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A prescription for Canada: rethink our tax policy

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Canadians have been watching with increasing worry as large numbers of prominent Canadian-owned companies in historically important Canadian industries are being acquired by foreign firms. The acquisitions of Inco by Brazil's CVRD and Falconbridge by Switzerland's Xstrata were particularly troubling to many Canadians. Inco and Falconbridge were global leaders in nickel, a key component of Canada's historically mighty mining industry. Virtually our whole steel industry has been acquired including the gem: Dofasco. Other great companies as diverse as graphic chip leader ATI, world leader in door manufacturing Masonite International, business forms giant Moore Corporation and luxury hotel giant Four Seasons have been swallowed up by foreign firms or investors. Is this a little or a lot? By pretty much any valid standard, it is a lot.

Over the past five years (2001-2006), 455 Canadian companies have been bought by foreign firms for combined price of $137-billion (U.S.). Adjusted for size of economy, the number of companies is the second greatest total in the world after Australia and the value paid is second highest after the U.K. And since the beginning of 2006 the value of acquired Canadian companies leads all countries. So factually, Canada is experiencing a high level of foreign acquisition of Canadian companies and the pace is accelerating.

Hollowing out is the term being applied to this phenomenon, connoting that as our Canadian-owned, Canadian-headquartered companies are bought up by foreigners, head-office jobs, capital markets listings, corporate tax revenues, and charitable donations are disappearing potentially resulting in the hollowing out of our economic sovereignty. While the issues at stake are complicated and their implications poorly-understood, we believe that Canadian policy in its current state is ill-equipped to help Canada protect and build its long-term competitiveness. In this article, we attempt to step back from the rhetoric and put the real phenomenon in appropriate context in order to focus on recommending long term solutions for ensuring and protecting Canada's competitiveness. There is a massive global transformation under way, so time is of the essence and committed action is required.

A Distinctly Canadian Phenomenon?

Is "hollowing out a distinctly Canadian phenomenon? The answer is no and a quick Google search would conclude that even the United States is concerned about the consequences of the merger phenomenon "hollowing out" key markets and cities. The Japanese raise concerns about the "hollowing out" of domestic production and R&D

capacity as jobs move offshore. And Australia has experienced a similar take-over bonanza to Canada raising concern that the movement of head offices offshore is weakening Australia business infrastructure and capacity leaving a branch office economy. The same holds for Korea, UK and New Zealand. In fact, pick up a newspaper in almost any city in the industrialized world and you can find some variant of the hollowing up story.

Hollowing out is not a distinctly Canadian phenomenon and virtually all industrialized countries around the world are reacting to the combined trend of consolidation and globalization. But in the area of foreign takeovers Canada may be heading toward leadership of the sort we don't want: since the beginning of last year, the value of public targets as a percentage of stock market capitalization has exceeded the U.K., U.S., Nordic countries and France combined. So while we should not feel alone in experiencing the effects of global consolidation, the relative size, openness and make-up of our country has resulted in a more dramatic impact and unlike many countries, we have not developed policies to encourage the development of Canadian champions or Canadian industries. But first let's examine how and why this hollowing out trend has evolved.

The Great Transformation

How is it that everybody can feel hollowed out simultaneously? Shouldn't it be a bit of a zero-sum game - one country's hollowee is matched with another country's hollower? One answer could be that this is a phenomenon felt in the industrialized world because it is the rapidly developing world – for example the BRIC countries of Brazil, Russia, India and China – that is doing the hollowing out. There is no question that there is a shift of manufacturing jobs from the industrialized world to China and some transfer of back-office and call centre jobs are flowing from the high-wage countries to India. But the hollowing out being referred to here is the purchase of national firms by foreign companies. On this front, the developing world is almost completely absent. Yes Brazil's CVRD bought Inco and India's Essar Global bought Algoma Steel. But the overwhelming majority of the 455 foreign acquisitions – in fact substantially all – were made by firms from other highly developed OECD countries. Yet these same OECD countries are all feeling hollowed out. Why?

