THE COST OF U.S. DIRECT FOREIGN INVESTMENT

by

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I. INTRODUCTION

The evaluation of the costs and benefits of direct foreign investment to the host country has been the focus of a great deal of debate and accusation. While a substantial amount of anecdotal evidence has been accumulated on specific cases where countries have been "exploited" by multinational investors, little analysis has been made of the cost of foreign investment to countries where foreign savings has been an important source of investment funds over an extended period of time. Estimates of such historical costs would be highly relevant information for those countries now in the process of designing policies to attract foreign investment.[1]

Any measure of the historical cost of foreign direct investment funds will contain, to various degrees, a rate of return which the foreign parent views as a return to offset the real opportunity cost of the investment plus a risk premium to compensate for the uncertainty associated with the particular investment located in a given country. A large part of the risk premium required by a foreign investor will reflect the political risk of a country and not the uncertainty of the project's productive outcome alone.[2] Hence, to derive a measure of the cost of direct foreign investment if a government were able to create a stable political and economic climate it will be necessary to examine the record of countries that have sustained this kind of business environment over a long period of time.

A prime example of such a country is Canada which hosts the largest amount of foreign investment of any economy in the world. Since the end of World War II, U.S. residents and corporations have been by far

the dominant owners of foreign investments in the country. By 1978 U.S. direct investment in Canada valued at its net replacement cost amounted to approximately $65.7 billion U.S. or over 14 percent of total investment in the industrial sector of the country.[3]

U.S. direct investment is not the only form of investment made by Americans in Canada. In addition, U.S. residents hold a substantial quantity of indirect investments such as government bonds, corporate securities (in amounts which are insufficient to exercise control), and U.S. residents' holdings of Canadian dollars. Approximately 60 percent of total U.S. investment in Canada is direct and 40 percent indirect.[4]

While Canada has maintained a generally favorable economic climate towards foreign investment it has not done this by providing preferential taxation or other special provisions which are commonly used specifically to attract foreign investors. At the same time a number of concerns have been expressed by both government and private individuals questioning the desirability of further growth in U.S. direct investment in Canada.[5] Still for the estimation of the cost of obtaining U.S. direct investment abroad the Canadian case probably reflects better than any other the supply price of U.S. direct investment when political uncertainty has been minimized.

This paper does not evaluate many of the economic and non-economic costs, such as the loss of control of key sectors or the brain drain of Canadian management talent to the United States, which have been purported to exist as a byproduct of U.S. direct investment. Instead, we focus narrowly on developing a set of estimates of the cost in terms of the financial real rate of return the Canadian economy has paid to the

U.S. residents who have made direct investments in Canada. These estimates will then be compared with corresponding real net-of-tax private rates of return generated by capital in the Canadian industrial sectors to find out if there is significant difference between the net return received by U.S. as compared to Canadian residents who have invested in Canada.

II. ESTIMATION OF THE REAL COST OF DIRECT INVESTMENT

Our principal source of information pertaining to the stock of U.S. direct investment in Canada and the income flows it has generated is a set of unofficial estimates developed by the U.S. Department of Commerce for the period extending from 1951 - 1973.[6] Recently these series have extended to 1978 and are published for the period 1966 - 1978.[7] The attraction of this data set is not only its length (28 years), but also the fact that it has been recompiled from unpublished records in a manner to ensure a high degree of consistency from year to year in the classification of investments falling within a particular industrial sector. The same effort has also been made to ensure consistency between the various income flows generated by these investments.

This data set provides us with annual observations on the book value of U.S. direct investment in Canada broken down into five broad industrial groups.[8] It also provides us with annual estimates of the following components of the income produced by these investments: branch profits, reinvested earnings, common dividends, preferred dividends, interest payments, withholding taxes, and royalties and fees.[9]

All the income items are measured in terms of the price level of the year in which they occurred. The annual book value of U.S. direct investment is comprised of a set of assets which have been purchased over a number of years where each asset is recorded at its historical cost at the time it was purchased. To estimate the real cost to Canada of this direct investment it is necessary to compare the payments made to the U.S. resident investors per dollar of the stock of direct investment located in Canada, where both elements of this ratio are measured in terms of the price level of the same year. Because each of the income items are expressed in the price level of the current year the most satisfactory procedure is also to express the book values of the U.S. direct investments by sector in terms of their net current replacement value for each year.[10] In this way both the annual income flows and the corresponding value of the stock of direct investment will be reported in terms of the same price level. Thus, the ratio of these variables will measure the annual rate of payment the Canadian economy has made per dollar's value of the stock of real resources invested in Canada by U.S. residents.

