

Business investment: Forging alliances abroad to create wealth here at home

Business investment is one of the pillars of the economy. Whether it comes from established local firms or from other parts of the world, it is generally believed to stimulate growth. Foreign investment is particularly appealing because it is associated with higher productivity. As a general rule, it introduces new technologies and, in so doing, stimulates local and national firms that will vie with this new competition, or that will aspire to become preferred trading partners. Foreign investment is highly sought after, and while the industrialized countries have long been its main destination, they are now having the rug pulled out from under them by the emerging economies. In this struggle, Quebec does have some advantages, but it also faces challenges. The responsibility is shared between governments and the business community. Overbidding happens, and one must be mindful of value.

DEFINITION OF FOREIGN INVESTMENT

For statistical purposes, there are two ways of defining foreign investment. The first has to do with foreign direct investment (FDI), and the second with investment under foreign control (IUFC).

FDI refers to investment carried out by a firm with the goal of creating, developing or maintaining a subsidiary in a foreign country, or of exercising significant influence over the management of a firm established in a foreign country. A foreign firm is considered to exercise significant influence when it owns at least 10% of voting shares.¹ FDI can take various forms, the main ones being the creation of corporations or subsidiaries, mergers and acquisitions, and the reinvestment of retained earnings in foreign subsidiaries. In order for an investment to qualify as an FDI, it must lead to a transfer of capital from one country to another.

IUFC is defined as investment by firms of which at least 50% of voting shares are held in foreign hands. An IUFC can also be an FDI, but this is not necessarily the case. The following example, drawn from a publication by the Institut de la statistique du Québec, clearly illustrates the difference between the two concepts: if a U.S. firm invests in expanding its factory in Quebec, this constitutes an

IUFC. If the expansion is paid for with funds borrowed locally, the investment will not be considered an FDI. On the other hand, it will be considered an FDI if it is funded by the U.S. parent company using retained earnings.²

International studies, in particular those of the Organisation for Economic Co-operation and Development (OECD), focus on the FDI concept. On the other hand, organizations whose mission is to attract foreign investment are more interested in IUFC, since their goal is to stimulate investment, regardless of whether it requires an entry of capital into their region.

GENERALLY RECOGNIZED BENEFITS OF FDI FOR THE HOST COUNTRY

The reason why countries vie with each other to attract foreign direct investment is that it is generally viewed as bringing numerous benefits. FDI generates positive effects on the economy of the host country: increased production, job creation and higher earned income and tax revenues. But most important, FDI helps improve the productivity of the host country thanks to the transfer of technologies and skills that it promotes (among other things). In practice, the majority of FDI is carried out by multinational corporations.

¹ Statistics Canada, "Canada's International Investment Position," No. 67-202-X in the catalogue, vol. 10, no. 1, 2012, p. 66.

² Institut de la statistique du Québec, *Bulletin FLASH*, "Investissements sous contrôle étranger, perspectives 2014," November 20, 2014, p. 3, www.stat.gouv.qc.ca/statistiques/economie/investissements/controle-etranger/ipp-etranger-2014.pdf.

When they set up a subsidiary abroad, the host country benefits from new technologies and the expertise of highly qualified labour that comes with it. Over the more or less long term, this new knowledge and new skills will spread through the industry, enabling local firms to improve their productivity.³

FDI also generally leads to greater competition, forcing local firms to improve their productivity in order to remain competitive. Furthermore, multinational corporations have high quality standards for their inputs. Consequently, their local suppliers will be encouraged to improve their products and their production processes, which will help increase their productivity.⁴ Finally, thanks to the vast distribution networks of multinational corporations, FDI gives the local firms that are associated with them access to new export markets.

DRAWBACKS ASSOCIATED WITH FDI FOR THE HOST COUNTRY

FDI does not only provide benefits to the host country; it also entails a number of drawbacks that must be taken into consideration. The loss of control over national industry to foreign interests certainly tops the list of risks inherent in FDI. The possibility of sustaining undue economic or political influence from the multinationals, and of losing control over strategic resources, does exist and can threaten national security and sovereignty.⁵

To avoid these negative consequences, countries generally impose restrictions on FDI. In some sectors, foreign shareholding can be capped, or even prohibited entirely. Foreigners may be barred from playing certain roles, such as supervisory roles, in the subsidiaries on the host country's soil. Limits may be imposed on the percentage of

foreigners who may sit on the boards of directors of firms with foreign shareholding.

In addition to the risks to the host country's security and sovereignty, FDI can generate a number of drawbacks of an economic nature: the profits earned by the subsidiaries of multinationals could be repatriated or reinvested elsewhere than in the host country, and small local firms could be stifled by the competition from large multinational corporations.

To prevent these undesirable effects, the restrictions imposed by some countries include clauses requiring foreign investors to demonstrate that their FDI will generate favourable economic benefits in the host country. Some regulations also limit the hiring of foreign workers, in order to protect national employment. Over time, however, the restrictions intended to protect host countries from the potential negative effects of FDI on their economies have tended to diminish, as a consensus has emerged that those effects are far outweighed by the economic benefits.

