The Case for Investing in Canada

By: Alan Nymark

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Prior to his present position Mr. Nymark held the positions of:

- *Assistant Deputy Minister, Industry and Science Policy Industry and Science Canada;*
- *Executive Vice-President of Investment Canada and Assistant Chief Negotiator, North American Free Trade Agreement;*
- *Assistant Chief Negotiator, Canada U.S. Free Trade Agreement, Trade Negotiations Office;*
- *Director of Policy for the Macdonald Royal Commission on the Economic Union and Development Prospects for Canada;*
- *Assistant Secretary and then Deputy Secretary to the Cabinet for Federal-Provincial Relations;*
- *Special advisor to the Royal Bank of Canada;*
- *Various positions with the Department of Finance, the International Monetary Fund and the Economic Secretariat of the Privy Council Office;*

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At first glance, the case for investing in Canada appears relatively straightforward; however, it is one of the most important issues Canada faces. As Sylvia Ostry put it, "we must learn to look at the international scene through the prism of investment, rather than trade... for mid-sized countries like Canada, international competition for investment and technology... will be the name of the international game."

At the national level, a country's investment climate determines how it will fare in the international competition for scarce capital, for technology and for management skills. The challenge, then, is to offer business investors a competitive investment climate.

The case for investing in Canada is strong: in the last decade, Canada has achieved a fundamental change to the investment climate, a change that makes Canada a clear and positive choice.

This article focuses on three points: Canada's fundamental change in economic thinking; the positive investment response that has resulted; and the North American Free Trade Agreement (NAFTA)—because the agreement represents an important element of the government's approach to investment issues. The article concludes with an assessment of the direction in which investment issues might be headed over the next few years.

Canada's Investment Climate—A Review

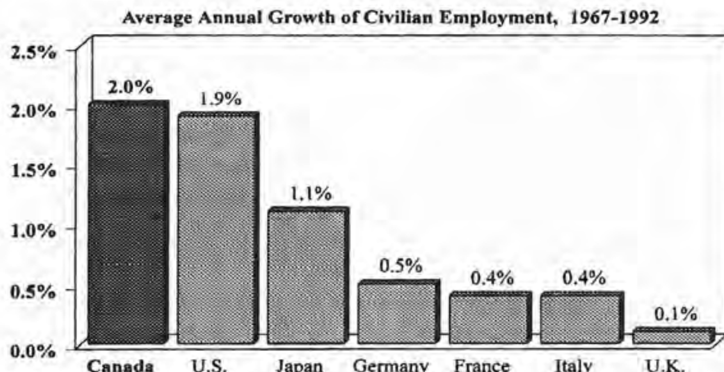
A host of factors determines investment climate: the overall economic performance of a country, taxation levels, infrastructure, proximity to markets, cost of capital, price and currency stability, skills in the labour force, the attitude and policies of the government towards investment, and, of course, other requirements specific to individual firms.

Investors contemplating direct investment make their decisions based on long-term considerations; for them, what matters is a country's long-standing performance in the areas mentioned.

Fortunately, Canada does not face the daunting human resource and structural challenges of the European Community and its Eastern neighbours. Instead, Canada has done well among the international competition. Of the G-7 countries:

- Canada has recorded the second-fastest rate of output growth over the last 30 years.
- Canada's standard of living, as measured by gross domestic product (GDP) per capita, is second only to the United States. Over recent decades, Canada's strong rate of growth has enabled us to substantially narrow the gap between Canadian and U.S. GDP per capita.
- The quality of life in Canada, as measured by the United Nations' Human Development Index, is the second highest in the world. For 1992, Canada is ranked just below Japan and significantly above all the other G-7 countries.
- Canada has had the fastest rate of job creation over the last 30 years. Although our unemployment levels are high, our ability to create jobs is beyond the reach of most countries.

Chart 1
Canada's Employment Growth in an International Context



Source: Compilations by Industry & Science Canada based on data obtained from the OECD.

