State Capitalism: Do We Need Controls?

By Debra P. Steger*

In December 2007, Industry Minister Jim Prentice introduced new guidelines under the Investment Canada Act for the review of foreign state-owned enterprises (SOEs) investing in Canada. The guidelines were the result of a commitment by the federal government in its economic plan, “Advantage Canada,” to address the concern that some investments by SOEs in Canada may not be to the benefit of Canadians. Ottawa’s main worry was that some companies controlled by foreign governments may have “unclear corporate governance and reporting” and may not operate with “commercial” objectives.

In February, Australia followed Canada’s lead with a new review procedure for investments by foreign governments and their agencies, including SOEs and sovereign wealth funds (SWFs).1 While stipulating that proposed investments by governments will be scrutinized on a case-by-case basis in the same way as private sector investments, the Australian Government announced six new principles that will guide consideration of foreign investment by government entities.

The moves by Canada and Australia are part of a growing reaction to the rapid rise in investments made around the globe by SWFs and SOEs. G7 Ministers recently called on the International Monetary Fund (IMF), the World Bank and the Organization for Economic Cooperation and Development (OECD) to develop a code of conduct for SWFs.2 The IMF is now working with SWFs in Norway, Singapore and Abu Dhabi to develop a code of conduct that is expected to be ready by the fall.3 The European Commission has introduced proposals aimed at developing, together with the SWFs, a voluntary code that would set basic standards of governance and transparency for these funds.4 And the US government recently announced new principles for major investments in Citigroup by SWFs from Singapore and Abu Dhabi, requiring that they make investment decisions strictly for commercial reasons, not political ones; provide transparency as a goal; provide strong governance structures and internal control of funds; ensure fair competition between SWFs and the private sector; and respect host-country rules and regulatory requirements.

* Debra Steger is Professor in the Faculty of Law at the University of Ottawa, where she teaches in the field of international trade, international dispute settlement and governance of international institutions. She is also the founder and Director of the EDGE Network on the emerging economies. Ms. Steger holds an LL.M. from the University of Michigan Law School, an LL.B. from the University of Victoria Faculty of Law, and a B.A. (First Class Honours) in History from the University of British Columbia. A senior negotiator for Canada during the Uruguay Round trade negotiations which led to the establishment of the World Trade Organization and its dispute settlement system, she also served as the first Director of the Appellate Body Secretariat of the WTO in Geneva.
The recent action taken by the Government of Canada is part of a major review of domestic competition and investment policies. An independent Competition Review Panel has been tasked with making recommendations on ways to enhance Canadian competitiveness and productivity. Ottawa has pre-empted the Panel with its announcement on foreign SOE investment in Canada, and is expected to issue new rules that address national security concerns governing foreign investment. On April 10, however, the Minister of Industry pre-empted the release of these new rules by announcing his decision to summarily block the proposed acquisition of Canadian icon MacDonald, Dettwiler and Associates Ltd. by Alliant Techsystems, Inc. of Edina, Minnesota.

Part of the motivation for the government’s statements on SOEs and national security appears to be the rise in influence of foreign government investments through SOEs and SWFs around the world. Canada is already seen as one of the least open developed countries for foreign capital because of our existing array of restrictions on foreign investment. The announcement of additional guidelines for SOEs could have a dampening effect on foreign investment, particularly by investors from emerging economies. This sends the wrong signal at a time when Canada needs injections of capital to carry out the structural reforms required to ensure that it remains competitive in the face of the major changes taking place in the global economy.

There are two paths the Canadian government can take in dealing with investment by foreign government-controlled entities. The first is to resist discriminating against investment on the basis of government ownership and to be a leader in the international movement toward the development of a code of conduct for SWFs and SOEs. The second is to take unilateral action against SOEs and SWFs under our own investment review regime, which could open the government to domestic protectionist pressures.

The Competition Review provides a unique opportunity for the government to take a critical look at the existing Investment Canada Act regime. The primary goals should be to open up Canada to foreign investment and make the review process more transparent, accountable, proportional and fair to investors, regardless of their origin or ownership.

Sovereign Wealth Funds: A Cause for Concern?

Sovereign wealth funds (SWFs) have attracted much attention recently from politicians, academics and the media. They have become a hot topic in the US presidential campaign, at the World Economic Forum in Davos, and among finance ministers and central bank governors.

SWFs are not new — they have been around since the 1950s, but are increasing rapidly in size and influence. One estimate puts their combined assets at US$1.9-2.2 trillion. They are projected to grow to US$7.9 trillion by 2011 and US$13.4 trillion by 2018. The IMF estimates that foreign assets held by sovereign governments presently include US$5.6 trillion of international reserves and between US$1.9-2.9 trillion in SWF-type arrangements. While significant, total assets held by the funds “amount to about 10 times less than the assets under management of mature market institutional investors (US$53 trillion) and modestly higher than those managed by hedge funds (US$1-1.5 trillion).”

