit test and in the factors that will guide the government in making a decision on a particular investment.

The first and most important factor, in my view, is that the policy recognizes that foreign direct investment has had and will continue to have a role to play in the development of the Canadian economy. It does not take a genius to realize why this is true. Canada is a country of 22 million people, which is not small, but on the other hand it is a country which clearly cannot do everything for itself. Even a country the size of the United States is unable to look after its economic and other interests alone. A country like Canada must recognize mutual interdependence, the value of the international division of labor, and the fact that it must rely on foreign inputs for certain things. Some of these inputs will be obtained by importing, others through licensing. In other cases the cheapest, most efficient, and most effective way of getting the foreign inputs necessary to achieve national objectives will be through foreign investment in the form of a minority position, a 50-50 joint venture, or a 100% foreign-controlled subsidiary. In this policy, the government recognizes this fact and accepts it as a rational approach to the achievement of national objectives.

Secondly, I think it important to point out that the policy is not discriminatory. We have heard a lot about the extent of American investment in Canada, but this policy is not directed against American investors. It is not directed against the administration or Congress. It is a policy which will be applied impartially, looking at each particular investment in terms of the benefits it brings to Canada.

The third essential element of the policy that I want to emphasize is that the policy is not retroactive. It applies only to future investment. After the bill is proclaimed, future take-overs, the establishment of new businesses, and the establishment of businesses in unrelated lines of activity will be reviewed. No grandfather clause exists and I think that businessmen and others should note that the Canadian government recognizes that a change in the rules affect-

ing past investment decisions would be unfair. Retroactivity simply is not part of the approach of the government.

A final point important in understanding the policy is that in introducing a screening mechanism to approve take-overs and new businesses, Canada is not a pioneer in the area. I wish that it were; I feel that too often Canadians find themselves imitating either the Americans or the British. In the foreign investment field, Canadians are advancing with respect to what other countries have been doing for a number of years. The British have been operating a form of review mechanism through exchange controls and through controls of the access of foreign-controlled companies to British capital markets. The French also have a mechanism of this nature, as do the Australians, who have used exchange controls and recently introduced a take-over policy similar to that proposed in Canada. The Norwegians and the Swedes also have mechanisms for controlling investments. In a sense Canada is simply catching up with what, perhaps somewhat belatedly, other countries have been doing for some time.

I want to spend just one moment addressing the lawyers in the audience, although I think my message is also relevant for any businessmen who are here. No one, to my knowledge, is enamoured of the review process approach of dealing with public policy issues because the process involves administrative discretion. Politicians and bureaucrats that I know are not happy with administrative discretion. In developing this policy, officials and ministers worked very hard to find rules which could be set forth to guide foreign investment decisions. But the very nature of foreign direct investment and the fact that the costs and benefits of investment varies from industry to industry and from case to case made it impossible to lay out a set of rules which would apply across the board and be economically rational. Any rigid system of rules (although obviously some general rules can be formulated) would be arbitrary, introducing a form of protectionism and a set of costs into the Canadian economy which the government judged would not be supported by the Canadian people. A basically no-cost economic policy is introduced by the administrative route.

The administrative approach could, of course, have found its locus of decision in an independent tribunal. This, too, was considered as a way of introducing less administrative discretion, but it was decided that some of the decisions to be made, for example the degree and significance of Canadian participation in an industry,

were basically policy decisions and could not effectively or in good conscience be given to an independent tribunal. The route of administrative discretion *faut di mieux* was taken because a sound no-cost economic approach through the rule-making function could not be conceived.

There are a number of other issues I would like to raise but, given the time, I will touch very briefly on only two other points. I have not described the basic underlying economic reasons why the Canadian government decided that a foreign investment policy was necessary. The economic (as opposed to the political) case for intervention is unfortunately a bit like obscenity, being very difficult to define but easy to recognize when you see it! Let me begin by stressing one point. The problems that culminated in the introduction of a foreign investment policy cannot be laid entirely at the door of the foreign investor. I must emphasize that the policy is concerned with what the Gray Report calls the "truncation" of subsidiaries operating in Canada, which exists when the decision-making function and certain important activities are located in the parent company. Research and development facilities may also be located there. The subsidiary in some cases imports a large part of its components and assembles them in Canada when restrictions on exports exist. The basic decisions on what to produce, where to produce, and the introduction of new products, and so on, are made by the parent company. This is the situation to which the policy addresses itself. But I emphasize that the problem is not solely the result of the foreign investor's decisions and behavior. A large part of the responsibility for the truncated nature of subsidiary operations in Canada lies at the door of Canadian government. The general economic environment the government has created results from a tariff policy which has given a fairly high degree of protection, inducing investors to penetrate the Canadian market by jumping over the tariff; a competition policy which has been relatively weak; and a tax policy which has been heavily oriented towards resource extraction.

However, even if an ideal economic environment existed in Canada, there would be, in my opinion, a strong justification for establishing a review procedure, namely, to deal with the distortions that exist in the international allocative process. Some distortions are the result of government intervention, and I do not have to spend much time dealing with them. Examples are the DISC, the American balance of payments program, the foreign assets control

regulations, and municipal bonds. But even if all governmental distortions were eliminated, others would remain because of multinational structure itself. National biases, risk aversion, sunk costs, and simple managerial lethargy are examples of these distortions. So, even if the general economic environment in Canada were perfect and even if all governmental distortions were eliminated, there would still be a ground for intervention through the review process.

I will make only one more comment, trying to relate what I have said about Canadian foreign investment policy with the issue of the industrial structure. I do not believe that the fundamental impact of this review process on the Canadian industrial structure will be very great, largely because additional policies would be necessary to change industrial structure. It might have some marginal impact in the cases in which investments are not screened, but a review procedure employing a case by case approach looking at a maximum of a couple of hundred investments a year, will not have a fundamental impact on the industrial structure in Canada. In cases in which a proposed investment is examined, the objective of the inquiry will be to rationalize and consolidate the operation by reducing truncation. The primary objective of the policy will be to develop internationally competitive companies in Canada, and in that respect the foreign investment policy is very much part and parcel of Canada's general industrial trust. This was evident in the Kennedy Round and I feel it will be manifest in the next round of negotiations.

Editor's Note: The Canadian Parliament enacted the Foreign Investment Review Act, Bill C-132, on December 12, 1973.