CHANGES IN THE UNITED STATES FOREIGN DIRECT INVESTMENT POSITION UNDER THE FREE TRADE AGREEMENT IN CANADA

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ABSTRACT The patterns of global foreign direct investment (FDI) have changed dramatically in recent years. The most obvious evidence is the reversal in the status of the United States from net outward direct investor to net host country for foreign direct investment. During the last decade the research agenda has reflected concern associated with the effects of FDI in the United States and less so with United States overseas investments. Recently some have argued that with liberalized trade there will be an expansion of investments as modern multinational firms compete on economies of scope whereby customized products for national markets and flexible manufacturing combine production efficiency with marketing intelligence based upon after sales service. Others state that United States subsidiaries in Canada will not close due to the effects of the Free Trade Agreement; however, there may be a slow down in the rate of increased direct investment. Using data from *Investment Canada* and *Statistics Canada*, this paper models recent changes in Canadian-based, United States controlled, investments, equaling nearly 80 percent of the Canadian total . Holding constant certain economic factors, the trends prior to the implementation of the Free Trade Agreement are compared to those, in the limited window, since January 1, 1989.

This preliminary study provides a comparison of the investment behavior of Canadian-based foreign firms with investors from the United States and overseas. There has been little comparative information produced about the investment patterns of these firms and they are vitally important because of the large number of Canadian-based foreign owned firms currently operating in Canada. A little more than 40% of foreign direct investment in Canada is now made through these firms.

After reviewing the investment climate, the investment patterns occurring in Canada are examined. The expectation is that foreign-owned firms currently housed in Canada do not tend to concentrate on core economic regions following the leader in an oligopolistic tendency as other foreign investors do. These firms have greater access to information, and knowledge in general, about Canada and therefore should have a more dispersed locational pattern.

The literature on international investment provides considerable evidence that foreign investors perceive space differently than domestic investors. They concentrate on regions where access to markets is maximized, specialized services are available and linkages are easier to establish. By adopting a follow the industry leader strategy, foreign investors are able to reduce their search costs and minimize risks associated with the establishment of foreign facilities.

The investment position in Canada indicates that the economy is a productive and economically sound one, producing a stable environment for firms rationalizing their activities. For example, the Canadian federal budget contained new incentives for corporate growth and investment. The nation is able to offer potential investors a low rate of inflation (1.6%), a low cost of capital, and an economy projected by *Investment Canada* to have the largest growth rate among G-7 countries in 1992 and 1993. Taxation is one of the major factors in determining the level and location of investment. The above actions, when combined with earlier tax reforms, make the Canadian investment position attractive to direct investors.

Before the changes in the budget, a Canadian company faced a four point differential in tax rate vis-a-vis the United States. When the budget measures are fully phased in, the average tax rate on income earned would decline to 5 percentage points, making the rate lower than in the United States. Firms will now have an increased incentive to allocate more of their investment funds in Canada. When marginal effective tax rates are compared, the changes will lower the MTR on an investment in machinery and equipment in Canada by 2.8 percentage points, making it about one point lower than the rate on comparable new investment in the United States.

Finally, talks continue towards the elimination of interprovincial trade barriers. The trade ministers adopted a list of principles on May 2, 1992 that calls on provinces to treat people, goods, services, and capital equally, regardless of provincial origin.

UNITED STATES FDI POSITION IN CANADA

FOREIGN DIRECT INVESTMENT

The value of inward foreign direct investment has continued to grow as has the Canadian direct investment abroad. The Canadian economy is dominated by the strong Toronto core and by Ontario in general. More than half the Canadian firms acquired between 1962 and 1985 according to one source were headquartered in Toronto. In comparison, that city was home only to one quarter of the firms targeted by domestic acquirerers.

In order to compare Canadian-based, foreign-controlled firms investment patterns with those from the United States and overseas, the record of notifications and applications by foreign investors was obtained from *Investment Canada*. (the governmental agency which replaced the Foreign Investment Review Agency in the third quarter of 1985). From the inception of Investment Canada to the end of the second quarter in 1989, there were 3,862 recorded foreign investments. The temporal pattern by location of investor is shown below (Figure 1).

The majority of the investments (43 percent) were initiated by foreign controlled firms already operating in Canada, followed by U.S. based investors (41 percent), and those based overseas (Figure 2). There was a slight decline in the total number of investment over the period. Levels of investments by Canadian-based foreign-firms and U.S. firms were quite variable, but the number of investments from overseas firms varied slightly around a mean of 50 per quarter. Further over this time period the total inflow of foreign direct investment was approximately $68.6 billion. About 96 percent of which was in the form of acquisitions and only 4 percent occurring in the form of new business formation.