To revalue the book value of U.S. direct investment into its net current replacement value we would ideally want to know the previous annual flows of gross direct investment into Canada and the classes of physical assets which were financed each year by these financial inflows. We should also have information on the movements in the prices of various classes of capital items through time along with their depreciation rates. In addition, if disinvestment by U.S. residents takes place, we need to know the amount of these outflows by year. Unfortunately, the only variables in this set available to us are the price indices for capital

goods.[11] Therefore, we have to look elsewhere to obtain weights to apply to these price indices in order to calculate the adjustment factors which will convert the book values of the stock of U.S. direct investment into current values.

After considering the alternative methods of obtaining weights, we decided that the least biased procedure would be to assume that the composition of physical assets purchased by the U.S. direct investment in a sector was similar to the composition of the total of that sector in Canada, i.e., both the part owned by Canadian residents as well as that owned by foreignors. In addition, we assumed that the time profile of total gross investment in a Canadian industrial sector and the time profile of the gross direct investment in the same sector by U.S. residents have similar shapes through time, but obviously, will be of different magnitudes.

Given these two assumptions we can estimate the adjustment factors for each sector and year by utilizing the annual estimates of the values for the net capital stocks by industrial sector constructed by Statistics Canada.[12] These capital stocks are evaluated both in terms of their historical cost prices (book values) as well as their net replacement values. The ratio of the mid-year net capital stock in an industrial sector at current replacement prices (MYNSC) to the mid-year net capital stock of the same industrial sector at historical costs or book value (MYNSH), will give us adjustment factors which will transform the book value of U.S. direct investment in a sector into its net current replacement value.

In some of the sectors, such as petroleum and mining where U.S. direct investment represents a large proportion of the total investment

in the Canadian industry, the above procedure should introduce little bias. In the other sectors a bias might result, but the direction of the net effect is uncertain.[13]

Using these adjustment factors the net current values for U.S. direct investment in Canada by sector (NUSC) for year t can be estimated as follows:

$$(1) \quad NUSC_t = (USBV_t)(MYNSC_t/MYNSH_t),$$

where $USBV_t$ is the book value of U.S. direct investment in a Canadian industrial sector at the end of $year_t$. The values for $MYNSC_t$ and $MYNSH_t$ are obtained by summing the values of the components of the capital stock across the appropriate Canadian industrial sectors in order to obtain the five aggregated sectors for which the direct investment data are available.

There are three measures of the payments made by Canadians to U.S. direct investors; these measures provide a range of values that likely bound the true cost of U.S. direct investment to Canada. As a minimum estimate, referred to as net payments, we include all repatriated branch profits, common dividends, preferred dividends and interest payments. All items are defined net of withholding taxes.

As a second measure, referred to as net adjusted payments, we add to net payments the value of the reinvested earnings which remain in Canada less the Canadian withholding taxes that would be paid if these earnings were repatriated the same year.[14] As a maximum measure of the cost to Canada of U.S. direct involvement, we calculate net adjusted payments plus fees. This measure is made up of net adjusted payments plus royalties and fees net of Canadian withholding taxes.

This last measure of the payments made for the use of U.S. direct investment includes royalties and fees because these payments are a potential vehicle through which companies transfer income from a foreign branch or subsidiary to the parent company. No doubt a large proportion of the royalties and fees paid to the U.S. parent corporations are payments for services rendered to the Canadian branches and subsidiaries by the parent corporation and not a part of the return to the investment made in Canada. However, to provide an upper bound on the payments made for the use of capital, the third measure is constructed under the assumption that all royalties and fees are nothing but transfers of profits to the U.S. percent corporations.

