BRINGING FOREIGN INVESTMENT TO CANADA

ADVISORY COUNCIL ON ECONOMIC GROWTH
October 20, 2016

Introduction

Foreign direct investment (FDI) is a critical driver of economic growth for both developing and advanced economies. In slower growing advanced economies, new investment by foreign firms in productive capacity can provide a boost to national income and employment. In any economy, it can help raise productivity, competitiveness, and living standards over the long term. In the modern era of globalization, FDI has played an increasingly important role in economic growth, rising from 0.6 percent of global GDP during the 1980s to 2.7 percent over the past 15 years (Exhibit 1).

Though FDI is important for the productivity and innovation that Canadians need, we are falling behind. We suggest that the government take two specific actions to attract more FDI of the kind that will position us to compete on the global stage:

1. Create an FDI agency to strategically increase inward FDI, and to attract anchor companies that will contribute to existing and new Canadian clusters of excellence.

2. Develop an FDI strategy in line with the country's economic growth strategy, with a focus on new investment that drives innovation and expands our capacity to trade, including with emerging markets.

These actions would bring much-needed coherence to what is currently a disjointed approach to foreign investment. We estimate that successful implementation could lift GDP by about $43 billion in the first few years of operation. It would also provide a solid foundation for long-term economic growth.

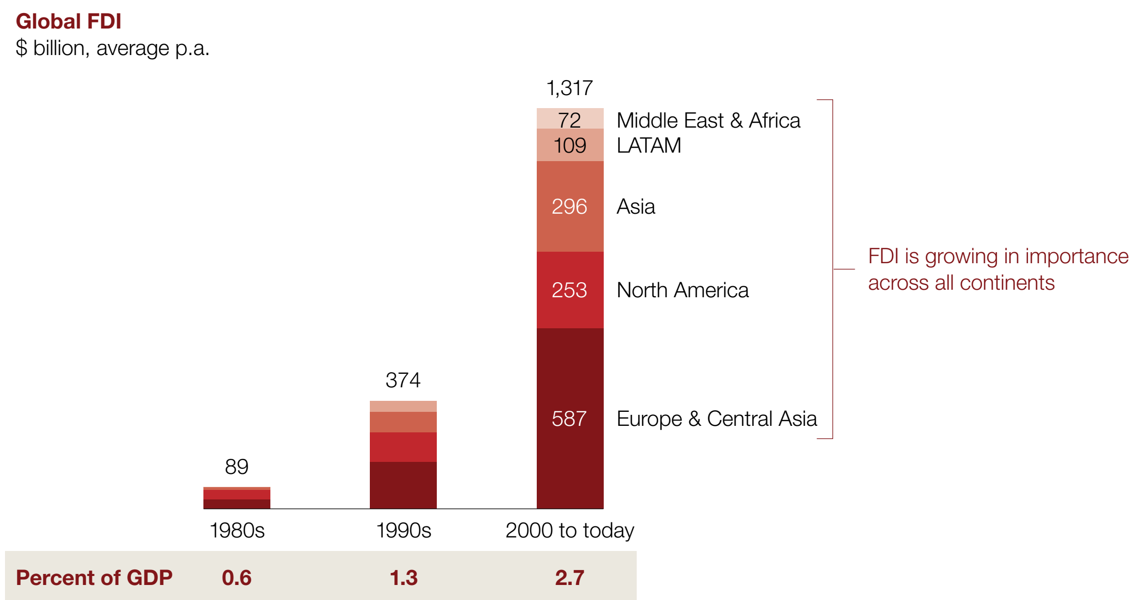
The FDI imperative

FDI strengthens Canadian productive capacity through knowledge transfer, the development of human capital, and new technology, management techniques, and production processes. International reciprocity may add additional benefits, as Canadian investors are more likely to be granted access to investment opportunities abroad when Canada is equally welcoming to foreign capital. Additionally, FDI improves local firms' access to international markets by opening channels and bolstering the country's reputation as a reliable and high-quality supplier to global value chains.

Greater inflows of foreign investment tend to generate greater trade flows. In 2013, foreign-controlled multinational enterprises in Canada were responsible for 50 percent of all merchandise exports and 37 percent of business expenditures in research and development.[3] The increased competition and trade from foreign firms reduces prices and improves the purchasing power of Canadians. As reported recently in *The Economist*, "a study of 40 countries found that the richest consumers would lose 28 percent of their purchasing power if cross-border trade ended; but those in the bottom tenth would lose 63 percent."