Yet, the positive effect of inward FDI on the host country's economic growth has not been demonstrated in black and white, despite numerous empirical studies carried out on the subject around the world. There are many reasons for this. First, the empirical studies' focus on total FDI rather than on FDI by sector tends to mask the major positive effects that FDI can have in certain sectors. Also, the type of FDI is not always taken into consideration. For instance, the creation of a subsidiary of a foreign corporation in the host country will probably not have the same effect on the country's economic growth as the acquisition of an existing national firm by a foreign corporation. Finally, the effect of FDI on economic growth depends on the level of the host country's development (economic, political, social, cultural or other). For example, in the absence of a qualified local labour force, it could be impossible for the host country to integrate the new technologies brought by the FDI. The absence of developed financial markets, or of a solid institutional infrastructure, could also be an issue in some countries.⁶ Of course, such problems do not apply in a developed economy like Canada's.⁷

³ For more details about the channels through which knowledge and skills linked to FDI are transmitted, see: Conference Board of Canada, "The Role of Canada's Major Cities in Attracting Foreign Direct Investment," May 17, 2012, p. 12-14, www.conferenceboard.ca/e-library/abstract.aspx?did=4817; also see: Kristelle M. Audet and Robert Gagné, "Ouverture aux investissements directs étrangers et productivité au Canada," *Centre sur la productivité et la prospérité*, HEC Montréal, October 2010, p. 60-63, cpp.hec.ca/cms/assets/documents/recherches_publiees/PP-2010-01_IDE_FRA_VC.pdf.

⁴ The authors of the study found "robust evidence for productivity spillovers from foreign-controlled plants to domestic-controlled plants arising from increased competition and greater use of new technologies among domestic plants." (p. 6): John R. Baldwin and Wulong Gu, "Global Links: Multinationals, Foreign Ownership and Productivity Growth in Canadian Manufacturing," *Research paper – The Canadian Economy in Transition series*, Micro-economic Analysis Division, Statistics Canada, December 2005, 43 p., www.statcan.gc.ca/pub/11-622-m/11-622-m2005009-eng.pdf.

⁵ This section is largely based on the following paper: Organisation for Economic Co-operation and Development, "Foreign Direct Investment Restrictions in OECD Countries," *Economics Department – Economic outlook*, analysis and forecasts, 9 p., www.oecd.org/eco/reform/2956455.pdf.

⁶ For a review of the empirical literature and a presentation of explanations about the divergence of results, see: Rui Moura and Rosa Forte, "The Effects of Foreign Direct Investment on the Host Country Economic Growth – Theory and Empirical Evidence," *FEP Working Papers No. 390*, Faculty of Economics of the University of Porto, 36 p., November 2010, www.fep.up.pt/investigacao/workingpapers/10.11.02_wp390.pdf.

⁷ The study quotes a few studies demonstrating the existence of a positive link between FDI and economic growth, productivity or employment: Conference Board of Canada, "The Role of Canada's Major Cities in Attracting Foreign Direct Investment," May 17, 2012, p. 14-16, www.conferenceboard.ca/e-library/abstract.aspx?did=4817.

In short, it has not been conclusively demonstrated that FDI necessarily has a positive effect on the host country's economic growth, but a consensus does exist regarding the numerous economic benefits that it brings.

FOREIGN INVESTMENT IN QUEBEC

Around the world, FDI plunged in 2008 and 2009 due to the financial crisis and the recession that followed. Since then it has resumed an upwards trend, but its structure has changed considerably over time. At the beginning of the 2000s, over 80% of FDI was aimed at the developed countries. In 2013, the situation was reversed: the majority of FDI, i.e. 61%, went to the emerging and developing countries (EDCs). Canada was among the top 10 recipients of FDI in 2000; it now stands in 13th place, after two EDCs, namely China and Brazil (see appendix, page 10 for more details on FDI trends in the world and in Canada).

Unfortunately, no data are available on FDI in the provinces. On the other hand, from 2004 to 2011, Statistics Canada did publish national and provincial data on IUFC.⁸ And in fact, IUFC data are probably more representative of the foreign contribution to investment than FDI data. Keep in mind that this type of investment refers to spending on non-residential construction and on machinery and equipment carried out by firms of which at least 50% of voting shares are in foreign hands. Contrary to inward FDI, IUFC does not necessarily entail bringing capital into the country. But it does enable us to evaluate the foreign contribution to non-residential investment made in Canada.

Although they date back a few years, the data compiled by Statistics Canada can be used to analyze IUFC trends in Quebec between 2004 and 2010 and to compare the profile of IUFC in Quebec with those of the other Canadian provinces.⁹ In 2010, the share of IUFC in private-sector non-residential investment reached 17% in Quebec, compared with 23% for Canada as a whole (graph 1).¹⁰ The contribution by foreign firms to construction spending, in particular, was lower in Quebec than in most of the other provinces.

⁸ Statistics Canada, "Foreign and Domestic Investment in Canada," No. 61-232-X in the catalogue.

⁹ In 2013 and in 2014, the Institut de la statistique du Québec compiled estimates of IUFC in Quebec. Unfortunately, those estimates are not comparable to those of Statistics Canada because the two statistical organizations used different methods to prepare their estimates.

¹⁰ Here we present the data from 2010, not those of 2011, because the latter were only forecasts when Statistics Canada published them.

