After the Gray Report:
The Tortuous Evolution of Foreign Investment Policy

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INTRODUCTION

On May 4, 1972 the Hon. Herb Gray introduced to the House of Commons Bill C-201, an "Act to Provide for the Review and Assessment of Acquisitions of Control of Canadian Business Enterprises By Certain Persons".[1] The proposed Bill was directed specifically at the potential takeovers of Canadian companies by foreign corporations, mainly American-controlled firms. According to the Minister's statement in the House when the Bill received first reading:

> ... takeovers are the form of investment least likely to add significant benefits to the Canadian economy. The extent of foreign control of a number of industries in Canada is large enough to make the acquisitions of more Canadian businesses a matter of concern to the government and to Canadians generally.[2]

Bill C-201, with its successor, Bill C-132, is the most recent policy instrument of a very short list of legislative enactments by the federal government directed towards the social control of foreign investment in Canada.[3] Despite the plethora of government studies and academic writing on foreign investment in Canada and the growing literature on multinational enterprises, the emergence of a comprehensive government policy on foreign investment has been conspicuous by its absence, despite the fact that "the extent of foreign control of Canadian industry is unique among the industrialized nations of the world".[4] To date, the few policy initiatives presently in force deal with specific industrial sectors, such as banking[5] and

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[1] Bill C-201, 21 Eliz. II (1972).

[2] Press Release, "Foreign Takeovers Review Policy", May 4, 1972.

[3] For a review of these measures, see *Foreign Direct Investment in Canada* (1972), ch. 20, 319-328. Hereinafter referred to as the Gray Report.

[4] Task Force on the Structure of Canadian Industry, *Foreign Ownership and the Structure of Canadian Industry* (1968), 1. Hereinafter referred to as the Watkins Report.

[5] Arnold, *Restrictions on Foreign Investment in Canadian Financial Institutions*, (1970) 20 U. of T. L.J. 196.

cultural activities, with voluntary guidelines for good corporate behaviour by foreign-controlled corporations,[6] or with attempts to improve Canadian entrepreneurship.[7] Superficially, therefore, one might conclude that the new bills represent nothing more than another limited measure within a general *ad hoc* approach to foreign investment in Canada. Bills C-201 and C-132 will be discussed at length in section V.

The Gray Report outlined encompassing policy alternatives, namely: 1) the foreign investment review process; 2) the key sector policy; and 3) the minimum nationality requirements. The Gray Report favoured the first alternative, that is, the review process, which envisaged screening the following categories of investment:[8]

1) takeovers of Canadian operations by foreign firms;
2) new foreign investment;
3) licensing and franchising;
4) expansion of foreign owned firms now in Canada;
5) current operations of foreign firms in Canada;
6) Canadian multinational firms.

It will be seen that Bills C-201 and C-132 fail to regulate many of these categories and are therefore merely additional instruments in the *ad hoc* arsenal.

The issues raised by the Gray Report and by the findings of a number of research studies on the multinational corporation suggest that a more comprehensive policy on foreign investment is needed. Such a policy would require a radically different approach to the process of collecting information, data analysis, and strategic decision-making from the uncertain, stopgap measures characterizing the federal government's present approach.

The purpose of this inquiry is to review the basic issues raised by the Gray Report as a means of identifying the critical areas where policy decisions are urgently needed. Two aims in particular stand out: first, to show the inadequacy of the present disclosure laws on various aspects of both the foreign-owned and Canadian-controlled sectors of the economy, an inadequacy which leads one to question whether the data required to implement the full screening proposals of the Gray Report are presently available; and second, to demon-

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[6] The Winters Guidelines, in the Gray Report, *supra*, f.n.3, 324.

[7] Most notably in the case of the Canada Development Corporation. See Couzin, *The Canada Development Corporation: A Comparative Appraisal*, (1971) 17 McGill L.J. 405.

[8] The Gray Report, *supra*, f.n.3, 462 *et seq.*

strate the limited usefulness of any foreign investment policy without a change in general economic policies. This paper proposes first, to review briefly the origins of the foreign investment debate in Canada and to identify the main themes and their origins; second, to provide a realistic description of the multinational enterprise (MNE), its corporate structure and source of flexibility; third, to relate the corporate development of the MNE to the main economic regulations in Canada, namely the tariff, taxation and anti-combines policies; and finally, to propose a Foreign Investment Council as a means of bridging the information gap for effective policy-making in the future.

The Issues in Perspective

Few public policy issues in Canada can claim such an enduring aura of priority and importance as that of foreign investment.[9] Concern over foreign investment dates as far back in Canadian history as Macdonald's National Policy in 1878 and the building of the CPR, and it has been related to trade discussions with the United States over reciprocity. Today it relates in the minds of some observers to the very independence of Canada as a sovereign state. In short, foreign investment in Canada is intimately connected to what Professor Morton describes as the character of Canadian nationhood, "an effort to preserve a slowly evolved independence as the intimate neighbour of a great world power under the stress and novelty of the power politics of the nuclear age".[10]

Canada's catharsis over the unparalleled magnitude of foreign investment has often been described as simply an unfortunate resurgence of Canadian nationalism, or as a counter-response to the actions of the foreign countries themselves and their instruments of economic policy.[11] On the other hand, foreign investment in Canada may also be viewed as part of a fundamental shift in the nature and operations of the world economy, a shift so profound that it represents a force of discontinuity with the past. According to Drucker:

> Today the whole world, whatever its actual economic condition — and whatever the political system in force in a given area — has one common demand schedule, one common set of economic values and preferences.

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[9] One of the earliest studies dates to the thirties: Marshall *et al*, *Canadian-American Industry: A Study in International Investment* (1936).

[10] Morton, *The Canadian Identity* (1961), 3.

[11] For example, compare comments by Russell, and those of Rotstein in *Nationalism In Canada* 2d ed. (1973).

> The whole world, in other words, has become one economy in its expectations, in its responses, in its behaviour.[12]

Furthermore, the developing world economy requires new institutions:

> Because world economy is strictly an economic community, the institution which represents it will have to be an economic rather than a political institution.... Such an institution, too, we already have at hand. Its development during the past twenty years may well be the most significant event in the world economy, and the one that in the long run will bring the greatest benefits. This institution is the "multinational corporation".[12a]

It is paradoxical, therefore, that what appears to be a new development in the world economy has existed to a considerable degree in Canada for much of the last century. It perhaps tells something of the nature of the Canadian public policy process that the present foreign ownership debate has emerged as much from concern expressed in countries such as Japan, France and even the United States, as from any attempts by Canadian politicians and academics to articulate a coherent industrial strategy to meet these international changes in the global economy.

To an outsider, then, it might be startling to learn that of two of the major government-sponsored documents on foreign ownership in Canada, one was immediately denied official support (the Watkins Report), while the other was leaked to the public through the back door under the auspices of the *Canadian Forum* before official publication several months later (the Gray Report).[13] It is hardly a record of public concern and open debate which can be regarded as a prelude to an orderly and specific government strategy on the whole question of foreign ownership, industrial policy, and guidelines for the multinational corporation.

Few can deny the enormous complexities of the basic issues. The literature on the multinational firm has grown enormously.[14] It encompasses a wide variety of disciplines: economics, political science, sociology, law, international relations; and an even wider variety of topics: international trade, industrial organization, organization theory, managerial economics, corporate law, international law, extra-territoriality, tariffs, customs unions, administrative de-

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[12] Drucker, *The Age of Discontinuity* (1968), 79-80.

[12a] *Ibid.*, 91.

[13] The abbreviated version appeared in the *Forum* in December 1971. The Gray Report was tabled on May 2, 1972.

[14] Most of it is written by economists. For a review of the major themes, see the following edited works: Kindleberger, *The International Corporation* (1970); Dunning, *The Multinational Enterprise* (1971); Brown, *World Business* (1970); Paguet, *The Multinational Firm and the Nation State* (1972).

cision-making, imperialism, mercantilism, and economic development, to list only the major themes dominating the most widely cited studies.

Certainly the Canadian public is now more aware of the presence and extent of foreign investment in the economy than at any time in the past. The roots of the current debate leading to the publication of the Gray Report probably date most specifically from the Royal Commission on Canada's Economic Prospects,[15] although previous studies had examined certain aspects of the question. Devoting a chapter to foreign investment, the commission reviewed the basic issues with remarkable insight and clarity, given the lack of data and theoretical refinements available even now, fifteen years later. The report emphasized the major areas of concentration of foreign ownership in the resources and manufacturing industries, and brought attention to the rapid growth of companies by expansion due to retention of earnings. As the report noted:

> The retention and reinvestment of earnings, plus amounts set aside for depreciation and depletion, ensures the rapid growth of existing companies and particularly the larger ones which are well entrenched, well financed and which hold dominant positions in their respective industries. In many of Canada's fastest growing industries the principal companies, the ones which hold the dominating positions, are controlled by non-residents. This concentration in certain key industries, and in large companies wielding extensive influence is the most important factor to be considered in connection with foreign investment in Canada.[16]

Despite the cogent analysis of this section of the Report, governments of successive administrations failed to act on the recommendations, probably because other aspects of the Report were viewed with some scepticism or as having greater priority. However, the debate was only in its infancy and inspired Walter Gordon's own pleadings. His ill-fated attempts at implementing policy as Finance Minister from 1963-65 are well known.[17] In the interim, various Canadian economists have analyzed the foreign investment issue and the growth of the multinational corporation in great detail. Notable among these studies are Johnson's essays on Canadian public policy and nationalist preoccupations,[18] Safarian's detailed study of

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[15] *Final Report of The Royal Commission on Canada's Economic Prospects* (1957), ch. 18. The terms of reference of the Commission do not specifically mention the question of foreign ownership (P.C. 1955-909) but the Commissioners' recommendations make interesting reading in light of proposals put forward today.

[16] *Ibid.*, 383.

[17] For example, see Gordon, *A Choice For Canada* (1966); and Godfrey and Watkins, *Gordon to Watkins to You* (1970).

[18] Johnson, *The Canadian Quandary* (1963).

the economic performance of Canadian subsidiaries,[19] Litvak and Maule's analyses of extraterritoriality and multilateral policy directions,[20] and, most recently, Levitt's polemic, *Silent Surrender*.[21] In addition similar reports have been sponsored by the government of Ontario,[22] the stock exchanges[23] and the Private Planning Association,[24] but no specific study of the question has been made by the Economic Council of Canada. Legal research on the multinational corporation is practically non-existant, as regards both the constitutional questions of foreign investment[25] and international law.[26]

In terms of the policy environment, it is rapidly becoming obvious even to politicians that some kind of regulation of foreign investment is required, even if only within the traditional economic framework of a competitive market. At the very least, therefore, there must be a recognition of the need for a maintenance of effective competition and the removal of any trade restrictions where foreign-based companies operate. As will be noted in the next section, there is some evidence to suggest a great deal more regulation is necessary, and the harshest critics of the MNE would go considerably farther in public regulation.[27] Ironically, it appears that successive federal and provincial governments have pursued what amounts to a national policy least likely to increase the advantages of foreign investment within a market economy, namely a policy of non-intervention of any kind, except in cases calling for *ad hoc* crisis legislation motivated by political values.

Only now is this picture slowly starting to emerge in the political arena, and the growing evidence of mature studies like the Gray

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19 Safarian, *Foreign Ownership of Canadian Industry* (1966).

20 Litvak and Maule, *Conflict Resolution and Extraterritoriality*, (1969) 13 J. of Conflict Resolution 305: Litvak, Maule and Robinson, *Dual Loyalty: Canada/US Business Arrangements* (1971).

21 *The Multinational Corporation In Canada* (1970).

22 *Report of the Ontario Inter-departmental Task Force on Foreign Investment* (1971).

23 The Moore Report (1970). See also *Financial Post*, June 30, 1970, 1-2.

24 For example, Lindeman and Armstrong, *Policies and Practices of U.S. Subsidiaries in Canada* (1961).

25 For an attempt to define the legal parameters, see Arnett, *Canadian Regulation of Foreign Investment: The Legal Parameters*, (1972) 50 Can. Bar Rev. 213. See also Hahlo, Smith and Wright, *Nationalism and the Multinational Enterprise* (1973).

