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The Corporate Governance of Multinationals

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ABSTRACT

Globalization is a result of an increasing need for companies to access larger markets to recoup the costs associated with an increased pace of innovation in many industries. This chapter argues that globalization and multinational firms are likely to be even more important to Canada's competitive position in coming years than they have been in the past. This global competitive pressure may make many contemporary public policy concerns about corporate governance moot. In a global economy, customers, investment capital and highly skilled employees need not tolerate poor management. They can simply do business with better run rivals. Canadian firms will have to deal with their governance problems not because they are legally required to do so, but because their survival will depend on it. In this context, government's best option for improving Canadian corporate governance may well be simply to foster competition and openness while providing good legal and educational infrastructure. This entails weaning firms from subsidies and captive markets, and providing sound basic public services like education, health care and law. Some specific issues as to the governance of multinational subsidiaries in Canada do arise, especially with regard to minority Canadian shareholders. We argue that the boards of foreign subsidiaries with Canadian minority public shareholders should have *conduct committees* charged with approving nonarmslength transactions with the parent or other related companies. Indeed, requiring this of all firms with controlling blockholders and publicly traded minority shares might solve many of Canada's corporate governance problems in one blow.

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Introduction

Before we can formulate suggestions about corporate governance in multinationals, we need to make clear why multinational firms are important and how they are different from purely domestic firms.

Multinationals have always been an important source of capital for Canada. As of 1990, Canada contained $108 billion worth of foreign direct investment, or 6.6% of the world's total stock.[i] In 1987, foreign owned subsidiaries accounted for 64.8% of total manufacturing sales, 75.35% of manufacturing exports and in 1985-88 88.3% of manufacturing imports (Corvari *et al.*, 1993). The flow of new foreign direct investment into Canada has averaged to about $10 billion per year in recent years, and the majority of this came from the U.S. (Knubley *et al.*, 1994). Canada's public policy toward inward foreign direct investment has thus been intimately related to its relations with the U.S. Cool relations with the U.S. and popular fears of U.S. domination in the 1960's and early 1970's led to the establishment of the Foreign Investment Review Agency (FIRA) in 1974. FIRA was allegedly designed to ensure that inward foreign direct investment brought significant benefits to Canada. Similar emotions brought about the National Energy Program (NEP), a system of partial expropriation of foreign investments in the energy sector.

The conservative victory in 1985 brought about a sharp change in policy. The NEP was eliminated. FIRA was recast into Investment Canada and given the mandate of *attracting* new foreign direct investment to Canada. The 1989 Canada-U.S. free trade agreement and the subsequent North American Free Trade Agreement further opened the Canadian economy, although both provided special status for specific industries, most notably the so-called "cultural industries". Investment Canada was placed inside the Department of Industry in 1993, and ceased to exist as an independent agency in 1994.

Economic policies in the twentieth century have been products of political ideology, popular opinion and economic realism. Political ideology seems a spent force, and popular opinion seems increasingly aligned with economic realism. The increasing realization that governments are not monopolies, but are in competition for footloose investment by global businesses reflects this. One effect of this is the on-going development of free trade and investment regional blocs and the multilateral trade and investment liberalization envisioned in the Uruguay Round of the GATT and the new World Trade Organization. Given this so-called GATTization of history, what should Canada's policy towards foreign-owned subsidiaries be in the remaining years of this century and beyond?

It is hard to over-emphasize the importance to Canada of the globalization of business. Rapid advances in information and communications technology and the wholesale economic liberalization of entire regions of the globe like China, Eastern Europe, and hopefully Latin America have been accompanied by an explosive growth in foreign direct investment. Business success often depends on globally integrated marketing, production, research and development, and human resources management. The increased competition due to globalization has brought about substantial improvements in management skills and in the way business is conducted in many countries. This free flow of ideas means that firms now strive to learn from the best of their rivals all over the world. Constant innovation is requirement for survival. Multinational enterprises are a conduit of this globalization phenomenon. They are vital for prosperity and yet they are ruthless enforcers of the "survival of the fittest".

Canada's policy toward foreign owned subsidiaries in the new economic order must be informed by an understanding of the economics of multinational firms. In the second section of this paper, we explore the following issues: Why do multinationals come to attaint a competitive advantage over uninational firms. What impact does foreign direct investment have on a host economy? How has the behaviour of subsidiaries changed over time? In the third section we explore how the international environment for foreign direct investment changing. In the final section, we present our views on the policy challenge and make some suggestions.

Our theoretical and empirical understanding of multinational firms

Why firms establish foreign subsidiaries

International operations are not simple to run. Entering into a new environment, a company has to start from scratch to build up an understanding of the local culture, legal system, regulatory environment, and the business environment in general. Moreover, doing business is more than just building a factory or a marketing outlet, it involves making local contacts, hiring correctly in the local labour and management markets, building up a good working relationship with suppliers, distributors, transportation service companies, and also with the local government. These considerations suggest that foreign entrants have an information disadvantage relative to indigenous firms. In the business literature, the assumption is often referred to as the "home court advantage" of local firms. For example, foreign entrants may often have to pay a premium in hiring local workers. They may make costly mistakes in building up its working relations with local suppliers and distributors. The question is: Why, given all these difficulties, would foreign entrants be interested in establishing overseas operations in the first place, and what allows them to overcome their local rivals' "home court" advantage

Practitioners give several answers: (1) access to inexpensive raw materials and/or labour, (2) access to markets, for example by jumping trade barriers, (3) strategic response to a competitors' presence, (4) improved flexibility in production or marketing, (5) access to business intelligence, like the development of the latest products, production techniques, marketing ideas, etc. (6) reducing taxes by shifting income to subsidiaries in countries with low tax rates.

