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Technological Innovation Studies Program

Research Report

DIRECT INVESTMENT IN THE
UNITED STATES BY SMALL AND
MEDIUM SIZED CANADIAN FIRMS

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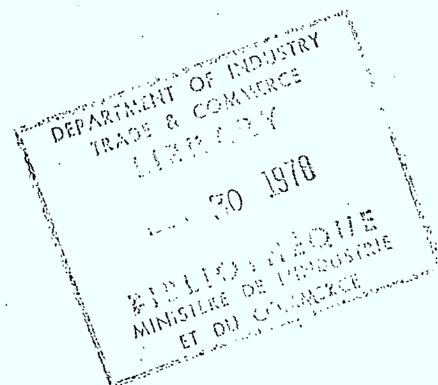
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The views and opinions expressed in this report are those of the authors and are not necessarily endorsed by the Department of Industry, Trade and Commerce.

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by

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EXECUTIVE SUMMARY

THE STUDY

During the Summer of 1978, the authors conducted a survey designed to provide empirical data about the reasons why small and medium sized Canadian firms invest in the establishment of affiliate operations in the United States, about the corporate form of their investment, and about the impact of such investment on their corporate operations, including the implications for Canada. The group of firms examined consists of twenty-five Canadian-owned firms with one or more affiliate operations in the United States. Each of these firms exhibit three key characteristics: (1) they are located in the secondary manufacturing sector; (2) they are small or medium-sized operations; and (3) they are all deemed to be technologically-based firms.

THE COMPANIES

The geographic distribution of the head-offices of the twenty-five secondary manufacturers is as follows: Ontario - 15; Quebec - 6 and the West - 4. Five firms had a sales volume of less than $5 million; eighteen firms had an annual sales volume between $5 million and $49.9 million; and two firms had sales in excess of $100 million a year.

A major feature of the companies studied is that they invest substantial monies on corporate research and development programs. Approximately one-half of the population studied received government grants in support of their research and development. In the case of some companies, their research and development activity is closely linked to the services they sell which include research and development done under contract for Canadian and foreign governments, and international agencies.

REASONS FOR INVESTING IN THE UNITED STATES

All twenty-five companies have affiliate operations in the

United States. The opening date of their operations took place during the past decade, none before 1967; for example, 2 between 1967 - 1970, 9 during 1971 - 1974, 2 in 1975, 3 in 1976, 2 in 1977, 6 in 1978 and one slated to be opened in 1979.

Market considerations were judged to be among the most important reasons for establishing a U.S. affiliate. The majority of the interviewees realized for themselves a particular niche in the Canadian market, through the design and development of a limited product line. Most of these companies occupy a dominant market position, and are not in competition with large firms. The drive for growth led these companies to invest in replicating their strategy and operations in the U.S., although they readily acknowledged the existence of opportunities to diversify their product line in Canada.

The unwillingness to diversify in Canada was attributed to a number of factors such as reticence to enter a new product-market, especially if there is probable competition from large firms, many of which are U.S. owned; the cost of building up a new product line in the area of manufacturing, sales and distribution; as well as general hesitation to engage in new business fields, especially if the corporate waters are uncharted. For these and other reasons, many of the companies elected to probe the U.S. export market as a means of increasing company sales.

Most interviewees stressed that a major objective for their U.S. subsidiary is to project to their American customers the image of a U.S. oriented company. For example, companies which have U.S. sales offices and warehouse facilities, but no U.S. plant, often maintain a direct tie-line between their U.S. office and their main plant in Canada.

The relative size and growth potential of the U.S. market is the major reason for investing in the United States - a view shared by most Canadian firms, regardless of size. Our study does not contradict this contention; however, our findings suggest that the difference between the Canadian and U.S. politico-economic environments was also a critical consideration in many of the

investment decisions. The environmental factors included the following: higher profit expectations in the U.S. because of lower relative political and economic risks; lower cost and greater availability of financing; lower relative production costs attributed to less labour unrest and increasingly more favourable labour costs; superior productivity growth related to lower labour costs and more aggressive management arising from a stronger committment to the free enterprise system; and less governmental intervention which promotes greater investment security for business.

Production cost comparisons were rarely judged to be the predominant reason for investing in the U.S. as opposed to investing in Canada. If, however, the production costs included the cost of doing business in the U.S. (for example, exporting to versus manufacturing in the U.S.) then tariff and non-tariff barriers, ease of financing and related considerations would have to be included in the total cost calculation. In this instance, the combination of the two groupings - U.S. production cost factors and U.S. politico-economic environment - was considered to be of comparable importance to the "market factors" by numerous interviewees, the majority of whom are based in Quebec and the West.