ANALYSIS

The majority of new foreign direct investment was undertaken by foreign controlled firms operating in Canada. The number of Canadian-based, foreign investments was closely matched by investments from the United States; together accounting for 84 percent of the total. The locational choices reveal some interesting patterns. There is a strong attraction to Toronto and Ontario as a whole. The strength of this attraction varies considerably according to investor location.

Canadian-based foreign firms make only one quarter of their investments in Toronto, a level consistent with domestic investment behavior (Figure 3). Other major investing countries target well over 40 percent of their investments in Toronto. Finally, the influence of relative spatial proximity is evident in the levels of investment by the Japanese and Hong Kong investors in Vancouver. The more diffuse nature of foreign-controlled Canadian investment is evident in the concentration of investment in the three most frequently targeted cities which is 29 percent for the Canadian-based, foreign investor; almost 7 percent below that of the U.S. investors and almost 10 percent below that of other investing nations. The total number of locations targeted also reveals a more diffuse pattern of Foreign-controlled, Canada based investment. They targeted twice as many centers as did overseas investors and 40 percent more than U.S. investors.

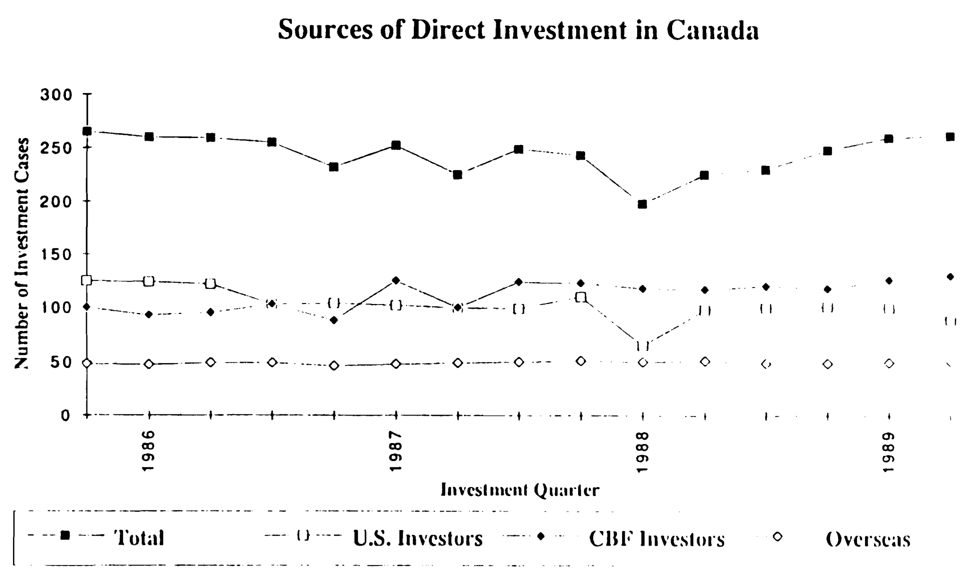

Figure 1. Temporal pattern of investment source by the number of individual cases (Source: Statistics Canada).

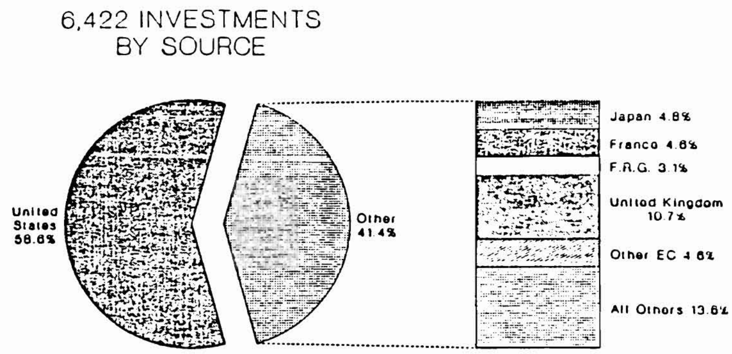

Figure 2. Almost 60 percent of international investments orginated in the U.S.A. (Source: Investment Canada, 1985-1992).