Since all these ideas seem *prima facia* legitimate, researchers have sought to understand more precisely what creates the synergies in a multinational network of affiliates. Does a multinational structure, in itself, create enough value to overcome local firms' "home court advantage", or is there a deeper economic reason for the survival of multinationals?

Recent research suggests that the intrinsic value of a multinational structure stems from the *internalization* of markets for a company's intangible assets; and that the above reasons are all tactics to achieve this. Intangible assets are i*nformation based*. They include innovative production techniques, new marketing skills, brand names, company images, company-based management skills, new organization routines. In short, they are innovations that bestow a competitive advantage or "edge" to the firm.

Because such intangible assets are information-based, expanding the scale or scope of their application adds few costs and does not deplete the intangible assets, but greatly increases the return on their up-front development costs. The firm should thus try to employ its "edge" on as great a scale as possible to gain the most from its innovation.

It is difficult to sell another firm the rights to use an information-based asset. For example, a buyer might reasonably demand information about a new marketing technique before paying for it, but once the buyer has the information, there is no further need to pay for it. The buyer already has everything he needs. Patents and copyrights mitigate these problems to some extent, but not completely. Licensing a new technology to a foreign firm may create a vigorous future competitor.

To employ its innovative "edge" on as great a scale and scope as possible while preserving exclusive control requires that the firm itself expand. In the international context, this means foreign direct investment. This is what is meant by internalizing the market for these information-based intangible assets.

Morck and Yeung (1991) examine the relationship between firm value and multinational structure. Their purpose is to reveal whether a multinational structure indeed enhances firm value, and to uncover the source of any changes in firm value.[ii] They find that a multinational structure is correlated with enhanced firm value to the extent of about 8¢ per dollar of total physical assets, Without intangible assets, a multinational structure either has no impact on firm value, or decreases it. More importantly, they find that this increase in firm value is strongly correlated with a firm's past R&D or advertising spending. Without intangible assets, a multinational structure either has no impact on firm value, or decreases it. This implies that information-based intangible assets are required for a multinational structure to add value, and that without them a multinational structure is a potential liability. Morck and Yeung (1992) find that announcing the acquisition of a foreign firm adds an average of 2% to a U.S. firm's total value. This positive stock price reaction is also restricted to firms with probable intangible assets. The announcement of a foreign acquisition by a U.S. firm without intangible assets either does not change its value or decreases it. This indicates that expanded multinational structure causes the increased firm value, and not the converse. A number of subsequent studies have confirmed these findings.[iii] Additional studies show that multinational firms on average have a much higher propensity to invest in intangibles than purely domestic firms.

Upon reflection, it is apparent that reasons practitioners cite derive from increasing the scale of a firm's "edge". A firm with such an innovative edge can benefit from entering costly and difficult raw materials that would be unprofitable for other firms. Flexibility, strategic moves, and obtaining intelligence are all long-term investments that a competitive "edge" makes possible. Income shifting is most useful when a firm has extra income to shift, and because tax authorities' increasing sophistication is making transfer pricing more difficult, intra-firm transactions involving intangibles are becoming the income shifting method of choice (Harris et al. 1993).

In short, from a firm's point of view, international expansion is fundamentally a way to expand the scale and scope of application of its intangible competitive "edge". International expansion is not an end in itself; rather, it is a means to combine firm specific assets with local assets and thereby enhance profits.

Furthermore, for both Canadian firms going abroad and foreign parents establishing subsidiaries in Canada, a multinational structure demands continuous investment in new intangibles. Intangibles are not everlasting. Like physical assets, they depreciate and become obsolete. They need continuous replacement and replenishment by on-going R&D, new marketing initiatives, new organizational structures, etc. If a firm allows its intangibles to become obsolete, it loses the "edge" that helped it overcome local firms' home court advantage. Its multinational structure becomes a liability. Firms whose overseas subsidiaries become net drains of corporate resources will not survive in the long run. Continuous innovation is a Darwinian necessity for a multinational.

Innovation is thus both more profitable and more essential for a multinational than for a uninational firm. It is more profitable because a multinational structure lets a firm use its innovations on a larger scale and scope, and thereby more readily recover its up-front costs. It is more essential because a multinational structure becomes a liability when a firm lacks intangible information-based assets. Constant innovation is required for a multinational to maintain an "edge".

From a policy point of view, foreign direct investment enhances the productivity of the local economy because of the intangibles it brings along. Furthermore, from an efficiency point of view, an economy with an open competition policy should have little fear of foreign multinationals exploiting its local factor inputs. A foreign subsidiary can overcome indigenous firms' "home court advantage" only because its intangibles make local inputs more productive in its hands, and thus allow it to outbid competing potential employers. Still, because of the political controversy surrounding it, the impact of foreign direct investment on the host country economy deserves special attention, to which we now turn.

The behaviour of subsidiaries over time

Active participation does not mean long term survival of any particular foreign-owned subsidiaries. International expansion is risky (see e.g. Mitchell *et al*., 1992) and many subsidiaries fail early (e.g. Newbould *et al*., 1978, Evans *et al*. 1991).

Unfortunately, the literature does not compare the exit or failure rates of foreign-owned subsidiaries with those of domestic firms. It is therefore not clear how to interpret the reported considerable failure and exit rates of foreign-owned subsidiaries. Specific case studies reveal reasons along the lines of: inability to adapt to the local business environment, insufficient expertise in running foreign operations, and insufficient benefits to the parent firm from the subsidiary.[iv] It is comforting to know that parents do fold up failed operations. Overall, these reasons are consistent with multinationals whose intangibles are insufficient to offset the home court advantage of domestic firms being forced to retreat.