Superior technology and international business experience, but not financial resources, were among the important corporate capabilities which led many of the interviewees to establish U.S. subsidiaries. They stressed that their competitiveness in Canada, possibly their survival, hinged on achieving market success in the U.S. Geographical diversification was regarded as the route to getting bigger in the confines of the small Canadian market; however, only a handful of firms exhibited financial strength, and viewed this corporate feature as one of the "very important" pre-conditions to going abroad.

Not one interviewee singled out the present Canadian politico-economic difficulties as the sole reason for investing in the United States. Nonetheless, all six Quebec based companies

admitted that the domestic political climate played a key role in their U.S. investment decision, but only after due consideration was given to the probable marketing and manufacturing implications for their Canadian operations.

THE U.S. SUBSIDIARY

Canadian companies which establish subsidiaries normally do so after having exported to the U.S. for a few years. The typical sequence is one of exporting first; followed by setting up a sales subsidiary with or without warehouse facilities; which may lead to the establishment of a plant for local assembly and/or full production. At the outset, the U.S. plants may engage in the partial manufacture of the Canadian parent company's product line, the items produced are often few in number and not always the most profitable. U.S. tariff and non-tariff barriers, transportation costs and U.S. customer service requirements are among the key factors which dictate the product mix to be manufactured.

All 25 companies had sales in the United States: in ten cases, 50 percent or more of total corporate sales were realized in the U.S. and only five companies had U.S. sales which accounted for less than 10 percent of total sales. Nineteen of the 25 companies were also marketing their product line outside of North America, and for six of these firms more than one-quarter of their total sales was generated offshore.

All 25 companies invested in some physical operating presence in the United States. Fifteen of the 25 companies had U.S. manufacturing plants, but only 3 of them had more than 1 plant. The 3 included a steel producer, a mobile home manufacturer, and a telecommunications equipment manufacturer. The square footage of these plants ranged from a low of 4,000 to a high in excess of 200,000 with most concentrated around the 100,000 mark. The staff employed at these plants were as few as 10 in one instance, and as many as 800 in another. In only 3

cases were the U.S. subsidiary operations, in size and output, bigger than their Canadian parent.

Ten of the 25 companies were largely sales subsidiaries with warehouse facilities. Five of the 10 were sales subsidiaries which subcontract some of their distribution and warehousing activities to U.S. distributors. These distributors, however, functioned as an extension of the Canadian companies' operations in the U.S. The facade used was to make the U.S. customers believe that they were dealing with a U.S. based operation.

Eighteen of the companies had declared assets in the United States, but only in 13 cases could it be considered significant, ie. in excess of 10% of total corporate assets. As for employees, 14 of the companies employed 10 percent or more of total corporate personnel in the United States. The geographic location of the Canadian operations in the U.S. was widespread: 6 in New York State, 3 in the Carolinas, 3 in California, 2 each in Colorado, New Hampshire, and Texas, and one each in Florida, Georgia, New Jersey, Ohio, Pennsylvania, Tennessee, Utah, Vermont, Washington and Puerto Rico.

Twenty-four of the twenty-five companies have wholly-owned subsidiaries. The U.S. subsidiaries enjoyed little autonomy, and only 4 of the 25 Canadian companies maintained a formal management contract with their U.S. operations covering such areas as research and development, and exporting. The formal approach was considered unnecessary since all key management decisions were taken in the Canadian parent company. Furthermore, for reasons of taxation and finance, it was felt that the informal approach is more practical because it allows for maximum flexibility to decide when, how much and for what activities the U.S. subsidiary should be charged.

The financial structure of the U.S. affiliates varied substantially from company to company. In terms of the mix of debt and equity, the ratios ranged from 2:1 to 10:1. There were also significant differences in the extent to which debt was local or imported. A key finding is that most companies prefer

high-debt ratios and a minimum of equity capital for their U.S. subsidiaries, with much of the debt capital raised in the U.S.

Fourteen of the 25 companies raised most of their capital requirements in the U.S., and of the remaining 11, six of the companies financed their U.S. operations wholly in Canada through the use of corporate funds and debt capital obtained from Canadian financial institutions. The cost of establishing the U.S. subsidiary ranged anywhere from $50,000 to $15,000,000, but most of the operations fell significantly below the $1 million level.

FINDINGS - Employment and Balance of Payments Effects

Three employment effects can be readily identified. First, there is the production displacement impact on employment in Canada. The assumption here is that employment would have occurred in Canada had the production of the U.S. subsidiaries been carried out in Canada. The assumption underlying the production displacement effect was questioned in 15 of the 25 companies interviewed; namely, those that engage in some manufacturing activity in the U.S. This was done by ascertaining the corporate motives which prompted these firms to establish U.S. manufacturing affiliates. As previously noted, the key reasons were largely market considerations, and the choice was rarely between expanding production in Canada and producing in the United States, but between supplying the U.S. market or dropping out.