26 Vagts, *The Multinational Enterprise: A New Challenge For Transnational Law*, (1970) 83 Harv.L.Rev. 739.

27 What is involved here are political and social values about the nature of the economic system itself, *i.e.*, quasi-capitalist, free enterprise or socialist. For a critical discussion, see Baran and Sweezy, *Monopoly Capital* (1966).

Report corresponds with a recognition of a rapidly changing world economy and the need to search for Canada's role in it. For many this search requires some form of industrial strategy, perhaps on a model such as Japan or Sweden, or one tailored more to particular Canadian needs and traditions.[28] In any case, the preponderance of foreign-owned companies in the Canadian resource industries and manufacturing sector makes coordinated economic and commercial policies imperative if the maximum advantages of foreign investment are to be gained. Furthermore, the specific recommendations of the Gray Report must be considered in this context. The adequacy or feasibility of these recommendations rests to a very large extent on the understanding of the operations of the MNE in Canada and elsewhere, and the economic environment the government develops by its economic and commercial policies.

The Multinational Enterprise

Modern industrial societies have long been familiar with very large corporations, high market concentration, and powerful business interests.[29] What is not so familiar, however, is the extension of the corporate network across political boundaries, so that the power of the corporate boardroom extends far beyond the citizenship of the legal charter. The multinational firm has been praised as the harbinger of a new economic order and business statesmanship in the aftermath of the cold war, and damned as the newest form of industrial imperialism and unchecked power.[30] The multinational firm has also been viewed largely as an American phenomenon, an outcome of the first trillion dollar economy and superior management practices.

Some estimates predict that some 300 corporations, two-thirds of them American, will dominate the world economy, just as a limited number of firms now dominate domestic economies.[31] The growth of American based MNE's has resulted in a fear for survival on the part of many host industrialists. Servan-Schreiber dramatically

[28] For various proposals, see Rotstein (ed.), *An Industrial Strategy For Canada* (1972).

[29] Galbraith, *The New Industrial State* 2d ed., revised (1971).

[30] For positive views of the MNE, see, for example, Ball, "Cosmocorp: The Importance of Being Stateless" in Brown (ed.), *World Business, supra,* f.n.14. For a critical view, see Penrose, *The Large International Firm In Developing Countries* (1968).

[31] Turner, *Invisible Empires* (1970); Perlmutter, *Super-Giant Firms in the Future,* (1968) 3 Wharton Quarterly.

writes of the trend as follows: "Fifteen years from now, it is quite possible that the world's third greatest industrial power, just after the United States and Russia, will not be Europe, but American industry in Europe."[32] This picture has itself been challenged on the basis of rapid growth of European based multinationals. What is perhaps most dramatic is not only the large number of American based MNE's, but the rapid growth of European and Japanese MNE's into the American economy.[33]

These events signal a very different epoch in international economic relations, and countries that fail to recognize and adapt to these changes do so at their peril. A different picture of the multinational corporation is also required.

Economic Orthodoxy: International Trade

By any standard of comparison, the present structure of the world economy has no precedent. Historians sometimes draw parallels between the multinational corporation and the large institutions of the past: the ancient trading organizations of Ur and Babylon, the Medici finance institutions of Florence in the fifteenth century, the East India companies of Britain and Holland in the seventeenth century and the Hudson Bay Company in Canada in the eighteenth century.[34] Yet the multinationals, however similar they may seem to the historic international enterprise, differ not only in size and magnitude, but also qualitatively, in their technology and organizational structure.

Economists have devoted a great deal of effort and resources to explain economic relations between nations. Today orthodox international trade theory has reached elegant refinement over the classical writings of Adam Smith, David Ricardo and John Stuart Mill. Economic inquiry into international trade and finance actually dates from them and the basic trade models stem from their theories.[35] At the heart of orthodox theory is the free market and the

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[32] Servan-Schreiber, *The American Challenge* (1968), 1.

[33] On the growth of European MNE's, see Faith, *The Infiltrators* (1971); Hymer and Rowthorn, "Multi-National Corporations and International Oligopoly: The Non-American Challenge" in Kindleberger, *supra*, f.n.14; and Rhodes, *The American Challenge 'Challenged'*, (1969) Harv.Bus.Rev. 45. On Japanese MNE's, see Tsurumi, *Japanese Multinational Firms*, (1973) 7 J. of World Trade Law 74. On foreign investment in Asia, see Kapoor, *Foreign Investment In Asia* (1972).

[34] Ellsworth, *The International Economy* (1964).

[35] For an extensive treatment, see Kindleberger, *International Economics* 4th ed. (1968). A highly readable introduction to the subject is Kenen, *International Economics* (1967).

doctrine of comparative advantage. According to this perspective, a nation should pursue policies which, by the nature and extent of its factor endowments (land, labour and capital), equip it to produce goods more efficiently than any other nation. It must surrender its production capacity to the dictates of the international division of labour. In its development, this theory, first articulated by Adam Smith, was a radical departure from mercantile theory, the paramount orthodoxy of its day. The mercantilists advocated national economic policies to increase the stock of gold bullion, the standard of wealth in vogue at the time.

But it was for Ricardo to refine the principle of comparative advantage in modern terms. He recognized that countries could not only export goods to advantage, but could also import goods and thus promote the international division of labour through specialization (thereby using the optimal mix of factor endowments and, gaining in experience, reducing unit costs). Rational policies of exporting and importing would result in a total net gain for all trading nations. Thus he thought that Britain should trade its wool to France for wine even though Britain might be able to produce both commodities. Diminishing costs and improvements in quality of each commodity would produce a gain for each partner to the trade, regardless of either's stage of economic development. An important corollary of this theory is that factor prices tend to equalize among trading countries, so that in the long run countries will make the best use of their own factor endowments.[36]

Although somewhat brief, these ideas are the central canons of economic trade theory. But the theory is valid only if nations are willing to play by the rules of the game, without barriers to free trade such as tariffs, surcharges, customs unions, or the like. Further, however elegant, the theory leaves much to be explained, not the least being the failure of international trade theory to reconcile the disparities between rich and poor nations. The major trading nations erect barriers to free trade for a variety of reasons: balance of payments, national security, corporate lobbying and military and economic exploitation. Indeed, as Professor Gordon has argued, countries typically have promoted and adopted free trade policies only from a position of economic strength (*e.g.*, Britain in the nineteenth century).[37] But the most obvious deficiency of the theory is its

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[36] For one of the classic analyses of factor equalization, see Samuelson, *International Trade and the Equalisation of Factor Prices*, (1948) 58 Economic J. 163.

[37] Gordon, "The Historical Perspective: Nineteenth Century Trade Theory and Policy" in English (ed.), *Canada and the International Economy* (1961).

failure to explain why trade and investment go hand in hand in the form of multinational corporations. Why do firms trade between subunits of the same corporate shell across political boundaries instead of trading by export? Trade is not promoted by the international division of labour of the *market*, but by the promotion of the international division of labour of the *firm*. The standard theory can apply here only if the subsidiaries of a multinational firm act no differently within the MNE shell than without. The workings of the boardroom of any MNE demonstrate how mistaken this proposition is.

The MNE Organizationally Viewed

Few academic economists have devoted much attention to the corporation as an organization, preferring instead to examine the organization of the market and the interplay of prices and exchange mechanisms between firms. Perhaps not surprisingly, it has been left to business school scholars to study the corporation as an organization and the multinational enterprise as the largest organization of all. The analytical focus is thus on corporate decision-making, managerial personnel and skills, the allocation of capital and knowledge resources and the means of maintaining operating control.

Normative economic theory conceptualizes corporate behaviour in terms of atomistic surrogate entrepreneurs who strive for profit maximization. Market domination is avoided by free competition, since the assumption of perfect knowledge allows consumers to switch demand to lower priced companies. As Herbert Simon, one of the most scorching critics of economic decision-making has observed, the macro-economist "often assumes competition which carries with it the implication that only the rational survive. Thus, the classical economist theory of markets with perfect competition and rational agents is deductive theory, that requires almost no contact with empirical data once its assumpitons are accepted."[38]

The sheer size of multinational corporations gives prominence to its decision-making structure. From a cluster of organizations de-

[38] Simon, *Theories of Decision-Making in Economics and Behavioural Science*, (1959) 49 American Econ. Review 253, 254. As Galbraith has noted, "Few subjects of earnest inquiry have been more unproductive than study of the modern large corporation. The reasons are clear. A vivid image of what *should* exist acts as a surrogate for reality. Pursuit of that image then prevents pursuit of the reality": *supra*, f.n.29, 72. It should be recognized that Galbraith's ill-concealed scorn for the conventional economic wisdom, and his own formulations of the firm, are based in part on the work of Simon and his colleagues: Cyert and March, *A Behavioural Theory of the Firm* (1963).

signed as profit-centers one may distinguish a central policy-making body. The emphasis is on the link between the separate operating units (divisions or subsidiaries) and overall, unified strategy. In this respect, the multinational firm epitomizes the large divisional, federated structure of management theory.[39] The evolutionary development of MNE's, as in the case of domestic corporations, emphasizes the change from small single-plant, single-product firms to multi-divisional structures, and the role that expanding markets and changing technology play in this transformation.[40]

One of the most significant studies in the growing literature on organizational growth and development is that of Alfred Chandler's case histories of American enterprise.[41] According to Chandler:

> Four phases or chapters can be discerned in the history of the large American industrial enterprise: the initial expansion and accumulation of resources; the rationalization of the use of resources; the expansion into new markets and lines to help assure the continuing full use of resources; and finally the development of a new structure to make possible continuing effective mobilization of resources to meet both changing short-term market demands and long-term market trends.[42]

Chandler notes that it was the growing U.S. population, the resulting new markets and technological virtuosity which provided the impulse for corporate expansion.

> The prospect of a new market, or the threatened loss of a current one stimulated geographical expansion, vertical integration, and product diversification. Moreover, once a firm had accumulated large resources, the need to keep its men, money and materials steadily employed provided a constant stimulus to look for new markets by moving into new areas, by taking on new functions, or by developing new product lines.[42a]

In his case study of four corporations (Dupont, General Motors, Standard Oil, and Sears Roebuck), Chandler develops his central theme:

> Strategic growth results from an awareness of the opportunities and needs — created by changing population, income and technology — to employ existing or expanding resources more profitably. A new strategy required a new or at least a refashioned structure if the enlarged enterprise was to be operated efficiently.[43]

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[39] For a classic analysis, see Drucker, *The Concept of the Corporation* (1945). For a recent analysis, see Stopford and Wells, *Managing the Multinational Enterprise* (1972).

[40] Wilkins, *The Emergence of Multinational Enterprise* (1970). For one of the few case studies of the MNE, but lacking a clear conceptual framework, see Neufeld, *The Global Corporation* (1969).

[41] Chandler, *Strategy and Structure* (1962).

[42] *Ibid.*, 385.

[42a] *Ibid.*, 15.

[43] *Ibid.*

Chandler identified three types of structure in the development stages.[44] Type I is similar to the small firm of economic theory, highly centralized, dominated by and subject to the interests and limitations of the Chief Executive. Type II is a larger unit but limited in product lines and still organized as a centralized structure run by narrowly trained executives. Thus it was Type III, with divisional structures organized as profit centers, flexible enough to train personnel for top levels and operating levels, and capable of generating new products by institutionalizing research and development, which became the archetype organizational form to adapt to growing markets and changing environments.

Empirical evidence supports the thesis that multinational firms develop in world markets in much the same fashion as small corporations developed Type III structures in response to the widening of the American market to encompass the entire continent. For example, Fouraker and Stopford,[45] analyzing Chandler's typologies on the largest American corporations listed in *Fortune's* industrial directory, found a strong and significant correlation between Type III structures and corporate expansion abroad. Corporations with limited technology (steel and non-ferrous metals), predominantly Type II organizations, had little expansion overseas, while firms displaying Type III characteristics (electrical, automobile, power machinery, and chemicals) had substantial overseas expansion.

It must be recognized that the exact structure of MNE's does vary considerably from Chandler's typology: Fouraker and Stopford found that 18 of 170 had a Type I structure, 90 a Type II structure and 62 a Type III structure. However, it would appear that the basic organizational processes identified by Chandler appear to hold across societal boundaries, particularly since overseas companies develop cosmopolitan executives with the management skills of their American counterparts.[46]

The important implication of examining the internal divisional structure is that it points to the flexibility of the large corporation, in part derived from its sheer size and the resources at its command,

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[44] *Ibid.*, ch. 1.