It is because we are smack in the middle of a great global transformation; a transformation that bears eerie similarity to that of the Industrial Revolution. Historians argue about the precise timing of the first Industrial Revolution but it happened over a 50 year period from 1780 to 1830 – plus or minus a decade or two depending on the historian. Powered by the steam engine and other technological and process advances, the world looked a whole lot different in 1830 than it did in 1780. Industries changed completely. Trade patterns changed; markets were created and destroyed. Some things about the revolution – child labour and dangerous factories – were decidedly bad, but on the good side was a huge step-change rise in the pace of economic growth. The important lesson of the Industrial Revolution for the hollowing out issue is that much about a country's relative place in the world for the subsequent century or so depended on how it reacted during the transformational period. England

drove the revolution and established its place as the world's economic superpower for a century or more. The newly-independent U.S. embraced the Industrial Revolution with gusto and transformed its agricultural economy into a manufacturing economy at arguably a faster pace than any other country, enabling it to emerge as England's economic successor. In contrast, France was tied up in the aftermath of a particularly messy political revolution and the Napoleonic wars, and as a consequence remained a much more agrarian and small business economy well into the 20th century. Germany had trouble taking advantage of the Industrial Revolution in part because it wasn't unified until 1871, well into the second Industrial Revolution. And China, whether for political, cultural or economic reasons – scholars disagree profoundly on that front – also did not embrace the Industrial Revolution and was late to adopt the newer technologies and manufacturing approaches.

In due course, Germany became a legitimate economic powerhouse, England lost its steam (no pun intended), and Japan came out of its isolationist shell to become a great economy, but it is arguable that by approximately 1830, the economic die was largely cast for a long period based on what countries chose to do – for whatever idiosyncratic reasons – during the previous 50 years. We believe that future historians will look back on the period 1980 to 2030 and say similar things: this was a period of fundamental transformation and what countries did or did not do during that period defined their place in the world for the next century - for better or for worse.

Nature of the Transformation

What then is the nature of this transformation, 200 years after the Industrial Revolution? We believe that we are in the middle of a transformation from the relatively flat world of 1980 to a much spikier world. 'Wait just a minute,' you might ask, 'didn't Thomas Friedman tell us that the world is flat in his 2005 book of that very name?' Like thousands of others, we think the book is fabulous and makes a real contribution to understanding the emergence of India and China in the global economy. However, we think the book leaves an unhelpful impression that the world is flattening in terms of economic activity – as if the economic activity of the world will be spread across the world like butter.

We side with Professors Michael Porter and Richard Florida in seeing a spiky world that is getting even spikier. In his landmark 1990 book The Competitive Advantage of Nations, Mr. Porter explained why entire global industries were often headquartered in a single country if not a single region within a single country, like movies in Hollywood or printing presses in Heidelberg. A set of conditions in the local market creates a cluster of competitive companies that pressure each other to innovate and upgrade, teach local customers to be ever-more demanding, draw in and develop fabulous human resources, and attract co-location of helpful related and supporting industries. The result is a cluster that keeps getting better and better and, on the basis of that beneficial local competition, helps its members succeed internationally against competitors from elsewhere who don't have the power of a strong local cluster behind them. Mr. Porter's theory predicts a spiky world in which most of the successful competitors in a global industry come from very few places and export to the rest of the world. And as trade

barriers come down, Mr. Porter predicts falling of the impediments to the natural spikiness of industries.

In a 2005 Atlantic Monthly article titled 'The World is Spiky', Richard Florida countered Mr. Friedman's flat world hypothesis by showing that economic activity in the world is incredibly spiky as is innovation activity, measured by patents. Mr. Florida showed convincingly that talented people agglomerate in a limited number of regions in the world where they work for innovative organizations that dominate their industries.

We believe that since 1980, the world has gotten progressively spikier as the world's companies began globalizing at an unprecedented rate. Increasing favourable trade conditions and falling transportation and communications costs combined to make globalizing more of a reality as leading national firms found themselves pressured by capital markets to expand globally rather than stay at home. Research and development-intensive firms found that the only way they could afford to invest in competitive technological solutions was to utilize the scale economies of a global market.

For some less-protected industries, the transformation has happened already. To use an unimportant industry (except for two months of Canadian summer), if you are swinging a golf club, there is an overwhelming likelihood that it was made by a company headquartered in the town of Carlsbad, Calif., home of Calloway, Taylor Made, Cobra and thirty other golf-related companies. In other industries like consumer banking where protection of home markets tends to still be substantial around the world, the transformation has only started.