There are a number of reasons for the surge in these funds. Some have been boosted by the boom in the price of petroleum, natural gas and other...
commodities – 14 of the 20 largest funds derive their income from commodities. Another key reason has been the tremendous growth in foreign exchange reserves, especially in the emerging economies in Asia and in the Middle East – total global foreign exchange reserves amount to US$5.75 trillion (Asia accounts for US$3.66 trillion) and are increasing rapidly. A recent study by Standard Chartered Bank projects that SWFs will continue to grow at a faster pace than the increase in foreign exchange reserves, because they are likely to make significant gains on their investments.  

There are many different types of SWFs. The OECD defines them as “government-owned investment vehicles that are funded by foreign exchange assets.” The common denominator is that they are government-owned funds or companies which invest in other countries. There are four main types: stabilization funds which are used primarily by commodity exporters (such as Russia and Saudi Arabia) to balance fluctuating revenue flows and insulate the economy; sovereign wealth funds which invest in bonds, equities and alternatives, but generally avoid management involvement (such as Norway’s Government Pension Fund and the Government of Singapore’s Investment Corporation); sovereign private equity funds or government investment companies which are aggressive investment vehicles that take on management stakes, rely on leverage and target high returns (such as Singapore’s Temasek, Qatar’s Investment Authority, Dubai’s Istithmar, Dubai International Capital and Dubai Group, and Abu Dhabi’s Mudabala); and state-owned enterprises which engage in foreign acquisitions (such as Abu Dhabi’s National Energy Company TAQA, the China National Offshore Oil Corporation CNOOC, Russia’s Lukoil, and Dubai World).

It is estimated that there are over 30 SWFs, with the top 20 managing well over US$2 trillion in assets. Within that group, there is a “Super Seven” that each manages over $100 billion in assets: Abu Dhabi, Singapore-GIC, Norway, Kuwait, China, Singapore-Temasek, and Russia. India and Japan have both signaled that they are thinking of establishing similar funds to manage their reserves. China established its China Investment Corporation in September last year to manage US$200 billion, one-seventh of its foreign exchange reserves. As these funds continue to expand in size and influence, political reaction in the developed world, particularly in the US, Europe, Australia and Canada, is growing. Not all funds are alike. Some are models of transparency – among them: Norway, Alaska, Singapore’s Temasek and Alberta’s Heritage Fund. Others, including UAE, Kuwait, China, Qatar, Brunei, Venezuela, Taiwan and Oman, appear to be very secretive.

SWFs represent only a very small share of global financial markets. Managed wisely, they can contribute significantly to stability in the international financial system. SWFs are playing an important and positive role in the current sub-prime mortgage crisis by providing long-term capital to major financial institutions adversely affected by the crisis. However, SWFs also raise some major concerns. The first is their sheer size and rapid growth. A second is the lack of transparency in some SWFs. And a third is the fear that governments may use some of these funds to invest for strategic reasons in key sectors of other countries. The evidence so far, however, is that SWFs are driven principally by investment objectives rather than by political and strategic calculations.

Dr. Gerard Lyons, Chief Economist at Standard Chartered Bank, warns that “[a] protectionist backlash against strategic investments is very real and threatens global trade.” He observes that the rise of SWFs derives from the transformation of the world economy. To prevent a major confrontation between developed country governments and emerging economies on this issue, he recommends that developed countries take the opportunity to work together with China, Russia and other emerging economies to develop common ground rules for the operation of SWFs.
Table 1: The Largest Sovereign Wealth Funds

<table>
<thead>
<tr>
<th>Fund Name and Year Established</th>
<th>Country</th>
<th>Estimated Assets $US B *</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abu Dhabi Investment Authority (1976)</td>
<td>United Arab Emirates</td>
<td>875</td>
</tr>
<tr>
<td>Various Saudi Arabian Funds (na)</td>
<td>Saudi Arabia</td>
<td>300</td>
</tr>
<tr>
<td>Reserve Fund for Future Generations (1953)</td>
<td>Kuwait</td>
<td>250</td>
</tr>
<tr>
<td>Temasek Holdings (1974)</td>
<td>Singapore</td>
<td>159.2</td>
</tr>
<tr>
<td>Oil Reserve Fund (2005)</td>
<td>Libya</td>
<td>50</td>
</tr>
<tr>
<td>Qatar Investment Authority (2005)</td>
<td>Qatar</td>
<td>50</td>
</tr>
<tr>
<td>Fond de régulation des recettes (2000)</td>
<td>Algeria</td>
<td>42.6</td>
</tr>
<tr>
<td>Alaska Permanent Fund Corporation (1976)</td>
<td>United States</td>
<td>38</td>
</tr>
<tr>
<td>Brunei Investment Authority (1983)</td>
<td>Brunei</td>
<td>30</td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td>171.4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>2998.2</strong></td>
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</tbody>
</table>