Graph 1 – Proportion of IUFC in private-sector non-residential investment* by province in 2010

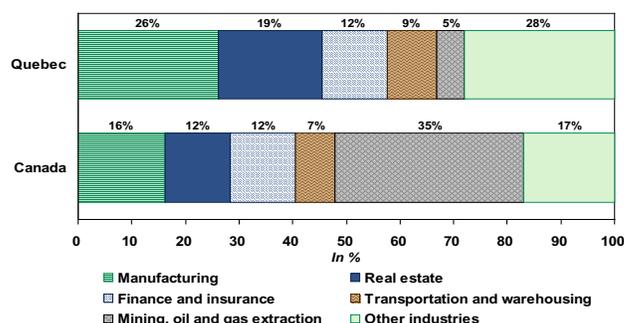
	Construction	Machinery and equipment	Total
Prince Edward Island	4%	9%	7%
Saskatchewan	5%	13%	7%
Manitoba	10%	19%	14%
New Brunswick	17%	17%	17%
Quebec	8%	25%	17%
Nova Scotia	15%	25%	20%
British Columbia	23%	24%	23%
Alberta	27%	21%	24%
Ontario	12%	35%	27%
Newfoundland and Labrador	65%	39%	57%
Canada	19%	27%	23%

* Private-sector non-residential investment is estimated as follows: total investment less investment by governments, health and social services, educational services and the housing sector.
Sources: Statistics Canada and Desjardins, Economic Studies

The share of foreign investment depends to a great extent on the industrial structure of the provinces. In Newfoundland and Labrador, Alberta and British Columbia, for example, the share of IUFC in construction spending is very high due to the importance of the oil and gas sector in those provinces. In fact, a large number of Canada's oil and natural gas producers are subsidiaries of foreign firms. In Ontario, on the other hand, the share of IUFC is far larger in machinery and equipment investment than in construction investment. This is due to the size of the auto sector in that province, which is dominated by U.S. and Japanese companies.

In Quebec, the manufacturing sector represents a significant share of the economy. This is reflected in the IUFC, since this is the sector that captures the largest share of total foreign capital spending, i.e. 26% (graph 2). In addition, 19% of IUFC goes to the real estate industry, a much larger proportion than in Canada as a whole (12%). On the other hand, the share of IUFC in the mining, oil and gas extraction sector is low in Quebec compared with the national average, which is not surprising, given that Quebec produces very little crude oil and natural gas.

Graph 2 – IUFC by industry in 2010



NOTE: Total may not equal 100 due to rounding.
Sources: Statistics Canada and Desjardins, Economic Studies

From 2004 to 2007, the share of IUFC in private-sector non-residential investment rose in Quebec (graph 3).¹¹ In 2007, it even surpassed that of all the other parts of Canada. Subsequently it followed a much steeper downwards trend than was the case in the rest of Canada. The difference is largely due to the size of foreign investment in the mining, oil and gas extraction industry. In 2010, for example, the deviation between the share of IUFC in private-sector non-residential investment in Quebec and in the rest of Canada reached seven percentage points (i.e. 24% less 17%), but just three percentage points (i.e. 21% less 18%) if we exclude the mining, oil and gas extraction sector from the calculations (graph 3).

Graph 3 – Proportion of IUFC in private-sector non-residential investment

	Total		Excluding mining, oil and gas extraction	
	Quebec	Canada excluding Quebec	Quebec	Canada excluding Quebec
2004	29%	33%	29%	32%
2005	30%	32%	31%	32%
2006	31%	32%	32%	33%
2007	33%	29%	33%	30%
2008	27%	29%	27%	26%
2009	20%	25%	21%	22%
2010	17%	24%	18%	21%

Sources: Statistics Canada and Desjardins, Economic Studies

In summary, the development of the EDCs has strongly influenced trends in inward FDI over the past 15 years. Although it is still among the countries receiving the most FDI, Canada now ranks behind two EDCs, and its share of global inward FDI has declined. We have no data on FDI by province, but the national and provincial statistics on IUFC show that foreign investment was lower in Quebec than in most of the other provinces in 2010. This is largely due to the importance of foreign investment in the mining, oil and gas extraction sector, which favours the oil-producing provinces.

DETERMINANTS OF INWARD FDI

In general, a firm that decides to invest abroad does so for one—or a combination—of the following three reasons: to win new markets, to exploit natural resources or to improve its efficiency. The choice of location will be closely tied to the reason why the firm has decided to invest abroad. Thus the size of the market, its growth outlooks and the

income of its inhabitants will stand at the top of the list of selection criteria for a firm that is establishing itself abroad to penetrate new markets (table 1 on page 5). On the other hand, the availability of the natural resource, its accessibility and its operating costs will be among the selection criteria of firms in the primary sector.

Finally, the top items that will be considered by a firm investing abroad to improve its efficiency are mainly linked to production costs, the availability and quality of human resources, and the reliability of the physical and telecommunications infrastructures that are in place.

After an initial selection based on the primary motivation underlying the FDI, a multitude of other factors will be taken into consideration in choosing the host territory. Many of them relate to the economic environment and government policies, such as the state of the economy, the tax regime and the regulations governing businesses, subsidy policies and restrictions on FDI. Other factors pertain to the governance of the host country and the quality of life of its population. A fairly exhaustive list of the many determinants of FDI is provided in table 1 on page 5.

WHERE DOES QUEBEC STAND?

For firms wishing to penetrate new markets

Quebec constitutes a relatively small market with rather limited growth outlooks, due to the aging of its population. That said, this population of 8 million people is part of a country with a population of 36 million, whose closest neighbour is home to nearly 325 million. Consequently, from the point of view of a foreign firm wishing to penetrate the North American market, Quebec represents an attractive point of entry. Certainly, Canada and the United States, like Quebec, have aging populations. But we must not forget that the standard of living in North America is among the highest in the world. Its inhabitants are great consumers, making this a preferred target for firms that wish to expand their clientele.

