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STUDY NO. 9:

Investment responses by multinational enterprises to three Canadian policy options for Canada-United States trade. (Institute for Research on Public Policy for Dept. of External Affairs. 1985)

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INVESTMENT RESPONSES BY MULTINATIONAL ENTERPRISES
TO THREE CANADIAN POLICY OPTIONS
FOR CANADA-UNITED STATES TRADE*

Derek Chisholm

Institute For Research on Public Policy

International Economics Program

This study examines probable changes in foreign direct investment within Canada by multinational enterprises (MNEs) in response to three separate choices for Canada's bilateral trade policy with the United States.¹ Our examination seeks answers to three questions about MNE responses to reductions in trade barriers that currently inhibit Canadian trade flows with the United States. First, will the level of foreign control over domestic industries change significantly? Second, will foreign-owned firms change their Canadian strategy by updating their Canadian production techniques, or mandating Canadian operations with exclusive rights for worldwide production of one output? Third, what is the impact on our trade with the United States of various economic determinants and policy determinants that are independent of foreign direct investment? Our answers assess key aspects of MNE responses to reduced bilateral trade barriers with the United States.

Clarification of the central concepts is necessary for the study. A MNE is a firm controlled by foreign residents with productive activities located in Canada. Foreign direct investment occurs through foreign residents' acquisition or enhancement of controlling interests in a corporation by purchases or augmentation of Canadian equity holdings. Hence, this study investigates how foreign-controlled domestic firms would respond to three separate options for our bilateral trade policy with the United States. The three policy options are:

- an unrestricted bilateral free trade agreement making Canada and the United States a free trade area;
- a bilateral free trade agreement restricted to either specific sectors or to sectors currently subject to trade restrictions defined in terms of functional areas; and

- a bilateral agreement establishing principles and procedures for trade negotiations between the United States.

The study is arranged in four sections. The first section develops a simple conceptual framework to explain the logic of changes in foreign control of domestic equity. The second section uses this framework to predict changes in the level of foreign control in Canadian firms resulting from each policy option. Section three investigates two MNE strategies for Canadian operations in response to reduced trade barriers: rationalization, which is updating Canadian production techniques to the most advanced standards, and world product mandating, which is mandating the Canadian subsidiary with exclusive rights to worldwide production of a specific product. A concluding section investigates the impact on our trade patterns of various domestic economic determinants and domestic policy determinants that are independent of foreign direct investment.

The Framework

This section develops a simple conceptual framework to explain the logic of changes in foreign control over domestic firms. This framework is then used to identify types of MNEs likely to be affected by changes in our trade relations with the United States.

Conceptual frameworks are logical constructions or thought experiments. They identify the fundamental principles of the relevant systematic economic causes and effects associated with observed events. Frameworks do not describe

observed economic events. Instead, their identification of the fundamental principles facilitates predictions of what will occur when the causal conditions alter. The predictions are conditional, in the sense that they are of the form that if specific causal conditions are present then inevitable consequences will result.

A conceptual framework for making predictions about MNEs must begin from the economic causes of firms. A firm is a social arrangement among two or more individuals to co-ordinate or manage their productive activities by commands or directives. These commands or directives allocate input resources just as prices allocate products in the markets that firms supply. Prices and commands are alternative social devices for signalling the allocation of resources among alternative uses.² The economic causes of a firm are the preconditions that make managerial commands the appropriate device for allocating input resources.

Managerial commands administered within the firm are more appropriate when prices in the same role would fail to indicate accurately the scarcity of the resources that are allocated. Prices fail to indicate scarcities when some costs of furnishing the resource are shifted to other activities. This shifting results from interdependence of productive input activities. The interdependence is often a consequence of the technical requirements of the production process.

Cost shifting in a complex production technique can be extremely difficult to monitor. For example, an assembly line process incorporates interdependence

among inputs whereby malfunctions of one piece of equipment or shirking by an assembly line worker imposes costs on the remaining equipment and labour inputs. An effective pricing arrangement in this circumstance would necessitate a reduced price for the malfunctioning equipment or the shirking worker sufficient to compensate for the costs imposed on remaining inputs. Individual pricing by the input owners is unlikely to adjust adequately to this cost shifting. Hence, the signalling properties of prices are unlikely to provide appropriate signals for allocating the input resources. Managerial commands or directives can take the interdependence of inputs into account more readily and command the replacement of malfunctioning equipment or discipline the shirking worker.³ The co-ordination of productive activities in a firm by managerial commands results from the superior ability of managerial resources to take interdependence into consideration. This superior monitoring capability generates a more productive production process yielding greater returns than would be available by using a pricing system.

The MNE is a specific type of firm distinguished by foreign control enforced through ownership of domestic equity. The interdependence that causes MNEs is a variant of interdependence discussed above. The interdependence is between inputs in one country and inputs in other countries whereby international co-ordination of productive activity by managerial commands yields greater wealth than either domestic co-ordination by firms or international co-ordination of markets.⁴ The international interdependence among inputs that causes MNEs occurs in several distinct manifestations.

A manifestation of this international interdependence that is relevant for Canada is the relationship between our natural resource endowments and both the managerial skills such as marketing and the large scale of productive output necessary for the American market. Natural resource endowments are relatively more abundant in Canada than in the United States implying that they are relatively less costly in Canada. Nonetheless, managerial skills are relatively more scarce and costly in Canada. Conversely, while managerial skills are relatively more abundant in the United States, natural resource endowments are relatively scarcer. Hence, a MNE combining American managerial skills and Canadian resource endowments undoubtedly generates more wealth than a domestic Canadian enterprise or a domestic American enterprise producing identical outputs.

