

Capital Movement, Foreign Ownership and Dependence on "Foreign Investment" in Canada and British Columbia

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Foreign investment in Canada is likely to be a major economic and political issue in this decade. It is natural, in a period of rising national consciousness, that Canadians should question the role of foreign capital in their economy.

It is probably true that most Canadians would agree that they would feel better off if their dependence upon foreign capital could be reduced and, at the same time, their growth and their standard of living could be sustained. Put another way, capital self-sufficiency is a good thing for all kinds of reasons, and we should achieve it if it does not cost us anything.

Economists have no special competency in assessing the strength of public opinion in these matters, but they can contribute to an understanding of the costs associated with policies aimed at reducing foreign ownership and control of capital resident in Canada.

Such policies already exist in the fields of communications and banking. Moreover, Ottawa has taken *ad hoc* measures in instances of foreign takeover in petroleum and mining. What price will Canadians pay if restrictive policies spread to other areas of economic activity? There is already a special withholding tax on the earnings of foreign capital. How would extensions of this tax with respect to coverage, and increases in its rate, affect our economic development? Specifically, how would reduction of foreign investment impinge on the economy of British Columbia?

Melvin Watkins, leader of the Waffle wing of the NDP, has asserted that capital independence (autarchy) would be virtually costless. The prevailing view on Bay Street seems to have it that even minor restrictions on international capital flows would trigger an economic disaster. Neither of these extreme views are likely to be correct. My task, along with John Helliwell and Jillian Broadbent in the next paper, is to lend quantitative substance to the debate. This is but a probing first attempt and much more work needs to be done. Nevertheless, I can predict with some confidence that even strong measures to restrict capital flows into Canada

would retard our material development by something like two years, once short run adjustments are made. The consequences for British Columbia would be of a similar magnitude but, as I shall suggest later, the pattern of development in British Columbia would be very much affected.

International capital flows take diverse forms, but usually we can identify a particular transaction as a *direct* investment (for example investing in a wholly owned subsidiary or buying out an established firm) or as a *portfolio* investment (for example, buying a B.C. Hydro bond or a Canadian common stock without intention of obtaining control of the company). In either case, the foreign investor is employing his saving to finance capital formation in Canada. In return, he expects a stream of profits (dividends plus capital gains), or a stream of coupons in the case of a bond, which is at least equal to what he could have had, if he had made a comparable investment at home.

What circumstances in Canada generate these investment opportunities for foreigners? To begin with, I note that the Canadian financial markets are quite small relative to capital markets abroad, and well integrated with them. This means that Canadian interest rates and capital costs, at least in the long run, are largely determined abroad. As the Canadian economy grows (due to labour force growth, improvements in its quality, resource discoveries and technological improvement), a stream of investment opportunities is created in Canada which is competitive with investment opportunities abroad.

Put against this stream of potential investments, is the flow of Canadian saving from households and businesses. If our own saving is insufficient to capture the investment opportunities created in Canada, then foreigners will snap them up. Foreigners close what might be called an "investment gap." If they did not, interest rates and capital costs would rise in Canada relative to the rest of the world. But that event is at present precluded by the close integration of our capital markets with those abroad.

Canada has had an investment gap and has been a net capital importer in the post-war period. If we accept my concept of the matter, we can attribute capital inflows to a high growth rate of potential investment in Canada relative to our saving. The high growth rate in turn, has been due to relatively high rates of population growth, improvements in the quality of our labour, resource discoveries, and technical up-grading of our productive processes.

You will note that I have not spoken in terms of relative interest rates, inflation rates, exchange rates, government development policies, international corporations, filling up empty lands, and the like. These con-

siderations are common in discussions of foreign investment. I do not stress them because they seem to me relatively minor in assessing the long term consequences of restricting capital inflows. I turn to those now.