[45] Fouraker and Stopford, *Organization Structure and Multinational Strategy*, (1968) 13 Admin.Sci. Quarterly 47.

[46] There has been little research on the attitudinal characteristics of MNE managers and directors in any systematic way, despite the importance of the subject to good parent-subsidiary relations. See, for example, the conflict-planning models in Rutenberg, *Organization Archetypes of A Multi-National Company*, (1970) 16 Man. Science B-337; and Brooke and Remmers, *The Strategy of Multinational Enterprise* (1970).

especially finance and technology. In addition there is a flexibility of management to learn by doing, the entrepreneurial experience of innovation first in the home market which, with relatively easy transferability of skills, can be used in the new market.[47] In its evolutionary form, the large corporation shifts from entrepreneurial functions to managerial functions, from tasks which originate as being unique to tasks which become recurrent. Thus it is the ability to produce goods, embodied in high technology sectors of industry, that becomes critical, rather than the goods themselves.[48] In terms of the orthodox trade theory model outlined above, the study of organizational structure shows the premium on knowledge and management skills as factors of production, a point often lost in economic theories of the firm.[49] But innovation implies elements of monopoly, at least temporarily. In the growth process, domestic firms may seek out new markets after home markets become saturated to exploit this monopoly. The study of organizational structure illuminates the process of innovation; the study of market structure shows how firms seek to defend the monopoly advantages accruing from innovation.

Market Structure and the MNE

The traditional doctrine of international trade and capital movements has been the cornerstone of economic orthodoxy in explaining foreign investment. A rather different theoretical approach to direct foreign investment has been provided by Stephen Hymer in a doctoral thesis at MIT, and more recently by Richard Caves.[50] Their explanation is that direct foreign investment (*i.e.*, equity investment) is to be found in the theory of industrial or-

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[47] For a brilliant elaboration of this "learning" model of organizational decision-making, see March and Simon, *Organizations* (1958).

[48] Consider the following comment about the development of Japanese MNE's: "Japan is generally less technologically advanced than the United States and Europe, and is distinctly more technologically advanced than her Asian neighbours and other developing nations. The recent technological innovations of Japanese firms have been directed to the *improvement of production processes rather than to the outright development of new products*". Tsurumi, in *supra*, f.n.33, 75. Italics added.

[49] The shift in emphasis is illustrated by the revision of a recent work by Kemp from *The Pure Theory of International Trade* to *The Pure Theory of International Trade and Investment* (1969).

[50] Hymer, *The International Operations of National Firms: A Study of Direct Investment*, Doctoral Thesis, M.I.T. (1960); Caves, *International Corporations: The Industrial Economics of Foreign Investment*, (1971) Economica 1.

ganization, that is, in market behaviour and imperfect competition in both the home country and the host country. Thus, for direct investment to occur in foreign markets, it is necessary not only for a multinational corporation to earn in the foreign market a greater profit than in the home market, but also a greater profit than competitors in the host market. In other words, there is a strong element of monopoly conduct in the host market, since the firm attempts to exploit or protect a particular economic advantage over its competitors — or potential competitors.[51] In the case of horizontal integration, corporations produce in the host market what is produced at home, and product differentiation typically prevails. In the case of vertical integration, corporations exist in oligopoly structured industries at home and seek sources of raw materials on production inputs for production in the home market.[52]

This analysis represents a dramatic shift of focus in the study of foreign investment, for it emphasizes the oligopolistic advantages accruing to the multinational firm, and more importantly, the techniques employed to secure and maintain these advantages. It also calls into question many of the economic policies adopted by host countries, some of which, like tariffs and taxation, may actually aid foreign investors to the detriment of local entrepreneurs.

The emphasis on market structure put forward by Hymer and the subsequent empirical studies of the largest multinationals highlights the primary role of technology and the timing of innovation as the dynamic engine of corporate growth.[53] Corporations which develop unique products first produce them in the home market. In time domestic saturation is reached. The uniqueness of the product, together with the firm's oligopoly industry position (*i.e.*, limited competition), enables the firm to gain monopoly profits in the short run. Over a period of time the high profit margins decline because of market saturation and an increase in potential domestic competition. The firm is then left in the position of having to face further decline in profit margins to maintain domestic customers, or to seek new markets abroad while searching for

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[51] For a lucid explanation, see Kindleberger, *American Business Abroad* (1969), ch. 1.

[52] Hymer, "Direct Foreign Investment and National Interest" in Russell, *supra*, f.n.11.

[53] The intellectual antecedent of this approach owes much to Schumpeter's innovation hypothesis. See Schumpeter, *Capitalism, Socialism and Democracy* 3d ed. (1950).

new products for existing customers in the home market. Corporations can attemp to export to foreign markets, but such factors as cheap labour, access to foreign capital, and high transportation costs may induce production in the host market by national entrepreneurs. More likely, however, is the possibility of tariff or customs barriers by host governments, and even potential competition by other foreign corporations in the host market — all inducing direct foreign investment. This emphasis on the product cycle of high technology products appears to have empirical support, especially for American-based multinationals.[54]

In a dynamic world, therefore, direct investment often occurs from a defensive posture intended to forego entry by competitors to a captive market. Size, technology, and even initial entry are strategic weapons to gain comparative advantage over any rival firm.[55] Direct investment does provide a certain amount of risk in that, once established, withdrawal is very costly for the firm and for the host country. From the perspective of uncertainty and unpredictability, multinational firms in oligopolistic markets must weigh the danger of remaining in existing markets, even when they are very profitable, as against the risk of entering new markets not necessarily as profitable, in order to forestall competitive entry and possible future barriers to entry.[56]

This motivation for direct investment demonstrates a very subtle but central issue in the analysis of foreign investment and the multinational firm. The subtlety rests in the fact that it is the barrier to trade through export, not the removal of barriers which is the raison d'être of the multinational corporation. As noted, there are obstacles presented by the location of one or

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[54] The link between organizational structure, innovation, and the product cycle is extensively explored in Wells (ed.), *Product Life Cycle and International Trade* (1972).

[55] Vernon argues that costs may not be so crucial as many economists often assume; market presence in a national market with high incomes, rapid communications, potential for innovation in production, and labour-saving devices may be more important location considerations. It follows that the United States would be the source of the most technological innovations, since these factors are more abundant than in any other national market. See Vernon, *International Investment and International Trade in the Product Cycle*, (1966) 80 Quarterly J. of Econ. 190.

[56] Caves, *supra*, f.n.50. It should not be deduced, however, that all foreign investment decisions are subject to rigorous analysis by top management, since many factors motivate the decision to move abroad, including executive contacts in foreigu countries, ethnic ties, and the like. For discussion, see Aharoni, *The Foreign Investment Decision Process* (1966).

more MNE's in a foreign market to the competitive detriment of any rival multinational which motivate entry by direct investment of additional firms. A further factor, however, is the action of host governments, most notably in the case of tariff barriers, but also in the case of differential monetary and fiscal policies and a battery of industrial policies (*e.g.*, tax advantages, subsidies to investment, etc.) which can provide a motivation for multinational firms to exploit local opportunities by entry into the host market. In other words, in a world of very high factor mobility, multinational firms are capable of moving from one jurisdiction to another, and if economies of scale are great enough (as they usually are), they can exploit the differentials created by national policy to their own profitable advantage.

The foregoing analysis, although somewhat abbreviated, brings out the link between multinational corporate structure, illustrated by the seminal work of Chandler outlined above; the market structure advantages conceptualized by Hymer and Caves; and the role that technology plays in fostering imperfect market conditions across a given industry in all countries where production occurs. These points serve to show that the more developed a multinational firm becomes, the more important is the need to integrate the production facilities in each country. In part the integration may be vertical, where the output of a subsidiary becomes the component input to another subsidiary's production; in part it may be horizontal, where subsidiaries exchange finished products. It also may be a combination of both. The fact that such integration clearly increases the potential conflict between the MNE and the nation state is only now beginning to be realized.[57] An absence of sensible economic policies to coincide with the potential costs to efficiency in the host environment, as well as a lack of information about economic performance, can largely dissipate the gains from foreign investment.

Indeed the study of foreign investment in Canada must be examined in this light. The basis of any foreign investment policy,

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[57] This conflict has typically been examined in the context of extraterritorial application of foreign laws. The three sources of conflict have been in the areas of anti-trust, repatriation of earnings and trade with communist countries. For a legal analysis in the American context, see Berman and Garson, *United States Export Controls — Past, Present and Future*, (1967) 67 Col. Law Review 791; Brewster, *Antitrust and American Business Abroad* (1958); Steiner and Vagts, *Transnational Legal Problems* (1968). See also Behrman, *National Interests and the Multinational Enterprise* (1970). An excellent treatment of extraterritoriality in Canada is given in the Gray Report, *supra*, f.n.3, ch. 16.

whether a limited approach such as that embodied in Bill C-201 or a much more global strategy, should be designed in terms of the economic environment in which the MNE operates (the MNE's subsidiaries in foreign countries and domestic corporations capable of growth toward global marketing). An analysis of how Canada has shaped its economic environment is the subject matter of the next section.

The MNE in Canada

The first forms of direct foreign investment originated with American corporations during their continental expansion in the nineteenth century.[58] In many cases, U.S. companies developed subsidiaries in Canada which were not much different from other branches established across the North American continent, and until very recently, many such companies often included their Canadian branches as part of the U.S. operations for financial and managerial control purposes. Although Britain was the main source of foreign capital until 1914, this took the form of portfolio (loan) capital, while U.S. investment has consistently taken the form of equity.[59] By 1930, the U.S. had overtaken Britain as the main source of foreign capital in Canada, accounting for 61.2 per cent, compared to 36.3 per cent from Britain. This proportion has increased ever since, and American capital now amounts to 80.7 per cent of all foreign capital in Canada.

Despite the shocking lack of reliable information, the picture of foreign investment in Canada reveals the following general characteristics:[60]

1. Direct foreign investment is not only very high, but it continues to grow, both by new investment into the economy and by growth financed from internally generated funds. At present, the book value of foreign-controlled firms, as distinct from the market value, is estimated at $30 billion, about 34.2 per cent of all Canadian corporate assets.

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[58] Wilkins, *supra*, f.n.40, 141. "Practically every American manufacturing company that exported sought to sell in Canada. As in Mexico before 1910, because the Dominion was a neighbour, American companies often administered their Canadian marketing within the framework of their domestic organization rather than as "foreign" business. Many more U.S. companies wanted to sell in Canada than in Mexico, because of the higher standard of living in the Dominion, which carried an ability to purchase."

[59] The Gray Report, *supra*, f.n.3, 15.

[60] *Ibid.*, ch. 2.

2. Profitability of foreign-owned firms is generally higher than Canadian-controlled companies. In manufacturing, foreign-owned firms had a higher proportion of profits and taxable income than sales.
3. The extractive industries are predominantly foreign-controlled (74 per cent in petroleum and natural gas, 65 per cent in mining in 1967). The proportions have not changed appreciably in the last twenty years, but show marginal changes to *less* ownership by Canadians. Moreover, non-resident ownership is greatest in the high technology industries.

These "facts" about foreign ownership are not in dispute, despite the limited availability of information about certain aspects of particular sectors. What is in dispute is the long term implications and trends of so much foreign investment in the key sectors of the economy. That Canadians in general and policy makers in particular have consistently and studiously avoided an assessment of the basic issues has hardly encouraged a meaningful debate over the range of available options.

Dissenting opinion within the federal cabinet, an increasingly "articulate" nationalist press, nationalist sentiments among younger Canadians and possibly some general disillusionment with American foreign policy have stimulated a new foreign investment strategy, even if the federal government has not acted with much urgency in the matter. However, how long this stance will last is now open to question. It seems imperative that the causes of the foreign investment problem should be analyzed rather than the manifestations of large scale foreign ownership. Canadian social policy has for too long failed to mobilize Canadian skills and resources; yet at the same time governments have employed what many experts see as an inappropriate blend of economic policies. Minor adjustments to this present mixture of economic and social policies, such as the advocacy of more Canadian directors or managers in foreign-controlled firms, or bilateral agreements to dilute the potential problems of extraterritoriality, serve only to postpone the ultimate reckoning. Three primary considerations stand out, namely the tariff, taxation, and anti-combines legislation.