The international division of labour that often characterizes natural resource production processes permits cost shifting when markets are the co-ordinating device. Inefficient natural resource extraction in one country imposes costs on the refining and marketing of the resource output in a second country that are unlikely to be incorporated in the prices of the extracted natural resources. This inefficiency and resultant cost shifting would be reduced if foreign owners co-ordinated extraction, refining, and marketing by managerial commands issued through a MNE. The consolidation of international activities in a MNE thus increases the value of productive output.

The consequences of trade liberalization for foreign direct investment hinge upon trade barriers as a causal factor responsible for international

interdependence. Trade barriers are policy instruments that impose costs on domestic consumers by restricting domestic market access of foreign producers. These restrictions on choices in domestic product markets have secondary implications for input markets. They can raise the price of domestically produced output to induce foreign owners to produce output domestically rather than export over trade barriers. Hence, restrictions on international movement of outputs may induce international movement of inputs. Tariff barriers drive a wedge between domestic prices and international prices that can be sufficiently large to make domestic inputs interdependent with foreign inputs and ownership.

International interdependence induced by tariff barriers is of secondary importance in causing MNEs. Nonetheless, industrialization and foreign direct investment were important objectives of Canadian import policy up to the 1930s. In 1879 Sir Leonard Tilley introduced the high tariffs that defined the National Policy with the famous remark that "the time has arrived when we are to decide whether we will simply be hewers of wood and drawers of water".⁵ Tariff restrictions were initially conceived as an instrument to industrialize the domestic economy. Tariffs were the major instrument of national economic policy until the great contraction of 1929-33. In 1930 the Canadian government responded to the severe international contraction in economic activity by raising tariffs to unprecedented levels to stimulate domestic output and employment. Tariff increases to expand domestic employment also attracted foreign direct investment. It has been estimated that of the 1350 companies in Canada controlled or definitely affiliated with American firms in 1934, 26 per cent were established or acquired between 1930 and 1934.⁶ Attempts to industrialize our

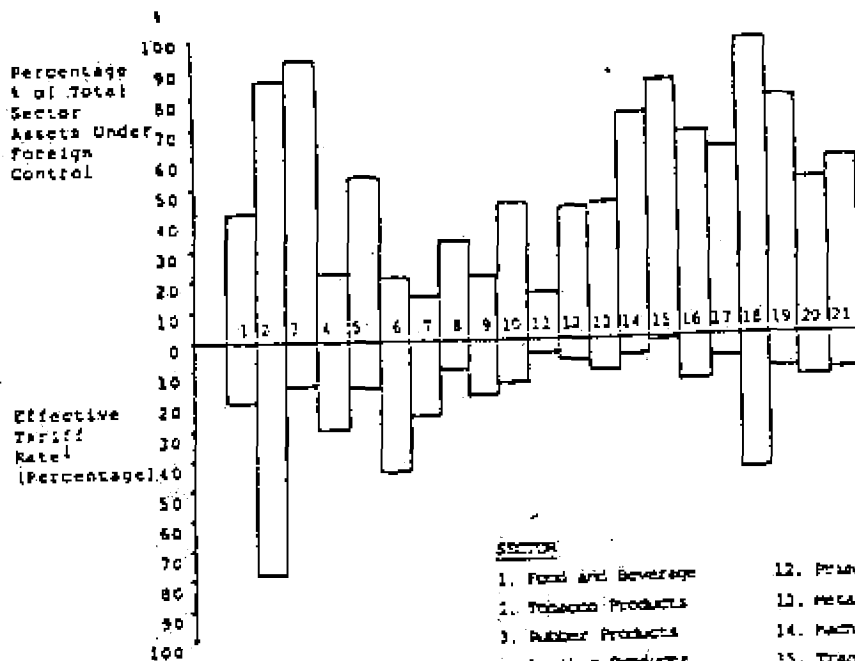
economy through tariff protection were partly motivated by the objective of diversifying employment opportunities by expanding the manufacturing sector. Innovations in economic policy after the 1930s broadened the governmental policy tools available for job creation and stabilizing the level of employment. Tariff barriers are now regarded as impediments to job creation and industrial re-structuring rather than as stimulants.

The conceptual framework indicates that tariffs are a secondary influence on the conditions necessary for MNEs. Moving from logical relationships to observed relationships we can compare the pattern in the sectoral incidence of tariffs with the sectoral incidence of foreign direct investment. Exhibit 1 displays percentages of foreign ownership with effective tariff protection for 20 manufacturing sectors in Canada.⁷ If tariff protection is an important cause of foreign direct investment, the pattern of sectoral tariff incidence of tariffs should mirror the pattern in sectoral incidence of foreign control across all 20 sectors.