The second major employment effect has to do with export stimulation. The literature on direct foreign investment indicates that a significant amount of domestic employment is generated through the production of goods which result from the establishment of overseas affiliate operations. The U.S. Department of Commerce notes three reasons why foreign investments stimulate U.S. export trade. First, a significant part of the overseas investment is made through an export of U.S. capital

equipment which usually requires some continuous supply of replacement equipment. This generalization does not apply to our group of Canadian companies. The equipment and machinery employed in the Canadian parent company plants were largely sourced in the United States, Europe and Japan. Thus, it is not surprising that most of the equipment and machinery installed in the U.S. subsidiaries was leased or purchased from manufacturers based in the United States.

Second, U.S. studies show that many U.S. parent companies export parts and components for further assembly. This situation is apparent in our sample of companies because most are engaged in partial manufacturing activities in the U.S. Third, an important volume of U.S. exports to foreign affiliates is resold with minimal assembly activity. This finding applies to our sample of companies, as well.

The third major employment effect has to do with whether the establishment of U.S. subsidiaries provides job opportunities for Canadians in the U.S. Most U.S. subsidiary personnel were recruited in the United States, and with few notable exceptions, minimal employment in Canada was created for companies which service the operations of Canadian parent firms with U.S. subsidiaries.

During the initial phase of setting up the U.S. subsidiary, parent company exports may increase significantly because of the expanded and more aggressive activities of the company's U.S. sales organization. However, as the U.S. subsidiary strengthens and expands its manufacturing capability, increasing reduction in exports from the Canadian parent is likely to take place. The cause is explained in terms of the tendency for Canadian companies to replicate their operations in the U.S.; specifically around product lines previously exported to the United States.

For our group of companies, there is a high proportion of debt to equity, with much of the debt raised in the U.S. This means that Canada will not receive much in the way of earnings on the investment for some time. In fact, there appears to be

a net outflow because most of the affiliates were recently established, and some are already experiencing serious difficulties requiring further financial assistance.

While the amount of capital invested outside of Canada by the 25 companies was not significant, two important observations can be made about such investment in terms of its impact on small business in Canada. First, the financial resources of small and medium sized firms are generally limited. Thus, if a company expands into the U.S., its financial ability to pursue similar investment opportunities in Canada will be constrained, because it will have had to mortgage most of its assets in support of its U.S. project. Raising the capital in the U.S. may reduce the impact of such investment on capital outflows, but it will hardly improve the financial capability of the Canadian firm to raise capital in Canada or elsewhere for other investment undertakings.

Second, the limited size of the Canadian market and the general reservation about growing through product diversification prompts small and medium sized firms to consider investing in the United States. If such a decision leads to the establishment of a manufacturing plant in the U.S., the former Canadian-U.S. export business is normally transferred to the U.S. operation, however slowly. The new "gap" in Canadian production can be filled either through an increase of Canadian or offshore sales. If this result is not forthcoming, the competitiveness of the Canadian firm can be jeopardized, particularly at a time when its resources are strained because of the competing demands emanating from its newly established U.S. subsidiary. A number of the firms interviewed closed their U.S. plant operations for this reason.

INTRODUCTION

Domestic economic and political circumstances are largely responsible for the public concern expressed regarding the motivation for Canadian direct investment abroad (CDIA), and its probable impact on Canada. Expanding abroad is seen by many as an alternative to expanding in Canada. Consequently, such corporate investment is perceived to be bad because of the probable loss of Canadian jobs, exports, and the exportation of technology and capital. Canadian direct investment abroad quadrupled from $2.5 billion in 1960 to $10.7 billion in 1975.[1] The United States accounted for approximately one-half of total CDIA, and since Canada's export trade is heavily dependent on the U.S. market, this type of corporate investment is viewed with alarm in some Canadian quarters, specifically among unions and governments (Federal and Provincial).

CDIA in the United States is concentrated among a small number of large firms in the primary resource and resource-oriented manufacturing industries. Much of this investment has taken place during the past decade, largely motivated by the need to grow through geographic and product diversification.[2] Foreign direct investment undertaken by small and medium sized Canadian firms has arisen primarily from the corporate drive to exploit U.S. market opportunities which were made difficult by trade barriers, particularly the non-tariff variety. A further critical factor prompting such investment is the need to establish local U.S. support facilities in order to serve U.S. customers in a highly

competitive and marketing-oriented environment.