This section outlines the costs and dysfunctions of each of these policies in the context of foreign investment and the MNE.

The Tariff

Few economic subjects dominate Canadian policy questions as much as the national tariff.[61] Historians have generally adopted a sympathetic attitude towards the tariff, in the context of Sir John A. Macdonald's tripartite National Policy: the tariff, the railroads, and immigration to the West. The goal of the National Policy was east-west economic development, the cornerstone of Canadian nationhood, and its success is considered as vindication of its basic purpose.[62] Economists, on the other hand largely speak with one voice on the tariff, citing it as one of the most defective policy instruments of Canadian authorities, and in consequence one of the root causes of much of Canada's imbalanced growth and market imperfections. The tariff is also seen as a major contribution to foreign investment inasmuch as American corporations, faced with the tariff, have traditionally established Canadian subsidiaries as a substitute for exports. The long run result has been a truncated economy of foreign subsidiaries with too many plants producing sub-optimal product lines at production costs exceeding world levels. As the Gray Report states succinctly, "[t]he Canadian tariff provides sufficient protection to a wide range of industries to enable them to compete in the domestic market even when they are less efficient than foreign producers."[63]

The economist's objection to the tariff is that it fosters inefficiency, oligopolistic market structures and less than optimal economies of scale. Wilkinson summarizes the basic points as follows:

> There are at least five issues regarding economies of scale. First, while the Canadian market could support one or more optimum-size plants, frequently more than the required number of plants (many of which are less than the minimum optimum size) are in operation. Second, even those plants which appear to be of at least minimum optimum size, in terms of the investment necessary, are producing too many product lines to achieve the length of production required for unit costs to be at a minimum. Third, even though some economies of scale in production are

[61] The literature is voluminous. Representative works include the following studies: Young, *Canadian Commercial Policy,* Royal Commission on Canada's Economic Prospects (1957); Dales, *The Protective Tariff in Canada's Development* (1966); Eastman and Skykolt, *The Tariff and Competition in Canada* (1967); English, *Industrial Structure in Canada's International Competitive Position* (1964); Wonnacott and Wonnacott, *Free Trade Between The United States and Canada* (1967).

[62] For a biting review, see Dales, *Some Historical and Theoretical Comment on Canada's National Policies,* (1964) 71 Queen's Quarterly 297.

[63] The Gray Report, *supra,* f.n.3, 218.

achieved, there may be additional, potential economies of large scale selling, which Canadian firms have difficulty achieving. Fourth, Canadian firms may be unable to realize economies of large scale research and development. Finally, external economies from having vast concentrations of industry within given areas (e.g. the availability of specialized services) may not be fully realized in Canada.[64]

Recent theoretical developments in tariff theory indicate that it is necessary to recognize and evaluate the distinction between "nominal" tariff rates and the "effective" tariff rates on imported goods. The effective tariff rate is a measure of industry protection since it adds value to purchased inputs in production, and includes the differences in the tariff rates between the output and input of a particular industry. Nominal rates are simply the scheduled tariff rates for imports. The distinction is important because in many cases, even though the nominal Canadian rates are low in the manufacturing sector, the effective rates provided are much higher than the nominal ones.[65] The Canadian practice has been one of high tariffs on finished manufactured products, but much lower rates on raw materials and intermediate inputs (components). The tariff thus becomes a rule of thumb by Canadian producers deciding pricing policies against foreign competitors, regardless of the relative efficiency (in terms of economies of scale) of the largest Canadian producers. Neither Canadian-owned nor foreign-owned firms in the Canadian market have a real incentive to reduce the selling price below the foreign price plus the tariff. Moreover, there is little incentive to improve economies of scale and specialization; therefore, the problem of too many plants and too many production runs persists even with the presence of foreign subsidiaries.[66] The reason is simple: the tariff makes it profitable for Canadian manufacturers, regardless of ownership, to be less efficient than American firms.

The tariff has had a dysfunctional effect not only on production inefficiencies but also in promoting disparities between the economic regions of Canada (especially the Atlantic provinces and the West) where proximity to the cheap American market is less than in central Canada.[67] The exact economic cost of the tariff for

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[64] Wilkinson, *Canada's International Trade: An Analysis of Recent Trends and Patterns* (1968), 110.

[65] For an elaboration, see Melvin and Wilkinson, *Effective Protection in the Canadian Economy*, Study No. 9, Economic Council of Canada (1968), 2-9, 38-44.

[66] Daly, Keys, Spence, *Scale and Specialization in Canadian Manufacturing*, Study No. 21, Economic Council of Canada (1968), 53-59.

[67] Economic Council of Canada, *Fifth Annual Review* (1968), 154-157.

each region is not known but there is some significance in the fact that it is in the West and the Maritimes that public sentiment for strong foreign investment initiatives has been least strong, historically and in the present situation. The Gray Report recognized the impact of the tariff, although surprisingly little attention was devoted to it. However, the report does raise the question of the "miniature replica" effect, that is, the production by subsidiaries of a larger than optimal line of products, usually the full line of the parent.[68] Two alternative paths to rationalization are suggested as the direct result of the removal of the tariff. The first form is a rationalization between the parent and the subsidiary, enabling the subsidiary to import (duty-free) part of the parent company's product line, while concentrating on the production of a more limited range of products. A second form of rationalization, clearly more beneficial, arises where the parent and subsidiary each concentrate on a specific product line which is sold to the entire foreign market. The level of foreign tariffs might have an influence, depending on the economies of scale achieved in the subsidiary. Evidence of such consequences are slim, although a recent case study of automobile components suggests that this second alternative might occur.[69]

Tariff policy alone, however, is not likely to bring about the required changes in Canadian industrial structure, or to improve the benefits of foreign investment. For example, in the short run small Canadian firms might have so significant a disadvantage, relative to the equally inefficient foreign subsidiaries (but backed by access to the huge resources of the parents) that they would not survive trade liberalization. The overall effect might be an oligopoly structure totally dominated by foreign-owned firms. Even if some Canadian firms did survive, the resulting structure would probably increase intra-company economic integration with American industry, with all that this implies for Canadian political independence.[70] These two consequences — a potential oligopoly

[68] The Gray Report, *supra*, f.n.3, 219. There is also some evidence that subsidiaries replicate the administrative and communications structure of the parent firm. See Brooke and Rimmers, *supra*, f.n.46, 40-42.

[69] Murray and Helmers, *Market Structure and Trade Liberalization: A Case Study*, (1973) 7 J. of World Trade Law 117, 126. "Markets in the United States and Canada often can be viewed as a single North American marketplace rather than as separate entities. And competition in this larger marketplace would not be Canadian industry versus American industry but rather company versus company, be they American or Canadian."

[70] Moore, *How Much Price Competition?: The Prerequisites of An Effective Canadian Competition Policy* (1970), 129-130.

structure and closer integration of the Canadian-American economies — indicate that tariff policy must also be linked with competition and fiscal policy: the first to allow mergers and rationalization among small Canadian plants to gain economies of scale; and the second to provide the motive for such a rationalization.

The Tax System

Taxation is a difficult subject in any country, but in the context of the MNE, it has a special complexity often overlooked even by the experts.[71] The fact that corporate income tax has a built-in incentive for companies to expand by investment of internally generated funds is generally recognized even by the tax authorities, but the relationship of corporate taxation to market power is often overlooked.[72] The notion that taxation policies also relate to foreign investment is only now beginning to be recognized. In Canada, which has just undergone an extensive period of tax reform, surprisingly little has been said about the link between these two issues, at least until the October 1972 election, and even then, often in highly politically charged terms. Yet taxation policies are a crucial source of host country benefits from foreign investment, and any obstacles to such benefits merit detailed attention.[73] Debate on this aspect of foreign investment has been limited and the Gray Report devotes no more than six pages to its analysis.[74] Three

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[71] Vernon, *Sovereignty At Bay* (1971), 274-277.

[72] Milton Friedman criticizes the practice of leveling a high corporate tax rate, which has the incentive of promoting expansion and tax avoidance. "This tax structure encourages retention of corporate earnings. Even if the return that can be earned internally is appreciably less than the return that the stockholder himself could earn by investing the funds externally, it may pay to invest internally because of the tax savings. This leads to a waste of capital, or its use for less productive rather than more productive purposes. It has been a major reason for the post-World War II tendency towards horizontal diversification as firms have sought outlets for their earnings. It is also a great source of strength for established corporations relative to new enterprises. The established corporations can be less productive than new enterprises, yet their stockholders have an incentive to invest in them rather than [in new enterprise] ... ." *Capitalism and Freedom* (1962), 130. Market power, of course, permits the corporation to pass its taxes on to the consumer. An improved tax policy to the corporate tax rate would be to tax the corporation as a partnership and have the shareholder subject to the full tax rate.

[73] Meier, "Private Foreign Investment" in *The International Economics of Development* (1968), 131-161.

[74] The Gray Report, *supra*, f.n.3, ch. 13. The following discussion differs somewhat from the Report's analysis.

issues are involved: multinational transfer pricing to minimize the tax burden in order to maximize retained earnings; prejudicial treatment of foreign-owned companies at the expense of Canadian firms; and economic distortions through a favourable treatment of the resource industries to the detriment of the manufacturing sector.

(a) Transfer Pricing

The development of the "profit center" concept in management theory was a response to the need to coordinate the exchange of goods and services between operating divisions, and to develop a yardstick of performance.[75] Internal resource allocation among semi-autonomous divisions or subsidiaries is controlled by means of transfer pricing. In recent years most large corporations practice this technique, even though its arbitrary calculus makes exact checks difficult.[76] In the context of the multinational firm, transfer pricing is a powerful management tool to distribute internal resources (raw materials, unfinished goods and components and overhead charges), especially in the stages prior to the development of a product divisional structure.[77] In the more mature stages of corporate development, profit levels of each subsidiary based on internal transfer pricing rates take on less priority than the national tax differentials in the jurisdictions where they operate.[78] Indeed such differentials in national tax rates may be sufficient to increase the rate of return in the low tax rate country such that, without the tax differential, the investment would not be a viable economic proposition.[79] In some cases, the shifting of the tax burden to the low tax country may not compensate the extra costs incurred by higher import duties or tariff rates. It is hardly sur-

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[75] Drucker, *supra*, f.n.39; Sloan, *My Years with General Motors* (1965).

[76] For a good textbook treatment of the subject, see Shillinglaw, *Cost Accounting: Analysis and Control* (1967), ch. 27.

[77] Brooke and Remmers, *supra*, f.n.46, 172-178. As Penrose states, "[i]f we assume that firms attempt to minimize taxes in their efforts to maximize retained earnings, we can infer that they will attempt to use the scope thus provided to allocate overhead costs among their foreign branches, subsidiaries, and affiliates, and to adjust their transfer prices, in order to reduce their total tax outlays". *Supra*, f.n.30, 43.

[78] Shulman, *When the Price Is Wrong — By Design,* (1967) 2 Col. Journal of World Business 69; Thomas, *Transfer Prices of the Multinational Firm,* (1971) 7 Abacus.

[79] Brooke and Remmers, *supra*, f.n.46, 141.

prising that the MNE undertakes the study of such advantages, since the tax benefits in a world of mixed rates can be substantial.[80]

The economic approach to transfer pricing, and the one underlying the philosophy of the Canadian *Income Tax Act* is the arm's length or fair market comparison, thereby avoiding monopoly and monopsony practices.[81] But arm's length pricing can also be arbitrary, and it is often very difficult to show that there is an approximation to fair market value, a demonstration on the part of host countries which probably varies with bargaining position and power. On the other hand, as long as multinational corporations maintain 100 per cent equity in their subsidiaries, as American firms prefer, transfer pricing is a highly rational practice not only for reducing corporate tax liabilities, but as some governments have learned to their cost, for taking advantage of shifting currency rates.[82]

There is little empirical evidence to document Canadian experience in the past, due to the lamentable disclosure laws for both foreign-owned and Canadian companies. However, Safarian's study indicates that when Canada had a corporate tax rate of 47 per cent, relative to the American tax rate of 52 per cent, U.S. corporations found it advantageous not to charge the Canadian subsidiary for management licensing fees and technology, since this would have the effect of reducing the Canadian subsidiary's tax burden and increasing the American parent's liability in the high jurisdiction. Similar practices are reported in the tax policies pursued by MNE's in other countries.[83] Obviously, as long as the Canadian tax rate remains below the American one, the likely effect will be to increase

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[80] Rutenberg, for example, has shown a variety of techniques — transfer pricing on goods and services, temporary loans among subsidiaries, and selective dividend payments — which reduce the world tax burden on MNE's by taking advantage of tax havens, tariffs, and varying tax rates. See Rutenberg, *Maneuvering Liquid Assets In A Multi-national Company*, (1970) 16 Man. Science B-671.