EXHIBIT I

Sectoral Incidence of Effective Tariff Protection and Foreign Ownership as a Percentage of Total Assets for 20 Canadian Manufacturing Sectors 1970, 1975, 1978

1970



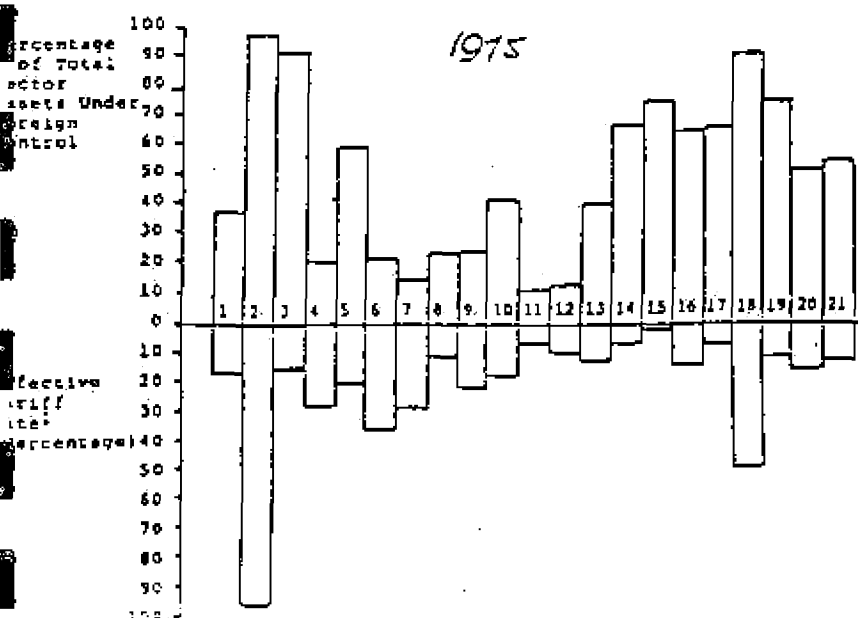
SECTOR

- | | |
|--------------------------------------|-----------------------------------|
| 1. Food and Beverage | 12. Primary Metals |
| 2. Tobacco Products | 13. Metal Fabricating |
| 3. Rubber Products | 14. Machinery |
| 4. Leather Products | 15. Transportation Equipment |
| 5. Textile Mills | 16. Electrical Products |
| 6. Knitting Mills | 17. Non-metallic Mineral Products |
| 7. Clothing Industries | 18. Petroleum & Coal Products |
| 8. Wood Industries | 19. Chemical & Chemical Products |
| 9. Furniture Industries | 20. Miscellaneous Manufacturing |
| 10. Paper and Allied Products | 21. All Manufacturing |
| 11. Printing, Engraving & Publishing | |

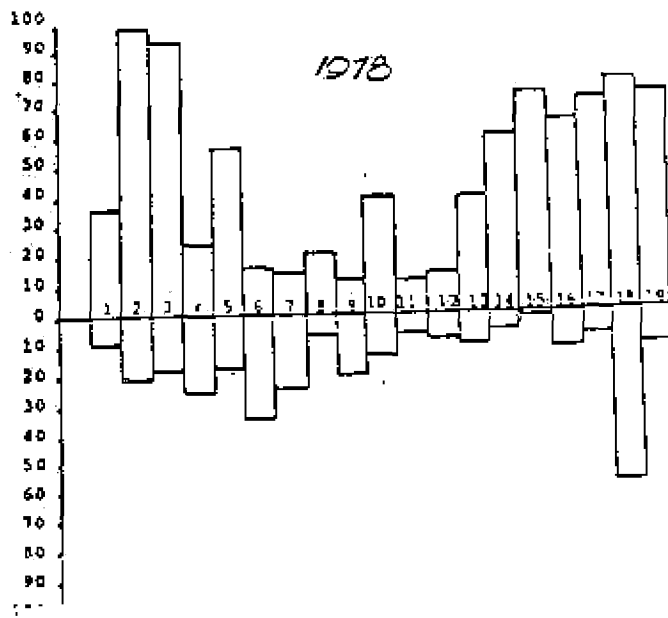
1. The effective tariff rate is calculated as the decline in value added that may occur if tariff protection were removed. Based on published input-output data on the Canadian economy and compiled by Baldwin et al.

SOURCES: Statistics Canada, CORPORATE AND LABOUR UNIONS RETURNS AND TALENT REPORT, Supply and Services, Ottawa, Various Years

1975



1978



The evidence displayed in the panels of Exhibit I is incompatible with a close causal relationship between tariff protection and foreign ownership within the Canadian manufacturing sector. This evidence accords with our conceptual framework conclusion that tariff protection has only secondary implications for the international interdependence necessary for a MNE.⁸

Our conceptual framework and the evidence in Exhibit I suggest that reduced trade barriers will not have a major impact on the overall level of foreign direct investment in Canada. Nonetheless, at the level of each individual sector reduced trade barriers could have an impact on foreign direct investment in some cases. In terms of our conceptual framework the relevant sectors are those where tariff barriers drive a sufficiently large wedge between the Canadian price and the world price that domestic productive inputs increase in value sufficiently to induce foreigners to acquire control. In terms of the evidence displayed in Exhibit I this interdependence could be present for the following sectors: tobacco products, leather products, knitting mills and clothing.

Foreign control responses to reduced bilateral trade barriers

This section predicts changes in the level of foreign control over Canadian industry associated with each choice for our bilateral trade policy with the United States.⁹ The first sub-section predicts the foreign ownership responses to a free trade area. The second sub-section predicts foreign ownership responses to either sectoral or functional free trade agreements. The role of a bilateral

agreement establishing principles and procedures for negotiating trade issues is discussed within each sub-section.

Foreign control of Canadian industry
within a Canada-United States free trade area

Eliminating trade barriers between Canada and the United States creates a bilateral free trade area. An immediate issue is how this new environment will influence foreign control of Canadian industry. Specifically, would a free trade area stimulate or diminish foreign ownership or leave it unchanged?