For firms wishing to exploit natural resources

Natural resources are plentiful in Quebec. The exploitation of forests, metals, minerals and many watercourses has always contributed to its wealth. Many foreign firms in the primary sector and in the natural resources processing sector are active in Quebec.

There is no doubt that Quebec is an attractive destination for foreign primary-sector investors, but it is in competition with other parts of the world that are equally rich in natural resources. Many factors will influence investors' choice, including access to the resources, the royalty system and the availability of qualified labour.

¹¹ The data used to produce this graph were drawn from the Statistics Canada reports, *Foreign and Domestic Investment in Canada*, for April 2008, May 2008, May 2009, May 2010 and May 2011. The data for 2004, 2006, 2007, 2008 and 2009 are actual data, whereas those for 2005 and 2010 are estimates that had been prepared when the reports were published.



Table 1 Determinants of foreign direct investment

Factors linked to the purpose of FDI

Markets: size, growth potential, income level, proximity to the largest markets, level of urbanization, changes in demand

Resources: availability of natural resources, access to resources, cost of resource exploration and exploitation

Efficiency: cost and productivity and availability of labour, availability and quality of infrastructures (buildings and land, transportation, education, research centres, telecommunications), availability and quality of utilities (electricity, water, etc.), cost and availability of financing

Factors linked to the macroeconomic environment and to government policies

Macroeconomic environment: price stability, economic growth, employment, exchange rate

Socio-political environment: political regime, social climate, demographics, standard of living, level of education

Business environment: tax regime, labour and capital subsidy policies, government support for research and development, efficiency of financial markets

Trade policies: openness to foreign trade, regional integration and access to regional markets, free-trade agreements

Regulations: regulations governing competition, regulation of the labour market, the regulatory burden

FDI regulations: restrictions on FDI, level of discrimination between foreign and national firms, transparency and stability of policies

Government policies: environmental and immigration policies

Factors linked to good governance and quality of life

Good governance: state of public finances

Quality of life: cost of living, health services, accessibility and quality of education services, crime rate, level of corruption, climate, culture and recreation

Sources: Center for the Study of Living Standards, KPMG and Desjardins, Economic Studies

As is the case nearly everywhere in the world, in Quebec the natural resources are far from urban centres and often difficult to access. Facilitating that access would certainly have a positive effect on FDI, but it is expensive. Consequently, government investment in transportation infrastructures intended to improve access to natural resources must be subjected to strict cost-benefit evaluations. However, these are difficult to carry out due to the uncertainty surrounding investment outlooks, which depend on a host of factors, starting with global commodity prices.

As far as royalties are concerned, this is a complex issue. It is not enough to develop a system that is nationally and internationally competitive. It must also provide fair and equitable compensation in exchange for the natural resources, while not discouraging the exploitation thereof by the private sector.

Finally, the issue of qualified labour is a major issue in the primary sector: We already know that the labour force is aging rapidly throughout this segment of the economy, and that recruitment is becoming increasingly difficult in the mining, forestry and agriculture sectors.

For firms wishing to improve their efficiency

Quebec enjoys a stable socio-political environment, its population is highly educated, and it has a high standard of living. These factors already make Quebec a more attractive destination for FDI than countries where the economic, social and political climate is changeable. That said, in these respects, many provinces, states or countries of the world offer a profile similar to that of Quebec. Therefore, we must differentiate ourselves in other ways if we are to win out.

Operating costs

One of Quebec's advantages lies in businesses' operating costs. Every year, the firm KPMG produces a report comparing business operating costs in a hundred-odd cities in ten different countries.¹² The operating costs that KPMG considers are those relating to labour, facilities (rent for office space or industrial premises), transportation, utilities, income tax and property tax. In 2014, Canada ranked

¹² KPMG, "Competitive Alternatives – KPMG's Guide to International Business Location Costs," 2014 edition, 70 p., www.competitivealternatives.com/reports/2014_compalt_report_vol1_en.pdf. The ten countries are: Australia, Canada, France, Germany, Italy, Japan, Mexico, the Netherlands, the United Kingdom and the United States.

second, after Mexico, with operating costs 7.2% lower than those of the United States. Furthermore, Montreal stands in fourth place among the 36 cities with populations of over two million that are considered in the study, ahead of the other two Canadian metropolitan areas that are included in the ranking, i.e. Toronto and Vancouver.

Tax regime

KPMG also assessed the tax competitiveness of the countries and cities covered by the report.¹³ To that end, it compiled a total tax burden index (TTBI) in which the tax burden consists of corporate income tax (less tax incentives), property tax, capital tax, sales tax, various professional taxes at the local level and the labour costs required by law (i.e. the cost of legally required social welfare programs and other payroll taxes).

Of the ten countries covered by the study, Canada presents the lowest TTBI. Its total tax costs are nearly 50% lower than those of the United States. As far as cities go, Montreal is in third place out of the 51 metropolitan areas reviewed. It stands behind Toronto and Vancouver, however, which rank first and second respectively, contrary to the ranking for operating costs.

Montreal comes out on top, however, in terms of the digital services and research and development sectors. This is largely attributable to the significant tax incentives offered to businesses in those sectors by the provincial government. The issue of tax incentives will be examined in greater detail in the section of this paper that discusses strategies for attracting inward FDI.