A further word on transfer pricing at this time might be appropriate. The practice of transferring profits between countries by multinational corporations to avoid taxes through the inflation of charges for goods and services by affiliated corporations has been well documented.[15] The incentives to engage in these practices are greatest if the income can be passed through a subsidiary or a branch located in a low tax jurisdiction. In the case of Canada there is substantial evidence to indicate that significant amounts of income generated by the petroleum refineries in eastern Canada have been transferred out of Canada to subsidiaries either producing or shipping crude oil to these refineries.[16] However, what is important to note is that for most of the industrial sectors in Canada there is little or no incentive to transfer income from the Canadian subsidiary or branch to the U.S. parent. In 1968 for twenty-eight out of thirty-five sectors in Canada there was no tax incentive to transfer income from Canada to the U.S. because the

combined effective income tax rate in Canada was less than the income tax rate on this income if it were transferred to the U.S. In 1974 not more than 3 out of a total of 21 sectors had a tax incentive to shift income by transfer pricing from the Canada affiliate to its U.S. parent corporation.[17] The U.S. parents of some Canadian subsidiaries in sectors such as iron ore mining probably have had an incentive to transfer profits from the U.S. to Canada. In the case of the U.S. steel corporations with Canadian iron ore subsidiaries, for example, during most of the period under examination the overall tax burden of the multinational organization could be decreased by shifting profits so as to take advantage of the much more liberal tax treatment provided the mining sector in Canada than the steel industry in the U.S. Therefore, in these estimates of the payments made from Canada for U.S. direct investment there are unlikely (with the exception of petroleum) to be significant downard biases due to transfer pricing practices. Even in the case of petroleum the transfer pricing of profits away from Canada is largely confined to the eastern refineries prior to 1970 and not to production and refining west of the Province of Quebec.

Using estimates of the three categories of payments and the estimated values for the net mid-year values of U.S. direct investment in Canada by sector, we have calculated the percentage which these payments have been of the current value of the stock of investment for each year from 1951 to 1978. Averages of these values for the periods 1951-1960; 1961-1970; 1971-1978 and 1951-1978 are presented in Table I.

From Table I we see that during the period 1951-1978 the real rate of net payments from Canada to the U.S. owners of direct investments

Table I

AVERAGE ANNUAL RATES OF PAYMENT BY CANADA FOR U.S. DIRECT INVESTMENT

	Mining & Smelting	Petroleum	Manufacturing	Trade	Other Non-Manuf. Activities	All Industries
	(percentages of Net Current Value of Direct Investment)					
NET PAYMENTS						
1951-1960	3.71	0.07	3.94	2.17	4.19	2.99
1961-1970	4.57	2.60	3.15	2.21	4.70	3.41
1971-1978	2.94	2.57	2.67	2.42	3.72	2.70
1951-1978	3.80	1.69	3.30	2.26	4.24	3.06
NET ADJUSTED PAYMENTS						
1951-1960	5.93	2.19	7.71	6.63	5.67	5.75
1961-1970	6.95	4.10	6.24	6.97	5.98	5.86
1971-1978	4.32	6.72	6.69	6.15	7.04	6.03
1951-1978	5.83	4.17	6.89	6.61	6.17	5.87
NET ADJUSTED PAYMENTS PLUS FEES						
1951-1960	5.95	2.51	8.45	7.88	7.55	6.51
1961-1970	7.13	4.45	7.86	7.99	7.64	6.99
1971-1978	4.67	7.01	8.56	7.06	9.18	7.17
1951-1978	6.01	4.49	8.27	7.69	8.05	6.87
PAY-OUT RATIO						
1951-1960	.635	.394	.512	.324	.735	.522
1961-1970	.654	.635	.511	.303	.784	.583
1971-1978	.697	.386	.412	.389	.600	.452
1951-1978	.660	.478	.483	.335	.714	.524

in Canada averaged 3.06 percent for all sectors combined. The petroleum sector recorded the lowest rate of net payments of 1.69 percent while the non-manufacturing sector, excluding trade, had the highest rate of 4.24 percent per year. For the period since 1970 the magnitudes are similar with an average rate of net payments over all sectors of 2.70 percent. However, during these years the lowest rate of net payments was made by trade (3.42 percent) and the highest was non-manufacturing (3.72 percent).