Foreign control expands or contracts in response to changes in the interdependence between foreign inputs and domestic inputs of the production process. From a Canadian perspective increased interdependence between foreign owners and domestic inputs often implies increased foreign ownership. Conversely, diminished interdependence reduces foreign ownership. The impact of a free trade area on foreign control thus depends upon the resultant interdependence between foreign owners and Canadian resources.

Interdependence between inputs derives from the technical characteristics of the production process. These characteristics specify the division of labour between input activities. Technical improvements in production processes often involve a finer division of labour and provide greater potential for international interdependence. A Canada-United States free trade area would increase competitive pressures and thereby stimulate the adoption of more technically

advanced production processes. This longer-term response can be designated technically advanced foreign investment.

A free trade area dilutes or eliminates the interdependence induced by tariff protection. If the domestic price in one country is closer to the world price then creating a free trade area will erode the interdependence between foreign owners and domestic inputs in the other country. A free trade area thus threatens prior foreign investment in branch plants established to circumvent the tariff. In the absence of a re-orientation in corporate strategy through rationalization or world product mandating, a free trade area implies disinvestment in foreign-owned branch plants.

The net impact of a free trade area on foreign direct investment depends upon the relative magnitude of the increase in technically advanced foreign direct investment compared to the decline in branch plant foreign investment. The relative magnitude is obscured by the different time horizons associated with each response. Creating a free trade area through the elimination of mutual tariff barriers immediately alters the environment for corporate decision-making to the extent that the consequences would become fully evident over a horizon of approximately five years. Technical advances in production processes are much more gradual so that their impact on the internationalization of production occurs over a horizon of between two and three decades. Hence, if a bilateral free trade area does not induce significant changes in corporate strategy for branch plants, the level of foreign direct investment will initially decline over a medium-term horizon of approximately five years and then subsequently increase over a longer-term horizon of two to three decades.

Creating a free trade area eliminates both tariff and non-tariff barriers. Eliminating non-tariff barriers is more complex than eliminating tariff barriers because their diverse formats and justifications make them difficult to compare and negotiate. This negotiating complexity implies the need for a concurrent bilateral agreement to establish principles and procedures for their elimination. Thus, choosing the free trade area option requires a bilateral agreement governing negotiations to remove non-tariff barriers.

Public policy on foreign investment screening could also require changes within a free trade area environment. The causal factors responsible for technically advanced foreign direct investment differ markedly from those responsible for branch plant foreign investment. The impacts on productivity differ because technical advancement raises productivity, while branch plants often diminish productivity owing to their relatively inefficient scale of operations. Hence, within a free trade area public policy on foreign investment screening could be altered to specify changes in productivity performance as a major criteria for suitable foreign investment.

Tariffs are an instrument of tax policy as well as trade policy. Hence, tariff elimination in a free trade area requires a thorough investigation of tax policy to determine if other taxes have the same impact on foreign ownership as tariffs. This might imply the need for modifications to tax policies that discourage imports. Tax policy would also require modification to recoup tax losses resulting from elimination of tariffs.

Foreign control of Canadian industry within Canada-United States sectoral or functional free trade agreements

Sectoral or functional free trade agreements restrict trade liberalization to specific sectors or functional areas. Sectoral free trade has an impact on foreign ownership according to the resulting changes in international interdependence of each liberalised sectoral production process. Functional free trade is trade liberalization in functionally defined areas. The consequences for the level of foreign ownership depend upon how the functionally defined areas relate to international interdependence of production processes.

Sectoral free trade agreements currently operate within both the Canada-United States automotive industry and the Canada-United States defence production industry. Since the two federal governments are the sole purchasers of defence industry output this sectoral agreement is a special case. The 1965 Canada-United States automotive agreement stimulated changes in corporate strategies within the automotive industry that comprehensively rationalized North American production. However, this sectoral agreement had virtually no impact on the level of foreign ownership. Recent sectoral free trade discussions have identified four "priority sectors" for possible trade liberalization: steel, urban mass transit equipment, farm machinery, and traded computer services.¹⁰ The potential impact of sectoral free trade within these sectors on levels of foreign ownership ultimately depends on whether removal of trade barriers makes each sectoral production process relatively more or less internationally interdependent. If interdependence between American owners and Canadian

inputs increases, then the level of foreign direct investment in Canada will increase. Conversely, if interdependence between Canadian owners and American resources increases, the level of Canadian foreign investment in the United States will increase.

International interdependence at the sectoral level results from the nature of the production process and efficiencies in managerial skills. If the production process is susceptible to an international division of productive inputs then the country with more efficient managerial skills will increase its foreign investment. This results because more efficient management adopts technological improvements more rapidly and because ownership usually entails ultimate responsibility for managerial decisions.

The four priority sectors have production processes that are subject to an international division of labour in varying degrees. Steel and farm machinery are produced by continuous assembly-line processes. Urban mass transit equipment is produced by discontinuous assembly line processes to meet contractual specifications. The standardization incorporated in assembly-line processes makes them amenable to internationalization. Computer services are not produced by assembly-line techniques and consequently are not subject to internationalization in the same way as the other three sectors. Thus, the impact of sectoral free trade on the level of foreign ownership in steel, urban mass transit equipment and farm machinery hinges upon national managerial skills.