There appears to be particular cause for concern when CDIA involves small and medium sized Canada-owned firms in the secondary manufacturing sector, which is the focus of this study. The reasons for this concern are many; however, the following are generally considered to be among the more important:

1. The secondary manufacturing sector is currently experiencing problems so that any corporate expansion outside of Canada by firms based in this sector is viewed as a loss to the Canadian economy. Given Canada's natural resource endowment, it is often alleged that when corporate diversification is geographic and in the U.S., the nature of this investment tends to be horizontal at the manufacturing level, rather than vertical. The perceived impact is that it is detrimental to the Canadian economy in terms of the export of jobs and capital.

2. Sales success in the U.S. market, because of its size, may easily promote a situation in which Canadian management will increasingly allocate more of its time to meet the demands and peculiarities of the U.S. market, relative to its domestic business. A modicum of success in the U.S. may generate sales results which quickly exceed the Canadian sales performance, but with the further opportunity to improve dramatically on the U.S. results. The latter opportunity is generally not available in Canada because of the small size of the market. This situation usually suggests that investment in future plant expansion will take place in the U.S.

3. Successful Canadian firms with U.S. affiliates quickly recognize the need to transfer parts of their corporate infrastructure (e.g. design engineering, research and development, etc.) to their U.S. based operations in order to service profitably the demands of U.S. customers resident in a highly competitive, large and complex market.[3] Such infrastructure transfers may result in a significant loss of professional jobs in Canada.

4. The high level of U.S. investment in the Canadian manufacturing sector has prompted Canadian governments in recent years to develop policies and programs aimed

> at encouraging the "start-up" of new Canadian entrepreneurial ventures, as well as to "dissuade" foreign investors from acquiring such enterprises (e.g. FIRA). The latter policy may be partially blunted by horizontal investments undertaken by small and medium sized Canadian firms in the U.S.; for if they are successful, the end result will be an "Americanization" of their corporate strategy and structure. The consequences of such actions may limit the immediate economic contribution to Canada by the companies in question.

THE STUDY

During the Summer of 1978, the authors conducted a survey designed to provide empirical data about the reasons why small and medium sized Canadian firms invest in the establishment of affiliate operations in the United States, about the corporate form of their investment, and about the impact of such investment on their corporate operations, including the implications for Canada.

The group of firms examined consists of twenty-five Canadian-owned firms with one or more affiliate operations in the United States. Each of these firms exhibit three key characteristics: (1) they are located in the secondary manufacturing sector; (2) they are small or medium-sized operations; and (3) they are all deemed to be technologically-based firms. "A technologically-based firm is defined as a company which emphasizes research and development or which places major emphasis on exploiting new technical knowledge".[4]

Information about these firms and their U.S. affiliates was primarily obtained through personal interviews conducted in the field, supported with material obtained from Canadian and U.S.

government agencies, associations and chambers. A questionaire guide was used to direct the company interview. The companies requested that their names not be identified in the study for fear of being unfairly criticized for investing in the U.S. at a time of high unemployment in Canada. Data was also collected from a variety of secondary sources such as annual reports, trade directories, Moody's Industrial Manual, company submissions to Parliamentary Committees, and one Form 10-K Report.

THE COMPANIES

The geographic distribution of the head-offices of the twenty-five secondary manufacturers is as follows: Ontario - 15; Quebec - 6; and the West - 4. Table 1 gives a breakdown of their sales, assets and employees.

In 1977, five firms had a sales volume of less than $5 million which according to the interviewees would designate them as "small" among secondary manufacturers. This appears to be the cut-off point between small and medium sized operations, at least as defined in sales terms. Eighteen firms had an annual sales volume between $5 million and $49.9 million; this is the medium sized operation. Two firms had sales in excess of $100 million a year, and at first glance might be termed large. Upon further examination, these firms were viewed as border line cases, exhibiting more of the characteristics of a medium sized firm, than a large mature corporation. For example, the two firms are owner-managed, recent corporate entrants, and are not ranked among the

100 largest Canadian firms. In fact, one of the two firms is a steel producer and is one of the smallest enterprises in its industry. Firms that appear large by Canadian standards are often small by international standards.