* As estimated by Morgan Stanley and the Peterson Institute for International Economics
Recent SWF Investments in Global Financial Institutions

<table>
<thead>
<tr>
<th>Date</th>
<th>Sovereign Wealth Fund</th>
<th>Target Financial Institution</th>
<th>Approx. Amount US$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan 2008</td>
<td>Government of Singapore Investment Corporation</td>
<td>Citigroup (US)</td>
<td>$6.88B*</td>
</tr>
<tr>
<td>Jan 2008</td>
<td>Korean Investment Corp, Kuwait Investment Authority &amp; Mizuho Corporate Bank**</td>
<td>Merrill Lynch (US)</td>
<td>$6.6B</td>
</tr>
<tr>
<td>Dec 2007</td>
<td>China Investment Corporation</td>
<td>Morgan Stanley (US)</td>
<td>$5B</td>
</tr>
<tr>
<td>Dec 2007</td>
<td>Government of Singapore Investment Corporation</td>
<td>UBS AG (SWITZ)</td>
<td>$9.8B</td>
</tr>
<tr>
<td>Dec 2007</td>
<td>Temasek Holdings</td>
<td>Merrill Lynch (US)</td>
<td>$4.4B</td>
</tr>
<tr>
<td>Nov 2007</td>
<td>Abu Dhabi Investment Authority</td>
<td>Citigroup (US)</td>
<td>$7.5B</td>
</tr>
</tbody>
</table>

*part of US$12.5B from Kuwaiti Investment Authority, Saudi Prince Alwaleed bin Talal, and others  
**Mizuho Corporate Bank is a Japanese investment bank and does not have state ownership

Canada’s Lagging Investment Record

There has been much debate in Canada over the years about the potential benefits and risks of foreign investment of any kind, let alone investment by sovereign wealth funds and state-owned enterprises. The belief that Canada should restrict foreign investment, especially by foreign government-controlled enterprises, is based on two misconceptions: first, that Canada will continue to prosper without more foreign investment, particularly in certain industries, and second, that Canadian companies will fare badly under foreign control. Neither is true.

Foreign direct investment (FDI) has been increasing rapidly in the past few years as the global economy becomes more integrated. The world stock of FDI reached levels of around US$12 trillion in 2006. While the Canadian economy has been strong due to demand for our natural resources, Canada’s productivity growth (which is a key indicator of economic performance) has been declining for the past several years. Canada is now well below the OECD average for productivity growth and is the second-lowest performer among the G7 countries. An important cause of the lagging productivity growth is Canada’s under-investment in machinery, equipment, technology and innovation as well as in workplace restructuring and worker training. On the competitiveness scale, Canada’s performance has also declined markedly. Ranked third among 125 countries by the World Economic Forum in 2001, Canada fell to 16th place in 2006.
This decline has been attributed to a lack of investment in research and development (R&D), technology and innovation.\textsuperscript{20}

While it is clear that Canada’s performance in productivity and competitiveness has declined — and hence we need more, not less, foreign investment — recent polls indicate that investors in other countries are unaware of the investment opportunities Canada affords.\textsuperscript{21} Moreover, there is a perception that there are considerable barriers for new investors to enter Canada because of our high labour costs, high taxes and restrictive foreign investment policies.

From 1990 to 2006, Canada’s stock of inward FDI grew from $131 billion to $449 billion. Over the same period, outward FDI quintupled to $523 billion from $98 billion. While Canada is a net outward investor, its global shares of both inward and outward FDI stock have declined. In 1980, Canada’s share of global inward FDI stock was 9.8\% compared with 3.2\% in 2006. The share of outward FDI stock also declined, from 4.7\% in 1980 to 3.6\% in 2006.\textsuperscript{22} These shares in global investment are declining at a time when FDI by the fast-growing developing countries is increasing rapidly. In mergers and acquisitions (M&A) activity alone, the developing world’s share grew from 4.4\% in 1990 to 14\% in 2006.\textsuperscript{23} In the Conference Board of Canada’s FDI Performance Index, Canada ranks well behind the leading performers — Ireland, the Netherlands, Switzerland, Sweden and Denmark — and also struggles to keep up with France, Germany, the United Kingdom and Australia, which have all outpaced Canada in terms of both FDI performance relative to economic size and FDI stocks and flows.\textsuperscript{24}