Inferior managerial skills have been attributed to Canadian management. The average Canadian manager tends to be older, to have moved through the ranks more slowly, to be less well-educated and generally less experienced in comparison with foreign managers.¹¹ Canadian managers also tend to adopt new production techniques more slowly than foreign managers.¹² Hence, the managerial skills in the four priority sectors must considerably exceed Canadian norms for sectoral free trade not to induce increased foreign ownership of Canadian industry. In standardized assembly-line production processes Canadian managerial skills are probably comparable to American skills, so the the level of foreign ownership is unlikely to change as a consequence of sectoral free trade. The computer services industry is a new industry characterized by diverse production processes and management techniques. Consequently, the implications of sectoral free trade for levels of foreign ownership are uncertain.

The implications of functional free trade for the level of foreign direct investment depend upon how functional areas relate to production processes. Functional free trade has been defined in terms of removing trade restrictions resulting from "government procurement or contingency protection measures such as emergency safeguards and countervailing duties",¹³ This definition of a functional free trade agreement suggests that it would encompass bilateral reductions in governmental non-tariff barriers. Governmental non-tariff barriers are usually imposed to ease transitory labour market adjustments resulting from permanent changes in import and export patterns. In recent years non-tariff barriers have been imposed to ease the re-allocation of labour from mature "smokestack" industries that cannot meet foreign competition. A functional

free-trade agreement thus implies a need for procedures to negotiate removal of non-tariff barriers.

A bilateral agreement establishing principles and procedures for negotiating removal of non-tariff barriers is a concomitant of a functional free-trade agreement. The principles and procedures must incorporate a definition of what constitutes a non-tariff barrier. The agreement must also clarify what constitutes permanent changes to export and import patterns as they relate to transitory labour market adjustments.

The relative importance of foreign ownership considerations could also be specified in the principles and procedures for bilateral reductions in non-tariff barriers. Since the functional free trade area concept does not relate to specific sectors the net impact on levels of foreign ownership is uncertain. This uncertainty makes it virtually impossible to develop specific implications for other public policies that would result from a functional free-trade area.

Foreign corporate strategy responses to reduced trade barriers

The form of foreign control within Canadian industry will change with each choice for our bilateral trade policy with the United States. The first sub-section predicts changes in the form of foreign direct investment from branch plant operations to rationalized operations incorporating the most advanced production techniques. The second sub-section predicts changes from branch plant operations to operations with world product mandates for exclusive worldwide production of a specific output.

Rationalization strategies in response to reduced trade barriers

The reduction or elimination of bilateral Canada-United States trade barriers radically alters the international environment for MNE operations. Trade barriers induce international interdependence by raising the value of domestic inputs to foreign owners. Corporate MNE strategy in response to this protected environment in Canada has often encompassed establishment of branch plants to supply the protected Canadian market. These branch plant operations typically produce inefficiently because of the absence of competitive pressures, while the protected Canadian market is too small to warrant efficient output levels. Corporate MNE strategy in response to a less-protected environment requires the MNE to re-define the role of the Canadian branch plants in its overall corporate strategy.

Rationalization is a corporate strategy that renews the branch plant with the most advanced production processes. It also narrows each plant's output to specialized units and the scale of operations is expanded beyond the requirements of the previously protected market to furnish the corporation's total output. For example, Massey-Ferguson rationalized its European production after the European Common Market was established. This strategic response took the form of building wheel assemblies in one location, chassis in a second, engines in a third, and assembling finished tractors in a fourth. Thus, rationalization can integrate previous branch plants into the MNEs' total productive processes. It replaces interdependence induced by trade barriers with economic interdependence achieved by a more productive international division of labour.

We must investigate the likelihood of rationalization strategies in terms of renewing the branch plant's economic viability within environments distinguished by reduced trade barriers. The two environments are bilateral free trade and sectoral free trade.

Bilateral free trade

A bilateral free-trade area for Canada and the United States establishes the environmental pre-condition for corporate choice of a rationalization strategy. This strategic choice is a response to the new environment incorporating a new international division of the production process. The economic and technical characteristics of production processes are such that greater divisibility facilitates greater rationalization. Economic influences on divisibility result from differences in input costs that exceed the transportation costs between production locations. In Canada, natural resource input costs are relatively low, while labour and capital costs are relatively high. Consequently, rationalization strategies are most likely to be adopted by MNEs with outputs requiring a large amount of natural resources. However, sectors producing these outputs are not characterized by inefficient Canadian branch plants. In the first section the tobacco products, leather products, knitting mills, and clothing sectors were identified as those where interdependence induced by tariffs was probably present. Competitive pressure on foreign-owned knitting mills, clothing industries and leather product industries originate from newly industrialized countries rather than the United States. Hence, viable corporate rationalization strategies for these industries would require branch plant

purchases by MNEs in newly industrializing countries. Corporate rationalization of the Canadian branch plants necessitates foreign investment from outside the proposed bilateral free-trade area.

Public policy on foreign investment screening could be modified to incorporate corporate strategic rationalization criteria if the free-trade option was chosen. This adaptation of screening criteria would also require negotiation with the United States to avoid competitive pressures for the attraction of foreign direct investment that would rationalize inefficient operations.

Tobacco products are subject to substantial non-tariff barriers in addition to tariff barriers. Thus, Canadian operations differ from the typical branch plant operation induced solely by tariff protection. A viable rationalization strategy for American MNEs in the tobacco products sector would require prior agreement for removal of non-tariff barriers. This could be achieved by a concurrent choice for a bilateral agreement that would establish principles and procedures for elimination of non-tariff barriers.