I cannot predict the particular measures that Canada will undertake in the future to limit foreign ownership. No doubt a mix of policies will develop, combining:

- 1) Extensions of the "protected industries" concepts beyond communications and banking. Measures may be devised to prohibit foreign participation entirely or to proscribe its role in various ways: "Canadian content" rules for boards of directors within firms, per cent of investment within the industry, and the like.
- 2) An expanded role for the Canadian Development Corporation, insuring Canadian ownership and/or control in "sensitive" areas of economic activity.
- 3) The use of a "screening committee" to rule out certain foreign investments.
- 4) *Ad hoc* responses to political pressures.
- 5) Measures to keep Canadian capital at home.
- 6) Extending the scope of the withholding tax on foreign earnings to include all foreign earnings, repatriated or not.

In the following article, Helliwell and Broadbent investigate the quantitative impact of an enlarged withholding tax. We focus on this policy not because we believe that other restrictive measures will not be important, but because their effects are far more difficult to predict. However, higher withholding tax rates, can be translated into a proportional reduction of foreign ownership. There is thus a rough correspondence between a reduction via the tax and a similar reduction achieved by other measures. The chief difference is that the tax yields revenues while other measures, on the whole, do not.

An increase in a comprehensive withholding tax rate on foreign ownership reduces the after-tax rate of return to foreigners on Canadian investments, making these investments less attractive in comparison with those elsewhere.

An investment gap, formally being closed by foreign investment, would open up and interest rates would begin to rise as the flow of new securities fails to find buyers in our financial markets at their original prices. As the cost of capital rises, some investment projects which would have been profitable are cancelled and new ones which would have been planned

are just not considered. Meanwhile, the labour force continues to grow and unemployment begins to rise. Clearly, restoring acceptable employment levels requires lower wages, but the adjustment period could be severe and protracted. However, as wages fall, firms find new ways to use more men and less capital. This effect will be most pronounced as engineers find ways to economize on the capital requirements of new investment projects while expanding labour requirements to take advantage of the cheaper labour. Adjustments will also occur as capital-intensive industries contract relative to labour-intensive industries which are relatively little affected by the higher capital costs.

Once all these adjustments have been made, a situation will have emerged where:

- 1) Interest rates and capital costs are higher, with capital costs (per dollar's worth of output) higher than it would have been if the tax rate had not been increased.
- 2) Canadians will be producing relatively more goods and services which are labour-intensive (shoeshines, manufactures) than goods which are capital-intensive (petroleum, minerals, hydro power).
- 3) Wages and labour productivity are lower than they would have been.
- 4) With labour productivity lower, per capita product is less than it would have been (assuming no change in the labour force participation rate).
- 5) Set against this fall in per capita product, Canadians will keep at home a higher proportion of the product they produce. This occurs because proportionately less of it must be exported to foreigners in the form of interest and dividend payments.
- 6) With less foreign participation in the Canadian economy, technological improvements originating abroad may not be transmitted as quickly into the Canadian economy.

These are permanent effects — they will be felt long after short run problems, mainly higher unemployment, have been solved. The short run problem will be of smaller consequence, however, if the tax rate is raised gradually over time.

The higher the tax rate on foreign earnings, the more foreign investment will be discouraged. In the following article, John Helliwell and Jillian Broadbent calculate that an incremental tax rate of 28.4% on foreign earnings would be sufficient to drive out *all* foreign capital. As a

consequence, Canadian gross domestic *product* (product produced in Canada) would fall by 16.5%. However gross national *income* (income received by Canadians) would fall by only 3% since debt service to foreigners would also have been eliminated.

This 3% setback in Canadian development is a "once-and-for-all" effect, calculated on the assumption that full employment is maintained as foreign capital pulls out. It corresponds to about seven months' worth of healthy economic growth. But how might our "on-going" rate of growth be affected?

The growth of per capita incomes over long periods of time can be attributed to improvements in technology which permit higher output levels for given inputs of labour, capital, and natural resources. Would not lower levels of foreign participation in the Canadian economy deny us the benefits of technological improvements made abroad and transmitted to Canada by international corporations in particular, and direct foreign investment in general? This argument has merit, but I tend to discount it. The alternatives are many. We could copy advanced technology being developed abroad, along lines suggested by the Japanese model. Failing that, we could pay for it through licence arrangements, patent leasing, and by importing capital goods which embody the new techniques. Moreover, we could, with some cost to ourselves, step up our own research and development efforts. Taking all this together, it is hard to imagine that the policy would shift us more than a year or so further behind "best-practice" world technology.