Yet, the public perception is that Canada is being “hollowed out” by foreign takeovers of major Canadian companies, particularly in the mining and resource sectors.\textsuperscript{25} A study by the Conference Board demonstrates that the recent “high profile mega deals are an exception in the long-term investment trend for Canada.” While there has been a spike in M&A activity in Canada in the past two years, the study shows that this is a departure from the longer-term trend.\textsuperscript{26} It concludes that: “the idea that foreign-controlled companies operating in Canada will turn us into a ‘branch-plant’ economy is out of touch with current global realities.”\textsuperscript{27} There has been a surge in M&A activity in the United States and Canada in the past few years due to record profits and low interest rates; however, this is projected to slow down in the immediate future due to the strong Canadian dollar and the weakening US economy.\textsuperscript{28}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{Abu_Dhabi_Investment_Authority_Tower.jpg}
\caption{Abu Dhabi Investment Authority Tower, head office of the world’s largest sovereign wealth fund. (Photo: Arun Ganesh/Wikipedia.)}
\end{figure}
Canada & Australia Establish New Guidelines for Review of Investments by Foreign State-Owned Enterprises & Sovereign Wealth Funds

On December 12, 2007, Canada’s Minister of Industry, Jim Prentice, announced new guidelines under the Investment Canada Act for reviews of investments by foreign state-owned enterprises. Specific principles to be considered include:

1. The nature and extent of control by a foreign government;
2. The corporate governance, operating and reporting practices of the state-owned enterprise; and
3. Whether the acquired Canadian business will retain the ability to operate on a commercial basis.

To ensure that acquisitions are of net benefit to Canada, investors are encouraged to support their plans by submitting specific undertakings. Examples of undertakings that have been used in the past include:

1. The appointment of Canadians as independent directors on boards of directors;
2. The employment of Canadians in senior management positions;
3. The incorporation of the company in Canada; and
4. The listing of shares of the acquiring company or the Canadian business on a Canadian stock exchange.

On February 19, 2008, Australia reacted to growing public concerns over the rising investments by foreign-controlled sovereign wealth funds and state-owned enterprises with a similar set of guidelines for review:

1. An investor’s operations are independent from the relevant foreign government.
2. An investor is subject to and adheres to the law and observes common standards of business behaviour.
3. An investment may hinder competition or lead to undue concentration or control in the industry or sectors concerned.
4. An investment may impact on Australian Government revenue or other policies.
5. An investment may impact on Australia’s national security.
6. An investment may impact on the operations and directions of an Australian business, as well as its contribution to the Australian economy and broader community.
Canada’s Foreign Investment Regime

The current review of competition policy represents the first major review of Canada’s foreign investment policy in over 20 years. In the 1970s, Canada maintained a restrictive policy toward FDI that was implemented in the Foreign Investment Review Act (FIRA). In 1985, the Investment Canada Act (ICA) was passed by Parliament, signaling a change in attitude on the part of the government that foreign investment could be beneficial to Canada. Greenfield investments by foreign investors, except in the cultural sector, were no longer subject to review, and the test of “significant benefit to Canada” — the test applied under the FIRA — was changed to “net benefit to Canada” in the ICA. Because of Canada’s international obligations under the World Trade Organization (WTO) and the North American Free Trade Agreement (NAFTA) in the 1990s, the financial thresholds for review of foreign takeovers of Canadian companies under the ICA rose to $281 million for WTO member countries and $5 million for non-WTO members. Ottawa still retains fairly restrictive policies in certain sectors, however, including financial and transportation services, uranium mining and culture, in which the financial thresholds for review of transactions are significantly lower — $5 million for direct investment and $50 million for indirect investment.

Until the Minister of Industry’s announcement last week rejecting the proposed acquisition of MacDonald, Dettwiler and Associates Ltd. by Alliant Techsystems, Inc., an American company, all 1,587 reviews undertaken by the Minister of Industry under the Act have been approved. This does not take into account applications that may have been withdrawn. The Minister of Canadian Heritage, who is responsible for reviewing investments in the cultural area, has approved 98 investments and disallowed three since 1999.

The purpose of the ICA is “to provide for the review of significant investments in Canada by non-Canadians in order to ensure such benefit to Canada.”31 Any non-Canadian (defined as an entity not controlled or beneficially owned by Canadians) must file a notification each time it starts a new business activity in Canada and each time it acquires control of an existing Canadian business where the establishment or acquisition of control is not a “reviewable transaction.” An investment is reviewable if a Canadian business is being acquired and its asset value equals or exceeds the financial thresholds in the Act. Applications for review must show that the foreign investment is of “net benefit” to Canada by addressing the following factors:

1. the effect on the level of economic activity in Canada, on employment, on resource processing, on the utilization of parts and services produced in Canada and on exports from Canada;
2. the degree and significance of participation by Canadians in the Canadian business or new Canadian business and in any industry or industries in Canada;
3. the effect of the investment on productivity, industrial efficiency, technological development, product innovation and product variety in Canada;
4. the effect of the investment on competition within any industry in Canada;
5. the compatibility of the investment with national industrial, economic and cultural policies; and
6. the contribution of the investment to Canada’s ability to compete in world markets.