Sectoral or functional free trade agreements

Sectoral free-trade agreements could establish formal conditions for adoption of corporate rationalization strategies. The Canada-United States automotive agreement is an outstanding example of an international sectoral free-trade agreement designed to achieve strategic rationalization objectives. The instruments within the agreement to fulfill these objectives are the

safeguard provisions that specify the maintenance of Canadian production locations. However, the knitting mills, clothing, and leather product sectors that are characterized by inefficient branch plant operations probably require rationalization by MNEs located in newly-industrializing countries. As a result, sectoral free-trade agreements with the United States could not incorporate viable rationalization objectives.

The tobacco products sector is more amenable to rationalization through a sectoral free-trade agreement with the United States. The sectoral agreement could be readily modified to incorporate both rationalization objectives and rationalization instruments. Nonetheless, a sectoral agreement for tobacco products would require a concurrent bilateral agreement for removing non-tariff barriers because of their key importance in this sector.

Sectoral free-trade discussions in Canada have not identified priority sectors in terms of rationalizing inefficient branch plants. The priority sectors of steel, urban mass transit equipment, farm machinery, and traded computer services have been identified in terms of requirements for large scale production and export potential. Hence, within these sectors rationalization of Canadian operations is not a relevant corporate strategy. Canadian foreign direct investment in the United States within the priority sectors is probably insufficient to induce rationalization of Canada-United States production.

Functional free-trade agreements encompassing bilateral reductions in governmentally-imposed non-tariff barriers have more substantial implications

for corporate rationalizing strategies. Since these barriers originate from transitory labour market adjustments, rationalization strategies could ease the sectoral re-allocation of labour. Functional free-trade agreements are thus complementary with rationalization strategies. Functional free trade would be most appropriate for rationalization if combined with a bilateral agreement establishing principles and procedures for removing non-tariff barriers.

World product mandate strategies in response to reduced trade barriers

Corporate MNE strategies in response to bilateral free-trade could encompass world product mandates for their Canadian branch plants. This strategy assigns the branch plant "total responsibility for particular products or operations within the multinational ... (including) responsibility for all aspects of research and development including conceptual or basic research; responsibility for manufacturing; and direct responsibility for international marketing."¹⁴ World product mandating is thus an enriched variant of the rationalization strategy. The enrichment relates to research, development and marketing. Exhibit II summarizes the basic differences between corporate MNE strategies for a protected branch plant, a rationalized subsidiary operation and a subsidiary operation with a world product mandate.

EXHIBIT II

Corporate Strategies for Subsidiaries in
Multinational Enterprises

	<u>Branch Plant Strategy</u>	<u>Rationalized Subsidiary Strategy</u>	<u>World Product Mandate Strategy</u>
Production	S	S	S
Selling	S	S	S
Process technology	S	S	S
Management	S	P	S
Marketing	S	P	S
Product renewal	P	P	S
Exporting	n.a.	P	S

S = subsidiary has Primary responsibility

P = parent has primary responsibility

n.a. = not applicable

The international economic interdependence that causes a MNE differs according to the corporate strategy. Interdependence between foreign owners and domestic resources that is induced by tariff protection causes a branch plant strategy. Interdependence between direct inputs to the production process causes a rationalization strategy. The interdependence causing a world product mandate strategy is an interdependence beyond direct inputs to encompass indirect inputs such as research, development and marketing. A world product mandate strategy is more interdependent with the parent MNE and less dependent than the branch plant or the rationalized strategy. Greater interdependence results from the consolidation of more operations in the subsidiary.

The formulation of world product mandate strategies for subsidiaries differs from the formulation of branch plant or rationalization strategies. Management within the subsidiary typically takes the initiative to acquire a world product mandate. In contrast, strategic decisions to create a branch plant or a rationalized operation are the preserve of corporate planners within the MNE. The MNE corporate planners assess the subsidiary management's initiatives for a world product mandate then integrate successful initiatives into overall corporate MNE strategy. Thus adoption of world product mandates by Canadian subsidiaries will depend upon the aggressiveness of Canadian branch plant management within either a bilateral-free trade environment or a sectoral free-trade environment or a functional free-trade environment.

(a) Bilateral free-trade

A bilateral free-trade environment would eliminate the induced interdependence between American owners and Canadian inputs that prompted establishment of Canadian branch plants. The central issue is whether the Canadian managers of a branch plant that becomes redundant will actively seek world product mandates from American MNE parent firms. The economic determinants of a viable world product mandate imply that the Canadian managers who seek this strategy must acquire appropriate research, development, manufacturing, and world marketing services. They must then coordinate these services to produce a product that competes effectively in world markets.

The leather products, knitting mills, and clothing sectors are faced with potentially redundant branch plants. Two considerations mitigate the likelihood of world product mandate strategies for Canadian subsidiaries in these sectors. First, the managerial capabilities within the branch plant subsidiaries are probably limited. This means they are unlikely to seek aggressively for world product mandates to transform their branch plants into world producers. Second, viable world product mandate strategies for these sectors would originate from MNEs in newly industrializing countries but the current pattern of Canadian foreign ownership mostly encompasses American MNEs. Thus, unless the potentially redundant Canadian branch plants are purchased by MNEs from the newly industrializing countries and Canadian branch plant management is significantly upgraded, viable world product mandate strategies are unlikely.