TABLE 1

Corporate Sales, Assets and Employees for the Year Ending 1977

Sales (IN MILLIONS $)		Assets (IN MILLIONS $)		Employees (IN HUNDREDS)	
Less than 1	(2)	Less than 1	(4)	Less than 100	(4)
1 - 2.9	(2)	1 - 2.9	(3)	101 - 199	(3)
3 - 4.9	(1)	3 - 4.9	(2)	200 - 499	(9)
5 - 9.9	(3)	5 - 9.9	(5)	500 - 999	(4)
10 - 24.9	(7)	10 - 24.9	(8)	1000 -1,999	(3)
25 - 49.9	(8)	25 - 49.9	(1)	2000 -4,999	(2)
50 - 99.9	(0)	50 - 100.9	(0)	5000 -9,999	(0)
100+	(2)	100+	(2)	10,000+	(0)

Many of the firms could be classified as successful technical entrepreneurial ventures, well on their way to implementing corporate structures which reflect characteristics of professionally managed corporations. A major feature of the companies studied is that they invest substantial monies on corporate research and development programs. In recent years, approximately one-half of the population studied received government grants in support of their research and development. Two of the twenty-five firms went so far as to allocate a small percentage of their budget for pure research, in addition to product and process de-

velopment work. Table 2 provides the range of expenditure on research and development.

TABLE 2

Corporate Expenditure on Research and Development for the Year Ending 1977 (in 000's $)

Less than 100	(3)	1,000 - 1,999	(1)
100 - 249	(6)	2,000 - 4,999	(4)
250 - 499	(5)	5,000 +	(0)
500 - 999	(6)		

Considering the sales realized by the companies, their research and development expenditure is impressive. In the case of some companies, their research and development activity is closely linked to the service products they sell which includes research and development done under contract for Canadian and foreign governments, and international agencies.

REASONS FOR INVESTING IN THE UNITED STATES

All twenty-five companies have affiliate operations in the United States. What is particularly significant is that the opening date of their operations took place during the past decade, none before 1967; for example, 2 between 1967 - 1970, 9 during 1971 - 1974, 2 in 1975, 3 in 1976, 2 in 1977, 6 in 1978 and one slated to be opened in 1979. Thus when interviewing the companies, the executives were in a relatively good position to

explain their reasons for investing in the United States. Table 3 provides a frequency distribution of the reasons, and their relative importance at the time the decision was taken.

Market Considerations

Home markets are rarely saturated, except in a relative sense. In this context, it is argued that when the cost of developing new business is greater in Canada than, say, in the United States, the Canadian company may contemplate investing in the U.S. The literature on foreign direct investment suggests that such a "situation develops most commonly in a mature domestic corporation which has surplus funds and management capability for which it foresees only marginal opportunities"[5] in Canada.

The foregoing observation is made with reference to the operations of large mature corporations, based in the U.S., and further states

> "If it (the firm) does not diversify, it must generally be content to grow no faster than the economy in general. But the reward system of American business makes it imperative to grow faster than that. Some such growth can come via introduction of new products from research or from licensing others' research. Acquisition of other companies offers additional potential. Foreign investment is a third way to grow, a way which is often cheaper, possibly more profitable, and always glamorous." 6

The benefits from investing abroad include the following: promote new growth from a low-market share position, which can be quickly achieved through the acquisition route; management

TABLE 3

REASONS FOR INVESTING IN THE U.S.

(Ranked in order of importance *)

MARKET CONSIDERATIONS	1	2	3	4
a. Maintain or increase market share in the U.S.	22	-	-	3
b. Faster sales growth in U.S. than in Canada	21	2	1	1
c. Difficult to reach U.S. market from Canada because of tariffs, transportation costs or nationalistic purchasing policies	16	4	3	2
d. Diversify product line/geographic market	18	2	1	4
e. Increase responsiveness to U.S. customer demands and improve servicing capability	12	10	2	1
f. Integrate forward/backward	1	1	0	23
g. Promote exports from parent Canadian firm through U.S. subsidiary	2	2	0	21
h. Secure U.S. sources of materials supply	2	2	3	18
i. To export from U.S. to third countries	4	1	2	18

U.S. PRODUCTION/COST FACTORS	1	2	3	4
a. Availability of advanced technology	3	1	1	20
b. Availability of natural resources	1	0	2	22
c. Availability of fuel	1	0	1	23
d. Availability of stable labour force	9	6	2	8
e. Availability of managerial talent	4	4	5	12