[81] The Gray Report, *supra*, f.n.3, 231; Copithorne, *International Corporate Transfer Prices and Government Policy*, (1971) 4 Can. Journal of Economics 324, 329-330.

[82] A recent study by the United States Tariff Commission discovered that liquid assets held by MNE's amounted to $268,000 million at the end of 1971, a sum equal to twice as much as all the central banks and international monetary institutions in the public sector: *Financial Times*, February 16, 1973, 5. For a comparison of national systems of corporate transfer pricing, see Arpan, *International Intracorporate Pricing: Non-American Systems and Views*, (1973) 3 Journal of International Business Studies.

[83] Safarian, *supra*, f.n.19, 194-196.

revenue in this country. How long American authorities would allow this net transfer to Canada is another matter.

b) **Prejudicial Taxes**

Canadian companies have long complained to tax authorities about the prejudicial effects of the tax system which tended to induce foreign takeovers of Canadian firms. The ten year review process leading to the 1972 tax reform bill has brought to light various anomalies in previous tax practices, and several of these have been corrected in the new *Income Tax Act.* For more than a decade, various budgets put forward limited proposals to use the tax system as a means of discouraging foreign equity investments. For example, in 1960 the *Income Tax* had been amended to repeal the differential in withholding tax on income paid abroad, a practice which encouraged wholly-owned subsidiaries.[84] It was an attempt to encourage capital inflows away from equity investment into debt securities. Tax on dividends paid abroad from wholly-owned subsidiaries rose from 5 per cent to a uniform 15 per cent. But the most notable attempt to relate the tax system to a policy of controlling foreign-owned firms was the Gordon budget of June 13, 1963.[85] This budget changed the withholding tax to 10 per cent from 15 per cent for companies where Canadians owned 25 per cent of their voting stock. Later this proposal was redefined to apply to companies whose shares were no more than 75 per cent foreign-owned and listed on a Canadian stock exchange. At least 25 per cent of the directors had to be Canadians. Another proposal, considerably more controversial, was the 30 per cent takeover tax on sales of Canadian companies, subject to specific restrictions of the transactions. This tax proposal was withdrawn within a week of the budget.[86]

Until the recent tax act, American firms had a particular tax advantage over Canadian firms in buying out a domestically-owned company. Not only would the American firm normally have access to cheaper capital in the U.S. market — or, in fact, in the Canadian market if it had a good credit rating — than the potential Canadian purchaser, but the American company could also deduct for income tax purposes the interest on capital borrowed for the acquisition, a tax liability not permitted the Canadian purchaser.[87] Just how

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[84] Canada: House of Commons, *Debates,* December 30, 1960.

[85] *Ibid.,* June 13, 1963, 1004-1007.

[86] *Ibid.,* June 19, 1963, 1321. Also June 24, 1963, 1497.

[87] Servan-Schreiber has made a similar point about American purchase of European companies. See *supra,* f.n.32. A recent amendment proposed by

significant this tax differential was in promoting takeovers is difficult to ascertain since the motive to purchase involves several other factors, but it points to the need for complementary enactments across a spectrum of legislative acts if prejudicial policies are to be avoided.[88]

c) Imbalanced Tax Mix

The third major implication of the tax system to foreign ownership is the general policy since 1949 of providing accelerated depreciation and investment allowances which reduce the cost of capital equipment compared to labour. The most articulate opponent of this policy is Eric Kierans, who views such investment stimulants as an instrument which favours the resource industries at the expense of the manufacturing and service sector, and large corporations over small firms. In an address to the Canadian Economics Association, he outlined his basic charge:

> Some of you have again called for investment stimulants or incentives. I am completely opposed to them as providing a solution to Canada's long term chronic unemployment problems. I also believe that they have contributed more than any other single policy to the concentration of American ownership that now exists in Canada. In other words it is not what the Americans have done to us but what we have done to ourselves.[89]

Kierans cites evidence from CALURA data for 1968 to show that such service sectors as retail trade and wholesale trade had an effective taxable income, as a percentage of book profits, of 90 and 87 per cent respectively: metal mining was 13 per cent, mineral fuels

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Finance Minister Turner allows Canadian companies a tax credit against Canadian tax for income taxes paid not only to foreign countries, as permitted at present, but in addition, from January 1, 1973, income taxes paid to the provinces or states of foreign countries. This is a revision to the tax reform legislation, and forms part of a strategy to foster the development of Canadian based MNE's. See *The Financial Post*, December 9, 1972, 1-3.

[88] There has been only one major study of the takeover of Canadian firms; it is somewhat out of date, and suffers from a shortage of critical data. Reuber and Roseman, *The Takeover of Canadian Firms, 1945-1961* (1969). Various reasons account for sell-outs, including finance, management, and technology. One can speculate that capitalization has a good deal to do with it, especially for small, family-owned corporations. Recent evidence from Europe shows that British firms, backed by access to Britain's capital markets, can afford to buy out French firms with low price earnings ratios, and then to raise the ratio to about 15. How much this parallels the Canadian case is difficult to say without better data. See *The Economist*, February 17, 1973, 88.

[89] Kierans, *Contribution of The Tax System to Canada's Unemployment and Ownership Problem*, Can. Econ. Assoc., Memorial U., June 3, 1971, 8.

5.7 per cent, and other mining 32 per cent. In terms of the size of the corporation, small firms of less than a million in assets pay a tax of 76 per cent on their book profits, firms with up to 5 million in assets pay 70 per cent and firms with up to 25 million pay 64 per cent. For larger firms, the rate drops to 47 per cent. At the same time, the Reserve for Future Income Taxes, an account which represents the amount of tax saved by excess depreciation, increased from a reserve amounting to 1,472 millions in 1965 to 2,778 millions in 1968. According to Kierans, this is tax relief with a vengeance, a relief which amounts to interest-free loans for investment in plant and equipment.[90] From the perspective of foreign ownership, this relief represents a principal means of superceding market forces for investment in the areas where foreign investment is highest, namely in capital intensive industries like oil, gas and mining.

A preferential tax system not only promotes foreign investment in the capital intensive sectors of the economy, but contributes to unemployment, since the industrial sectors which have high labour-capital ratios are less favourably treated. Moreover, growth in the capital intensive resource industries does not necessarily provide a corresponding increase in employment. As Kierans notes:

> ... an additional $1 billion export of energy resources to the United States, for example, would give us $68 million in wages and salaries. The balancing inflow of $1 billion manufacturing goods could mean that we are importing anywhere from $200 million to $350 million in wages and salaries, depending on the industry. An exchange of dollars but not of employment![91]

Despite Kieran's arguments against the conventional wisdom of the Department of Finance, the incumbent government has continued its tax policy with only minor modifications and a promise to study the matter in 1974.[92] The Gray Report makes no reference to these tax issues and their relationship to foreign ownership, except for a passing reference to the Tax Reform Bill.[93] Public debate about the efficacy of Canadian tax policy increased during the 1972 federal election, with David Lewis's campaign against "corporate

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[90] *Ibid.*, Table 2 and Table 3. An identical argument has been given before Congressional hearings on tax reform. See Samuelson, "America Turns Against Its Own Multinationals", *The Sunday Times*, March 11, 1973.

[91] Kierans, "Towards A New National Policy", in Rotstein, *supra*, f.n.28, 88-89.

[92] In his 1973 budget address, the Hon. John Turner promised an end of the system by 1974 and a thorough review by his department.

[93] The Gray Report, *supra*, f.n.3, 360-365. The discussion in the report centres around the use of the tax system to increase both Canadian ownership and the benefits from foreign direct investment. Only two paragraphs are devoted to the second point.

welfare bums".[94] Unfortunately, the debate served to obscure the fundamental issues of the tax policy by placing blame on the companies and not on the assumptions underlying it. Criticisms directed at the companies which paid low tax rates seem misplaced. The tax concessions were legal, and there is no duty for a corporation or an individual to pay more tax than the legal requirement. What should be questioned are tax laws which allow such deductions. Many economists have advocated the abolition of similar tax allowances in the United States, and some, like Milton Friedman, have gone so far as to propose that the corporation tax should be replaced by a tax on the corporation as a partnership, with each shareholder paying his full pro rata share.[95]

The difficulties imposed on the United States by the balance of payments deficits have brought to light the tax implications of American laws on U.S. tax credits. At present, U.S. law allows American MNE's to offset dollar for dollar tax paid to foreign governments against American taxes. Proposals have been made in Congressional hearings to change this practice by allowing foreign taxes to be deducted only against income, not taxes. Since this proposal would have the effect of levying an effective tax rate on foreign income of about 75%, the elimination of the tax credit could have serious implications for the taxes paid by American corporations in Canada. But the questions of how much tax the corporations are actually paying and what benefits they receive through tax allowances require detailed study,[96] and the lead taken by the U.S. Congress may provide the incentive for a new look at the policies in effect in Canada.

Competition Policy

It is paradoxical that an economy operating on the principles of the invisible hand needs a visible hand to guide it. In other words, the entire case for free enterprise rests, in the real world of commerce, on its proximity to perfect competition. Regulation by government through anti-trust action is one of the principal means of enforcing competition. While it may be true, as Professor Samuelson has argued,[97] that anti-trust policy is "a thorn in the

[94] This is the charge by the Hon. David Lewis of the "corporate rip-off" during the 1972 election. See Lewis, *The Corporate Welfare Bums* (1972).

[95] Friedman, *supra*, f.n.72

[96] For one such attempt, see Mauser, *Financial Role of Multinational Enterprises* (1973).

[97] Samuelson, *Foundations of Economic Analysis* (1965), 203.

side of what are usually thought of as conservative interests", even conservative economists favour vigorous anti-trust laws, and Ralph Nader has made anti-trust the cornerstone of his consumer movement.[98]

Despite the fact that Canada's 1889 anti-trust laws predate the American Sherman Act by one year, anti-trust enforcement has been singularly selective and generally more ineffective than U.S. regulation.[99] Competition policy generally and anti-trust in particular are still high on the agenda in the foreign investment debate. Like tariff policy, anti-trust legislation touches on market structure, which in turn relates to economic performance. However, the close relationship between competition policy and foreign ownership has only recently been recognized, as the works of Hymer and others reviewed above indicate.[100] It will be recalled that foreign investment and the MNE thrive in an environment of market imperfections. Government policy which, by omission (in the case of strong anti-trust legislation) or commission (in the case of tax legislation or tariffs), promotes market imperfection actually increases the likelihood of foreign investment, and at the same time reduces the probable benefits of such investment.

Only recently has the federal government reviewed Canadian competition policy.[101] The excellent background study carried out by the Economic Council provides the major proposals for Bill C-256, presented to Parliament in June 1971, and now being revised.[102] This new competition bill is the first major reform of anti-combines legislation since 1960. Experience with existing legislation has been adequately reviewed elsewhere,[103] but it is generally agreed that it has not been a success. This legislation, the *Combines Investigation Act*,[103a] amended on August 1, 1960, received the following assessment in the *Interim Report* of the Economic Council:

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[98] Green, *et al.*, *The Closed Enterprise System* (1972). This study was carried out by Nader's Centre for Study of Responsive Law.

[99] For a useful collection of papers on the Canadian experience, written by lawyers and economists, see Stanbury (ed.), *Competition, The Law and Public Policy* (1970). An important text on the subject is Gosse, *The Law on Competition in Canada* (1962).

[100] Hymer, *supra*, f.n.50.

[101] Economic Council, *Interim Report on Competition Policy* (Ottawa, 1969).

[102] Bill C-256, 19-20 Eliz. II (1970-1971).