A more appropriate measure of the income received and accrued by the U.S. owners of direct investment in Canada is the rate of net adjusted payments. These payments include the reinvested earnings after a deduction has been made for future withholding taxes. For the entire period 1951-1978 the average rate of net adjusted payments was 5.87 percent per year while since 1970 the rate was 6.03 percent. Over the entire period the petroleum sector had the lowest rate of net adjusted payments of 4.17 percent; however, since 1970 the rate for this sector has increased to 6.72 percent. Averaged over the 28 years the highest rate of net adjusted payment was made from manufacturing of 6.89 percent. The rate of reinvested earnings was the highest (alternatively stated the payout ration was the lowest) in the trade sector where only about 33.5 percent of total earnings were paid out directly to U.S. investors.

Including all payments of royalties and fees as payments for the use of invested capital (net adjusted payment plus fees), we find that the rate of these payments, when averaged over all industries, was 6.87 percent. For the period 1970-1978 the rate was 7.17 percent. The petroleum sector had the lowest rate of payments to its U.S. parents (4.49 percent) while the other non-manufacturing sector had the highest rate equal to approximately 9.18 percent.

III. COMPARISON OF THE REAL RATE OF PAYMENT TO THE REAL RATE OF RETURN ON CAPITAL IN CANADA

Because both the values for the payments as well as the U.S. direct investment are expressed each year in the current price level, the rates of payment reported in Table I are real (net of inflation) rates. Therefore, they are not comparable to nominal market interest rates which also contain a component which provides compensation for the expected rate of inflation.

As a means of deriving some impression as to whether or not U.S. direct investors in Canada have over this period earned abnormally high or low private rates of return on their investments in Canada, we will compare these rates with the real rates of return earned on equity and total invested capital in the Canadian manufacturing and non-manufacturing sectors.[18] In a recent study the real private rates of return on equity and total invested capital have been calculated by sector for the period 1965 to 1974 in a manner consistent with the methodology used in this paper.[19]

During the period 1965 to 1974 the average real rate of return to equity (net of all business taxes) in the manufacturing sector was 7.87 percent and in the non-manufacturing 7.60 percent.[20] These rates of return to equity are larger than the average rate of net adjusted payments to U.S. direct investment for any of the sectors examined. However, U.S. direct investment is not only made up of equity but consists of both debt and equity. A more appropriate comparison might be with the private rates of return earned by the total invested capital in Canadian manufacturing and non-manufacturing.

For the period 1965-1974 the average private rate of return to total invested capital in manufacturing was 6.9 percent, while in non-manufacturing it was 6.5 percent.[21] These rates are still above the average rate of net adjusted payments made to U.S. direct investment of 5.89 percent. However, if we exclude the petroleum sector, because of the transfer pricing problem, we find that the private rates of return generated by all capital invested in the Canadian manufacturing (6.9 percent) and non-manufacturing (6.5 percent) sectors fall in the upper end of the range (5.8 to 6.9 percent) of the rate of net adjusted payments received across all sectors by U.S. direct investors in Canada. Even if we consider the rate of net adjusted payments plus fees, we find that the average rate of return to equity in Canada (7.7 percent) falls well within the range (6.0 to 8.3 percent) of these values for the period 1961 -1978 while the private rates of return from all industrial investments in Canada lie close to the lower bound of these payments to U.S. direct investors.

CONCLUSIONS

From this evidence it would appear that on average U.S. direct investors have not earned an abnormally high rate of return over the past 28 years from thir direct investments in Canada. From a previous study we also know that on average U.S. investors have paid taxes on the income from capital at a rate of 4 percent of the net replacement value of their total direct investment in Canada.[22] Hence, when we consider these two results together the obvious conclusion is that U.S. direct investment in Canada has been a very financially profitable arrangement for Canada.