U.S. POLITICO-ECONOMIC ENVIRONMENT	1	2	3	4
a. General political stability	3	5	5	12
b. Trade Unions' Attitudes	5	3	4	13
c. More favourable taxation policies	5	3	5	12
d. Relative freedom from regulatory constraints	5	3	2	15
e. Easier access to financing	5	2	5	13
f. Wage/Price policies	7	2	5	11
g. Federal government economic incentives	0	2	1	22
h. State government economic incentives	2	1	1	21
i. Buy American policies	7	3	1	14
FIRM'S CANADIAN CORPORATE RESOURCES AND CAPABILITIES				
a. Possession of superior technology	21	4	0	0
b. Growth in experience in international business	17	6	2	0
c. Growth in corporate capacity to finance investment via retained earnings/ borrowing/issue of new equity	4	9	9	3
CANADIAN POLITICO-ECONOMIC ENVIRONMENT				
a. General political climate	3	6	4	12
b. Quebec-Canada constitutional debate	3	4	3	15
c. Trade unions' attitudes	4	3	5	13
d. Taxation policies	4	3	7	11
e. Regulatory constraints	4	2	4	15
f. Access to financing	5	3	5	12
g. AIB controls	3	2	5	15
h. Federal government policies	5	3	3	14
i. Provincial government policies	3	2	1	19

* Rating Scale: 1 - very important; 2 - Important; 3 - of minor importance; and 4 - unimportant

and technical know-how from the parent company can be readily transferred via a few parent company employees who may form the nucleus of the new subsidiary management team; foreign markets can be better serviced by a local subsidiary which provides a complete line of services in support of the Company's marketing programme; profitability is often higher in the foreign market; and by expanding the domestic company's operations beyond its national boundaries, management can take greater advantage of product and marketing innovations.

While these observations help to explain the foreign investment motivation and strategies of large mature Canadian corporations with affiliates in the U.S., they do not characterize the operations of our sample of companies, nor do they explain their reasons for investing in the United States. In the first place, none are large and mature; second, only a few had surplus cash at their disposal; and, third, all were involved in the manufacture of very narrow product lines. The last feature distinguishes the operations of small and medium sized firms in Canada, and is critical to understanding their marketing motivation for investing in the United States.

Table 3, under the market classification, shows that the first five (a,b,c,d, and e) considerations were judged to be among the most important reasons for establishing a U.S. affiliate. This is not surprising since similar findings would apply to large mature Canadian companies. In the case of the latter type of firms, however, their product range tends to be much

broader, and more diversified.

The crux of the answer lies in the fact that the majority of the companies interviewed realized for themselves a particular niche in the Canadian market, through the design and development of a limited product line such as "Measurement Sensors and computer control systems for the paper industry". In this product category, as is the case with many of the other corporate interviewees, the company occupies a dominant market position, and is not in competition with large firms. The drive for growth led this company to invest in replicating its strategy and operations in the U.S., although it readily acknowledged the existence of opportunities to diversify its product line in Canada; for example, in terms of other industry applications.

The unwillingness to diversify in Canada was attributed to a number of factors such as reticence to enter a new product-market, especially if there is probable competition from large firms, many of which are U.S. owned; the cost of building up a new product line in the area of manufacturing, sales and distribution; as well as general hesitation to engage in new business fields, especially if the corporate waters are uncharted. For these and other reasons, many of the companies elected to probe the U.S. export market as a means of increasing company sales.

The Third (c) market consideration is often pivotal because it pushed a number of Canadian companies into setting up U.S. subsidiaries. For example, a Canadian manufacturer of automotive parts explained,

> "The American people are very proud, and there is a great tendency on their part to identify an American factory as being inherently or automatically better than a foreign factory as a source of goods they are going to buy. I think that is a very big factor. People in the United States, if they knew you are going to supply them with goods from a Canadian factory, seem to feel that in some way those goods will be inferior."

Most interviewees stressed that a major objective for their U.S. subsidiary is to project to their American customers the image of a U.S. oriented company. For example, companies which have U.S. sales offices and warehouse facilities, but no U.S. plant often maintain a direct tie-line between their U.S. office and their main plant in Canada. Thus, U.S. customers calling the "U.S. sales office" can be linked into the main Canadian plant and frequently are not aware of the fact that they are talking to someone outside the U.S. All catalogues, literature, and direct mail pieces sent to U.S. customers make no mention of the fact that the company is Canadian. Canadian corporate executives typically keep business cards for both the U.S. and Canadian companies.

The strategy of downplaying the Canadian image is not out of the ordinary. Commenting on this phenomenon, the president of a geophysical manufacturing firm contends that,

> "For those who feel that the Canadian lamp should not be hidden under a bushel basket of prairie wheat I say forget it. It is true that the U.S. and Canada are each other's biggest customers. It is true that the Production Sharing program makes it easier to bid on the U.S. Department of Defense Contracts. It is also true that the U.S. markets are

> becoming increasingly chauvinistic in their buying patterns. It is also true that labour and protectionist lobbies have never been louder. Leave the flag waving and image building to Canadian Government officials. We don't feel we're misrepresenting anything -- like the door on the Volvo we just don't make a big thing of it."