Regardless, we see the transformation proceeding in one direction only – to a spikier world in which all the globally competitive firms in all industries are headquartered in a limited number of locations. In some industries like golf clubs, cutlery, fax machines and movies, it will only be one location. In others, like automobiles, computers, consumer electronics, it will be a few. But the days of being spread like butter across the world are quickly disappearing in this epochal transformation that we estimate to be about half over.

Implications for Canada

During this transformational period, we need to be building as many globally competitive firms and clusters thereof as possible. We won't get a second chance – at least not for a century or so if history is any guide. As these industries get intensely spiky, a country is either a player or not; there is not an in-between. It has to be our No. 1 economic policy imperative to build globally competitive companies and in the industries we now know exist, we believe that game is going to be largely over in the next twenty years or so. Some games are over for Canada already. We aren't going to have a globally relevant consumer electronics company, automotive OEM, consumer packaged goods company, or beer company. Other games appear to getting over quickly. Steel is almost gone and much of mining appears headed that way. Those have become spiky already with the spikes driven into foreign soil. We must have a

sense of urgency because the looming downside is that we hit 2030 with few or no global leaders. If that were to be the case, we would be doomed to be an inconsequential country in the world; an outcome that is unacceptable for Canadians.

So, How are We Doing?

As is so often the case, there is good news and bad news in terms of how Canada has fared in the first half of the transformational period. It would be handy if it was an unambiguous picture, but it is not. However, on balance, we are more concerned than not and believe we need to take action.

The good news is that in this transformation to a spiky world of global leading companies that operate around the globe, Canada has managed to increase its numbers. If we go back to the early part of the transformation and ask how many world-scale global leaders Canada had in 1985, the answer is only 14 companies. By world-scale global leaders, we count only companies that are Canadian-owned, Canadian-headquartered and rank in the top five of their industry worldwide in revenues and have more than $1-billion in annual sales in that industry (or the equivalent in 1985 dollars of $617-million for the 1985 list). The 1985 list contains some great Canadian companies that have remained Canadian global leaders – like Bombardier, McCain and Nortel – but it also contains ones that have been snapped up by foreign firms - like Seagram, Hiram Walker, and Moore Corporation.

The most extreme form of the hollowing out thesis would argue that we have many fewer as of today. But the good news is that is far from true. The current list includes 39 firms – almost three times as many as two decades ago. Great Canadian names such as Magna, RIM, Husky Injection Molding, Couche-Tard, and Manulife have grown themselves into world beaters in the intervening period. And even though they may not all be the household names of old, the average revenues (even after inflating the 1985 sales to current prices) are 50 per cent larger than the 1985 firms. The good news is that Canada can and does grow global leaders and is doing so in this period of transformational globalization.

Buttressing this good news is the fact that after having a net deficit of international investment for most of the twentieth century – i.e. the amount invested by foreign firms in Canada versus the amount invested abroad by Canadian firms – in the past 10 years Canadian firms have out-invested abroad the foreign firms investing in Canada. So our Canadian firms have figured out that going global is a good idea to a greater extent than they did historically.

So what is the bad news? First, it appears that 2003 was the peak year for the number of globally competitive Canadian companies. Between 1985 and 2003, the number of such companies skyrocketed from 14 to 46 – a 3.3 times increase. But since 2003, seven companies, a full 15% per cent of our precious stock of such companies ceased to be Canadian companies and this trend may be accelerating. One company exited the list in a perfectly happy way – Placer Dome was acquired by Barrick, another Canadian company on the list. However, six were acquired by foreign firms, half of which (ATI,

Domtar and Masonite) were firms that built a global position between 1985 and 2003. That is a lot of hard Canadian work to get taken out by a foreign investor.

Second, it is appearing as though absolute size is mattering more and more in the global consolidation game and Canada is not doing great with respect to keeping up in absolute size. For example, both Inco (nickel) and ATI (graphic chips) were clear number one players globally in their respective industries. But they were acquired by considerably larger players in the broad industry in which they narrowly participated: CVRD in mining broadly and AMD in chips broadly. And if size continues to matter, it is a disadvantage that we have lost ground as measured by the number of Canadian firms in the global 500 rankings. Royal Bank of Canada (RBC) is the top Canadian at number 250.