Consequently, a tax policy, which totally eliminates foreign capital, might cost something like two years' economic development. Recall, however, that full employment of labour has been assumed throughout the adjustment process. Thus, there would be additional costs associated with the policy if it is implemented abruptly. Indeed, even gradual implementation, coupled with the wisest of employment policies, could not totally avert unemployment effects as foreign capital departs. To estimate these effects is beyond the scope of this study.

British Columbia would be affected as interest rates rise across Canada. Some industries would be harder hit than others, namely, those which have relatively high capital requirements. Capital requirements are greatest in electric power, finance and mining, in that order. Surprisingly, forestry is sixth on a list of ten. It follows that some regions would feel greater impacts than others, namely those that have a more capital intensive mix of industries. Regions which rely on manufacturing, for

example, would fare better than those which rely on mineral extraction and processing.

There is no question that high interest rates and capital scarcity would have a disproportionate impact on the development of British Columbia's industries.

Development here has come to mean more electrical power, new mines and mineral processing plants. These activities are particularly capital intensive and they would be hard hit by higher capital costs.

The impact of capital scarcity on electrical generation would be significant. Although thermal plants and even gas turbines could be substituted for new hydroelectric dams, or atomic thermal stations, their capital requirements are still relatively high. For similar reasons, the mining industry would be particularly hard hit, even though less capital intensive methods could be adopted.

In addition to these specific industry effects, we would observe across all industries in B.C. a transfer abroad of the more capital intensive processes. The incentives would be great, for example, to locate highly automated pulp or smelter operations in nearby Washington State.

Irving Brecher and Simon Reisman have expressed a popular view in assessing Canada's economic prospects:

From the search by foreign investors for profit Canada has received a supply of capital, entrepreneurial skills, technological know-how and markets which — for magnitude, quality, and stimulus to domestic growth — has probably never been surpassed anywhere in the world. There can be no doubt that without this capital inflow Canada's industrial development and living standards could not have approached their present levels.¹

Nothing I have said contradicts Brecher and Reisman. I have tried to give us some rough idea of the magnitudes involved.

But whatever the magnitudes, it is useful to observe that an appropriate population policy at the national level could go a long way toward offsetting per capita income effects of foreign investment policies. Roughly, a rise of the Canadian interest rate by one percentage point can be offset by a fall in our population growth rate by one percentage point, leaving our per capita incomes unchanged.

Population growth has two dimensions: natural increase and immigration. Natural increase seems to have a life of its own, so to speak, but an immigration policy, reducing the flow of migrants, could be effected with relative ease. Indeed, it might be effected "automatically" if the immigra-

¹ Brecher, Irving and Reisman, S.S., "Canada — United States Economic Relations," Royal Commission on Canada's Economic Prospects, Ottawa, 1957, 158-159.

tion flow subsides as jobs become more scarce and per capita incomes fall. One could go so far as to argue that, over the long term, the Canadian population will adjust, by immigration and emigration, so that per capita incomes here will, in turn, adjust to incomes abroad. In short, a reduction in foreign investment would automatically give rise to a corresponding reduction in population, leaving our population lower, but our standard of living intact.

These considerations focus on a national and provincial policy dilemma. We cannot reduce capital inflows and maintain population and income growth all at the same time.

The "no free lunch" principle in economics holds once again.

It is not clear to me what a population policy can mean from a provincial point of view. A province cannot erect migration barriers. Nor can it efficiently discourage migrants. It can do so inefficiently by failing to fund the education system (including universities) by failing to build roads, hospitals, and the like, and by a failure to fund adequately the municipalities. Moreover, it can encourage industries which have relatively low labour requirements. But these measures would have the effect of reducing the standard of living for those already in the province, as well as discouraging new migrants. These are hardly desirable policies.

But provincial pressures can bear on the formation of a national policy. I can hope that provincial desires for population growth, where they exist, would not stay Ottawa from an appropriate immigration policy.