Admittedly, this is only part of the story. Throughout the late 1970s and early 1980s, several elements important to the investment climate deteriorated:

- Government finances became highly expansionary and inflation soared.
- Deficits and debt rose significantly, with interest rates following suit.
- Government intervention in the economy increased (e.g., National Energy Policy, regulation of transport and communications, Crown corporations) and productivity fell.
- The tax system became overly complex, catering to a wide variety of special interests.
- Foreign investment was presumed to be contrary to national interests.

By the early 1980s, the economic situation had been critically weakened and the investment climate suffered.

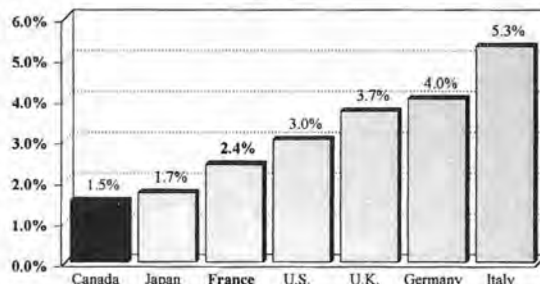
However, a significant change in Canadian economic policy over the past decade has reversed this situation. Underpinning this development has been a recognition that, to assure Canadians of an increased standard of living, it is essential to solve the lagging-productivity riddle of the 1980s and adapt to the opportunities of globalization.

Investment in capital, in people and in technology are the key. Today, attention to the investment climate and a policy framework supporting "Growth with Jobs" are the central focus of government activity.

To create an environment that favours investment, the government has moved vigorously on three fronts of its policy agenda:

- A macro-economic plan is in place and working.
- A structural agenda of micro-economic reforms is well under way.
- A dual-track trade policy agenda aimed at liberalizing and expanding markets multilaterally and regionally is paying off.

Chart 3
Consumer Price Inflation Rates in an International Context
1992



Source: Compilations by Industry & Science Canada based on data obtained from Statistics Canada and the OECD.

Restoring Macro-Economic Balance

The macro-economic framework has created a stable business environment through the pursuit of low inflation, fiscal prudence, trade policy objectives and tax reform.

Inflation

An essential element of the macro-economic plan has been to contain and to lower inflation pressures. In the 1970s and much of the 1980s, Canadian inflation pressures rose substantially, especially relative to our trading partners. Over the second half of the 1980s, Canada's domestic unit labour costs in manufacturing rose 25 percent, while U.S. domestic unit labour costs did not rise at all. This large gap greatly worsened our competitive position.

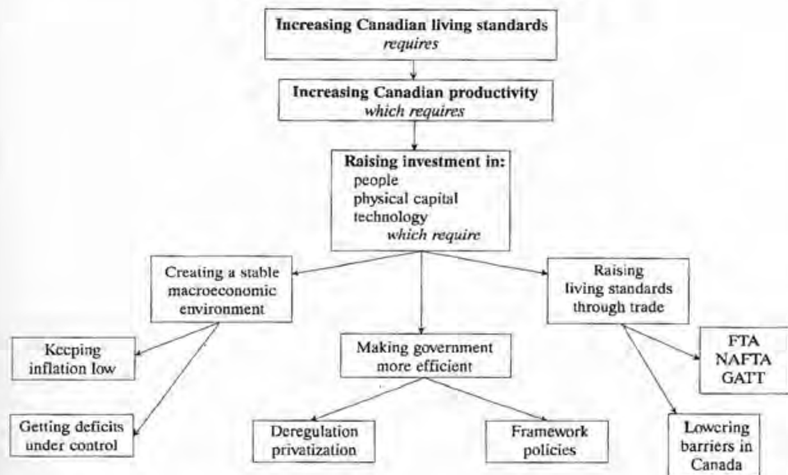
The Government and the Bank of Canada responded with firm monetary policy and tight fiscal policy aimed at containing and lowering inflation pressures. The commitment to these goals was reinforced in the 1991 budget, which established, in concert with the Bank of Canada, medium-term targets for lowering inflation. (The target bands were set at 2 to 4 percent for 1992, falling to 1.5 to 3.5 percent for 1994.)