[103] See, for example, Rosenbluth, "Monopolistic Practices and Canadian Company Law" in Oliver (ed.), *Social Purpose for Canada* (1961), 212-234; Bell, *The Development of Canadian Anti-Trust Legislation* (1973); and ch. 4, *supra*, f.n.101.

[103a] S.C. 1953-54, c.51.

> There appear to be few grounds for supposing that the total impact of the legislation on economic efficiency has been more than modest. Certainly the impact has been uneven. The Act has mainly been effective in restraining only three kinds of business conduct deemed to be detrimental to the public: collusive price-fixing, resale price maintenance, and misleading price advertising... .
>
> It is unlikely that the Act has done much to effect efficiency via changes, in the structure of the Canadian economy... But in respect of corporate mergers which are one of the most important means by which changes in industrial concentration and other dimensions of economic structure takes place, the Act has been all but inoperative. The only two cases brought to court under the merger provisions (the *Canadian Breweries* and *Western Sugar Refining* cases) were both lost by the Crown and were not appealed.[104]

The new act, Bill C-256, significantly departs in four ways from the existing legislation. First, the practice of exclusive reliance on criminal courts is broadened to extend to civil law, greatly modifying the "punishment" aspects of prevailing law. Second, it is left to the courts to deal with the practices subject to outright prohibition (Sections 16-26). Thirdly, the new Act extends competition policy to the service sector. Finally, the responsibility for administering certain aspects of the Act, especially those relating to mergers, will fall on a Competitive Practices Tribunal. On the tribunal will sit a body of experts:

> ... who should possess a blend of experience and qualifications appropriate to the very difficult tasks with which they would be faced, and also be able to take a balanced and unbiased view of economic questions. The individual members would have to take particular care to avoid any conflicts of interest arising out of matters coming before them.[105]

The importance of the new Act should not be under-estimated, for viewed in the context of foreign ownership and tariff policy, some fundamental contradictions in Canadian commercial policy emerge. The contradictions relate primarily to the conflicting purposes of competition and anti-trust policies and how each relates to the overall goal of economic efficiency. Two observations can be made at the outset.

First, despite many mergers in several areas of the economy, there is some reason to question whether this has resulted in greater efficiency. Thus, the Economic Council's *Interim Report* provides data from a questionnaire survey on acquisitions from the years 1945-1961. (Service industries were excluded.) Despite methodological caveats, the study indicated that in a large percentage of cases where acquisitions occurred (46.4 per cent), negligible economies

[104] *Supra*, f.n.101, 64.
[105] *Ibid.*, 111.

resulted. In cases where some economies were achieved, they could be ascribed to other factors.[106] It is tempting to draw certain conclusions about management talent and administrative overhead expenses as a result of this rather surprising finding, but this should await further evidence. What is particularly relevant here is the fact that the fairly high number of mergers and acquisitions has not in the past corresponded with a high degree of industrial rationalization, as might be expected, or as the branch plant nature of the economy would require.

Second, the Canadian economy displays not only a very high level of concentration in absolute terms, but has a higher degree of economic concentration than the United States.[107] More than a third of all Canadian manufacturing shipments come from industries which are very highly concentrated, as compared to only 13.7 per cent in the U.S.[108] Equally important is the relationship between non-resident ownership and industry concentration. Stewart found that industries dominated by Canadian-owned firms showed high concentration. However, of 33 industries in the study dominated by foreign-owned firms, all but three were in the high concentration categories.[109] Not surprisingly, industries in Canada which are highly concentrated are in general the same industries which are most concentrated in the U.S.[110] In other words, oligopoly structures of U.S. corporations extend their oligopoly structures to the Canadian market, often by the takeover of a Canadian firm or by a direct merger with a domestic operation. While it may be true, as Green *et al.*, point out,[111] that the impact of such mergers and acquisitions is marginal on competition, the ultimate result of 300 to 400 such acquisitions by U.S. companies is the effective reduction of competition by international oligopoly. Moreover, European and Japanese anti-trust laws, like Canadian legislation to date, have different aims than their American counterparts. Thus moves towards lessening concentration are unlikely.[112]

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106 *Ibid.*, 216-219.

107 Stewart, *Concentration in Canadian Manufacturing and Mining Industries* (1970).

108 *Ibid.*, 62.

109 *Ibid.*, 72.

110 Rosenbluth, *The Relation Between Foreign Control and Concentration In Canadian Industry*, (1970) 3 Can. Journal of Economics, 14-38.

111 Green, *supra*, f.n.98, ch. 7.

112 Indeed, government policy has been directed towards the creation of larger units to compete with the American giants. For a study of European competition policy, see Cairns, *The Regulation of Restrictive Practices — Recent European Experiences*, Economic Council of Canada (1972).

In the theory of industrial organization, two schools of thought emerge with regard to anti-trust policy.[113] The first, more conservative, emphasizes conduct variables in market behaviour. Here, regulatory practices govern such factors as price collusion, resale price maintenance, misleading advertising, etc. The proposed Competition Act is a marked improvement over existing legislation, and covers the concerns of this first "school". The second school is more radical, and advocates changes in the market structure to lessen concentration. This, it is thought, makes collusion among firms less likely and market entry more possible.

The structural approach to anti-trust problems has a special complexity in the Canadian context. In the first place, the likely economic need is for greater rationalization among existing operations because of less than optimal economies of scale.

Secondly, many of the inefficient plants located in Canada are foreign-owned, chiefly by Americans. In consequence, these plants could be subject to American anti-trust law, and rationalization on a massive scale would appear unlikely. Both the Watkins Report and the Gray Report went into these problems in great detail and outlined certain options available to Canadian policy-makers, including special legislation to prevent foreign anti-trust applications in Canada.[114]

The proposed Competition Act does provide for flexibility in meeting the need for some kinds of mergers, especially where increased efficiency is attained and there is no reduction in competition. Even where reduced competition may result, a merger might be allowed if improvements led to better products or lower prices. Section 44 of the proposed Bill outlines a number of factors to evaluate mergers, including size, concentration and competition in the industry, previous mergers, the degree of international competition and the effect on other firms in the industry. What should be noted, however, is that the proposed Tribunal requires a considerable amount of information to assess these factors, information that present disclosure laws do not require. Moreover, there are very real difficulties in assessing mergers where efficiency may result for the companies, but where the cost savings may not be passed on to the consumer. Would direct price-fixing be necessary? The possibility that the terms of reference and jurisdiction of the

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113 The theory discussed here follows the treatment by Low, *Modern Economic Organization* (1970).

114 The Watkins Report, *supra*, f.n.4, 408-409; The Gray Report, *supra*, f.n.3, 270-279.

new Competitive Practices Tribunal and the Review Agency recommended by the Gray Report in many ways overlap and possibly conflict, will be dealt with in the next section.

However, as regards foreign investment and Canadian competition policy, the record is clearly inadequate in terms of structural conditions: concentration of industry, limited entry features and strong market power.[115] Worse still, this inadequacy also extends to conduct variables, such as pricing, misleading advertising and resale price maintenance.[116] Viewed in the larger context of economic policy, Canada's record of competition policy, taxation legislation, and tariffs has created an economic environment inducing the creation of small sub-optimal plants, protected from the rigours of full domestic and international competition. Perhaps the real wonder is that even more foreign investors have not been attracted to such an environment.

THE TORTUOUS EVOLUTION OF PUBLIC POLICY

The foregoing analysis of the structure and development of the MNE and the description of the Canadian economic environment suggest what new public policies are required. The MNE is a large, flexible, powerful economic actor; governments typically act with slow bureaucratic inefficiency. The policies Canada adopts must take cognizance of these basic realities.

Fortunately, the debate on foreign ownership in Canada has reached the stage where concrete proposals supercede polemical discourse and academic niceties. Two basic proposals have been introduced in Parliament. One is a Competitive Practices Tribunal, as embodied in Bill C-256 and proposed by the Economic Council's *Interim Report on Competition.* The second, a screening mechanism of certain aspects of foreign investment decision-making, as embodied in Bill C-201 and its successor, Bill C-132,[117] follows directly

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[115] That competition policy must be strengthened is given support by the evidence of exclusive dealerships documented in the Royal Commission on Farm Machinery, *Special Report on Prices* (Ottawa, 1969). This report is particularly interesting, but it documents corporate practices in an industry where tariffs have a small significance — a point which illustrates that various commercial policies must be integrated to have maximum effect.

[116] Thompson, *Resale Price Maintenance in Canada,* (1971) 21 U. of T. L.J. 67.

[117] Bill C-132, 21 Eliz. II (1973). The name given to this Act, the *Foreign Investment Review Act,* indicates its increased coverage of foreign investment screening, in contrast to Bill C-201, the *Foreign Takeovers Review Act.*

from the recommendations of the Gray Report. In practice, both proposals represent a major shift in Canadian commercial policy, and both provide, even in minimum form, a new and direct regulation of many aspects of business behaviour.[118] These proposals should be analysed in concert since both deal with similar characteristics of the market structure (competition and efficiency), and would operate with much the same criteria. This section sketches the main administrative features of each agency and examines their operation in light of foreign investment regulation in other countries with particular reference to Japan.

The Review Agency

Of the three major alternatives examined, including the key sector approach and across the board ownership rules, the Gray Report chose the Review Agency. The alternatives are not mutually exclusive, but the Review Agency is sufficiently novel to merit closer examination as a foreign investment strategy. The original legislation, Bill C-210, would have limited screening only to takeovers of Canadian firms, but the revised act, Bill C-132, introduced on January 24th, 1973, extends this limited coverage to include expansion of existing foreign-controlled firms and the entry of new foreign investment. Bill C-132 is very similar to Bill C-210. It provides for a Review Agency, headed by a Commissioner who is the chief executive officer responsible to the Minister. The Commissioner will have access to the staff and resources of the Minister's department "as are necessary for the proper conduct of the work of the Agency".[119]

The Act applies only to Canadian firms with assets valued at more than $250,000 or with gross revenues exceeding $3,000,000, determined by the previous fiscal year's operations. No change was made to these levels, although some criticism was levied against them after Bill C-210 was introduced. The Canadian Manufacturers' Association, for example, urged an increase in size, arguing that it might hinder small businessmen wishing to sell their firms.[120] A more important difficulty, however, with a uniform threshold may be the uneven composition of assets among small businesses. The

[118] Yet the nature and extent of regulation remain relatively limited, even in comparison to the United States, where disclosure laws, antitrust laws, and some regulatory agencies are much more stringent than in Canada.

[119] Sections 7(1) and 7(2), Bill C-132.

[120] *The Globe and Mail*, June 16, 1972. The CMA presented its views before the House of Commons Finance Committee in a written submission.

asset composition would likely vary considerably by industry and by industrial sector: receivables and inventory would be two cases in point. Profitability probably also varies as a ratio of assets and sales across industries. Statistics in the Gray Report indicate that there were 30 takeovers in 1968 and 44 in 1969, involving less than half a million dollars in assets.[121] The screening mechanism would apply to these cases and it may be found that variations are great enough to warrant a variable threshold.

But these are small points and can be ironed out over time. A more serious issue with regard to the Review Agency is the criteria established to guide the weighing of costs and benefits. Bill C-132 and its predecessor Bill C-201, adopt the same general criteria outlined in the Gray Report:

(a) The effect of the acquisition on the level and nature of economic activity and employment;
(b) the degree and significance of Canadian participation;
(c) the effect of the acquisition on productivity, industrial efficiency, technological development, product innovations, and product variety in Canada;
(d) the effect of the acquisition on competition within any industry or industries; and
(e) the compatibility of the acquisition with Canadian industrial and economic policies.[122]

Much discretion would have to be exercised in applying these criteria. The requirements of each criterion could vary greatly in the circumstances, and one criterion might have to be weighed against another. For example, a takeover bid might increase employment in the first criterion but mean less competition in "d". How would the Review Agency weigh the presumed benefits and costs? Would the entry of new business to Canada which satisfied all but the second criterion be accepted, or would the lack of Canadian participation be sufficient to block approval? (Legislation on Canadian participation could easily be enacted separately, so that this criterion would not then conflict with the others.)[123] It can be seen

[121] The Gray Report, *supra*, f.n.3, Table 57, 475.