While we would be among to be the first to say that in the great transformation going on today that we should expect global consolidators from abroad to acquire companies such as our Canadian global leaders, we can't help looking at the overall foreign acquisition numbers and the decline since 2003 of our global leaders and ask whether we are doing enough to make sure that we exit 2030 with the volume of global leaders necessary to underpin a prosperous and growing economy?

Net, we think we are not. We think that Canadian policy is largely indifferent to, if not ignores, the transformation that is going on today. While things may turn out fine with a policy of indifference, we think that the likelihood of that is sufficiently low and the downsides so devastating for Canada that we will argue that Canada needs to take positive action now.

Policy Prescriptions for a Positive Position

There are many policy prescriptions that Canadian governments could and should pursue to help Canada exit the transformational period with an attractive number of global leaders, but we will focus on the four most important: taxation of corporate investment; screening of foreign takeovers; regulation of the Canadian business environment; and support for Canada's global aspirants.

Taxation of Business Investment

The general view among Canadians is that we have a high tax environment. This is simply not true. If we take the broad comparator of the Organization of Economic Cooperation and Development which includes the 30 most developed and high-income countries in the world, Canada's tax take as a share of the overall economy of 33.9 per cent is 11th lowest out of thirty countries – below the average of 35.8% per cent. Among the narrower sample of the Group of Seven, we are third-lowest. So Canadians have little in the way of legitimate argument that we are highly taxed: we aren't.

However, our corporations are. Among those 30 countries, Canada has the third highest tax rate on business investment: 36.6 per cent versus the average of 20.6 per

cent. Interestingly, Canadians probably think that our taxation of corporations is higher than that in the U.S., but its corporations face the second highest rate (38.0 per cent) on business investment, a mere tenth of a per cent below Germany, the king of unhealthy corporate taxation.

Sadly, Canada's tax system overall was designed well before the inception of this globalization era. If our overall taxation is below average and our corporate taxation is sky-high, then what must be low? The answer is that our personal taxes and consumption taxes are comparatively low. That makes Canada attractive internationally from a tax standpoint in the ability to attract immigrants and an attractive environment for consumption spending. But the cost of that structure is that it is a crummy space for corporations to set up shop and for them to invest in machinery, equipment, software, hardware, branding, expansion, etc.

That may have been a fine mix for a pre-spiky world in which we wanted to populate Canada and encourage demand-driven economic growth. However, in the current spiky world, it is just a dumb structure. For individuals, Canada is considered one of the most attractive jurisdictions in the world and we suspect it would still be even if its personal tax levels were at OECD averages or higher. And there is no need to spur consumption by keeping GST/sales taxes well below OECD averages. But what is desperately needed is for our corporations to invest as aggressively as they can to upgrade their productivity, innovate and expand globally. Sadly for Canada, much of the rest of the industrialized world has figured this out and has tax structures tilted toward encouraging rather than discouraging corporate investment. Australia and New Zealand for example have approximately the same overall tax take as Canada but have tax rates on new business investment of around 24 per cent versus our 37 per cent. The socialist-leaning Scandinavian countries have figured out the way to play the game at a much higher government involvement than us. As a group, their overall tax take is way higher than Canada's (47.1 per cent versus 33.9 per cent) but their business investment taxation regime is way, way superior (19.6 per cent versus our 36.6 per cent).

There is a very interesting relationship between corporate taxation strategy and socialist background: the more socialist the ethos of the country, the more the country has figured out how to be intelligent about corporate income taxation. In addition to Scandinavia clocking in at 19.6 per cent, the four OECD countries that were formerly Communist-controlled average a mere 14.2 per cent. It is ironic indeed that the socialists are pragmatic rather than ideological about business taxation.