The tobacco products sector differs from the preceding sectors because viable world product mandates could be acquired from American parent MNEs. World product mandates in Canadian tobacco products will depend primarily upon the aggressiveness of Canadian branch plant management. Nonetheless, bilateral free-trade will be inhibited by non-tariff barriers on tobacco products. These barriers are a major influence on the sectoral environment, so viable world product mandates would necessitate a bilateral agreement establishing principles and procedures for their removal.

World product mandates are more likely to be won in sectors producing new products subject to expanding worldwide demand. The relative newness of most sectors producing these products means they are not already characterized by

significant numbers of branch plants in Canada. Hence, world product mandate strategies are unlikely to yield permanent solutions to problems arising from branch plants made redundant by a bilateral Canada-United States free trade area.

(b) Sectoral or functional free-trade agreements

Sectoral free-trade agreements are unlikely to prompt adoption of world product mandate strategies for Canadian subsidiaries. The knitting mills, clothing, leather products, and tobacco products sectors that require industrial renewal are unlikely candidates for sectoral free trade agreements. Also, required adoptions of world product mandate strategies would be exceptionally difficult to incorporate in a sectoral agreement. Production responsibilities encompassing product mandates enforced by an intergovernmental agreement would not be welcomed by MNEs.

Sectoral free-trade proposals originating from Canada have given steel, urban mass transit equipment and traded computer services priority status. The basis for their priority status is incompatible with world product mandates for Canadian subsidiaries. Thus, their prioritization on the basis of both competitive export potential and needs for large scale production runs means that they are potential producers for world markets regardless of specific objectives in the firm's strategic plans. In addition, Canadian foreign direct investment in the United States in the priority sectors is probably insufficient to motivate managers of the American subsidiaries to actively seek world product mandates.

Functional free-trade agreements relate to governmental non-tariff barriers. Comprehensive functional free-trade agreements covering entire sectors could establish the environmental preconditions but they have no necessary implications for adoption of world product mandate strategies.

CONCLUSIONS

This section assesses the relative importance of public policies that have an impact on our trade patterns in the first sub-section. The second sub-section assesses the impact of specific economic determinants governing our patterns. A brief concluding sub-section summarizes the answers to the questions concerning MNE responses to reduced trade barriers between Canada and the United States that were posed at the outset of the study.

Public policies and Canada's international trade patterns

Public policies that have impacts on our trade patterns include taxation, exchange rate management, labour legislation and competition legislation. Each one of these policies has an independent impact on our trade patterns. Their relative importance depends upon the relationship between the prime objective governing the uses of each policy instrument and the consequences of this use for Canada's specialization in certain economic activities.

Taxation policy is the most important public policy instrument influencing our trade patterns. Tariffs are a tax on imports so tariff policy is an instrument

of tax policy. The prime objective of tax policy is to raise maximum revenue with minimum distortions to resource allocation. Tariffs directly distort the international allocation of resources through their impact on trade flows. In evaluating the impact of taxation on our trade patterns the central issue is whether domestic taxes have impacts on exports and imports that are comparable to the tariff in their impact on Canada's trade flows.

Exchange rate management comprises actions by domestic monetary authorities to alter the value of the exchange rate from the value that would result from supply and demand conditions in the foreign exchange markets. The supply and demand conditions are the channels whereby the overall balance of payments position is transmitted to the exchange rate. Exchange rate management is prompted by objectives for the domestic inflation rate or for the domestic unemployment rate. Either one of these can be the prime objectives achieved over a short run horizon of up to a year through switches of domestic residents' expenditure patterns between internationally traded goods and domestically traded goods. Nonetheless, exchange rate management has its impact upon nominal valuations expressed in terms of money instead of real valuations expressed in terms of the items traded. Rational economic behaviour means that individual economic behaviour responds to real valuations. Consequently, exchange rate management influences on nominal valuations cannot permanently change the real patterns of exports and imports that are traded. Exchange rate management can only have a significant impact on transitory changes in the permanent patterns of our trade flows.

Labour legislation and labour market policy encompasses governmentally imposed changes in the operations of labour markets. The primary objectives of labour legislation and labour market policy are to alter labour market operations for the benefit of domestic labour, subject to minimal distortions to the efficient allocation of labour services. Labour market legislation and policy is very unlikely to have direct implications for Canada's permanent international trade patterns because excessive benefits enjoyed by domestic labour can be offset by subsequent choices of labour-saving production techniques. Nonetheless, labour market policies operate over a shorter time horizon in comparison to the time horizon necessary for selection and implementation of new production techniques. In the transition period before production techniques are adapted to the results of labour legislation or policies higher benefits for domestic labour can raise the price of tradeable goods and services produced domestically. Thus delayed adjustment can lead to transitory alterations in domestic patterns of exports and imports until the technique of production has adjusted.

Competition legislation and policy establishes the bounds of appropriate market strategies for buyers and sellers. The primary objective of competition legislation and policy is to improve allocative efficiencies of domestic markets. This objective is compatible with Canada's specialization in economic activity according to her comparative advantage. Nonetheless, implementation of competition policy can encounter difficulties because the primary objective of competition policy may conflict with the objectives motivating the implementation of other governmental legislation and policies. These conflicting objective can have transitory impacts on the structure of Canada's trade.

Economic determinants of Canada's trade patterns

This sub-section examines the impact of two economic determinants on Canada's patterns of international trade and foreign investment. First we consider labour cost determinants. Then we consider transportation cost determinants and their specific impacts on the location of inputs in relation to domestic production processes, as well as on the location of production processes in relation to market demand for final output. The impact of each determinant on the level of foreign ownership in the Canadian economy is also briefly summarized.