Surviving foreign operations appear to increase their involvement in the host country's economy over time. Aharoni (1966) documents a gradual increased in local involvement from exporting to licensing to the establishment of a full fledge subsidiary. Teece (1985) argues that American and British firms' offshore operations develop from sales branches into contractual production and ultimately into foreign direct investment as the firms gradually accumulate more information about the offshore market. Shaver (1994) finds that ,out of the 354 foreign acquisitions or green-field constructions of new production plants by foreign firms in the U.S. manufacturing sector in 1987 recorded by the U.S. Department of Commerce (International Trade Administration), 205 or fully 58% were by foreign firms that already had a presence in the U.S. Moreover, 107 or 30% of them were by foreign already present in the U.S. in the same industry. In short, a substantial portion of foreign direct investment is by multinationals that are already committed to the host country.

Such a sequential approach makes sense. With all its disadvantages on domestic firms' "home turf", the foreign entrant takes a cautious first step, perhaps it begins exporting into the market. This lets us accumulate information about the host economy and about whether its competitive advantages can outweigh the "home turf" advantage of local firms. If the host economy looks promising enough, the foreign entrant commits more resources. If the host country's "home turf" advantage is too formidable, for example strong political connections might be needed to get anything done, the foreign entrant retreats.

An implication of this sequential approach is that multinationals gradually increase their involvement in a host country that provides a favourable investment climate. A hospitable environment entices the multinational to expand and deepen the synergies between its intangibles and local economic resources. In doing this, multinationals serve the local economy as a conduit to global markets, a source of information and innovations, a stimulant of new business opportunities, and a source of competitive pressure.

The importance of multinationals for Canada

The traditional way of understanding the impact of foreign direct investment on an economy is to model it in terms of capital migration and analyze it using traditional tools of international trade theory. This approach may not be the most fruitful one. Canada is a small open economy; changes in its factor endowments due to capital migration are unlikely to change the prices of its products and thus its terms of trade. With no change in prices, classical static trade theory in the Stolper-Samuelson tradition predicts no changes in factor return.

Public debate about foreign direct investment often turns to the issue of job creation. If there is genuine involuntary unemployment, an injection of investment can indeed create jobs in the short run, and that is important. However, such market disequilibrium is usually temporary, and therefore should not be the paramount consideration in determining a long-term public policy strategy. Except in the depths of a recession or in certain economically troubled regions, Canadian unemployment is probably not far above the long-term natural unemployment rate: the level of unemployment in a healthy economy due to workers taking their time searching for the best job. Under these circumstances, the criterion for "desirable" foreign direct investment is not job creation *per se*, but the creation of jobs that are more desirable for Canadian workers. The creation of better paying jobs can only be based on a potential employer's ability to make Canadian workers more productive. More generally, "desirable" foreign direct investment must make Canadian capital, labour, and material inputs more productive.

Does foreign direct investment make Canadian inputs more productive? Empirical research generally produces an affirmative answer. Globerman (1979) shows that labour productivity in Canadian production plants is positively related to the degree of foreign ownership in an industry. Corvari et al. (1993) conclude that foreign controlled plants are usually more productive than domestically owned plants and that the former have, in particular, a higher level of labour productivity.[v]

Why is foreign direct investment is positively correlated with productivity? We can point to several reasons.

First, successful multinationals possess intangible assets. Their more innovative production, marketing, and managerial skills let them use other inputs, such as labour, more productively.

Second, multinational firms are a conduit through which local labour, capital, and raw materials become a part of the world economy. For example, multinational software firms employ Indian programmers to develop product that will eventually be marketed in the West. In the absence of multinationals, these skilled Indian workers would probably not be able to find comparably attractive employment in India. Also, local firms that establish business relationships with multinationals become indirectly linked to global markets. Doing business with a multinational may allow a local firm to supply overseas markets that would otherwise be to costly to access. This indirect access to broader markets greatly expands the scope of opportunities available in the local economy.

Third, multinationals serve as information gathering and processing machines. Through their presence in multiple markets, they collect and, where possible, exploit information from all over the world about new production techniques, new market opportunities, or changed business conditions. They are uniquely able to create global synergies, that is the gain "edges" in one market by applying information they gather elsewhere. For local firms, this aspect of multinationals is a two edged sword. The spill-over of new techniques and information, as well as the indirect access to global markets a multinational provides, benefit local firms and workers by helping them increase their productivity beyond what would otherwise be possible. But at the same time, because the multinational is constantly searching for newer, better ways of doing business, local firms are under constant competitive pressure. Doing business with a multinational force local firms to invest more in innovation and productivity enhancement than they otherwise would.

Indeed, multinational enterprises, because of their information-based intangible assets and global connections stimulate improved local production, marketing, and management. Clark *et al*. (1987) argue that Japanese transplants in the U.S. served both as stimulants of and conduits for the transfer of skills to the lagging U.S. auto-industry's productivity. Eden (1994) argues that multinationals serve as agents of change in the Canadian economy.

Fourth, multinationals stimulate competition. In a small closed economy, optimal economies of scale may lead to a small number of local firms in each industry, and a consequent tendency toward oligopolistic pricing. Foreign entrants can increase the number of competitors and thus make collusion more difficult. The dynamic implications of this are especially important. Collusion reduces the need for firms to constantly innovate, and may result in an industry sliding into a cosy stagnation. By breaking entry barriers and competing for business, foreign entrants force entrenched firms to be more innovative and productive, or to lose business. Poor corporate governance of local firms becomes more obvious and more dangerous in the presence of multinational competitors.

Also, because their market power is weakened by this increased competition, entrenched local firms are less able to exploit their suppliers, investors, workers or customers. They have to pay workers, investors, and suppliers factor prices closer to marginal values. They also have to charge their buyers reduced prices closer to marginal costs. Overall, there should be an improvement in overall economic efficiency.