On receiving an application, the Minister of Industry has a short time to decide if the investment is indeed of net benefit to Canada. The Minister can require the investor to make additional representations, usually in the form of undertakings. The review process takes place quickly and in secret, purportedly to protect confidentiality of information. The Minister typically consults other federal government departments and provincial governments during the review process, but representations from outsiders are not solicited.
The Minister and government officials have a great deal of discretion, and the review process is not known for its transparency or due process guarantees. The criteria are not clear; there is no requirement for reasoned, published decisions; and there is no appeal from the Minister’s decision. Because information is not made available on the outcomes of reviews, it is difficult to ascertain what really occurs during particular reviews.

The new guidelines for SOEs were issued by the Minister of Industry ostensibly to “clarify” the government’s policy on takeovers of Canadian businesses by SOEs. An SOE is defined by the guidelines as “an enterprise that is owned or controlled directly or indirectly by a foreign government.” In applications for review of transactions, non-Canadian investors are required to disclose their controllers, indicating in particular “any direct or indirect state ownership or control.” Purportedly applying the principles already in the ICA, the Minister will determine whether a reviewable acquisition of control by a non-Canadian SOE is of net benefit to Canada. The guidelines set out additional criteria for the Minister to examine the corporate governance and reporting structure of the SOE as well as to inquire whether the company will operate on a commercial basis after the acquisition.

The guidelines stipulate that the examination will include whether the SOE follows Canadian standards of corporate governance and complies with Canadian laws and practices. In order to evaluate whether the target firm will be able to operate on a commercial basis after the acquisition, key factors are whether it can decide such matters as: export destination; process location; the participation of Canadians in its operations in Canada; support of ongoing innovation, research and development; and the appropriate level of capital expenditures to maintain the Canadian business in a globally competitive position. The guidelines encourage non-Canadian applicants to support their plans for maintaining the Canadian business on a commercial basis by providing specific undertakings, including the employment of Canadians in senior management; the participation of Canadians in its operations in Canada and elsewhere; support of ongoing positions; appointment of Canadians to the board of directors; incorporation of the business in Canada; and listing of shares on a Canadian stock exchange.

The question that arises is whether these guidelines bring greater clarity or greater uncertainty to the existing ICA review procedures and whether a specially designated category of SOE was really necessary. In other words, were these new guidelines, specifically for investments by SOEs, a necessary response to a major new phenomenon or simply a protectionist response to perceived, but ill-founded, fears?

▲ A heavy oil facility in Alberta. Chinese and Abu Dhabi funds hold stakes in several Alberta oil sands projects.
Foreign Government-Controlled Investment in Canada

State-owned enterprise (SOE) and sovereign wealth fund (SWF)-related investment in Canada has been mostly confined to the natural resources sector. In the fall of 2004, MinMetals, a Chinese SOE, offered to buy Noranda Inc., Canada’s largest mining corporation. MinMetals eventually withdrew its offer, but the attempted purchase attracted much debate on Canada’s existing foreign investment regulations. Since then, Chinese state-owned oil companies have taken interests in the oil sands of Northern Alberta. In 2005 the Chinese National Offshore Oil Corporation (CNOOC) bought a 17% stake in MEG Energy for $150 million, and SinoCanada, a subsidiary of Chinese oil giant Sinopec, bought a 40% stake in Alberta-based Synenco’s Northern Lights oil sands project for $4.5 billion. The Abu Dhabi National Energy Company, TAQA, has invested in Alberta, acquiring two oil and gas-related companies in the past year: Northrock Resources Inc, purchased for $2 billion in 2007, and PrimeWest Energy Trust, purchased for $4.6 billion in early 2008. Abu Dhabi’s TAQA has indicated that it plans to significantly increase its presence in Canada in the next four years — by as much as $20 billion. In June 2007, the China National Petroleum Corp (CNPC), China’s largest oil company and SOE, announced its plans to develop some 260 square kilometers in Athabasca. By September, however, CNPC’s international arm announced that it would withdraw support from major Alberta oil sands developments, citing concerns over Canada’s political climate.

Not all SOE and SWF investments in Canada have been confined to Alberta’s resource sector. In 2007, Temasek Holdings, the Singaporean SWF, purchased a 13% stake in Canada-based Sino-Forest, the largest commercial forestry plantation owner in China. Dubai Ports World, the world’s third-largest terminal operator and a subsidiary of the UAE-based Dubai World, acquired and subsequently expanded a container terminal in Vancouver when it purchased a number of P&O’s North American terminals in 2006.

