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Foreign investment policies and capital flows in Canada: a sectoral analysis

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Abstract

This paper develops and estimates a statistical model of foreign investment flows in Canada in order to determine the degree to which Canadian foreign direct investment (FDI) policies affected these flows. Theoretical considerations suggest that host government policies directed at inward foreign investment (FDI) also influence outward direct investment (ODI), especially investment by affiliates of foreign-owned companies. Our study documents the empirical importance of this relationship with respect to specific host government initiatives. A distinguishing feature of the study is that we estimate the effects of Canadian policies at the sectoral level. Specifically, we focus on three sectors: manufacturing, finance services, and energy. We utilize time-series data over the period 1950–1995 to specify and estimate the three sector-specific models. In so doing, we are able to compare the effects of sector-specific policies with those of policies that applied to all sectors. To this end, we develop a policy framework that suggests that general policies are less likely to deter FDI flows than are sector-specific policies. We do in fact find that public policies have (to some degree) been influential in determining capital flows, but the effects are not uniform.

Keywords: Foreign direct investment; Multinational enterprises; Public policy

1. Introduction

Most countries have in place a variety of policies to regulate inflows of foreign direct investment (FDI) (Brewer, 1993). A number of empirical studies have sought to identify the impact of host government policies on overall foreign investment inflows (see, for example, Gomes-Casseres, 1990; Kudrle, 1995; Loree and Guisinger, 1995; Aswicahyono and Hal, 1995; Vachani, 1995). There is, however, a dearth of studies that compare and contrast the effects of host government policies toward foreign investment across industrial sectors. This research gap is unfortunate, since FDI policies are often sectoral in nature. Examples include ownership restrictions that many countries have imposed on "sensitive" sectors such as banking, communications, and broadcasting [The WTO allowed countries to exempt specific sectors from the relevant liberalization provisions. Similarly, the North American Free Trade Agreement (NAF TA) and the Canada–US Free Trade Agreement (FTA) resulted in a range of industrial sectors being protected from investment liberalization provisions such as "national treatment" and "right-of-establishment". In contrast, the European Union is seeking to eliminate all capital restrictions among member countries.].

Canada is a country that has experimented with a wide range of foreign investment-related policies, including sector-specific restrictions on foreign ownership and entry. Distinct policy regimes can be identified in which FDI restrictions were either tightened or loosened, both at the economy-wide and sectoral levels. The Canadian experience therefore presents an opportunity to examine the effects of a variety of policy initiatives on foreign investment flows.

The purpose of this paper is to estimate the effects of FDI policies on foreign investment flows in three Canadian sectors: manufacturing, finance and insurance, and petroleum and gas. In so doing, we are able to compare the effects of sector-specific policies with those of policies that applied to all sectors. We utilize time-series data over the period 1950–1995 to specify and estimate three sector-specific models of both capital inflows (FDI) and capital

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outflows (ODI). Although foreign investment policies are typically directed at inbound flows, these policies may create an investment climate that simultaneously either encourages or discourages firms resident in Canada to invest abroad (Brewer, 1993). While many policies are explicit in their aim of encouraging investment at home (and thus perhaps reducing investment abroad), some policies may have the unintended consequence of increasing capital outflows. These effects are typically not analyzed, and the evaluation of both within the context of a single analysis is a unique feature of this study. We examine both FDI and ODI flows and employ estimation methods that treat the two equations (FDI and ODI) as independent (ordinary least squares), as well as methods that treat them as a system (seemingly unrelated regression, SUR).

The paper proceeds as follows. Section 2 provides a brief description of Canadian government FDI policies implemented at both economy-wide and sector-specific levels, considers the theoretical impacts of FDI policies, and proposes testable hypotheses for both FDI and ODI. Section 3 identifies a regression model used to estimate the theoretical relationships outlined in the preceding section. Section 4 discusses the variables and the data sources, and Section 5 provides the estimation results. Conclusions and policy implications are presented in the last section.

2. Foreign investment policy in Canada

Canada has experimented with a range of policies directed primarily at inward FDI. We refer to these as formal foreign investment policies, in order to distinguish them from other policies that might affect FDI, but which are directed primarily at other targets. Major manifestations of formal direct investment barriers include broad legislation governing terms and conditions under which foreign-owned businesses can be established and operated, screening and monitoring of investors for purposes of approval, and legislative or regulatory restrictions on the extent of foreign ownership and control in specific sectors.

We draw a distinction between general and sector-specific policies. The former apply to all firms and industries (unless exempted), while sector-specific policies apply to designated firms or industries. Canada has relied on both types of policies [Safarian (1993) and Globerman and Shapiro (1998) provide a more detailed description of the relevant policies.]. The major policy initiatives of relevance to this study are summarized in Table 1. For the purposes of this study, we focus on two relatively narrow sectors, the financial and energy industries, and a third broader sector, manufacturing [The financial sector includes banking, trust companies, insurance companies, and securities firms. The energy sector comprises oil and gas exploration and extrac-

Table 1
Public policies toward foreign investment in Canada

Policy	Description	Time period
General policies: apply to all sectors		
FIRA	Foreign Investment Review Act. Required review of all acquisitions and new establishment of a business by foreign-controlled entities. Applied a "significant benefit" test.	1974–1985
Investment Canada	Investment Canada Act liberalized the foreign investment process by limiting the number of reviews required. Applied the more lenient "net benefit" test.	1985–present
FTA–NAFTA	US–Canada Free Trade Agreement (1989) further limited the review of direct acquisitions by US firms, Replaced by the North American Free Trade Agreement (1992), which went even further by providing national treatment to US and Mexican investors.	1989–present
Sectoral policies		
Bank Act (1967)	Foreign investment in banking is not covered by Investment Canada. Revisions to the Bank Act in 1967 restricted foreign investment by effectively preventing foreign banks from establishing branches or subsidiaries. Applied ownership limits.	1967–1980
Bank Act (1980)	Bank Act Revisions of 1980 liberalized the restrictions somewhat by allowing foreign banks to establish subsidiaries, but maintained ownership restrictions.	1980–present
Little bang	Deregulation of Canadian securities markets, relaxed regulation of foreign entry into Canadian securities market. By 1988 all entries were effectively allowed.	1987–present
NEP	National Energy Program, limited market shares of foreign firms in the primary oil and gas industries and imposed ownership limits.	1980–1985
Energy liberalization	Easing of restrictions on foreign acquisitions in the energy sector. Oil and gas to be treated like other sectors under Investment Canada Act.	1992–1995
Autopact	Canada–US Automobile Pact of 1965 liberalized trade and investment in automobiles and parts. Obliged US car makers to increase capacity with Canadian sales. Challenged successfully under WTO by Japanese and European producers, 1999.	1965–present