Chung *et al*. (1994) showed that increased competition is the most important short run mechanism via which foreign direct investment increases host country productivity. Moreover, foreign entrants increase competition and thus force better resources allocation within firms as well as among firms. Mitchell *et al*. (1993) show that firms' exit rates are higher in industries in which multinationals have higher market shares.

In summary, foreign direct investment increases host country productivity *via* an immediate transfer of information-based intangible assets. But, this is a one-shot static improvement. More importantly, foreign direct investment provides continuous conduits to global markets for the local economy, ongoing transfers of information and innovations to the local economy, and sustained pressures on local firms to innovate and increase their productivity. These dynamic pressures lead to an increased level Schumpeterian creative destruction, and therefore a higher long-run growth rate for the economy.

The changing environment of foreign direct investment

The environment in which foreign direct investment takes place is changing rapidly. The most visible change is the development of NAFTA, the EC, APEC, and the new World Trade Organization established in the Uruguay Round of GATT. Less visible, but perhaps more important, is a rapid evolution in the way business is done - popularly called "globalization" .

Declining Trade and Investment Barriers.

Reduced trade barriers should lead to an increase in foreign direct investment that achieves synergies between multinationals' information-based intangible assets and host countries' assets. They will reduce foreign direct investment aimed at jumping trade barriers.

The Uruguay Round of GATT produced a new World Trade Organization (W.T.O.) along with promises of general tariff cuts, reductions in subsidies on agricultural products, the "tariffication" of nontariff barriers, the elimination of voluntary export restraints, and the phasing out of the Mutilfiber Agreement. The rules on safeguards, anti-dumping actions and subsidies are to be reviewed. The effectiveness of these changes is an open question because of long phase-in periods will greatly delay most of these changes, especially for developing countries.

The Trade Related Investment Measures component of the W.T.O. directly affects foreign direct investment. It prohibits W.T.O. member countries from imposing local content requirements, trade balance requirements, or foreign exchange balance requirements. In the past, these measures have constrained trade in motor vehicles, chemicals, pharmaceuticals and high-tech products. Unacceptable requirements must be eliminated within two years by developed countries, within five years for most developing countries and within seven years for the least developed countries. The Uruguay Round Agreements also strengthens intellectual property rights and includes a General Agreement on Trade in Services. Major features in the latter are national treatment and a most favoured nation clause, and a framework for further negotiation on the liberalization of trade in services.

The full impact of this shift is not yet clear. What is clear, though, is that despite the Uruguay Round's success, significantly freer international trade and investment are neither imminent nor assured. Indeed, the ingenuity of protectionists in devising new trade and investment barriers should not be underestimated; they have repeatedly undermined the liberalization efforts of previous GATT rounds. One major insight in the trade literature is the equivalent of domestic tax and subsidy policies to trade barriers. For example, a tariff is equivalent to a consumption tax plus a production subsidy. In the W.T.O. agreement, research subsidies and regional development subsidies are permitted. Complex and "progressive" tax codes can be rigged to affect different firms or industries differently. For example, a progressive corporate income tax is essentially a tax on highly productive firms. Tax codes can discriminate against foreign ownership and can punish the import of foreign inputs. (See Slemrod, 1995) Scope for hidden trade barriers clearly remains.

Therefore, despite the Uruguay Round, economic regionalism will certainly continue to affect trade and investment. This means that direct and secure access to regional free trade and investment blocs *via* wholly owned subsidiaries will remain attractive to many businesses. Many companies have established European subsidiaries to gain access to the European Community's market. Similarly, foreign firms have come to understand that secure access to North American markets is best assured by direct investment in North America.

N.A.F.T.A. creates a rigorously non-discriminatory investment environment within North America. It requires all signing countries to treat investors from other NAFTA countries no worse than domestic investors or any other foreign investors from NAFTA countries or elsewhere. Performance requirements for investments are either eliminated or phased out. Restrictions on capital movement, like payments and profit remittances, are banned except for balance of payments reasons. Expropriation is outlawed unless enacted under ordinary domestic laws. NAFTA, broadly speaking, has put competition between the United States, Canada and Mexico for investment on purely economic terms.

The globalization of business.

Advances in communications technology and improved transportation efficiency let companies scatter their production and other value-chain activities throughout the world. Some companies, for example G.E., actually pull intercontinental teams together to design and engineer products without ever needing to put them under the same roof. Some companies are able to produce a product by shipping components from Hong Kong to Panama. Better inventory control techniques, systems management, and the like, allow companies to work with affiliates and other supporting companies around the world.

Improvements in organization and related management techniques have been made possible by these developments and made necessary by intensified global competition. For example, companies now farm out activities to specialists and thus improve overall efficiency and productivity. The North American auto-assembly industry has gone through a well publicized slimming down to "lean" production techniques. These firms now produce a much smaller number of parts than before. Internal and external units have learned how to collaborate and cooperate. Ford and Chrysler are now able to form new car design teams that include people who are not employees and even people who are not in North America. Many previously hierarchical companies, such as Xerox and AT&T, are now engaged in so-called "lateral blending".

There are several implications of these developments. First, companies are now more focused in their development of core competencies (Prahalad and Hamel, 1990). Overtly integrated conglomerates were revealed to be inefficient organizations in the 1980's. Unrelated integration and expansion were viewed unfavourably by financial markets (Morck *et al*., 1990) and were seen by many observers are signs of managerial agency problem. Less cross industry diversification means companies are now more agile and alert for changes in the markets upon which they are focused. Second, the scale of plants and companies are substantially reduced. Large massive and integrated plants are rarer than before. Smaller physical facilities with more flexible product design and mix possibilities are seen as preferable. Changes in product design need not await the development of mass consumption, nor do they require the high adjustment costs typical in large plants. At the same time, because smaller facilities are easier to establish and dispose of, exit and entry are becoming more prevalent. Third, companies are now competing in groups rather than alone. Nike and Addidas each have an associated group of suppliers and shippers, and it is these two networks of firms that compete.