[122] In s.2(2)(e) of Bill C-132, recognition is given to the industrial policies of the provinces where acquisition or establishment of a new firm has some significant effect. In practical terms, this criterion probably means political pressure from the provinces on the Review Agency's proceedings.

[123] In fact, legislation for federally incorporated companies may be forthcoming, and some provinces have announced plans for similar legislation for corporations in their jurisdiction. *Financial Post*, February 11, 1973, 3. It is

that no matter how specific the criteria laid down for the operation of the Review Agency, administrative discretion would still be an integral aspect of the screening process. On the other hand, the worst features of arbitrariness are reduced by the provisions for advance notice, for a right to representation including third party representation and consultation and for the right of appeal.

Bill C-132 defines the acquisition of control of a Canadian public company as occuring when 5 per cent of the voting shares are owned by foreigners; in the case of a private company, when 20 per cent of the shares are held by foreigners.[124] On the basis of these criteria, a large Canadian company, publicly quoted and having only 10 per cent of its voting shares held by foreigners, would have to apply to the Review Agency for approval to purchase another Canadian company — a situation which might occur in several takeovers each year. A similar anomaly exists in the case of the outright sale of a Canadian business by a foreign individual or corporation. If the Canadian assets are not owned through a corporation but sold directly, the Act would not apply, whereas if the assets were owned through a Canadian corporation, the sale would be covered by the screening mechanism. Is this really the intention of the Act? There is also the possibility of gradual foreign acquisition of a Canadian company without facing the Review Agency. A group of foreign investors could purchase shares in a Canadian public company such that no one purchase amounts to the 5 per cent limit under Section 3(3). As long as there is no joint action on the part of the foreign purchasers, the takeover legislation would not apply to such gradual acquisitions. Just how important these points are for the operational basis of the Act remains to be seen; in any event, it is possible that certain amendments or supplementary legislation may be passed to cover such loopholes.

A more problematic matter for the Review Agency is its working relationship to the Competitive Practices Tribunal to be established by the proposed Competition Act. Unlike the Review Agency, which would be responsible directly to a Minister, the Tribunal would act with a considerable degree of independence. Consisting of seven members appointed for ten years, it would function as a "court of

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an interesting yet melancholy commentary on Canadian affairs that while this country is preoccupied with getting Canadian citizens into positions of management and directorships in the largest corporations, several European countries are establishing guidelines to attain worker participation in these same positions. See, for example, *The Economist*, March 24, 1973.

[124] Sections 3(3)a and 3(3)b.

record" which would examine anti-competitive practices and "bring its judgement to bear".[125]

The Tribunal would be empowered to examine corporate mergers, inter-company export and franchising agreements and certain trade practices such as price discrimination or trade allowances; and to conduct special inquiries such as those provided for in Section 42 of the present Act. The Tribunal would conduct hearings which would be more informal than the proceedings of a court. As the Economic Council suggested:

> Hearings would ordinarily be public. The prevailing atmosphere would ideally be one of a collective search for understanding of business practice and its economic effects, and for the progressively clearer discernment of the nature of the public interest in particular cases. In line with this objective, the Tribunal might wish to give witnesses considerable freedom in their presentation of evidence.[126]

One of the principle functions of the Tribunal is the examination of corporate mergers. It is in this area where concentration of the Canadian economy persists, and where the activities of the Tribunal relate most directly to the screening mechanism of the Review Agency. Mergers between companies would be registered and reviewed where combined assets or annual revenus exceeded five million dollars, or where one of the companies is under foreign control. Advance approval may be sought, but once the Tribunal grants approval, it cannot later recommend its prohibition. The major criterion used to permit corporate mergers is an improvement in corporate efficiency with no reduction in competition. It will be recalled that the Economic Council's *Interim Report* found that in the minority of cases where efficiency was increased by mergers/takeovers, the improved efficiency could be attributed to other factors.

The Tribunal may still grant approval to a merger even when this will adversely affect competition "if substantial benefits will accrue to the community through increased efficiency, better products, or lower prices", according to the explanatory notes to Bill C-256. Section 44 of the proposed bill outlines several factors which the Tribunal would take into account in assessing the likely effects of a merger on competition:

(a) the relevant market structure of a particular industry, including actual and potential market shares;

(b) the history of previous mergers and concentration trends;

(c) the likely effects on market entry by existing firms, new firms, or expansion of existing firms in the relevant market;

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[125] *Interim Report on Competition Policy, supra,* f.n.101, 68.
[126] *Ibid.,* 64.

(d) the history of anti-competitive behaviour on the part of the parties to the merger;
(e) the amount and intensity of domestic and import competition in the relevant market;
(f) the likelihood of foreclosure of sales markets or sources of supply.

The following criteria relate to the determination of potential improvement in efficiency arising from the merger:

(a) the economics of the relevant market and minimal scale economics;
(b) the size of the merger parties relative to the minimal scale of operations;
(c) the likelihood of improved economies of scale;
(d) the potential effects on meeting import competition, increasing export trade, improving research and development, or any other relevant factors the Tribunal feels necessary.

It is obvious that both sets of criteria are closely related to the criteria established for the screening mechanism of the Review Agency. Indeed, the questions of corporate mergers and foreign acquisitions of Canadian companies are so closely intertwined that it is difficult to treat them separately. The Gray Report foresaw this eventuality and specified what the likely administrative links would be. Where a foreign controlled firm is involved in either an acquisition or a merger, the Review Agency would have jurisdiction to examine the potential results in addition to the Competitive Practices Tribunal. Consequently both bodies would have to apply their criteria of assessment before granting approval. As elaborated by the Gray Report:

> If a review process were implemented, a proposed takeover would be subject to examination by two public bodies. This cannot be avoided, however, without removing all consideration of foreign mergers from competition policy, or all takeovers from the jurisdiction of the review process. Neither of these alternatives is desirable for both policies would be serving a well defined public objective. It would be inappropriate to have the review authorities administer competition policy for foreign takeovers and the Competitive Practices Tribunal for domestic mergers, since conflicting interpretations of competition policy could arise.[127]

The Gray Report suggests that "only a few" takeovers would be subject to the work of both the Review Agency and the Tribunal. In these cases, corporations could seek application first to the Review Agency for approval, which would in turn notify the Tribu-

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[127] The Gray Report, *supra*, f.n.3, 464-465.

nal. If the Tribunal granted permission for a takeover on grounds of improved efficiency or the absence of adverse competitive effects, it would be then left for the Review Agency to negotiate the best terms.

What then are the probable effects of both bodies on the structure of Canadian industry? The combined influences of the tariff, various tax policies and an ineffective combines policy have resulted in a highly concentrated, sub-optimal scale, branch plant economy. To view either the Review Agency or the Competitive Practices Tribunal in anything less than this larger perspective is economic and legal myopia of the highest order. The basic thrust of both bodies must be directed to this larger issue, and not necessarily to the question of foreign ownership *per se*. The MNE has enormous resources and bargaining skills at its command. It should have little difficulty showing some benefits of any takeover or new investment even if some doubt remains regarding one or two criteria. Armed with its negotiating power and capacity to reach out to the sources of power within Government, the MNE will face both the Review Agency and the Tribunal with coherent policies and the means of articulating them. Any screening mechanism, however general in its application, must have the resources, skills, and coherent operating strategy to face this prospect. Has the groundwork been laid for the Tribunal or the Review Agency? Are public servants available with the necessary blend of experience in law and business to weigh the criteria of the Review Agency, the industrial goals of the nation and the economic priorities of the provinces against the corporate needs of the multinational corporation? Has sufficient attention been given to the development of coherent strategies for industrial development of Canadian resources within the framework of a mixed economy? There is reason to believe not: first, because information, the lifeblood of any administrative agency, is lacking; and second, because of the persistance of conflicting goals and purposes. These points need elaboration.

(a) Information

One of the difficulties about foreign investment in Canada is the problem that present disclosure laws do not provide sufficient information for economic analysis and government surveillance of firms. Ironically, one of the best sources of data on foreign investment in Canada is the U.S. government! The Watkins Report, the Wahn Report, and the Gray Report all recommended changes in existing means of collecting and analyzing information relating to foreign ownership and investment. This is necessary since the successful administration of both the Review Agency and the Competitive Practices Tribunal is contingent on having a great deal of information which is not presently available.

At present information is collected from three sources: CALURA,[128] the International Investment Position (IIP), and the Department of Industry, Trade and Commerce. All these sources use a different conceptual reference and a varying data base. Certain concepts such as "control" and "ownership" are not employed consistenly for purposes of economic analysis generally, for identification of foreign control, and most critically for the operation of the review process. In an excellent chapter outlining the most significant gaps in information, the Gray Report glosses over the improvement of corporate disclosure laws as a prerequisite to the operation of the Review Agency.[129] It does offer some possibilities of the Review board getting better information from other government departments, from the corporations which appear before it or from special studies undertaken under its auspices. Such a glib response to the "knowledge gap" about foreign ownership is rather startling, particularly because Canadian disclosure laws are even less stringent than American ones. It is worth noting that a recent study commissioned by Ralph Nader recommended the establishment of an Economic Information Centre, to which all publicly and privately held corporations would report sales and profit along divisional lines, as well as general data ranging from their investment accounts to advertising expenditures, in order to promote intelligent "planning for competition".[130]

It is not clear how the members of the Review Agency or the Tribunal could decide on the technical matters of corporate efficiency without better data. It is true, of course, that the American economy is considerably larger than the Canadian one, but the need for information is no less great. Information about product lines, technological licensing, minimal economies of scale or any of the several other operational criteria which must be weighed is not now available. Information provided by one of the parties to a merger or a takeover might narrow the gap, but would hardly be sufficient to ascertain industry averages and market conditions in aggregate. It is doubtful whether even a very large and experienced research staff could provide the required data without better disclosure laws.

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[128] *Cf.* the Canadian *Corporations and Labour Unions Returns Act,* 10-11, Eliz. II, c.C-26.

[129] The Gray Report, *supra,* f.n.3, ch. 22.

[130] Green, *et al., supra,* f.n.98, ch. 4.

(b) Conflicting Goals

Mention has already been made of the argument that consumer protection aspects of the Competition Bill should not be included with the provisions relating to mergers and market structure. A more serious problem exists in the need to restructure the Canadian branch plant economy. Two industrial goals are involved in this matter: first, to provide anti-competitive regulations for firms which will not be subject to industry rationalization; and second, to foster consolidation of small, inefficient firms within the same industry. New foreign investment is one way of promoting competition and rationalization, but at a cost of greater foreign ownership.

The difficulties attendant in this administrative process are very great and are further exacerbated by two additional considerations. Firstly, the Competitive Practices Tribunal is envisaged as an independent body, free from the direct control of Parliament and the provincial authorities where the largest firms are located. A Tribunal which actively engaged in a merger process to restructure specific industries, even where economic theory would so recommend, would be likely to incur the wrath of politicians at both the federal and provincial level. The same result might occur if the Tribunal prevented mergers which promoted provincial interests but at the expense of the national welfare. Secondly, even if industrial policies governing corporate mergers were articulated, the Review Agency and the Tribunal would still function as quasi-legislative bodies by the precedents of their own decisions. There seems little doubt that this process of "rule making" by doing is unavoidable since even specific guidelines still require a certain degree of administrative discretion. In another context Professor Low [131] has discussed the paradox of "procompetitive effects", following Samuelson's analysis of the "paradox of thrift".[132] If everyone saves, no one will save because overall income declines. In competition policy, cases which are decided in the same way by general rules result in a situation that, while each case decided on its own may give a defensible, procompetitive result, the net overall result may actually be anti-competitive. "A thousand mergers may each be clearly anti-competitive; banning all those mergers may be anti-competitive in its effect on the capital market, the mobility of assets, and so forth."[133] This paradox of procompetitive effects illustrates the need for discretion

[131] Low, *supra*, f.n.113, 397.
[132] Samuelson, *Economics*, International Ed. (1968).
[133] Low, *supra*, f.n.113, 485.

even where the criteria to be applied are much more specific than those provided for the Review Agency and the Tribunal.