Lower inflation reduces the real cost of capital for investments. On the other hand, a high inflation rate contributes higher costs by way of an imbedded inflation premium. The higher inflation is, the riskier investments become to lenders, who then demand a greater return. This is an important reason why Japan and Germany have had a low real cost of funds for investment—they have achieved and maintained low inflation.

The pay-off for economies with a low real cost of funds is that longer-term investments, those that would be risky if inflation expectations were uncertain, are more attractive. The benefits of such long-term, "patient" investments are again evidenced by strong research and development (R&D) spending and productivity growth in countries like Japan and Germany. A similar low real cost of funds in Canada will encourage much-needed, long-term investment and stronger productivity growth.

It has been tough to move the Canadian

Chart 2
Policies for sustainable growth



Source: Investing in Growth by Department of Finance.

economy to a regime of low inflation. But we have succeeded. We now have the third lowest inflation rate among all of the Organization for Economic Co-operation and Development (OECD) economies—a rate of less than 2 percent per year. What counts now is real opportunity in the Canadian marketplace.

Fiscal Situation

Canada's fiscal problem, and the source of today's debt burden, was a basic structural imbalance between spending on programs, and revenues. In the period from 1970 to the mid 1980's, spending on programs increased by almost 14 percent; nearly six points faster than the growth of the economy every year.

The deficit must be reduced because of the huge costs it imposes. It competes with investment for the use of the limited flow of Canadian savings, and that competition drives up real interest rates.

Canada's continuing emphasis on spending control, plus an improved and more stable revenue yield through tax reform, have resulted in a rapid and steady righting of the structural fiscal imbalance. The improvement in the operating balance has been particularly dramatic.

In the first quarter of 1985, the operating balance—the difference between revenue (minus interest expenses) and program spending—was in deficit by 3.9 percent of GDP. Since 1986, however, the operating balance has been in surplus. In the second quarter of 1993, the baalance rose to a surplus of roughly 1.2 percent of GDP. About three quarters of this improvement was due to expenditure restraint.

Rapid growth of debt charges after 1985, reflecting the increased interest rates, took up much of the fiscal gains from program-spending restraint. Despite a cumulative operating surplus of $25 billion since 1984, the national debt has more than doubled since that time to $420 billion.

Compared with our major North American competitor for investment, the U.S., Canada has made substantially more progress in reducing the deficit relative to GDP. We have moved from being in a worse position than the U.S. to being in a much better one. The job is not yet done however. All governments in Canada must be keenly aware that international interest in investment opportunities in Canada will depend very heavily on continued progress in lowering government debt.

Tax

Taxation is also a key component of the investment climate. As a percentage of GDP, taxes on corporations in Canada are at a 20-year low, having decreased from 4.4 percent in 1975 to 2 percent in 1991. Since 1970, Canadian and U.S. corporate taxes as a percentage of GDP have grown apart and then converged. In 1991, Canada moved 0.2 points below the U.S.

Among the G-7 overall, corporate taxes have converged. In the G-7 (except Japan), corporate taxation as a percent of total taxation has fallen. Most countries, including Canada, are unwilling to relinquish tax advantages to competitors.

Indeed, recent federal tax measures have been designed to encourage investment:

• The Manufacturers' Sales Tax that had been levied on some capital purchases, placing domestic manufacturers at a competitive disadvantage in export markets and against imports, was replaced by the Goods and Services Tax.

• The Capital Cost Allowance for eligible machinery and equipment was increased from 25 to 30 percent in the 1992 budget.

• The federal corporate tax rate for Canadian manufacturing was also reduced in the 1992 budget.

• A number of investment incentives, including a one-year investment tax credit for machinery and equipment purchases, were announced as part of the December Economic Statement.