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Origins and Target Locations of Foreign Direct Investment Cases 1985–1989

Location of investor	Percentage of cases by row										
	To.	Ont.	Mon.	Que.	Cal.	Prai.	Van.	BC	Mar.	Oth.	Cases
Canada-cbfs	25.1	25.6	5.9	8.4	8.0	8.1	7.4	7.5	2.4	1.6	1657
US	41.6	27.7	4.3	4.7	5.5	4.6	3.7	4.7	1.6	1.7	1588
UK	45.2	25.3	3.8	2.7	4.8	4.3	5.9	3.8	1.6	2.7	186
France	16.4	8.2	32.9	35.6	1.4	2.7	0.0	2.7	0.0	0.0	73
Japan	25.4	25.4	0.0	1.7	0.0	1.7	28.8	10.2	5.1	1.7	59
Germany	42.4	24.2	6.1	6.1	9.1	6.1	3.0	3.0	0.0	0.0	33
Netherlands	48.5	15.2	0.0	15.2	6.1	3.0	0.0	3.0	3.0	6.1	33
Switzerland	40.6	28.1	18.8	9.4	3.1	0.0	0.0	0.0	0.0	0.0	32
Hong Kong	37.5	16.7	4.2	4.2	4.2	0.0	25.0	8.3	0.0	0.0	24
Australia	52.2	17.4	0.0	4.3	0.0	0.0	4.3	13.0	8.7	0.0	23
Others[1]	34.3	22.1	7.1	7.1	5.2	2.6	8.4	4.5	4.5	3.9	154
Cases	1304	997	217	268	244	225	230	228	81	68	3862

Figure 3. Location of foreign direct investments, 1985-1989 (source: Investment Canada).

Examination of the four digit SIC classification for targeted products and services revealed further differences between the three groups of investors. Canadian-based foreign firms made almost 5 percent of their investments in crude petroleum and natural gas and an additional 2 percent in the wholesale side of the petroleum industry. The next largest four digit SIC were operators of non-residential buildings (4 percent) and electronic machinery (2 percent). U.S. based investors targeted 5 percent of their investments in computer and related services, 4 percent in electronic machinery, and 3 percent in professional machinery (Figure 4). This compares with only 2 percent in oil and natural gas and less than one half of a percent in operators of non-residential buildings. Investors located overseas most frequently targeted construction and mining machinery (5 percent) and hardware wholesaling (4 percent).

The choice of investor mode as to the form (acquisition or greenfield) and the size of the investment indicate some interesting trends. On average, there were only half as many new businesses as acquisitions and one fifth as many applications as notifications (Figure 5). The most interesting finding is that foreign-controlled Canadian-based firms made relatively few investments in the form of new businesses, while 60 percent of U.S. investments were greenfield operations. France and Japan also made more greenfield investments than acquisitions.

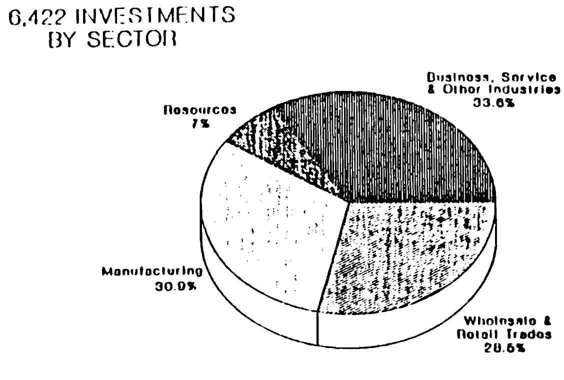

Figure 4. Target sectors of international investments (Source: Investment Canada).

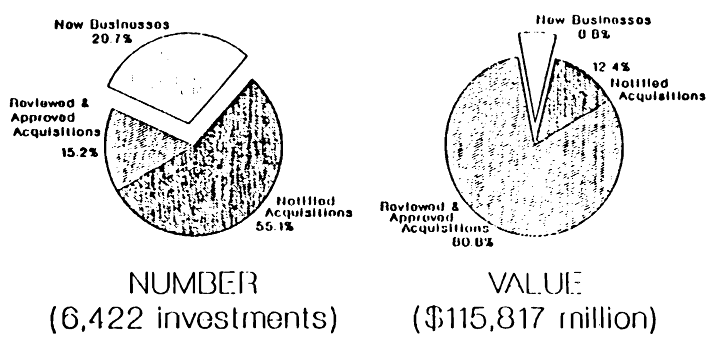

Figure 5. Value and number of acquisitions from June 1985 - June 1992. Sixty percent of international investments are in manufacturing and trade (Source: Investment Canada).

CONCLUSION

The preliminary analysis presented in this research suggests that Canadian-based foreign firms are more spatially diffuse, having a high likelihood of occurrence outside of the Toronto and Ontario regions. U.S. investments are by comparison highly concentrated in the Toronto region. Secondly, the Canadian-based foreign firms appear to be targeted less frequently at the manufacturing sector in comparison with investments made by U.S. firms. Finally, foreign firms based in Canada are more likely to make acquisitions when compared to their U.S. and overseas counterparts.

The next phase of this research will explore the effects that the Canadian-United States Free Trade Agreement has in the number of plant openings and closings and general locational shifts in investment decisions. Potential trends in the FTA will be compared with the established European Economic Community and the possible effects of an integrated North American Free Trade Area will be proposed.