As for the remaining four market considerations, (f,g,h, and i) only "i" can be deemed to be important, but not necessarily critical to the U.S. investment decision.

One interviewee established a U.S. "domestic international sales corporation" (DISC) to take advantage of preferential tax treatment. Another 3 interviewees ranked the (i) consideration as very important because they "intend" to use their U.S. manufacturing base to launch an export drive into Latin America. A key finding under the "market" heading is that few firms with U.S. subsidiary manufacturing operations saw the establishment of such facilities as a means of promoting Canadian exports to the U.S.

U.S. Production Cost Factors and Politico-Economic Environment

The relative size and growth potential of the U.S. market is the major reason for investing in the United States - a view shared by most Canadian firms, regardless of size.[7] Our study does not contradict this contention; however, our findings suggest that the difference between the Canadian and U.S. politico-economic environments was also a critical consideration in many of the investment decisions. The environmental factors included

the following: higher profit expectations in the U.S. because of lower relative political and economic risks; lower cost and greater availability of financing; lower relative production costs attributed to less labour unrest and increasingly more favourable labour costs; superior productivity growth related to lower labour costs and more aggressive management arising from a stronger committment to the free enterprise system; and less governmental intervention which promotes greater investment security for business.

The cost of production factors including land, labour, material, capital and management seldom constituted the rationale for the U.S. investment decision. For example, all interviewees claimed that labour costs were lower in the U. S. - from 15% to 40% lower; however, only a few were involved in labour intensive manufacturing activities, ie. where labour costs represent a high proportion of the value of output.

The production cost comparisons were rarely judged to be the predominant reason for investing in the U.S. as opposed to investing in Canada. Certain executives remarked that the impact of inflationary forces, price stabilization activities of governments, wage agreements, or changes in taxation, tariff and foreign exchange rates can quickly nullify or aggravate differences in the relative costs of production.

If,however, the production costs included the cost of doing business in the U.S. (for example, exporting to versus manufacturing in the U.S.) then tariff and non-tariff barriers, ease of financing and related considerations would have to be included

in the total cost calculation. In this instance, the combination of the two groupings - U.S. production cost factors and U.S. politico-economic environment - was considered to be of comparable importance to the "market factors" by a number of interviewees; the majority of whom are based in Quebec and the West. All interviewees singled out the extremely nationalistic and provincial posture of their U.S. customers in terms of buying "American" from U.S. based companies, as well as the "Red Tape" problems encountered at U.S. border points when trying to clear Canadian manufactured products through customs.

Canadian Corporate Capabilities
and Politico-Economic Environment

A major finding highlighted by the interviewees is that the requisite product and process technologies produced and serviced by them are commonly available in the United States. Thus, Canadian firms wishing to compete in the U.S. believe that they must establish U.S. bases of operations since competition will then focus on product differentiation, sales effort, and service differentiation. This cannot be readily accomplished via exporting, especially if the Canadian firm is small and does not have the resources and/or proprietary protection to merchandise a truly differentiated product. Moreover, a Canadian presence is necessary in the U.S. in order to generate confidence among U.S. customers; ie., the customers will see this as guaranteeing supplies and the associated support - service requirements.

Superior technology and international business experience, but not financial resources, were among the important corporate capabilities which led many of the interviewees to establish U.S. subsidiaries (see Table 3). This finding should not be surprising since a major weakness of most small and medium sized firms in Canadian is a lack of capital.[8] Obviously, this limitation is not a sufficient condition to dissuade the companies from investing in the U.S. The form of financing employed by these firms will be examined in a later section.

The key point made by many of the interviewees was that their competitiveness in Canada, possibly their survival, hinged on achieving market success in the U.S. In brief, geographical diversification was regarded as the route to getting bigger in the confines of the small Canadian market; however, only a handful of firms exhibited financial strength, and viewed this corporate feature as one of the "very important" pre-conditions to going abroad.

Not one interviewee singled out the present Canadian politico-economic difficulties as the sole reason for investing in the United States. Nonetheless, all six Quebec based companies admitted that the domestic political climate played a key role in their U.S. investment decision, but only after due consideration was given to the probable marketing and manufacturing implications for their Canadian operations.

As for the other interviewees, the majority of whom are based in Ontario, the environmental considerations were examined

in relative terms, vis à vis the United States. On the whole, the United States was regarded as the more attractive site for corporate investment.

One symptom of the current economic and political difficulties experienced in Canada is the decline in value of the Canadian dollar. The actual extent to which capital flows may or may not be influenced by the undervaluation or the overvaluation of the Canadian dollar is virtually unquantifiable. Opinion is divided on the extent to which the 1978 exchange rate realignments may reduce the size of corporate capital outflows in the form of direct investment. While there may be some reduction, our findings indicate that corporate capital migrates for a host of other reasons, and that the current exchange rate fluctuations have a limited impact on the U.S. investment decisions of small and medium sized Canadian firms.