Macro-Economic Outcomes—Summary

The consistent application of the macroeconomic framework has been broadly successful. Inflation is at its lowest level in 25 years. The fiscal situation has improved and, with continued effort, will continue to improve. Corporate tax rates are in line with our G-7 partners. The dimensions of the big economic picture are well known and predictable.

However, much remains to be done. Governments must be forward-looking in setting agendas. In Canada, this has led to a new focus on micro-economic issues.

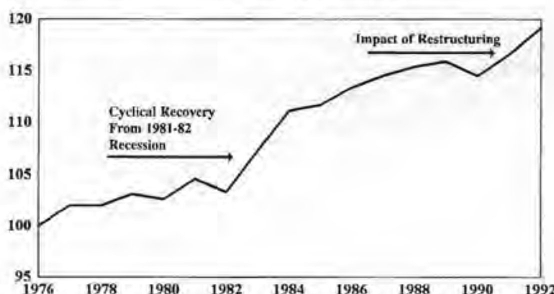


Chart 4
Real Output per Person Hour Worked (Business Sector)
Canada 1976-1992 (1976=100)

Source: Compilations by Industry & Science Canada based on data obtained from Statistics Canada.

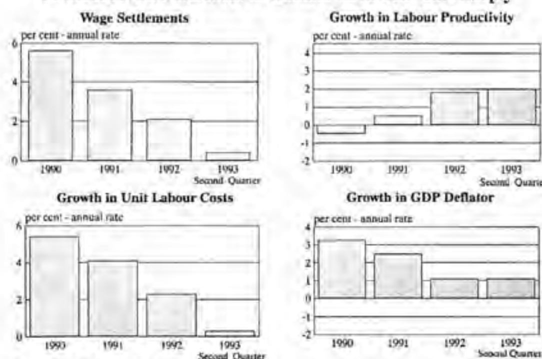


Chart 5
Production cost increases in Canada have been cut sharply

Source: Statistics Canada & Finance Canada.

Re-orienting the Structural Agenda for Micro-Economic Reform

The government has sought to open up the economy to international competition and international investment. Canada has achieved major reform of the tax system and substantial deregulation of the transportation, telecommunications, energy, and financial services sectors. Our bankruptcy and competition laws have been revised to make them more contemporary. Legislation intended to provide greater protection for intellectual property has been passed in the Senate.

The result of working at this broad micro-economic agenda has been an improvement in the investment climate.

This improvement has not been easy to achieve. Changes of such magnitude create significant transitional adjustment costs for business, labour, governments and people; and the benefits can take time to be realized. In addition, much of the agenda was introduced as the economy went into recession, which exacerbated some of the transition costs.

However, looking to the market shows that soon these improvements to the investment climate will spur strong growth and productive investment.

Currently, Canada's share of investment in GDP is at a 25-year high and surpasses the U.S.

But perhaps the best barometer of the investment climate is the ratio of machinery and equipment to GDP. That ratio has increased from a low of about 6 percent in 1980 to its current high of about 8 percent. It has passed the U.S. and approaches Germany. It has held up during the recession, indicating that the market continues to see opportunity even during this period of slow growth.

Recent evidence in the economic literature suggests that this traditional measure of investment contribution to growth may have been underestimated. The inherent embodiment of technology in machinery and equipment may well provide a more dynamic boost to the economy than was previously thought. If so, Canada's productivity performance may leap forward in the years to come.

Perhaps most importantly, Canada has made substantial productivity gains recently that leave us better positioned to compete internationally. Growth in labour productivity has risen sharply while production cost increases have fallen sharply. As a result, growth in unit labour costs is now well below what it was in 1990.

Structural Reform Outcomes

Structural reform has helped create an environment for Canada to achieve an impressive investment record. As well, significant improvements in productivity have been made. By any standard, these results are impressive, but they are only part of what must be done to attract more high-quality investment.

Improving International Trade and Investment Policy to Liberalize and Expand Markets

Canada has responded at the international level with a strong focus on trade and investment. Major steps have been taken to both liberalize and bind Canada's trade and investment regime, in line with international standards.