One possible remedy to this conflict of goals is to establish a specific policy on industrial reorganization, possibly formulated by federal and provincial representatives. The policy would be directed towards the restructuring of certain areas of the economy where rationalization and market reorganization are required. This alternative would remove from the Competition Bill the main responsibility for mergers directed towards large scale reorganization in industries which display the worst features of sub-optimal scales, such as the refrigerator industry, cited by the Watkins Report. This approach might take the form of Britain's *Industrial Reorganization Corporation Act, 1966.*[134] The IRC had as its purpose the following:

(a) to promote or assist in the reorganization or development of any industry; or

(b) if so requested by the Secretary of State, to establish or develop, or promote or assist the establishment or development of, any industrial enterprise.

After two years of operation, the industrial reorganization function of the IRC was supplemented by passage of the *Industrial Expansion Act, 1968,*[135] because the former did not initiate the major changes envisaged by its supporters. As one critic noted, the IRC "has only (1) offered informal advice and (2) in its most significant moves, promoted mergers between major electrical, computer and nuclear instrument companies".[136] The *Industrial Expansion Act* provides the means of directly involving government financial support in a reorganization effort, particularly in specific sectors chosen by policy makers. In Canada, this model could have some parallels in the use of the Canada Development Corporation as a complementary instrument of industrial rationalization, although only within parameters established by commercial policy.[137] Furthermore, it might help to sort out the ambiguous and conflicting commercial goals imposed on the Competition Act and the Review Agency. The purposes of these bodies should constantly be shaped by a general industrial strategy and their operational criteria weighted towards this general goal.

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[134] 14-15 Eliz. II (1966) c.50.

[135] 16-17 Eliz. II (1968) c.32.

[136] Caves, *et al.*, *Britain's Economic Prospects* (1968), 388n.

[137] For discussion, see Couzin, *supra*, f.n.7, 434 *et seq.*

A Foreign Investment Council

The main function of the Review Agency outlined in both Bill C-201 and Bill C-132 is to screen certain foreign investment decisions. Yet the Gray Report recommended the following additional functions:

(a) to advise the government on foreign investment policy;
(b) to perform an advisory or consultative function in relation to foreign investment implications of other government policies and programmes;
(c) to gather information necessary for purposes of identifying foreign control and effectively negotiating with foreign investors;
(d) to conduct investigations on matters relating to foreign investment policy, industries or practices at the request of the minister responsible for its activities.[138]

Both the Watkins Report and the Wahn Report recommended the creation of a special agency whose work would be similar to these functions.[139] The obvious rationale for such work is to make information gathering and analysis a continuous process, in contrast to the *ad hoc* policy approach featured to date, highlighted by intermittent task force studies surreptitiously brought to the public through the back door.

Several possibilities are open to the government. The resources of government departments are available for the Review Agency's work. There is also some likelihood of the appointment of a small staff of researchers responsible to the Commissioner. It remains open to doubt, however, whether either of these alternatives is sufficient to carry out the advisory functions envisaged by the Gray Report. Indeed there is a danger that the use of the same staff for the advisory and research functions as for the day to day administration of the screening mechanism would endanger the successful work of both, a familiar bureaucratic malaise known as the displacement of goals.[140]

A more satisfactory solution, based on the historical experience of regulatory agencies in the United States and on the literature of

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[138] The Gray Report, *supra*, f.n.3, 453.

[139] The Watkins Report, *supra*, f.n.4, 395; *Eleventh Report of the Standing Committee on External Affairs and National Defence Respecting Canada-U.S. Relations* (1970).

[140] For an analysis of this goal displacement problem in organizations, see March and Simon, *supra*, f.n.47.

decision-making and bureaucracy, is the creation of a body empowered to act as an advisory agency on the long-run policy implications of foreign investment. Such a body might be called the Foreign Investment Council. Its main purposes would be directed not so much to the short-range problems which face the Review Agency, as to strategic decision-making for foreign investment analysis and industrial and commercial policy. By systematically gathering data on a continuous basis, by undertaking or delegating intensive studies of specific subject areas and by reviewing government policy in a number of separate departments, a Foreign Investment Council could act as an intelligence unit for the economy.[141]

One model for Canadian policy-making in foreign investment is Japan's experience with its Foreign Investment Council. The Japanese model is interesting not only because Japan has been successful — too successful in the eyes of some critics — at policing foreign investment, but also because it illustrates the judicious combination of administrative agility and efficient data collection and analysis.

Japanese legislation on foreign investment began with the *Foreign Exchange and Foreign Control Law* enacted in 1949 to regulate foreign transactions.[142] A year later Japan passed the *Foreign Investment Law* to screen foreign investment and "to create a sound basis for investment of foreign capital" which would allow self-sufficiency and a balanced growth of the economy.[143] This law provided for the establishment of a Foreign Investment Council, which was to be an advisory body on foreign investment to the Minister of Finance. In the first phase of its existence, the FIC rigorously screened all new foreign investment. By 1966, with the resurgence of the economy and Japan's entry into the Organization for Economic Cooperation and Development, a new phase of liberalization began.[144] In 1967 the FIC was reorganized to consist of a blue ribbon committee under the Minister of Finance, but the members were chosen entirely from the private sector. A special advisory body of recognized legal and economic experts was created to work with the Council to study particular issues and gather relevant data on foreign

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[141] Intelligence is used in the sense that the meaning and implication of data (information) is as important as the data itself. Too often data is available but not used or not understood. See Wilensky, *Organizational Intelligence* (1967).

[142] Kobayashi, "Foreign Investment In Japan" in Maule and Litvak, *Foreign Investment: The Experience of Host Countries* (1970); Kawakarni, *Foreign Investment Regulation in Japan,* Unpublished Thesis, Harvard Law School, (1969).

[143] Kobayashi, *supra,* f.n.142, 134-135.

investment. In 1967 the Council held a series of hearings on capital liberalization, and made a report to the Minister on June 2, 1967. The report outlined a general policy on foreign investment, a series of specific recommendations on phasing in liberalization over time and a list of guidelines for foreign-controlled firms in Japan. Such firms should:

(1) Seek coexistence and prosperity with Japanese enterprises through joint ventures on an equal partnership basis.
(2) Avoid concentration of investment in specific industries.
(3) Avoid suppressing small enterprises when entering into industries characterized by small firms.
(4) Cooperate voluntarily with the Japanese effort to maintain proper industrial order.
(5) Avoid entering into unduly restrictive arrangements with parent companies abroad, and not resort to unreasonable restrictions concerning transactions or to unfair competition.
(6) Take positive steps towards developing Japanese technology, and not hamper the efforts of Japanese industries to develop their own technology.
(7) Contribute to the improvement of the nation's balance of payments through exports and other means.
(8) Appoint Japanese to the board of directors and top management positions and make shares of company stock available to the public.
(9) Avoid closures of plants, mass dismissal and unnecessary confusion in employment and wage practices by paying due regard to the prevailing Japanese practices.
(10) Conform to the government economic policy.[145]

These guidelines amount to a comprehensive package of rules which apply to all foreign corporations in Japan. Obviously there are certain cultural factors which reinforce the administrative implementation of these guidelines. However, the advisory capacity of the Council and the highly effective but stringent disclosure laws on companies in Japan are features which merit a great deal of study and possible imitation for a Canadian foreign investment council. More resources for statistical analysis, as well as an improved

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[144] *Ibid.*

[145] Yoshino, "Japan As Host To The International Corporation", in Kindleberger, *supra*, f.n.14, 361.

statistical information system implemented by Statistics Canada would go a long way to closing the knowledge gap about foreign investment in Canada, if policy makers are serious about improvising the decision-making process.[146]

It might be argued that the Economic Council of Canda would be a better vehicle for foreign investment analysis. However, the record of performance of this body remains a matter of dispute, and on foreign investment its silence borders on being deafening. This is not to suggest that the Economic Council has no role to play. On the contrary, most of the issues discussed in this paper deal with economic regulation or defensive economic planning as a reaction to the behaviour of foreign firms. Much more needs to be said about aggressive strategies for growth — capital development, entrepreneurship, business and legal education, productivity and corporate structure, business-government relations, export agencies, etc. — a range of issues which are the basis of any coherent industrial strategy. The function a Foreign Investment Council can best serve is to provide a coherent annual report on the activities of foreign-controlled firms in relation to the Canadian-controlled sectors, the key structural changes, and the economic trends such changes imply. Moreover, the Council could provide a set of recommendations on a continuous basis for policy or legislative action.

In any case, it must be recognised that better tools to gather and analyse statistical information are the *sine qua non* of both the Review Agency and the Competitive Practices Tribunal. The criteria laid down for both bodies, to be meaningful in any operational sense, require a knowledge of corporate activity and industry averages, as well as of Canadian-controlled and foreign-controlled firms. That the information for this is not presently available is perhaps the greatest oversight in Bill C-132 and Bill C-256.

Conclusion

Few countries in the world have done so little about the level of foreign investment within their borders as Canada. For more than a century, government policy has consisted of little more than *ad hoc* decisions tied to the framework of the National Policy. There could hardly be a better formula to attract huge amounts of foreign investment. But as Canada moves into the last quarter of the twentieth century, the world economy and the national economic inter-

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146 This is an important assumption, especially in the Canadian context. For a general analysis, see Dror, *Public Policy Re-examined* (1965).

ests of the member states are undergoing profound changes. The old ideological labels of socialism and free enterprise, of *laissez-faire* and government ownership mean little in a world of international oligopoly, giant multinationals, and instant communications. Moreover, the economic muscle of the largest economy, that of the United States, is now challenged by the resurgent strength of Europe and Japan. Various competing "models" of economic planning, in which government takes an activist, interventionist stance, not only in the Keynsian stabilizing role but in entrepreneurial endeavours, open the way for new possibilities for the mixed economy.

This paper has reviewed the foreign investment debate in Canada, tracing its development from 1957 to the present, in light of the startling growth of the multinational enterprise. In examining the MNE, emphasis has been placed on its logic of development, its search for market superiority, and the means of maintaining market control once it is achieved. Once it is recognised that market imperfections are at the basis of MNE development, it follows that policies of social control which fail to correct or ameliorate such imperfections do not come to grips with the reality of these large corporations. It is in this context that the Review Agency must be judged. As documented in scores of books and articles, the Canadian economy is highly concentrated, but at the same time retains too many sub-optimal size plants. Government policies foster the growth and permanence of this situation by a blend of tax and tariff measures which are less than likely to bring out the maximum benefits of foreign investment. In the narrower context of the administrative and legal framework, the Review Agency, like the Competitive Practices Tribunal, must operate with a high degree of discretion and subjective evaluation. The criteria laid down by statute are vague and possibly contradictory; but to suggest that they can be otherwise is to ignore the monopolistic revolution in economic theory and the economic and social power of the MNE. The absence of the economic data needed to apply the criteria commissioned for the Review Agency makes improved disclosure laws and better techniques of economic data analysis a prerequisite of any regulatory screening mechanism. So great is the need for more data and the continuous interpretation of aggregate and sectoral changes, that the establishment of a particular body dealing with this function is proposed. A body such as a Foreign Investment Council would serve as a clearing house for continuous foreign investment analysis, including the study of federal and provincial initiatives and policies adopted in other countries; and for the assessment of existing legislation. In this way, the government would only be doing what the large MNE has done consistently well: analyzing its own performance in the light of desired and actual results.

The Review Agency is not the final word on foreign investment. In a most fundamental way, the Gray Report has exposed the need for new policies, and it now seems that a majority of Canadians agree.[147] To date, the legal community has not involved itself in the foreign investment debate, possibly because lawyers have been content to accept the familiar economic surrogate-entrepreneur model of the firm as descriptive of the MNE. Hopefully, the Gray Report and the appearance of legislation based on its proposals will stimulate active legal scholarship directed to the challenges and problems created by the MNE.

Similarly, the Report may spur the lethargy of the public policy process itself. For too long the loudest voice on foreign ownership in Canada has been the crushing silence of the politicians. Whether they will act in the future to provide the public with a real engine of policy-information and analysis is the great question. If they do, then it is perhaps possible that Canadians at last will be able to exert some influence in their own affairs.

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[147] A public opinion poll in February 1972 showed that 69 per cent of all Canadians favoured the establishment of a screening agency. Even in the Maritimes the poll found 66 per cent in favour, and only 15 per cent against. In the West, 75 per cent were in favour, and 16 per cent against. *Toronto Star*, February 16, 1972. Polls such as this one seem to indicate that when information about foreign investment is available, the public supports government policy initiatives.