Multinationals must excel at developing information-based intangible assets, the innovative "edges" upon which their survival and success depends. For example, multinational pharmaceuticals companies compete to amass and blend their R&D capabilities globally, and take advantage of whatever tax, regulation, and labour cost advantages various host countries offer. Retailers, like Benetton and Toys' R Us, compete to be cost effective and consumer conscious with improved inventory systems, better marketing flexibility, and more efficient coordination of their suppliers. Motorola relies on its technological capability and its ability to manage its work force to produce high quality new products faster and better than anyone else.

In this environment, multinationals become extremely productivity sensitive. Foreign subsidiaries, besides managing internal operation and strategy, also serve as team leaders creating productivity and synergies between themselves and local support firms. In this context, they demand a pool of superb local managers, a highly efficient local workforce, and very competitive local support firms. It is in these terms the provision of these that US and Canada are really competing for foreign investment.

Multinationals and Canadian Corporate Governance

In this section we consider public policy options for how Canada should deal with foreign multinationals. We first examine some specific issues that arise in the governance of foreign controlled subsidiaries. We then turn to public policy on corporate governance in general, and how it should reflect what we know about globalization and the increasing importance of multinational business.

Unique Corporate Governance Problems in Multinationals' Subsidiaries.

Revenue Canada has long been concerned about a practice of many multinationals that economists call *income shifting* or *transfer pricing*. Harris *et al*. (1991), Grubert and Mutti (1991), and Hines and Rice (1994) all present evidence that U.S. multinationals shift taxable income from subsidiaries in high tax countries to the U.S. and from the U.S. to subsidiaries in low tax countries. This is accomplished by setting artificial prices for patents, copyrights, insurance, assets being transferred to or from subsidiaries, and services provided to or by the subsidiary; and by having highly taxed subsidiaries issue a disproportionate amount of the firm's debt. Aggressive taxation of their subsidiaries simply causes multinationals to transfer profits away and thus reduces tax revenues. Multinationals can transfer profits and assets easily from country to country and taxation authorities appear unable to halt the practice.

Are minority shareholders likely to succede where Reveue Canada has failed? If multinationals consistently transfer profits out of Canada to avoid taxes, the value of any minority shares that trade in Canada is depressed. If the multinational's subsidiary was established as a green-field expansion, the shareholders who bought a minority stake in it arguably knew what they were getting into. However, if the multinational acquired a previously independent Canadian firm as its partially owned subsidiary, there is a real possibility that Canadian minority shareholders might be harmed by asset and profit transfers out of the country.

There is a potentially serious conflict of interest for corporate directors. Which comes first, their duty to the firm as a whole, to help it avoid unnecessary taxes and allocate assets optimally; or their duty to Canadian shareholders of the subsidiary, to maximize the value of their shares?

Insisting that Canadian citizens serve on the board of multinationals' Canadian subsidiaries is unlikely to solve this problem. In general, multinationals appoint top executives of the subsidiary to its board to fulfil this requirement. These Canadian executives are unlikely to overtly criticize head office decisions for fear of damaging their careers in the firm.

One option is to required that these Canadian directors also be outsiders. But they must then be totally free of any commercial links with the firm. Replacing Canadian executives with partners of the Canadian law firm that handles the multinational's Canadian business is not likely to lead to a more independent board. Still, unless independent directors form a majority of the board, they may well be impotent to block non-arms-length transactions with the parent or other subsidiaries that harm Canadian minority shareholders. Foreign multinationals are likely to see a requirement for a majority of independent Canadian directors as overly onerous.

A reasonable compromise might be to require the boards of subsidiaries with minority public shares to have c*onduct committees*. This could have a majority of independent Canadian directors, while the board as a whole and could be required to approve all transactions with related companies. The special charge of directors on the conduct committe could be to protect the subsidiary's minority shareholders. As an added bonus for the government, these directors would simultaneously be protecting Revenue Canada's coffers.

Conduct committees would be objectionable if they were required only of foreign controlled subsidiaries. However, the problem of minority public shareholders being harmed by non-arms-length transactions is a general issue in Canadian corporate governance. It is a concern in conglomerates and closely-held firms in general, not just foreign controlled subsidiaries. Perhaps there might be a general requirement that all firms with a controlling or dominant shareholder should have a conduct committee charged with protecting public shareholders from non-arms-length transactions. Foreign subsidiaries would obviously be included.

An alternative policy might be to push multinationals to buy all the shares of Canadian corporations they acquire, so there are no minority shareholders to protect. While this neatly solves the corporate governance problem, it does nothing to help Revenue Canada. Moreover, multinationals with Canadian minority shareholders are forced to produce separate annual reports, proxies, etc. for their Canadian subsidiaries. This makes multinationals' Canadian operations considerably more transparent than they would otherwise be. These broader public policy concerns might tip the balance towards conduct committes as a solution to the corporate governance concern.

Another alternative might be to mandate full disclosure of all large intercorporate transfers. This would involve applying to multinationals a requirement similar to Ontario's section 9.1 rules for groups of companies in that province. If full disclosure of all intercorporate transfers were augmented by rules allowing shareholders

Globalization, Multinationals, and Canadian Public Policy on Corporate Governance

In his 1942 book *Capitalism, Socialism and Democracy*, Joseph Schumpeter first described the process of continuous innovation we described above, and called it "creative destruction" - if firms do not constantly create new ideas, they are destroyed. There is increasing agreement among mainstream economists that this process underlies the success of the capitalist democracies. In our view, the ultimate effect of the worldwide reductions in trade barriers and the globalization of business described above is to make the world more Schumpetarian: to survive, firms must innovate.