The Free Trade Agreement (FTA) marked the end of more than a century of debate and uncertainty over closer trade relations with the United States.

With respect to investment, the FTA and the NAFTA mark another important shift for Canada—we have moved from being a country that was quite sceptical of the benefits of foreign investment to one that, along with the U.S., represents the leading edge of commitment to international investment agreements.

Canadian attitudes and policy towards international investment can be broadly divided into three periods since World War II.

The first period, 1945–1972, saw Canada maintain a largely open system for foreign investment, in recognition of the large investment needs of the country. However, we did not bind ourselves internationally—we kept our options open.

During the second period, 1972–1984, Canadians were increasingly sceptical that the private interests of foreign-owned large corporations were in the national interest. The Watkins Report and the Gray Report led to the establishment of the Foreign Investment Review Agency (FIRA) and a number of sectoral policies and laws. Taxation measures and corporate law on such matters as Boards of Directors either restricted foreign participation or attempted to protect perceived national interests. While there were a number of developments internationally to establish the rules of the game for government actions, Canada chose not to bind itself.

The beginning of the current period was in 1985—FIRA was abolished and Investment Canada was created on the presumption that foreign investment is good for Canada. In addition, Canada moved to adhere to the OECD Codes of Liberalization of Capital Movements and of Current Invisible Operations.

In 1989, the Canada–U.S. FTA was implemented. It covered investment, but only majority-controlled investments by Canadians and Americans. However, as is the case with trade, the significance of the agreement is that there is "no going back" to the inward policies of the past. We cannot be more protectionist than we are now.

The Role of the North American Free Trade Agreement

In 1992, Canada completed negotiations with the United States and Mexico on the NAFTA.

Canada's negotiation in the NAFTA was a strategic move, more than a move based on expectations of immediate gains. One of the principal Canadian objectives in negotiating the NAFTA was to ensure that Canada remains an attractive place to invest.

This objective was accomplished by securing Canada a place in the largest trading arrangement in the world.

The NAFTA ensures that Canada and the U.S. participate in the North American market on the same terms. Had the NAFTA been negotiated without Canada, the U.S. would have been the main beneficiary, being the only country with privileged access to both Canadian and Mexican markets.

The Conference Board has suggested that Canada's share of foreign direct investment (FDI) in North America may decrease and that in 30 years Mexico may overtake Canada as the leading trading partner with the U.S. However, it is unrealistic to expect that Canada's share of foreign direct investment in North America will remain fixed. Indeed, based on the recent liberalization of the Mexican investment regime, robust investment growth into Mexico is to be expected if the structural economic reforms of the past five years continue. Thirty years is a long time in today's world and long-term predictions are risky. Who would have believed, when the FTA was implemented in 1989, that the NAFTA would be concluded so soon afterwards? Perhaps Mexico will conquer its problems with inflation, maintain growth and make the huge structural changes in its economy that will be required.

Mexico is moving from a closed economy to an open economy. That is a win–win–win opportunity for all three partners in North America under a trilateral free trade arrangement. With improvements in Mexico's economy, Canadians will benefit.

Performance under the Free Trade Agreement

In attempting to assess the NAFTA, it is worth looking at Canada's performance under the FTA.

Under the FTA, Canada's trade surplus with the U.S. has increased. Canada's exports have done best in those sectors liberalized by the FTA, particularly in non-resource-based manufacturing (e.g., telecommunications, chemical products, precision equipment). Compared with other trading partners, Canada has also increased market share in key sectors of the U.S. economy.

Looking at investment, there has been a sharp increase in foreign direct investment inflows to Canada since the FTA. During the 1980s, inflows of foreign direct investment averaged $0.7 billion. More specifically, the three years preceding the FTA produced, on average, net inflows of $3.5 billion. In 1990, inflows were at a record level of $6.8 billion and were almost $6 billion in 1991 despite weakness in the world economy. Since the FTA was introduced, there has been a $15.1 billion increase in new foreign direct investment in Canada.