Industrial clusters and niches of excellence

An industrial cluster is a geographic concentration of firms and institutions that collaborate with each other in a particular discipline, in order to share their expertise and resources. The existence of a solid industrial cluster in its field undeniably constitutes a source of appeal for a multinational corporation. It enables it to have access to specialized suppliers and labour and to be at the cutting edge of the most recent technologies used in its field. It also provides an opportunity for it to innovate in collaboration with the firms and research institutions of the cluster.

Quebec now has eight industrial clusters, created between 2006 and 2013, and a ninth one that is emerging (graph 4). Many of them now have a well-established

Graph 4 – Industrial clusters in Quebec by year of creation

Name of cluster	Year of creation	Industry
Aéro Montréal	2006	Aerospace
Montréal InVivo	2006	Life sciences and healthcare technology
TechnoMontréal	2007	Information and telecommunications technology
Action Montréal	2007	Film and television
Écotech Québec	2010	Clean technologies
Finance Montréal	2010	Financial services
CargoM	2010	Logistics and transportation
AluQuébec	2013	Aluminum
mmode	2015	Fashion

Sources: Montreal clusters, mmode and Desjardins, Economic Studies

reputation around the world, so they constitute an asset for Quebec from the point of view of foreign firms that belong to these industries and that wish to invest internationally. And many clusters have subsidiaries of foreign corporations among their members.

Meanwhile, niches of excellence meet certain criteria, according to the Ministère de l'Économie, de l'Innovation et des Exportations. Each niche of excellence is a set of organizations with related and interdependent activities, which collaborate and compete with each other. They are grouped together in a defined territory and constitute a sector in which each region has managed to stand out thanks to particular areas of expertise and products, while employing qualified researchers and workers.¹⁴ In short, they constitute an additional attraction for foreign investors.

Transportation infrastructures

For many firms, the quality of infrastructures, especially transportation infrastructures, is one of the most important criteria in choosing a location. In this respect, Quebec compares very unfavourably with many other jurisdictions. Years of under-investment have led to serious deterioration of the road network. The provincial government has started to remedy the situation in recent years with massive investments in renovating the network. However, the many construction sites that exist and those that will materialize during the construction of the new Champlain bridge and the replacement of the Turcot interchange could discourage some foreign investors.

¹³ KPMG, "Competitive Alternatives – Special Report: Focus on Tax," 2014 edition, 44 p., www.competitivealternatives.com/reports/2014_compalt_report_tax_en.pdf.

¹⁴ www.economie.gouv.qc.ca/objectifs/informer/creneaux-dexcellence/.

WHERE SHOULD WE PLACE OUR BETS TO ATTRACT FOREIGN INVESTORS?

Provincial initiatives

Tax incentives

Tax incentives can be very effective in attracting foreign capital. As was previously mentioned, it is thanks to many tax assistance measures from the provincial government that Montreal is the city where the corporate tax burden is the lowest in the digital sector and in research and development, according to the KPMG study.

Thanks to these incentives, both of these sectors have seen extraordinary development in the past decade. Montreal is now recognized around the world for its expertise in the video game industry, for example; a cutting-edge sector that generates many high-quality, well-paid jobs.

But Quebec is not the only jurisdiction to offer tax assistance in this sector; it is rivalled by many other Canadian provinces and by a large number of U.S. states and cities abroad. Consequently, a race towards tax incentives has ensued.¹⁵

It is also not enough to assume that tax incentives have positive repercussions; we must check out the truth of the matter. There are numerous tax incentives that are likely to encourage FDI or IUFC in Quebec: the tax holiday for major investment projects, the investment tax credit, the tax credit for the production of multimedia titles (which the video game industry enjoys), the scientific research and experimental development tax credit, the tax credit for the development of e-business and the film or video production services tax credit.

The Commission d'examen de la fiscalité québécoise has evaluated the economic and tax repercussions of each of these incentives and has prepared recommendations regarding them, i.e. whether they should be continued or abolished, or whether certain adjustments should be made to them. To guarantee the quality of its evaluations as far as possible, the Commission has also proposed the use of a specific methodology.

The tax regime

The corporate tax burden is higher in Quebec than in the other Canadian provinces. The Commission d'examen de la fiscalité québécoise has recommended to the government that it eventually reduce the corporate tax rate from 11.9%

to 10.0%.¹⁶ It has also suggested, by way of balance, that the investment tax credit be eliminated.¹⁷

Many analyses have shown that corporate income taxes have a major negative impact on business investment.¹⁸ As for the investment tax credit, it has some disadvantages, in particular due to the fact that it applies only to tangible assets. It does not encourage businesses to increase their productivity by investing in the organization of work, marketing or employee training, for example.¹⁹ Lowering the corporate income tax rate would benefit around 90,000 businesses, while the investment tax credit currently benefits just 4,000 firms.²⁰

By reducing its corporate tax rate to 10%, Quebec would offer the most competitive tax rate in Canada, along with Alberta.

Promoting Quebec abroad and prospecting for foreign investors

Many organizations, such as Montréal International, Québec International and Investissement Québec, have a mandate to attract foreign investors to Quebec. These organizations are very proactive. In 2011, the Communauté métropolitaine de Montréal (CMM) published an action plan for attracting foreign investors to the Greater Montreal region.²¹ The attraction process described in that plan is very detailed. It includes, first of all, describing the territory or neighbourhood in question with a view to attracting

¹⁵ Gouvernement du Québec, "Rapport final de la Commission d'examen de la fiscalité québécoise – Se tourner vers l'avenir du Québec," *Volume 1 – Une réforme de la fiscalité québécoise*, Commission d'examen sur la fiscalité, March 19, 2015, p. 244, www.examenfiscalite.gouv.qc.ca/uploads/media/Volume1_RapportCEFQ_01.pdf.