Why Protectionism is the Wrong Medicine

As many recent studies of the Canadian economy have shown, the patient might indeed be sick, but protectionism is the wrong medicine. Canada faces a major structural challenge over the next few years. While recent high energy and resource prices have given Canadians a false sense of security, key economic indicators of growth and prosperity, such as productivity growth and investment in R&D, have declined. Despite a handful of large, recent foreign takeovers in the natural resource industry, Canada’s global share of inward FDI has also declined. To arrest this trend and make the Canadian economy more globally competitive, we will need to attract more FDI, not less. Indeed, the recent transformation occurring in the emerging economies has provided them with the capital to invest elsewhere, thus creating more growth and opportunities around the globe. Canada should not send a signal that it is open only to certain kinds of investment, depending on the ownership of the investor.

While foreign investment can take different forms, more than 50% of FDI in Canada has taken place through M&A activity in recent years. Governments are generally more concerned with M&A activity, which they regulate through competition laws and investment review mechanisms, than they are with “greenfield” investments in new areas and injection
of new capital into existing companies. However, as a recent study by the OECD of foreign investment demonstrates, foreign M&As usually have positive effects on the host economies. They raise wages, productivity and employment; encourage greater investment in the domestic companies; and, in general, outperform domestic firms without moving management positions out of the country. The empirical evidence confirms that the effects of foreign takeovers are largely beneficial. The acquired firms benefit significantly with enhanced productivity growth, increased salaries, especially for skilled workers, and major increases in their operational efficiency and international competitiveness.

Statistics Canada recently released a research report on the operation of multinationals in Canada based on detailed empirical data from business surveys. The data show that foreign-controlled companies generally have larger plants, higher labour productivity and a higher percentage of skilled workers who command higher salaries than their Canadian-owned counterparts. Rather than reducing the number of head offices or head office employment in Canada, as is commonly believed, the statistics show that foreign takeovers of Canadian companies have led to more new head offices in Canada as well as increased employment in them. From 1999-2005, six out of ten new head office jobs were created by foreign firms. Foreign-controlled firms innovate more frequently than Canadian-owned companies, regardless of their size, and are more likely to use advanced technologies or have R&D divisions. Foreign-owned firms also contribute significantly to productivity growth. They create spillovers to Canadian companies, while mergers involving foreign owners are more likely to lead to gains in productivity, wages, profitability and market share than mergers between Canadian companies.

Statistics Canada researchers concluded that foreign-owned firms operating in Canada “are not truncated, branch plant operations that do little to enhance the competitiveness of domestic industries. To the contrary, Canadian establishments of foreign multinationals are businesses that, on balance, make larger investments in their knowledge capital via relatively large investments in innovation, advanced technology and skilled labour. These investments often translate into superior market outcomes, as foreign-controlled establishments often enjoy relatively high rates of productivity growth compared to their domestic competitors.”

The new guidelines introduced by the federal government are a step in the wrong direction. Fears of a “hollowing out” of the Canadian corporate community have been proven to be unfounded, and the recent major foreign takeovers in the energy and resource sectors were historical anomalies that are unlikely to be repeated in the future.

The new federal government policy toward investment by SOEs could have a chilling effect on investment, particularly from the emerging economies and resource-rich countries that have significant capital to invest. Although the government continues to espouse that Canada is “open to investment,” the signal being sent by the new guidelines is that certain kinds of investment are more welcome than others. SOEs and SWFs are diverse and have many different characteristics. To put them all in the same basket is inequitable. Worse, Canada could miss out on the biggest investment boom of this century, which could provide us with the FDI needed to restructure our own economy and ensure it remains globally competitive in the future.

It is ironic that the government’s new policy with respect to investments by SOEs is based, in large part, on concern with the lack of transparency of some SOEs. And, yet, the administration of the review process under the ICA itself is not transparent. Rather, it is unclear, unpredictable and disproportionate. The criteria in the review process are ambiguous, and the process itself is secretive and arbitrary. Government officials are given wide powers of discretion and, ultimately,
their decisions are not published, they are not required to give reasons, and there is no right of appeal. Few procedures like this remain in federal statutes affecting business precisely because this type of process is not transparent and does not provide the basic guarantees of fairness and due process usually provided in administrative law. To be sure, the ICA deals with foreign investors, but foreign investors should receive the same treatment as Canadian businesses when it comes to transparency, fairness, and due process under the law. Without clear criteria and a fair process in which the enterprise concerned has a full opportunity to be heard, ICA reviews create uncertainty and do not guarantee the security and predictability that is essential to business.