During the 1980s (1980–1988), U.S. net direct investment flows to Canada were negative. Flows from the U.S. to Canada have rebounded since the FTA. It is useful to remember this performance when considering the suggestion that trade liberalization will result in the relocation of foreign subsidiaries. Rationalization is working in Canada's favour.

In addition, Canada has seen a marked diversification of sources of FDI. Although the U.S. continues to be the dominant source country, its importance has diminished considerably within the last decade. Other sources, notably the U.K., Japan and other Pacific Rim economies, increased their respective direct investment stakes. This is further evidence of Canada's ability to continue to attract foreign direct investment.

Trade and Investment Outcomes

As with the FTA, the real significance of the NAFTA is that Canada cannot retreat to the past—our future prosperity will depend heavily on Canadian business turning an agreement into profits. Indeed, the NAFTA puts Canada and the U.S. on the leading edge of international investment agreements. Whether our principal competitors are prepared to liberalize and bind themselves as we have, is open to question. Given that international investment seeks out security and stability, this will be of long-term significance for Canada.

Within North America, the NAFTA removes most internal barriers to business activity. This puts the focus directly on the economics of each country. That is why Canada has singled out the "Growth with Jobs" policy agenda that I have just described and why it is essential that we maintain a highly competitive investment climate.

Challenges Ahead

What is next? What will the future mean for investment in Canada? Canada has its economic act in order after a decade of hard work: our country will perform well.

This is not to say that there are not risks. Canada must continue to focus on, and successfully deal with, government finances, particularly at the provincial level.

The current slow growth seen in Europe and Japan, perhaps representing a long-term structural adjustment, represents a significant risk. While North America is well positioned, the world economy may inhibit growth.

And finally, there is the ever-present caveat concerning U.S. policy. Although the Administration has been relatively clear about the direction they intend to take with respect to trade matters, recent developments in Congress can be read with some concern.

Significantly, with respect to many of the difficult economic issues, Canada is well positioned vis-à-vis the United States, our principal competitor for investment. In most cases, the U.S. has not been able to proceed as quickly nor in as organized a fashion as we have. And while President Clinton has a broad strategic approach that is in many ways similar to our own, he is just beginning to implement his agenda.

Canadians now understand in greater depth the links between investment and competitiveness. They will be paying more attention not only to the adequacy of the investment climate (for example, taxes, cost of capital, fiscal coordination) but also to the placement of additional investment resources (government and business) to achieve the best return. Is the marginal dollar best invested in machinery and equipment, research and development, infrastructure or human capital? President Clinton's "investment agenda" promises to fuel the debate in Canada.

On the international front, there will be more attention on the need to clarify and expand international investment rules. Do we need a General Agreement on Tariffs and Trade for investment? Canada is well positioned to take a leading role in such discussions.

Canada is having to compete for investment against a wide range of other competitors. While we have made important strides in building a positive investment climate, our major competitors have been aggressive in developing investment strategies and related program initiatives. We need to be prepared to meet this competition.

Our micro-economic priorities must:

- re-orient technological and infrastructure investment decisions to reflect the importance of knowledge-based infrastructure;
- develop skilled human resources capable of adapting quickly and able to apply best-practice technology; and,
- implement strategies to help firms succeed in the international marketplace.

Lastly, the FTA and the NAFTA increase the need to ensure that European and Asian investors, and investors already in North America, recognize the advantages of locating their plants and manufacturing and R&D mandates in Canada. A lot of attention is currently focused on the U.S., and, to some extent, Mexico represents a novelty. Europe is still greatly turned inwards and Japan is perhaps making a generational change in its economic structure. It is one thing for Canada to have its economic act together. It is quite another to ensure that the world knows we do.

So, the investment agenda is full. But, while it will be influenced by the pressure of continuous change that is today's reality, Canada's direction is firmly established—the case for investing in Canada will continue to be strong.❐