¹⁷ The 2015–2016 budget calls for the general corporate tax rate to be reduced by 0.1 percentage point annually starting in 2017, taking it to 11.5% in 2020. The government says it hopes to continue reducing income tax rates once economic growth accelerates: Ministère des Finances du Québec, "The Québec Economic Plan," March 2015, p. B.52, www.budget.finances.gouv.qc.ca/budget/2015-2016/en/documents/BudgetPlan.pdf.

¹⁸ Gouvernement du Québec, "Rapport du groupe de travail sur l'investissement des entreprises – L'investissement au Québec : on est pour," March 13, 2008, p. 153-155, www.groupe.finances.gouv.qc.ca/GTIE/fr/documents/Rapport_InvestissementENT.pdf.

¹⁹ *Ibid.*, p. 159-162.

²⁰ Gouvernement du Québec, "Rapport final de la Commission d'examen de la fiscalité québécoise – Se tourner vers l'avenir du Québec," *Volume 1 – Une réforme de la fiscalité québécoise*, Commission d'examen sur la fiscalité, March 19, 2015, p. 246, www.examenfiscalite.gouv.qc.ca/uploads/media/Volume1_RapportCEFQ_01.pdf.

²¹ Communauté métropolitaine de Montréal, "Plan directeur de l'investissement direct étranger du Grand Montréal 2011-2015," June 2, 2011, 38 p., cmm.qc.ca/fileadmin/user_upload/documents/20110602_PDIDE.pdf. It should be noted that the foreign investment discussed in this paper meets the definition of IUFC, rather than FDI. That is why, in this section, we speak of foreign investment, rather than IUFC or FDI.

¹⁵ Gouvernement du Québec, "Rapport final de la Commission d'examen de la fiscalité québécoise – Se tourner vers l'avenir du Québec," *Volume 3 – Un état de la situation*, Commission d'examen sur la fiscalité, March 19, 2015, p. 90, www.examenfiscalite.gouv.qc.ca/uploads/media/Volume3_RapportCEFQ.pdf.

foreign investment (competitive advantages, opportunities for growth, etc.); promoting the territory or neighbourhood (brand image, mission abroad, etc.); targeting foreign firms that might be interested; and canvassing the targeted firms. The second phase of the process is to guide potential investors, which consists of informing them (about regulations, tax assistance, sources of funding, etc.) and advising them. If they do make the decision to invest, the process does not stop there; efforts are constantly made towards foreign subsidiaries (guidance and support) to encourage them to stay in the region and to invest in it.²²

This process of attracting foreign investors is carried out in collaboration with all the players involved: the economic development corporations of the municipalities of Greater Montreal, Montréal International, Québec International, the industrial clusters of Montreal, Investissement Québec, the Ministère de l'Économie, de l'Innovation et des Exportations, the niches of excellence of Quebec, and Foreign Affairs, Trade and Development Canada, all across Quebec.

In its action plan, the CMM assessed, for each step of the attraction process, the extent to which collaboration among the players could be improved, and presented a number of recommendations in that regard. It also suggested improving the method used to measure the results achieved, and disclosing the results more transparently. In reality, what is important for us to know is the value of the impact of the foreign investments made in relation to the funds invested in the attraction process.

International competition for attracting foreign investors is fierce, and Quebec needs to showcase its advantages in order to succeed. But what emerges from the research on strategies for attracting FDI is that while organizations that promote their region are certainly useful, what really counts when foreign investors make their decisions is the business environment and climate of the region.²³ We also know that large metropolitan areas like Montreal exert a huge magnetic effect upon foreign investors, besides making an important contribution to the prosperity of neighbouring regions.

National initiatives

Free-trade agreements

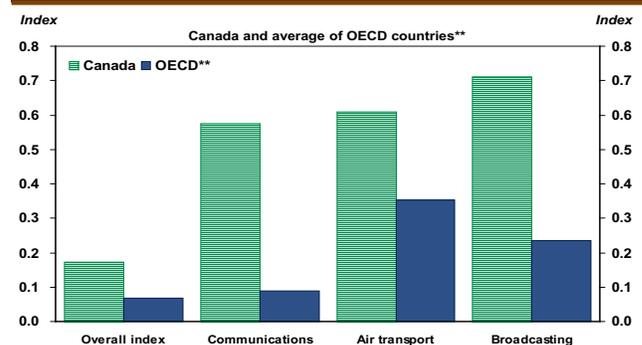
Free-trade agreements can encourage inward FDI. An example of this is the Comprehensive Economic and Trade Agreement (CETA) that Canada recently entered into with the European Union (EU). The agreement includes the obligation not to treat foreign investors less favourably than national firms, to guarantee foreign investors access to the national market, to prohibit restrictions on the nationality of company directors, to prohibit the imposing of conditions on investments (such as a percentage of national content) and to prevent the expropriation of foreign assets without compensation.²⁴

As a result of the CETA between Canada and the EU, Quebec, like the other Canadian provinces, could benefit from increased foreign investment from European sources. However, this type of treaty must include provisions to preserve the rights of the parties to impose regulations and to implement their own public policy objectives. In other words, when it comes to investments, bilateral agreements must take into account the drawbacks of FDI, in particular risks relating to the sovereignty and security of the host country, which were discussed in the first part of this paper.