Firms operating or investing in Canada are subject to all federal, provincial and municipal laws and regulations. Anti-competitive behaviour of firms in Canada can be examined under the Competition Act, which proscribes abuse of dominant position by companies controlling major industries as well as cartel-like behaviour, price-fixing, misleading advertising, and other restrictive business practices. Our comprehensive regulatory regimes for product safety, consumer protection, environmental protection, health, and public security apply equally to Canadian-owned and foreign-owned firms operating in Canada. The Competition Review Panel is examining whether the Competition Act, last revised 20 years ago, contains the right mechanisms to deal with anti-competitive practices in today’s global economy. Any changes made to the Competition Act will apply equally to companies operating in Canada regardless of their ownership.

Aware of the potential for review of certain types of transactions, SOEs and SWFs often restrict their investments to portfolio deals, ensuring that they purchase shares equivalent to something less than control of the target companies. Thus, one effect of potential review of certain types of transactions – i.e. control of a Canadian business – will be to divert investments into other types of transactions that are not reviewable, such as greenfield investments, purchases of interests that represent something less than control of the companies concerned, and infusions of equity into existing Canadian businesses.

Another possible risk from this new policy is that it may invite reciprocal treatment by China and other countries against Canadian investment abroad.41 Alberta’s Heritage Savings Trust Fund is a major SWF with significant assets internationally. By treating foreign SOE investors differently from other investors, we may inadvertently open Canadian investors to similar treatment in other jurisdictions. A multitude of unilateral responses by individual countries in their investment review mechanisms does not add up to a coherent, positive, multilateral response to the issues raised by SOEs and SWFs.

Toward a Global Code of Conduct

As a member of the WTO and the OECD, Canada has long-standing commitments to promote freedom of investment and provide open and transparent policies with respect to investment. Under the voluntary OECD Codes of Liberalization and National Treatment, principles of proportionality, regulatory transparency and predictability, and accountability of implementing authorities are paramount. As a WTO member, Canada has an obligation to provide transparency and non-discrimination to other members in trade in goods as well as in trade in services. Canada is also a party to a number of bilateral Foreign Investment Protection Agreements (FIPAs), and is presently negotiating one with China. Principles of non-discrimination, transparency, fairness and accountability are key obligations in these international agreements.
While the WTO technically does not yet require its member governments to treat foreign and domestic investors equally, principles of non-discrimination have long been part of the GATT and WTO lexicon in relation to trade in goods and services. Under the previous GATT system, Canada was found to have violated the principle of national treatment in its administration of the Foreign Investment Review Act by requiring certain undertakings from foreign investors before approving their investments. Until recently, China, Saudi Arabia and other oil-rich Arab states were not members of the WTO, and Russia is not yet a member. Having let China and Saudi Arabia and other oil states into the WTO, it goes against the spirit of the WTO, if not the letter, to discriminate against investments by their SOEs. A far wiser and more consistent policy would be to treat all foreign investors similarly without distinguishing between investments by SOEs and privately-owned enterprises.

OECD governments recently agreed to respect the principles of proportionality, transparency and predictability, make their investment authorities accountable, and avoid imposing unnecessary restrictions on international investment. To encourage further collaborative efforts among OECD members and non-members toward the negotiation of a code of conduct for SOEs, the Secretary General of the OECD, on his own authority, issued Guidelines on Corporate Governance of State-owned Enterprises in 2005.

G7 Finance Ministers and Central Bank Governors recently agreed that “sovereign wealth funds (SWFs) are increasingly important participants in the international financial system and that our economies can benefit from openness to SWF investment flows.” They emphasized that they “see merit in identifying best practices for SWFs in such areas as institutional structure, risk management, transparency and accountability.” For governments receiving investments from SWFs, G7 Ministers highlighted that it is “important to build on principles such as nondiscrimination, transparency and predictability.” With these principles in mind, the G7 directed the IMF, World Bank, and OECD to examine these issues in an effort to develop global codes for governance of SWFs.

The IMF has taken up the challenge and is currently working with the major SWFs, particularly in Norway, Singapore and Abu Dhabi, to develop a voluntary code of conduct for SWFs with specific benchmarks for transparency and corporate governance. The European Commission also has made a major proposal, which has gone to European member states for approval, aimed at working with the SWFs to develop a common code of conduct. The European Commission and some member states, including France and Germany, have indicated that they strongly prefer to develop common international rules rather than take unilateral action against investment by SWFs in individual countries. However, domestic pressures to take action are increasing in many European countries — particularly in Germany, where concerns about foreign investment are high. The United States Treasury Department is working with the IMF and OECD to develop international guidelines for investment by SWFs, preferring a global approach.

![Syncrude Canada Ltd.'s oil sands plant at Mildred Lake, Fort McMurray. Foreign sovereign wealth fund interest in Canada so far has mostly been in the natural resources sector.](image1)
What Should Canada Do?