Canada, however, has not grown inward FDI as much as other countries, and has missed out on much of the benefits. While advanced economies such as the United States have made concerted efforts to attract greater FDI, Canada's efforts have been limited and haphazard; the stock of foreign investment in Canada has grown by just 2 percent a year since 2005, compared with an average of 7 percent for all OECD nations and 8 percent for Australia.[1] Not only have Canada's efforts to attract investment been concentrated in only a few sectors—mining and manufacturing receive half of all inbound FDI—but the nation's regulations and cross-

Exhibit 1 **FDI is growing as a share of global GDP—and regional shares are shifting.**



Source: World Bank, McKinsey analysis

border investment rules are seen by foreign investors as unwelcoming. Canada ranks 33rd out of 40 countries on the OECD's FDI restrictiveness index.[2]

In short, Canada stands to gain enormously by attracting more FDI in a manner consistent with the federal government's emerging growth strategy. In particular, Canada should (1) develop a coherent national FDI strategy and (2) create a world-class agency to attract new investment aligned with that strategy.

The case for Canada

Other nations are moving fast to attract FDI; competition is global, and fierce. Yet Canada's strong economic fundamentals provide a strong foundation on which solid improvements can be based. Canada can raise total inward FDI flows by doing a better job promoting its economic advantages. It can also broaden the sources of its FDI to more countries, relying less on flows from the United States and more on faster-growing countries in Europe and Asia. Canada can also diversify its FDI to a wider range of sectors, such as agriculture, technology, health, clean tech, and infrastructure.

Why should foreign firms choose to invest in Canada? For three broad reasons.

Market access. Globalization is under pressure and the trade policy environment is deteriorating. Through participation in regional trade agreements such as NAFTA and CETA (the pending Canada-EU Comprehensive Economic and Trade Agreement), Canada is poised to achieve unparalleled market access. The NAFTA and

CETA economies combined account for nearly $37 trillion (US) in GDP, or one-half of the world's output of goods and services. If the Trans-Pacific Partnership (TPP) comes into being, it will provide liberalized trade with 12 Pacific Rim nations, boosting access to economies that generate another 10 percent of global GDP.[3] The most trade-connected countries experience 40 percent greater GDP growth from trade flows.[4]

Business environment. Once established, Canada offers investors a welcoming business environment in a highly diversified and developed economy. According to both Forbes and Bloomberg, Canada is the best G-20 nation in which to do business. Total business tax costs in Canada are by far the lowest in the G-7, and 46 percent lower than those in the United States.[3] Thanks to our tremendous endowments of fresh water, Canada also has low electricity costs relative to most other countries. In addition, Canada's public indebtedness is low and it has a strong and stable banking system—the soundest in the world, according to the World Economic Forum.

Educated and diverse labour force. Canada prides itself on its diverse and highly skilled labour force—one of the most highly educated in the OECD. The country's deep reservoirs of knowledge and expertise are produced in part by its extensive science and research assets. Canada also tops the OECD's Better Life Index, which measures the living conditions and quality of life that are so important to attracting and retaining a high-quality workforce. Its clean and safe cities, strong public-education and health-care systems, and political stability offer a haven for talent from around the world.

The Bold Idea

How can Canada turn this potential into a stronger stream of inward investment?

Recommendation 1: Develop a national FDI strategy

A new FDI agency should be charged with developing a new FDI strategy for Canada, working constructively and collaboratively with other government agencies as well as with provincial and urban economic-development organizations. In this regard, it will be important to reduce the inevitable competition for FDI among various provinces and cities, thus promoting the national rather than specific regional interests.

Canada's FDI strategy should emphasize new investment that boosts innovation, and the commercialization of technologies, and that can also help Canada expand its trading relationships. In this regard, "greenfield" projects generally bring greater economic benefits to Canada, and are less contentious, than "brownfield" investments (involving the acquisition of Canadian firms by foreigners). That said, brownfield investments can also deliver many benefits, such as improved technology, trade and reciprocity, and should not be overlooked.