Easing restrictions on FDI

Canada is one of the OECD member countries that imposes the most restrictions on FDI. These are particularly severe in the communications, air transport and broadcasting sectors (graph 5). In its most recent note on growth outlooks in Canada, the OECD recommended that the barriers to FDI be reduced in these three sectors.²⁵ In fact, the OECD

Graph 5 – FDI restriction index in certain sectors in 2014



* The closer the index gets to 1, the more restrictions there are. ** Organisation for Economic Co-operation and Development. Sources: Organisation for Economic Co-operation and Development and Desjardins, Economic Studies

²² *Ibid.*, p. 8.

²³ Alexis Abodohou *et al.*, "Managerial Analysis of the Attraction of FDI in Canada," *International Journal of Business and Management*, vol. 10, no. 3, February 27, 2015, p. 37, www.ccsenet.org/journal/index.php/ijbm/article/viewFile/43465/24862.

²⁴ Desjardins, Economic Studies, *Economic Viewpoint*, "Canada-European Union Comprehensive Economic and Trade Agreement – An overview of the agreement, trade and advantages," April 22, 2015, p. 3, www.desjardins.com/ressources/pdf/pv150422-e.pdf?resVer=1429702950000.

²⁵ Organisation for Economic Co-operation and Development, "Economic Policy Reforms 2015 – Going for Growth," February 9, 2015, p. 156, ifuturo.org/documentacion/EconomicPolicyReforms_OCDE.pdf.



has been advising Canada to reduce barriers to FDI for several years now. In the 2011 edition of its annual note on Canada, it wrote: “*Restrictions on foreign direct investment, remain higher than in the majority of OECD countries, discouraging productivity-enhancing capital deepening.*”²⁶

In the telecommunications sector, public consultations were undertaken by the federal government in 2010, but apart from the lifting of foreign participation restrictions in Canadian satellite programs, nothing concrete has been done since then. In an article on restrictions on FDI and productivity in Canada, published by the Centre sur la productivité et la prospérité at HEC Montréal, the authors deplored the restrictions on FDI imposed on firms in the telecommunications sector as follows. The services provided by this industry are essential to the everyday activities of any organization, be it public or private. Therefore, by reducing the potential impacts of FDI, such restrictions delay the propagation of new technologies and the access to better-quality telecommunications services, at lower cost.²⁷

The purpose of the restrictions that are imposed on inward FDI is to preserve national sovereignty and security and to minimize other drawbacks of an economic nature. They should not, however, uselessly hinder the operations of national firms. Restrictions on FDI should, as is the case for tax assistance, be subjected to an assessment intended to determine to what extent they attain their objective, and at what cost.

CONCLUSION

Quebec is an appealing destination for foreign firms, whether they wish to capture new markets, exploit natural resources or improve their efficiency. It has some major assets, in particular the existence of numerous, solid industrial clusters, well-organized niches of excellence, and relatively low operating costs for businesses. However, the struggle to attract foreign investment is bitter, and other provinces, states and countries also have a lot to offer.

There are many ways to improve Quebec’s competitiveness in the race to attract foreign investment. Governments can offer ad hoc tax assistance, reduce the corporate income tax rate, promote Quebec, prospect for investors, enter into free-trade agreements and reduce restrictions on foreign direct investment. Each of these strategies entails benefits and drawbacks that are important to consider, because while Quebec does need to attract investment, it also needs to gain a clear benefit from it.

²⁶ Organisation for Economic Co-operation and Development, “Economic Policy Reforms 2011 – Going for Growth,” p. 78, taxwatch.org.au/ssl/CMS/files_cms/207_OECD%20-%20Economic%20reform%20-%20full.pdf.

²⁷ Kristelle M. Audet and Robert Gagné, “Ouverture aux investissements directs étrangers et productivité au Canada,” *Centre sur la productivité et la prospérité*, HEC Montréal, October 2010, p. 74, cpp.hec.ca/cms/assets/documents/recherches_publiees/PP-2010-01_IDE_FRA_VC.pdf.

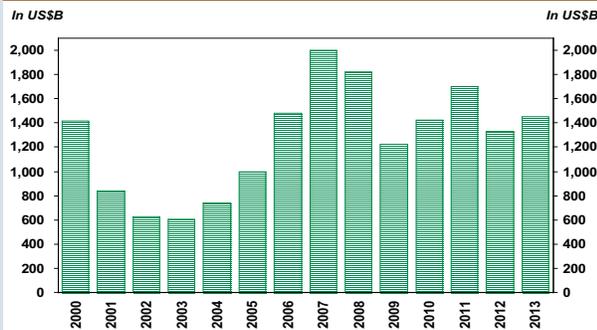
APPENDIX

FDI trends around the world and in Canada

Global trends in FDI

After falling at the beginning of the 2000s due to the global economic slowdown that followed the bursting of the technology bubble, FDI resumed an upwards trend and reached US\$2,000B in 2007 (graph A). The financial crisis that occurred in 2008 and the ensuing recession of 2009 led to a decline in FDI during those two years. It has recovered some ground since then, but has not returned to where it was in 2007.