The results from this analysis point out a number of factors which other developed and developing countries might wish to consider when considering a policy to open their economies to foreign investment. First, in countries where the level of political risk is low, it is likely that the returns U.S. investors will demand will be of the same order of magnitude as the rate they earn net of tax from domestic investment in the U.S.[23] Secondly, the existence of a well developed system for the taxation of the income from capital (both domestically and foreign owned) need not preclude the possibility of a substantial inflow of foreign investment and will significantly enhance the return the host country receives from this investment. Finally, under a reasonably stable political and economic environment the rates of return which U.S. investors have required on direct foreign investment has also been remarkably stable. Over the past three decades the average rates of return paid to foreign investors has only increased slightly from 5.75 percent in the 1950s to 5.86 in the 1960s to 6.03 in the 1970s. There is no obvious reason why other developing and developed countries cannot expect to enjoy an experience similar to Canada's with respect to foreign investment if the preconditions with respect to political risk are maintained.

FOOTNOTES

1. Examples of such countries at the present time are Sri Lanka, Malaysia, Chile, Ireland, Singapore, Taiwan and the Philippines.

2. For an overview of the effect of political risk see S.J. Kobrin, "Political Risk: A Review and Reconsideration," Journal of International Business Studies, Spring/Summer 1979, Vol. 10, No. 1, pp. 67-80. A good analysis of the behavior of multinational companies to diversify risk is found in Alan Rugman, International Diversification and the Multinational Enterprise (Lexington, MA: Heath & Co), 1979.

3. The estimate of the total investment in the Canadian industrial sector obtained from Statistics Canada, Fixed Capital Flows and Stocks, Manufacturing and Non-Manufacturing: Canada 1926-1978, Catalogue No. 13-523.

4. Statistics Canada, Canada's International Investment Position 1968-1970 (Ottawa: Queen's Printer Cat. No. 67-202), Table 11. Direct foreign investment is comprised of equity and debt instruments held by U.S. residents in subsidiaries and branches in Canada which are more than 1 percent owned by a single investor.

5. Some examples of such expressions of concern may be found in the following: M.H.Watkins et al., Foreign Ownership and the Structure of Canadian Industry (Ottawa: Privy Council Office, 1968). H. Gray, "Domestic Control of the National Economic Environment: The Problems of Foreign Ownership and Control," (Ottawa, 1971). A.J. Cordell, "The Multinational Firm Foreign Direct Investment and Canadian Science Policy," Special Studies No. 22 (Ottawa: Science Council of Canada, 1971). J.K. Laux and M.A. Molot, "Multinational Corporations and Economic Nationalism: Conflict over Resource Development in Canada," World Development, 1978, Vol. 6, No. 6, pp. 837-49.

6. This data set was prepared by The Data Retrieval and Analysis Branch, International Investment Division, Bureau of Economic Analysis, U.S. Department of Commerce, Washington. Any person who wishes to obtain

these data for research purposes may do so by contacting the above organization or the authors.

7. U.S. Department of Commerce, Selected Data on U.S. Direct Investment Abroad 1966-1978, Bureau of Economic Analysis (Washington: U.S. Government Printing Office).

8. The industrial groups are mining and smelting, petroleum, manufacturing, trade and all other industries combined.

9. Branch profits are earnings of the Canadian branches of U.S. direct investors after provision has been made for Canadian income taxes, but before depletion charges or provision for U.S. taxes. Also included is the U.S. share in the net earnings of other types of unincorporated affiliates. Reinvested earnings are net earnings of Canadian incorporated affiliates less gross dividends on common stock. Net earnings of Canadian incorporated affiliates are measured after provision has been made for Canadian income taxes and preferred dividends, but before provision for U.S. taxes. Common dividends are dividends on common stock credited to a U.S. direct investor by its Canadian-incorporated affiliates after deduction of Canadian withholding taxes. Preferred dividends are dividends credited to a U.S. direct investor on its preferred shares in its Canadian-incorporated affiliates after deduction of Canadian withholding taxes. Interest payments are net interest payments on net inter-company accounts and long-term debt received by or credited to the U.S. direct investor or other non-bank U.S. investor on Canadian affiliates, after the deduction of Canadian withholding taxes. Royalties and fees are net receipts (and net of Canadian withholding taxes) by a U.S. direct investor from its Canadian affiliates for professional, administrative and

management services and for use of tangible and intangible property rights, etc.). Abstracted from Bureau of Economic Analysis, U.S. Department of Commerce, "Technical Notes", Survey of Current Business, vol. 54, No. 8, (August 1974): 24, 40.