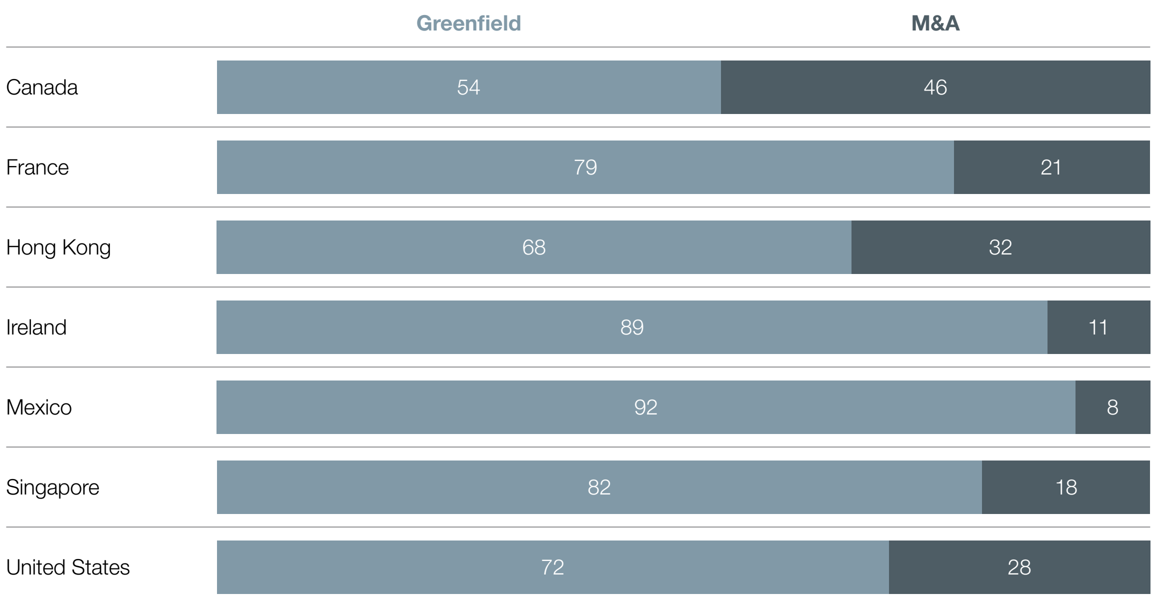
Since 2000, Canada has been far less effective than many other countries in attracting greenfield FDI (Exhibit 2). Only 54 percent of Canada's FDI deals over the past 5 years have been of the greenfield variety, whereas the ratio in countries with best-practice FDI agencies is between 68 and 92 percent. Additionally, the recent trend is not promising; both the number and dollar value of greenfield investments in Canada fell significantly over the same period.

Recommendation 2: Create a world-class FDI agency

Canada should create a world-class FDI agency, reporting to the Minister of International Trade and modeled on best practices in attracting foreign investment (see box). The central mission of the new FDI agency

Exhibit 2 **Greenfield investment in Canada is less common compared to "best practice" nations.**

Cross-border M&As and Greenfield projects
2010–2015, %



Note: data for value of greenfield FDI projects refer to estimated amounts of capital investment
Source: Dealogic FDI markets, UNCTAD, FDI/MNE database, McKinsey Global Institute analysis

should be to increase inward FDI in sectors aligned with the government's economic growth strategy; its focus should be on attracting anchor companies and investments that can create or add to Canadian clusters of excellence.

By creating a single agency with a clear focus on FDI, Canada would leave behind its uncoordinated and often incoherent system. FDI activities are currently spread across multiple agencies and geographies. There is no clear national strategy and no critical mass of FDI knowledge and talent; no single agency is directly accountable for improving the flow of foreign investment into Canada. The federal Trade Commissioner's Service is the main department dedicated to FDI attraction through its "Invest in Canada" program, but only 75 out of 1,000 commissioners stationed domestically and abroad focus on attracting FDI—and only 13 do so on a full-time basis. Other agencies focus on investment in particular industries. Innovation, Science and Economic Development Canada, for example, is mainly concerned with the auto industry, and Natural Resources Canada is active primarily in the resource sector.

Provinces and cities also have FDI attraction efforts, but they are not coordinated and often compete with each other in a zero-sum game for the same investment opportunities. As the data show, Canada's system

Best practices for FDI agencies

France, Hong Kong, Ireland, Mexico, Singapore, and the United States have successful FDI agencies with some common elements. Canada can learn from these nations as it attempts to improve its inflow of FDI. Perhaps most importantly, success in attracting FDI appears to rely on a commitment at the highest political level as well as the provision of financial support and resources needed to get the job done.