In view of the pressing need for Canada to increase its productivity and competitiveness, we need to send a strong signal to foreign investors around the globe that Canada is open for business. Canada should lead by example, both internationally and at home. On the international front, Canada should put significant efforts and resources into heading the collaborative movement to develop a global code of conduct for SOEs and SWFs. The European Commission and US Treasury Department are already out in front with this initiative, together with the IMF and OECD. Ottawa should follow this example and actively participate in international efforts to establish codes of conduct for SOEs and SWFs as well as help secure SWFs’ participation in future investment frameworks.

Domestically, the government should take immediate steps to reduce existing restrictions on foreign investment and strengthen regulatory frameworks governing competition and good corporate governance in the marketplace. The Competition Review Panel has a unique opportunity to recommend specific reforms to our competition regime and new regulations for corporate governance that will apply across the board to Canadian companies as well as all foreign-owned enterprises investing in Canada.

If the Canadian government concludes after the Competition Review Panel that there is a continuing need for a foreign investment review mechanism, then it should design such a mechanism based on clear, transparent principles and criteria that ensure predictability and security for businesses making investment decisions. The existing ICA procedures should be reformed so that they accord fully with the principles of transparency, proportionality, fairness and accountability of authorities established by the OECD.

Furthermore, foreign-government-controlled companies operating in Canada should be subject to the same regulatory requirements within Canada as other foreign-controlled firms or Canadian businesses. Investment in Canada by SOEs or SWFs should not be excluded, but foreign companies operating in Canada should be regulated to ensure that they follow Canadian laws and practices. For SOEs, Ottawa could start by applying the OECD Guidelines for Corporate Governance of State-owned Enterprises as it works together with the international community to develop a global code of conduct.

Finally, having established principles for good corporate governance domestically, Canada’s development agencies should create programs to promote these models for corporate governance abroad. Canadian multinational companies are leaders in good corporate governance and social responsibility around the world. The government could partner with them to promote Canadian models of corporate governance internationally, including in the emerging economies.

If we are willing to open our minds and look to the future, we can develop new economic regulatory frameworks that will reverse the trends of declining productivity growth, competitiveness and innovation that have dogged Canada for the past decade. We can meet the challenges of the future and take advantage of the tremendous opportunities that the transformative growth in the emerging economies brings to the world.

But we cannot take part in this global economic transformation, and benefit from it, unless we take major steps toward openness, transparency and freedom of investment within our own borders. Promulgating new guidelines which allow our government to arbitrarily close Canada’s doors to certain types of investment from abroad — that add another layer of restrictions upon our already restrictive foreign investment regime — is a giant step in the wrong direction.
Notes


6 The issues related to SOEs and national security are not under review by the Panel because the government had indicated that it intended to deal with these topics immediately. See *Sharpening Canada’s Competitive Edge*, October 30, 2007, consultation paper issued by the Competition Review Panel, p. 1.

7 *The Overflowing Bathtub, the Running Tap and SWFs*, Global Economics Report, 5 October 2007.


12 Standard Chartered Bank, *supra* note 24, pp. 4-5.


14 *Ibid.*, pp. 3-10. The Chairman of the $200 billion China Investment Fund, Mr. Lou Jiwei, in the United States recently to placate American fears, stated that China had no intention of gaining a controlling interest in any US companies, that it would be a “good corporate citizen” and not invest in companies that damage the environment, waste energy or produce tobacco. He also pledged that the CIF would disclose more of its investment decisions and provide more information about its portfolio, and that the Chinese government would not interfere in the operations of the CIF or dictate its investment decisions. In other words, he promised that the CIF would be more transparent, commercial and develop its own corporate governance structure in accordance with good financial practice. Steven R. Weisman, *China Tries to Reassure U.S. about its Investing Plans*, New York Times, Feb. 1, 2008.


17 OECD, *Factbook 2007*.


20 Canada ranks 6th among the G7 according to the OECD, and the Conference Board of Canada recently ranked Canada 14th out of 17 countries for innovation.


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Ibid., p. ii.

Ibid., p. 2.


Competition Review Panel, *supra* note 4, p. 16. These figures also do not take into account proposals that may have been withdrawn.

ICA, section 2.

ICA, section 20.

The Conference Board of Canada, *supra* note 21, p. 4.


Ibid., pp. 86-88, in Chapter 4, *Economic and Other Impacts of Foreign Corporate Takeovers in OECD Countries*.


Ibid., p. 9.


The Conference Board of Canada states that “there are good reasons to believe that the balance of acquisition numbers will return to their historic pattern.” Ibid., p. 13.


The WTO has provisions dealing with the operation of state trading enterprises contained in Article XVII of the GATT. They are required to act in a non-discriminatory fashion, to be transparent, and to function in accordance with commercial practice. The Canadian Wheat Board was recently subjected to scrutiny under these provisions in a dispute settlement case brought by the United States in the WTO.


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