This has direct implications for the corporate governance debate. Indeed it may render most concerns about poor corporate governance moot within a few years. When the economy is changing rapidly, when competitors from previously remote parts of the world are entering Canadian markets, and when Canadian firms, to pay for their own increased costs of innovation, must sell to foreign markets, poor corporate governance is untenable. Canadian firms must either fix corporate governance problems fast or fail.

The government has a critical role to play in the new economy that is quite different from its traditional part. The central theme that underlies this new role for the government is that, to help Canadian firms compete abroad, the Canadian economy at home must be as efficient as possible. An efficient economy both attracts foreign investment that brings with it new ideas, and encourages local firms to innovate and grow, which makes our economy even more efficient - a positive spiral of growth. An inefficient economy, in contrast, fails to attract foreign investment and thus misses out on new developments that could increase its efficiency - a negative spiral of stagnation described by Murphy *et al*. (1991, 1993).

The fundamental long-term goal, from which improved corporate governance will result and which it will promote, is an efficient, innovative, and internationally competitive economy. In the new global economy, multinational subsidiaries will come if Canada has an efficient economy, but are neither a means nor an end in the master game plan.

We feel there are three broad philosophical principles Canadian policy makers should bear in mind as they consider different options for improving Canadian corporate governance.

1). Hippocrates tells physicians to do the patient no harm. If, as we argue, the world is becoming more Schumpetarian, Canada probably needs foreign multinationals more than they need Canada, especially in the NAFTA era. Rules about the governance of multinational subsidiaries should not so onerous as to compromise the attractiveness of the Canadian economy to foreign investors and thereby limit its long-term productivity growth prospects.

2). Public policy must aim at providing a stable environment with as few economic pitfalls as possible. Transparency and predictability are important. Uncertainties and frequent sharp changes in regulations and laws drive out existing investment and discourage future investment. They make corporate governance more difficult than it need be.

3). The role of government outlined in Finance Minister Paul Martin in the 1995 budget is to provide public goods that the people want and that private industry can not provide as efficiently. In the new economy, government must be especially resistant to lobbying by special interest groups for government subsidies or other favours. If firms find that investing in lobbying government is more profitable than investing in new technology, corporate governance becomes perverted. The best lobbyers may serve their shareholders well, but they are hardly advancing the national interest.

Given these three overarching philosophical considerations, we can formulate some specific things that government ought to and ought not to try to do in regards to corporate governance and multinational firms. We turn first to the list of things not to do.

1). Domestic firms should not be given preferential access to natural resources, subsidies, special preference in submitting bids for government contracts or other advantages over multinationals. Protectionism and favouritism of domestic firms hurt a country's competitiveness, frustrate innovation (Lenway et al. 1993). Such policies shelter Canadian companies from the full force of international competition and thereby allow them greater leeway to survive despite poor corporate governance.

2). Foreign firms should not be restricted on the grounds that this would give Canadian firms more freedom to become competitive and innovative. Substantial empirical evidence backs the contrary view, that the presence of foreign firms increases competitive pressures and fosters innovation (Chung *et al*., 1994). Creative destruction means poorly governed firms fail, and some of these are going to be domestic firms.

3). The government should not try to pick winning firms or industries. New research indicates that the often repeated stories about the success of Japanese industrial policy are probably fables inspired by the political interests of the Liberal Democratic Party. Beason and Weinstein (1994) show that the Japanese government mainly directed subsidies at losers, not winners, and that Japanese government assistance either had no effect or a negative effect on industry productivity. An industrial policy of subsidizing "expected winners" encourages managers concerned about maximizing share value to invest in lobbying government for subsidies. If investing in lobbying is more lucrative than investing in R&D, the social value of good corporate governance is subverted.

4). Requirements that multinationals place more Canadians on the boards of their subsidiaries here are unadvisable. Government policy should not be based on the assumption that multinationals view their Canadian subsidiaries as second class affiliates. Under adversity, multinationals do retreat from foreign markets and strive to retain their home country operations. But this is more a reflection of open global competition (multinationals go to where productivity is high and costs of production are low) and the fact that domestic firms' "home court advantage" makes overseas subsidiaries vulnerable. Pull-outs by multinationals are likely to reflect higher costs, deteriorating economic conditions, etc. in the host country. Accusations about multinationals' fickle natures mask the real issue.

Related allegations are also heard in the popular press from time to time that multinationals do not invest enough in increasing foreign subsidiaries' productivity, do not promote foreign host country managers to senior positions, underpay locals, etc. While this sort of behaviour may have occurred in the past, we feel it is likely to be less viable in the future. Multinationals cannot afford to tolerate less than optimal productivity. Underinvestment, passing over qualified candidates for senior positions, and underpaying workers are simply not viable options in the highly competitive global economy that is now emerging. Stiff competition makes discrimination very expensive.

5). Corporate governance rules should not be used as social policy tools. Trying to shift social policy costs through, for example, director liability for back wages, simply decreases the attractiveness of doing business in Canada and thereby adds to our long-term problems. Globalization has exposed fundamental weaknesses in Canada's social programs, but it did not cause them. Canada is in a fiscal crisis because government revenues have consistently fallen short of spending commitments. The long-run solution is higher overall productivity so that our social programs are sustainable as a smaller fraction of a larger economy. Exposing the Canadian economy to international competitive pressures to innovate is critical to raising productivity.

6). Legislation forcing multinationals to locate head office activities like corporate finance, strategic planning, R&D, marketing strategy, and organization planning in Canada would be unwarranted interference in corporate governance.