Canadian labour costs are a major determinant of our international trade patterns. In the Canadian economy labour is a scarce resource relative to some of our other inputs such as land and natural resources. This relative scarcity implies that labour is a high priced or costly input into production processes. Consequently, our exports incorporate relatively small amounts of labour inputs while our imports incorporate relatively larger labour inputs.

This pattern of labour endowments and resultant labour costs influences the type of foreign ownership flows into the Canadian economy. Economic interdependence between foreign owners and domestic inputs that causes MNEs follows from their distinctive production techniques and input choices. Since production techniques are relatively fixed over the medium term foreign investment decisions will be heavily influenced by input costs. High labour cost is a structural feature of the Canadian economy, so viable foreign investment is unlikely to occur in sectors requiring large amounts of labour inputs.

Transportation costs are a minor determinant of our international trade patterns. Transportation technology has steadily improved and thereby diminished unit transportation costs. Despite increases in energy costs Canada's technologically advanced transportation sector provides relatively inexpensive transportation input services. Transportation costs also have an impact upon the location of input services in relation to production processes where they are used, as well as on the location of the production process in relation to the market demand for final output. Continuing technological advances in transportation imply that these locational considerations will become a less important determinant of our future trade patterns. Thus our steadily expanding trade with distant Pacific rim countries reveals the relatively minor impact of transportation costs on our international trade patterns.

Transportation costs and their influence on locational decisions are a subsidiary factor in the pattern of foreign ownership. The interdependence between foreign owners and domestic inputs causing MNEs is conditioned more directly by production techniques and input costs associated with labour services, capital services and natural resources.

Conclusion

We can now provide conditional answers to the three questions posed at the beginning of the study. First, the level of foreign control over domestic industries could initially diminish during the medium term after trade barriers are diminished, but over a longer horizon technically advanced foreign

investment and foreign control could increase. This sequential pattern of MNE responses assumes no change in corporate MNE strategies for Canadian subsidiaries. Second, the form of foreign control could alter as MNEs respond to reduced trade barriers with corporate strategies that integrate Canadian subsidiaries by rationalization or world product mandates. These strategic responses are not likely to occur in sectors where branch plants are made redundant by reductions in Canada-United States trade barriers. Viable rationalization and world product mandate strategies are more likely to occur within sectors producing new products by production techniques amenable to Canada's endowments of productive inputs. Third, taxation is probably the most important policy influence on our trade patterns. Legislation and policies for exchange rates policy, labour markets, and competition can induce transitory changes in our trade patterns but they are unlikely to permanently alter the structure of our exports and imports. Labour costs are the major determinant of both our trade patterns and foreign investment flows.

FOOTNOTES

- * A research study to fulfill contractual arrangements with the Department of External Affairs, Government of Canada. Greg Meredith provided valuable research assistance and stimulating discussions. Liabilities for errors rests exclusively with the author.
1. In each case we assume that the United States agrees to the Canadian choice. Thus, we do not consider either bargaining or United States policy options.
 2. Armen A. Alchian and Harold Demsetz, "Production, Information Costs and Economic Organization," in Economic Forces at Work: Selected Works by Armen A. Alchian (Indianapolis: Liberty Press, 1977).
 3. Managerial commands or directives are economic devices for co-ordinating or allocating productive inputs within a firm. They are supplemented by other non-economic social devices such as ethical values, team spirit, and company loyalty.
 4. John McManus, "The Theory of the International Firm," in The Multinational Firm and the Nation State, Gilles Paquet ed., (Don Mills: Collier-MacMillan, 1972).
 5. Quoted by Orville John McDiarmid, Commercial Policy in the Canadian Economy, (Cambridge: Harvard University Press, 1946) p. 186.
 6. Herbert Marshall, Frank A. Southard Jr., and Kenneth W. Taylor, Canadian-American Industry (New Haven: Yale University Press, 1936) p. 149.
 7. Effective tariff protection differs from nominal tariff rates by taking account of the tariff protection on imported inputs. This provides a more accurate measure of the protection to domestic production.
 8. Subject to three qualifications. First, our conclusions are for relationships between the national patterns and need not hold for individual sectors. Second, our evidence is for the rate of tariff protection and the stock of foreign ownership. There might be a closer relationship between changes in the rate of tariff protection and the flow of foreign ownership. Third, non-tariff barriers have not been considered.
 9. This section predicts changes in the overall level of foreign ownership. Section 3 predicts changes in the form of foreign ownership.
 10. Michael Hart, "Some Thoughts on Canada - United States Sectoral Free Trade," the Institute for Research on Public Policy, Essays in International Economics (Montreal, 1985) p.19.
 11. Don J. Daly, "Canadian Management: Past Recruitment Practices and Future Training Needs," in Highlights and Background Studies Max von Zur-Muehlen ed., (Ottawa: Canadian Federation of Deans of Management and Administrative Studies, 1979).

12. Don J. Daly and Steven Globerman, Tariff and Science Policies: Applications of a Model of Nationalism, (Toronto: University of Toronto Press, 1976).
13. Canada, "How to Secure and Enhance Canadian Access to Export Markets," Department of External Affairs Discussion Paper, p. 25.
14. Ontario Ministry of Industry and Tourism, The Report of the Advisory Committee on Global Product Mandating, (Toronto: Government of Ontario, 1980) p. 3.



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