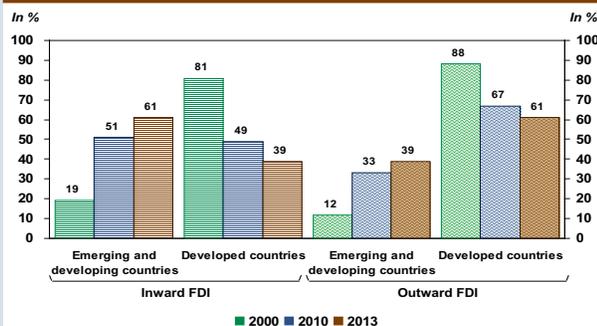
Graph A – Flows of FDI around the world from 2000 to 2013



Sources: United Nations Conference on Trade and Development and Desjardins, Economic Studies

The structure of FDI has evolved a great deal since the beginning of the 2000s. At the start of the millennium, the vast majority of investments (i.e. 81%) were carried out in the developed countries (graph B, inward FDI). Since then, many EDCs have become preferred investment destinations for firms based in the developed countries, as they offer an opportunity for those firms to

Graph B – Distribution of FDI according to countries' level of development

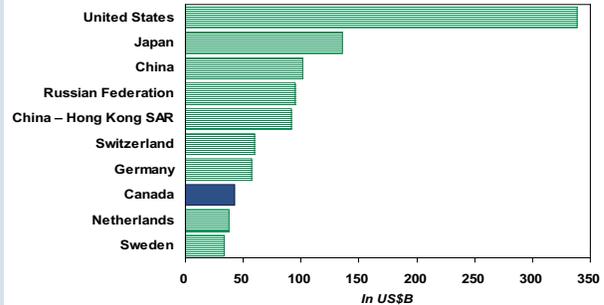


Sources: United Nations Conference on Trade and Development and Desjardins, Economic Studies

reduce their production costs and access a broad market. In 2010, EDCs welcomed slightly over half of total FDI, and in 2013 their share of it reached 61%.

Meanwhile, we have observed a significant increase in FDI carried out by the EDCs. Their share of global outward FDI climbed from 12% in 2000, to 39% in 2013 (graph B, outward FDI). China, for example, which ranked 33rd among source countries of FDI in 2000, stood in 3rd place in 2013. Similarly, the Russian Federation is now among the ten largest investors in foreign countries, having shot up from 28th to 4th place during the same period (graph C).

Graph C – Outflows of FDI: Top ten source countries in 2013



SAR: Special Administrative Region
Sources: United Nations Conference on Trade and Development and Desjardins, Economic Studies

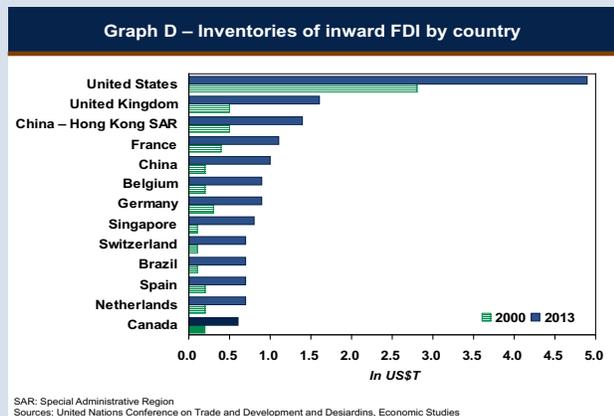
Emerging countries like China need commodities in order to develop. In 2014, approximately 20% of China's FDI was carried out in the mining sector.*

But Chinese investments abroad are not limited to that sector. In that same year, 17% of China's outward FDI went to the commerce sector. Chinese entrepreneurs not only want to guarantee their supply of commodities; they also want to make sure that trade outlets exist for their products.

* National Bureau of Statistics of China, "Statistical Communiqué of the People's Republic of China on the 2014 National Economic and Social Development," February 26, 2015, www.stats.gov.cn/english/PressRelease/201502/t20150228_687439.html.

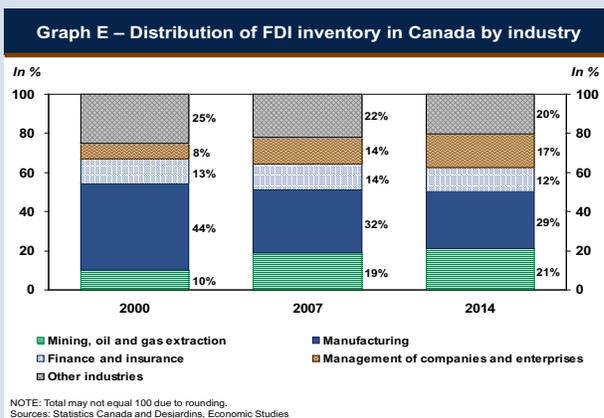
Trends in Canada's inward FDI

In 2013, Canada was among the top ten countries receiving inflows of global FDI. In terms of inward FDI inventory, however, it was in 13th place, whereas it had stood in 7th place in 2000 (graph D).** Inventories represent the accumulation of inflows from one year to the next. Two emerging countries, China and Brazil, now surpass Canada in this respect.



The composition of FDI in Canada has changed over time. The inventory of FDI in the mining, oil and gas extraction sector increased by 12% per year between 2000 and 2014, four times more than in the manufacturing sector. Consequently, that sector's share of total FDI doubled between 2000 and 2014, from 10% to 21%, while that of manufacturing, which stood at 44% in 2000, was just 29% in 2014 (graph E). FDI in the management of companies and enterprises sector also doubled during the same period.

** Inventories of inward FDI represent the accumulation of inflows at a given point in time.



The sources of FDI have also changed. The share held by the United States has declined, from 61% in 2000 to 49% in 2014 (graph F). That of the Asia-Pacific region has more than doubled, rising from 4% to 10% over the same period, while Europe's share has remained stable.