It is likely that multinationals keep activities that are vital to their competitiveness in the safest economic environment - usually the home country.. For example, the "engine and power chain" is what Honda is famous for, and Honda is keeping its production in Japan as much as possible. In short, companies are keeping jobs most directly related to the establishment and possession rights of their intangible "edges" at home. These jobs probably do involve the highest return activities from both private and societal standpoints. By the latter, we mean the so-called "spillovers" these activities generate: innovative activity attracts more innovative activity. For example, new computer companies are most likely to be able to recruit the professionals they need if they locate near established computer companies. "Keeping the goodies at home" is a sensible economic decision. Maintaining possession of the innovative "edges" that make their multinational structures profitable is vital to these firms' prosperity and survival. There is no reason to think these companies are the slightest bit concerned with scheming to oppress foreigners.

But globalization means multinationals are fast losing allegiance to their home countries. The economies of scale in centralizing head office activities could be achieved elsewhere too . Why, then, do multinationals keep these most critical of their activities in their historical home countries? We believe there are three key reasons: First, their home countries provide a pool of professionals that is at least as good as the alternatives available in other countries, and who are more familiar with the managerial and social culture of the headquarters environment. Second, their home countries have legal and economic systems that protect and foster the sorts of innovative intangible assets multinationals need. And third, what economists call "path dependence" and what others call "history".

These points require a bit of clarification. The continual development of new information-based intangible assets gives the firm the "edge" it needs to prosper abroad. These activities are carried out in the home country head office before the company goes abroad. Once the firm is international, it already has routines, physical assets and organizational structures cantered around that office. Moving these activities abroad would require costly new investments. Thus, even if another country provides a pool of well-trained professionals and an attractive legal and economic system, multinationals will not normally move their core activities there.

Yet such transfers of high value added activities do occur. For example, the transfer of these activities out of Sweden by its multinationals is becoming a major public issue in that country. And, over time, the tangible and intangible assets in multinationals' home countries will depreciate. In a more globalized economy, new assets may well be located wherever the best economic opportunities for the firm are to be found.[vi]

How can Canada attract these high value added head office activities? Specifically, how do we attract "spillover" generating activities that start a "positive feedback loop" of innovation stimulating more innovation?

The fundamental issue is to *make the Canadian economy more amenable to Schumpeterian creative destruction*. That is what public policy OUGHT to do! We now turn to our second list of positive policy options for government.

1). Better disclosure rules would help Canadian shareholders improve corporate governance. For example, Canadian companies need not disclose how much R&D they are doing. The chapter in this volume by Giamarino shows that U.S. financial markets penalize firms with low R&D spending by depressing their share prices. Investors are attracted to innovative firms, and the current Canadian rules protect stagnant firms from their shareholders.

2). Canadian firms with poor governance practices are likely to decline rapidly under heightened global competition. This is a socially costly way of solving corporate governance problems. Many of the suggestions for improving corporate governance in other chapters of this volume are really ways to decrease the cost of correcting poor corporate governance. They would make Canadian capital markets less forgiving to managers.

Elsewhere in this volume, the point is made that most Canadian firms are closely-held. The main corporate governance concern here is therefore entrenched managers. Shleifer and Vishny (1991) raise the possibility that entrenched managers might divert corporate resources into avenues that preserve their control even though this subtracts from their firms' values. Magee *et al*. (1985) and Morck *et al*. (1988) present empirical evidence supporting the proposition that entrenched managers can become liabilities to their firms. Morck and Stangeland (1995) study the relation between different categories of dominant shareholders and firm performance, and find that closely-held firms controlled by their founders' heirs perform significantly worse than all other firms in several dimensions. The apparent long-run viability of these firms is a tribute to the forgiving nature of Canadian capital markets and institutions.

3). A firm, credible commitment to eliminate subsidies to corporations is critical. Lobbying for government assistance is an attractive substitute for investing in innovation, as Lenway *et al*. (1993) show using U.S. data. Canadian firms must see "mining" the government as a less profitable investment than R&D. Otherwise, managers acting in their shareholders' interests, will quite rationally invest in lobbying rather than R&D, to the long-run detriment of the economy.

This is emphatically not a call for government to subsidize R&D spending by corporations. There is too high a risk that some firms will "mine" these, and become innovative only at extracting public money. Consumers will reward results, the government need not reward apparent effort.

4). Fostering good corporate governance means letting firms pass on the fruits of successful innovation to their shareholders. Corporate income taxes and personal taxes on investment income must be low. Shareholders will not be concerned about poor corporate governance if they do not benefit from good corporate governance because of confiscatory taxes.

General reductions in the level of corporate taxation are probably politically impossible at this juncture, but certainly no increases should be contemplated. Also, general tax rate reductions would be preferable to faster accelerated depreciation, tax write-offs, etc. as the former would reward success while the latter reward effort.

5). The best guarantee of good corporate governance is stiff competition. Free trade allows innovations to yield the highest returns by opening bigger markets to innovators. To foster Schumpeterian creative destruction, remaining international and interprovincial trade barriers should be dismantled. This will cause some protected "fat cats" to lose business or even fail, but it will also allow innovative Canadian firms access to markets big enough to make a higher level of continuous innovation profitable. Foreign entrants into Canada provide local firms with indirect access to international markets, elicit more innovative effort from domestic firms by increasing competition, and act as a conduit for innovations from abroad.

6). Poorly governed firms must be allowed to fail, and workers must be allowed to be unemployed if creative firms are to displace stagnant ones. Social programs and labour laws have important roles to play in Canada, but they must not interfere too extensively with the process of creative destruction, or they will destroy the economic activity that supports them. We feel that much of the government's current difficulty in maintaining its program spending ultimately stems from this interference.