The common features from the best-practice jurisdictions include:

- active involvement and promotion by senior government officials
- a single agency that coordinates information and services across various government offices
- top-level talent, with deep business knowledge and experience
- a clear investment strategy, including focus on specific economic sectors
- use of targeted financial incentives
- a "concierge" service for investors, from initial contact and cultivation to assistance after the investment takes place

In the United States, the president, governors, and ambassadors are all involved in marketing and recruiting efforts. *Select USA* provides a single point of contact for foreign investors and coordinates with more than 20 federal agencies to help foreign companies invest. The United States has targeted ten "priority countries", which account for more than 30 percent of FDI flows. The US government also has well-publicized incentives, including an industrial assistance fund and tax credits for relocation and expansion.

In Singapore, the Economic Development Board (EDB), a government-backed private company, is responsible for a wide range of business development activities including attracting FDI. It has 500 employees and a $400 million budget. The EDB attracts and retains top talent and operates an effective FDI sales force through performance-based evaluation.

has not delivered an impressive inflow of FDI; we can do much better, and a new FDI agency and strategy will be central to our success.

Canada's new FDI agency should be responsible for marketing Canada as an investment destination. The marketing team should be supported by experts, with deep knowledge of key target sectors and strong market intelligence about gaps in the Canadian economy that can be filled by foreign investment. Agency personnel should generate a pipeline of potential deals and help to close transactions, including by assisting investors with applications for incentives and regulatory approvals.

As occurs in the best-practice jurisdictions, Canada's new FDI agency should be a single point of contact for foreign investors, providing "concierge" service throughout the entire investment lifecycle. It should have a dedicated marketing staff and use proven B2B sales management techniques, with targets and performance-based incentives. A market intelligence division should maintain a thorough database with metrics that can help fine-tune performance.

The new FDI agency should coordinate with provincial and local development agencies and work with other federal departments. Similarly, it should work with embassies and trade offices in countries earmarked for increased FDI flows. The FDI agency should also provide input to federal policy makers on topics such as reform of the Investment Canada Act and working visas.

To operate most effectively, the new FDI agency needs to be politically flexible with compensation packages and structures; that will help attract talent and build credibility with the private sector. The agency should be overseen by an advisory council, appointed by the Minister of International Trade and composed of Canadian and global business leaders with the expertise to advise on sectorial strategies and support major deals. The prime minister and cabinet ministers should be called on to promote Canada on the world stage, and for closing top-priority deals.

Initially, the new FDI agency should be relatively small in scale (perhaps 100 or so full-time experts) so it can be nimble and remain focused on the top FDI priorities. It should fit within the current FDI attraction ecosystem in Canada, playing a premier advisory and convening role. A small and focused agency may be more likely to score some "quick wins" than an agency pursuing a broader agenda. If and when this new agency succeeds, it will be important to scale up to a size commensurate with Canada's overall FDI objectives. The appropriate size is difficult to determine—though we note that even Singapore's highly successful FDI agency has 500 dedicated staff, and an annual budget of $400 million.

Once the new FDI agency is built and successfully operating, the Canadian government should consolidate the redundant or ineffective assets currently involved in FDI promotion. This will be especially important if there is a desire to scale up the new agency, as the required resources will need to come from somewhere. Building new government agencies is sometimes crucial; but it is just as important to stop doing the things that are no longer effective.

Potential impact

If Canada's new FDI agency, in its first few years of operation, can raise the growth rate of inbound FDI from its current 2 percent to 6 percent annually (still below the OECD average rate), this would add approximately $43 billion to Canada's GDP—an amount currently equal to 2 percent of our national income.[5] There would also be more subtle and longer-run effects. For example, higher FDI would stimulate more intense competition among domestic firms, leading to lower prices for goods and services. Greater inflows of FDI would also translate into higher trade volumes, including rising exports. And since exporting firms tend to pay higher wages than companies serving only domestic customers, Canadian incomes would be likely to increase.[6] ■

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1 Organisation for Economic Co-operation and Development.

2 The FDI Index looks at the four main types of restrictions on FDI: foreign equity limitations, screening or approval mechanisms, restrictions on the employment of foreigners as key personnel, and operational restrictions (e.g. land ownership).

3 Global Affairs Canada; "World Economic Outlook," International Monetary Fund, imf.org.

4 *Global flows in a digital age: How trade, finance, people, and data connect the world economy*, McKinsey Global Institute, April 2014, mckinsey.com.

5 Assumptions: $982 billion inward stock in 2015 (OECD calculation model), 4 percent compound annual growth rate, 10 percent multiplier (innovation and productivity gains).

6 Sébastien Breau and W. Mark Brown. *Global Links: Exporting, Foreign Direct Investment, and Wages: Evidence from the Canadian Manufacturing Sector*, Statistics Canada, August 2011, statcan.gc.ca.