Canadian policy falls prey to an important categorical fallacy in respect to corporate taxation. Our logic of fairness holds that poor people make little income and should pay little tax; middle class people make moderate income and should pay moderate taxes; rich people earn lots of income and should pay high taxes; and corporations earn huge income and should pay really high taxes. But corporations are a different category altogether; they aren't like rich people only richer. They are legal constructions whose purpose in the modern economy is to invest, innovate and create high-paying jobs. Taxing them highly, as all the socialists have figured out, works against them investing, innovating and creating high-paying jobs. As the socialists have figured out, the way to

tax corporate activity is to tax at a personal level the earnings that rich people collect from the ownership of corporations.

In order for Canada to prosper in this transformational age, we need a fundamental rethink of our taxation philosophy. The question is not lower taxation overall; that is not the fundamental problem. The question is not left versus right; that is a red herring. The question is how to structure taxation so that corporations have the best chance of becoming global leaders and well-to-do Canadian individuals pay their fair share of the overall tax burden. Incremental changes won't work and congratulating ourselves for being slightly lower than second-highest US is not useful either. The U.S. suffers from the same categorical fallacy. But if it ever wakes up and for example creates a 7 per cent GST, it could eliminate corporate income taxation entirely and Canada would be in desperate shape. The flip side is that we create a significant tax advantage relative to the U.S., it would provide Canada with a great competitive advantage as a location from which to grow.

Screening of Foreign Takeovers

In this transformational age, the ability of our global leaders to acquire foreign companies is critically important. Thus even though we may wish to prevent foreign takeovers of our global leaders or emerging global leaders, if we re-established a harsh Foreign Investment Review Act (FIRA), we would jeopardize the ability of our leaders to expand and prosper abroad as other countries retaliate. Also, foreign investment in Canada has been a large contributor to our economic prosperity and should not be discouraged. That having been said, governments around the world have a big incentive to help their global leaders and it would be foolish for Canada to be more accommodating to foreign investors in Canada than their home country governments are to our global leaders. It is not some sort of even-handed level playing field out there and as world economic power shifts, countries are playing an increasing role in global economic expansion. Governments are influencing foreign acquisitions by their home country firms and acquisitions of their home country firms by foreign acquirers. We need to assure that Canada is giving its firms a fair platform for globalization rather than passively accepting aggressive policies that advantage foreign firms.

On this front, we argue that the role and mandate of Investment Canada should be reviewed to ensure that it has the ability to protect Canada's interest with respect to foreign acquisitions.

First, Investment Canada should be empowered to delay any acquisition of a Canadian firm by a foreign company if a foreign government is withholding or restricting approval of a related or opposing acquisition by the Canadian firm.

Second, it should work to extract more value from foreign acquisition of Canadian companies through commitments from an acquirer such as maintenance of head office location or research programs. Clearly, this is tricky territory. Overly aggressive negotiation by Investment Canada would be taken by the international community to be the moral equivalent of protectionism. However, there are good recent examples of

successful action by governments elsewhere. For example, when U.K.-based Billiton and Australia-based BHP proposed merging in 2001, the Australian Foreign Investment Review Board (FIRB) provided the merger with expedited approval and the Australian government made a number of regulatory changes that enabled a dual listing for the combined firm in Australia and UK in exchange for the commitment to maintain the BHP Billiton head office in Melbourne. As a result, Australia is home to one of the three giant mining conglomerates in the world rather than the ex-home of one of the pretenders to that echelon.

Third, Investment Canada should also be allowed to disallow any acquisition of a Canadian firm by a foreign firm that is government owned or controlled. Large state-owned enterprises are becoming increasingly aggressive with respect to foreign acquisitions and we should have the right to access this issue on a case by case basis and ensure open market forces prevail. CVRD is a company partially owned by agencies of the Brazilian government which also owns its six 'golden shares' which enable the government to prevent acquisition, head office relocation or even name change of CVRD. Neither Inco nor any other global mining company could acquire CVRD; but CVRD can go into the international market and acquire firms such as Inco, hardly an even playing field. This is not to suggest that CVRD should not have been allowed to acquire Inco, but rather that Canada should have policies to deal with these types of transactions.

Governments are going to increasingly compete as we get to the end-game of this transformational era and we can't allow foreign governments to block our international advances (directly or indirectly) while we let them do whatever they wish in Canada. We need to ensure reciprocity of regulatory protection and how we deal with government entities.