10. In this context "net" refers to the value of the capital stock less accumulated depreciation.

11. Price indices by fixed asset class and industrial sector have been constructed by the Prices Division, Statistics Canada and are used to estimate the values of fixed capital flows and stocks by industrial sector. Statistics Canada, Business Finance Division, Fixed Capital Flows and Stocks, Manufacturing and Non-Manufacturing Canada, 1926-1976, Cat. No. 13-523.

12. Statistics Canada, op. cit.

13. This method of adjustment for price changes might create two biases for sectors where the U.S. owned portion of the total capital stock is relatively small. First, in the early years covered by this study the Canadian owned portion is likely to be older. Thus, if the U.S. owned portion is adjusted by the inflation factor applicable to the whole sector, the net current replacement value of U.S. direct investment will be overestimated causing the per dollar cost to Canada of this investment to be underestimated. Secondly, a bias in the opposite direction is introduced because the adjustment factor is applicable to the total stock of fixed capital in the sector while usually the proportion of the U.S. direct investment represented by equity is greater than the ratio of equity to total debt and equity in the sector. Because the liabilities of the firm are already measured in current prices when we adjust the value of

total assets upward by a given percentage (K), the value of equity should be adjusted upward by a percentage Q, which is equal to (K)(Liabilities + Equity) / (Equity). However, our methodology will only adjust the U.S. direct investment in a sector by K and thus the value of the U.S. owned capital stock is underestimated. This will cause our estimated cost per dollar of U.S. investment in Canada to be overestimated. As these two biases are in opposite directions, the net bias is indeterminate. It is our tentative judgment that the latter bias will dominate, particuarly in the more recent years when the age distribution of Canadian owned and U.S. owned assets will have tended to be equalized.

14. A 15 percent withholding tax has been used in these estimates. However, recently the new international tax treaty with the U.S. has decreased the rate of this tax to 10 percent. The reinvested earnings are decreased by 15 percent because when eventually repatriated they will bear this tax as will any additional profits generated by the incremental reinvested earnings.

15. G.F. Kopits, "Taxation and Multinational Firm Behavior: A Critical Survey," International Monetary Fund Staff Papers, 23, 3 (November, 1976): 652-59. C.F. Bergsten, T. Horst, and T.H. Moran, American Multi-Nationals and American Interests (Washington: The Brookings Institution, 1978): 172-73, 379-80, 491.

16. Glenn P. Jenkins and Brian D. Wright, "Taxation of Income of Multi-national Corporations: The Case of the U.S. Petroleum Industry," The Review of Economics and Statistics, Vol. LVII, No. 1 (February, 1975), Table 3.

17. Glenn P. Jenkins and Antal Deutsch, Foreign Tax Credits and the International Interdependence of Corporation Tax Policies, Harvard Institute of Economic Research, Discussion Paper 384 (October, 1974): 13.

18. Capital invested in Canada includes both the part owned by Canadian residents as well as the part owned by foreignors.

19. Glenn P. Jenkins, "Capital in Canada: Its Social and Private Performance 1965-74," Discussion Paper No. 98 (Ottawa: Economic Council of Canada, October, 1977).

20. The estimated rates of return which are consistent with the rates of payments measured in this paper are found in Ibid., p. 35, Table 2-5, rows 5 and 6.

21. Ibid., p. 39, Table 2-6, rows 3 and 4.

22. Glenn P. Jenkins, "Tariffs and Taxes and the Evaluation of the Benefit from Foreign Investment," The Canadian Journal of Economics, XII, No. 3 (August, 1979): 423.

23. A similar observation has been made in a recent study by Donald Tate who found that both U.S. and Canadian resident companies engaged in making international investments held identical views as to the relative attractiveness of Canada versus the U.S. as locations for direct investment. Donald G. Tate, Government Assistance and Corporate Investment in Canada, unpublished manuscript, 1980, chapter 7.

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