7). In coming years, good corporate governance will increasingly come to be synonymous with innovation. Canada must have legal and economic systems that protect innovators' property rights over their innovations. Canada ranks far ahead of many other countries in this regard, and might therefore attract R&D and other high value-added operations from foreign multinationals. Certainly a lack of protection for intangible property rights is becoming widely seen as a serious barrier to development in some Asian countries.

8). Education from kindergarten through graduate school should be a top public policy priority. Sound education at the grade school level and in community colleges producing workers and technicians capable of learning will make Canada competitive. Good universities are needed to train scientists, professionals, and managers. It appears that Canada is doing a rather good job at this, at least relative to the U.S. There is doubtless fat in the Canadian educational system and this should be eliminated. But, care should be taken not to lower the quality of Canada's stock of "human capital" too much. If we are to concentrate on higher value added activities here, we clearly need highly skilled scientists, managers, professionals, technicians and workers. As global competition speeds up innovation, Canadians must be equipped to embrace continuous learning of new ideas and technologies. This is the ultimate purpose of education today, and is thought by many to be the secrets to the success of countries like Japan, Korea, and Singapore. The "public good" inherent in education makes it an obvious choice as one of the government's "core businesses".

9). Research and development at universities should be supported. Basic research, the investigation of new ideas and theories that have no immediate commercial application, is essential to fostering more overall innovation in our economy in the future. Because of their lack of immediate applicability, it is almost impossible to value these ideas or to say whether one university is producing more or better basic research than another. Because of these ambiguities, artificial, pointless research aimed only at generating publications and more grant dollars is often confused for genuine contributions. Although improving the governance structure of Canadian universities and granting agencies is beyond the scope of a paper on foreign subsidiaries, we believe there are several options. The fundamental problem is that Canadian universities and granting agencies must, like Canadian businesses, reward success and not effort. Given the problems inherent in measuring research productivity, this is much easier said than done. However, we believe there are analogies to the situation in business, and we hope there will be opportunities in the future for further exploration of governance problems in universities and granting agencies.

Conclusion

Globalization stems from an increasing need for companies to have larger markets that let them quickly recoup the costs of the rapid innovation that is overtaking many industries. This chapter argues that globalization and multinational firms are likely to be even more important to Canada's competitive position in coming years than they have been in the past. This global competitive pressure may make many contemporary public policy concerns about corporate governance moot. In a global economy, customers, investment capital and highly skilled employees need not tolerate poor management. They can simply do business with better run rivals. Canadian firms will have to deal with their governance problems not because they are legally required to do so, but because their survival will depend on it. In this context, government's best option for improving Canadian corporate governance may well be simply to foster competition and openness while providing good legal and educational infrastructure. This entails weaning firms from subsidies and captive markets, and providing sound basic public services like education, health care and law. Some specific issues as to the governance of multinational subsidiaries in Canada do arise, especially with regard to minority Canadian shareholders. We argue that the boards of foreign subsidiaries with

Canadian minority public shareholders should have conduct committees that monitor nonarmslength transactions with the parent and other related companies.

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variable	**foreign-owned subsidiaries**	**domestic firms**	**t-test prob. level**
sales growth	8.75% (169)	12.7% (323)	.04**
asset growth	8.81% (154)	11.2% (306)	.31
income growth	150.% (75)	138% (190)	.88
5 yr. income growth	78.3% (76)	223% (178)	.10*
return on investment	16.1% (98)	12.7% (236)	.05**
return on equity	12.8% (88)	10.9% (205)	.11
return on assets	4.38% (115)	2.53% (284)	.01***
return on sales	3.55% (115)	2.74% (289)	.28
income per worker	$20.0 (108)	$46.7 (283)	.31
sales per worker	$1166 (162)	$2656 (323)	.22
capital labor ratio	$528 (148)	$3762 (306)	.06*
sales	$1052 (170)	$1093 (330)	.85
workers	3448 (162)	5344 (323)	.03**
assets	$764 (155)	$1938 (311)	.01***

Notes

[i] U.S. Department of Commerce 1990 data.

[ii] Morck and Yeung (1991) reported results obtained by regressing Tobin's q on various representation of a multinational structure: a firm's number of foreign subsidiaries, the number of host countries in which a firm has subsidiaries, or dummies based on these two variables. They find positive and significant regression coefficients. They find that these positive coefficients are due to the presence of intangibles, proxied for by past R&D and advertising spending. For firms with little past spending on R&D and advertising, the multinational structure variables attract negative and sometimes significant regression coefficients. Morck and Yeung (1992) report that the stock price reactions of U.S. firms' stock to news of its foreign acquisitions are, on average, positive. They used multiple regression analyses to show that the stock price reactions most positive for U.S. firms with large past investment in R&D or advertising, or with an optimal level of management ownership. Their regression analyses revealed that, net of these variables, the stock price reactions to foreign expansions are on average negative.

[iii] See eg.

[iv] It is rather difficult to study the systematic determinant of the survival of foreign owned subsidiaries because segmented data are hard to come by or may not even exist. Of course, results based on parent firm survival is not good enough because the survival of parents does not imply the survival of subsidiaries.

[v] The same study concludes that foreign owned subsidiaries do not seem to offer higher wages than domestically owned plants. This indicates that foreign owned subsidiaries are able to extract most of the rents related to their intangible assets that lead to higher labour productivity. The point is that foreign owned subsidiaries are not offering substandard wages. The concern that multinationals pay substandard wages because their multi-location production facilities gives them more bargaining power is not borne out.

[vi] Hines (1994) suggests that localized R&D is a response to high royalties. In the NAFTA context, this is not viable even if Hines is right.