Regulation of the Canadian Business Environment

In a spiky world, the quality of the home market from which global leaders attempt to arise is critical. It must be an environment featuring a combination of pressure and support. The pressure needs to come from intense competition and sophisticated/demanding customers while the support needs to come from abundance of sophisticated resources like highly-skilled human capital and specialized infrastructure, and the presence of related and supplier industries. Regulation can and does prevent Canadian companies from benefiting fully from a pressure and support-filled home environment. Entry regulation reduces competitive intensity and dulls beneficial customer power. Inter-provincial trade barriers fractionate an already small market.

Archaic securities regulation makes our capital markets less attractive and somewhat of an international embarrassment. In our biggest and highest wage industrial cluster, financial services, policy oriented toward a pre-spiky world prevents our banks from capitalizing on the same opportunities as global competitors. Government and regulatory policy has restricted consolidation, prevented the selling of insurance, imposed capital tax on foreign acquisitions and is more restrictive with respect to

leverage. This, in combination, creates a very uneven playing field when competing internationally and increases the relative cost to Canadian banks of international growth. Environmental, safety, and consumer protection regulation are as important to maintain as they ever have been. But regulation of competition and competitive dynamics must be done in the context of Canada's desired position at the end of this transformational age and not in the context of ages gone by.

Support of Our Global Aspirants

In this great transformation, it is critical that Canadian governments support our global business aspirants. The future of our 39 $1-billion-plus global leaders is critical to Canada's economic health and prosperity, as is the future of our additional thirty-two global leaders between $100-million and $999-million in revenues. In addition, the firms that are not currently in the top five in their industries globally but are striving for that position matter. Together this group of perhaps one hundred global aspirants deserves our country's support.

But support is a tricky concept. There is little evidence outside several industries that are highly subsidized by governments around the world - like aerospace vehicles - that giving monetary subsidies to firms produces global leaders. Likewise, protecting them against competition works against not for global leadership.

However, making sure that they have access to sophisticated and demanding customers, highly-specialized talent, world-class infrastructure and open foreign markets are critical to success and governments can and should provide support on all of these fronts. Canadian governments should be in continuous contact with the global aspirants and asking what they need to succeed. Some things governments will be unable to provide, but others will be in their capability and they should make their provision to the global aspirants a high priority.

The Role of Management

Government policy changes can do no more than set a positive context for Canadian firm senior managers. It is then up to Canadian corporate leaders to take their firms aggressively into the global market. It is arguable that Canadian managers have not been sufficiently aggressive in globalizing in the first half of this transformational age and it is critical for them to step up to the task in the latter half. In a spiky world, your firm either globalizes or eventually gets swallowed up by a globalizing corporation, typically headquartered elsewhere. Canadian managers that ignore this reality are fooling themselves and selling Canada short but we need to ensure this is an attractive country from which to grow.

They will need the Canadian capital providers behind them. If the capital providers treat international expansion as more dangerous than staying at home, corporate leaders in Canada will have a more difficult time pursuing aggressive international expansion. This has been altogether too frequent an occurrence for Canadian capital providers. The large Canadian pension funds need to recognize that if they want to

invest in Canadian companies, they will need those Canadian companies to globalize aggressively or they will be bought by a foreign company. And while the acquisition may produce a handsome one-time premium, the global acquirer will capture the long term upside associated with owning the previously-Canadian company. While that may comfort Canadian capital providers in the short term, in the long term, they won't have Canadian global leaders in which to invest if they don't support them in the short run.

Summary

Canada is at a critical point in its economic history. The decisions it makes in the next few years will determine its position in the world for the next century. While Canada enjoys high prosperity currently, continued prosperity is contingent on our production of global leading companies. That means both helping our current global leaders prosper and maintain their Canadian ownership and growing new global leaders. The current spate of foreign acquisitions of our significant Canadian companies suggests that we need to dramatically enhance the policy and managerial environment in Canada. In a global world, we are not competing within our borders but against companies and industries that are supported by the laws and policies of their home country and we have to ensure that we are at a minimum on an even playing field. We recommend that we make a major change in our taxation philosophy, fine tune Investment Canada's role and improve the regulatory environment to give our Canadian managers the best opportunity to build global leaders for the long term and succeed from a Canadian base.

We urge action: now is the time; now is the opportunity.

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