The findings suggest that the reasons for investing in the U.S. are seldom emotional and non-marketing. The following two examples help to illustrate this fact by highlighting the key factors which motivated two of the interviewed companies, one in Quebec and the other in Ontario, to establish subsidiaries in the United States.

Geldart Research Limited

The decision to establish a Geldart Research office and laboratory in the Denver, Colorado area was made during 1976 for the following reasons:

(a) Denver is a major centre for mining and hydro-carbon exploration operations and offices are maintained in Denver by a large number of mining and oil companies.

(b) Activity in the energy exploration and development field for uranium, oil, gas, coal and geo-thermal energy is currently at a very high level and a significant proportion of the United States national effort in these areas is managed from Denver bases.

(c) Denver is one of the largest centres for United States Federal Research funding outside of Washington.

(d) The Denver-Boulder area is an important centre for government research laboratories such as those of the United States Geological Survey and the National Center for Atmospheric Research. The area also contains numerous research and development facilities supported by the private sector.

(e) Geldart Research has the potential for greatly increasing its penetration of the United States markets through a United States facility. The lack of such a facility has been a significant inhibiting factor with Geldart's U.S. customers in the past.

(f) The established expertise of Geldart in the earth sciences, exploration technology and contract research and instrumentation for remote sensing of the environment, are ideally matched with the opportunities available in the Denver region.

Geldart's initial move has been to establish a small geochemical laboratory and photogeological facility. Contract work has already commenced on these premises. Particular emphasis is being placed upon energy areas in the Denver laboratory, and expansion into contract research is also scheduled after the geochemical laboratory is fully established. As far as possible, it is planned to integrate the Denver and Toronto capabilities in a complementary fashion.

During the initial phases of growth of the Denver operation, some corporate investment will be required, but this will be

reviewed continuously with a view to achieving a self-sustaining operation as soon as possible.

For the reasons given, Gledart's management considers the growth possibilities of the Denver facilities to be very substantial and with a view to ensuring that the company's investment is applied with full vigour, the President of Geldart - Canada intends to make Denver his personal base during the period of establishment.

Kartash Products, Limited

The prospect of losing U.S. customers for product X to an expanding U.S. industry prompted Kartash to build a new plant in South Carolina that will produce as much as its two Canadian plants combined. The South Carolina location was chosen because of its proximity to Kartash's customers for product X. The plant could cost as much as $15 million and employ 100 or more persons.

The cost of manufacturing in Canada was not a factor in its decision, nor was the offer of capital inducements to locate in South Carolina. A U.S. production base is expected to lead to large savings in tariff and transportation costs of products sold to U.S. customers. Employment at the Canadian plants, which are operating at close to capacity at present, is not expected to be affected now or when the new plant comes into production in 1979. The domestic and international markets for product X are expanding fast enough to accommodate output of all three company plant facilities.

Kartash traditionally held a large part of the U.S. market; however, because its U.S. competitors announced plans of their own to expand production, these actions could jeopardize Kartash's market share if it did not make a similar move in the United States. The two Canadian plants are well located to serve export markets other than the United States, and Kartash will make intensive efforts to expand its offshore sales.

Product Diversification

Growth through product diversification, on the other hand, a strategy pursued by many large mature Canadian companies, was seriously attempted by only two interviewees. To-date, one of the two companies failed, and as for the other, it is too soon to tell.

The Failed Company

In 1970, a manufacturer of geophysical instruments decided to diversify his product line to include audio equipment. The company's audio division, whose operations were concentrated mainly in Buffalo, New York, incurred substantial losses between 1971 and 1976. A change of management and a major advertising program instituted early in 1974, resulted in a temporary increase in sales, only to be followed by a sharp reversal related largely to the economic recession in the United States.

The decision to divest the company of this division, made in 1975, culminated in its sale to a large U.S. corporation.

The sale was closed on July 25, 1975. The benefits to the company of this divestiture were:

1. release from ongoing operating losses of the audio division, which in 1974 and 1975 alone amounted to $264,000.

2. release of the capital tied up in the inventory, machinery, plant and land related to the audio operation. The total capital recoverable was in the order of $500,000, of which approximately $200,000 was realized from the disposal of inventory and machinery. The remainder came from the ultimate sale of the land and buildings in Buffalo. Realized funds were applied to reduce bank borrowings, and consequently, the burden of interest charges.

3. improvement in working capital resulted from the sale of the fixed assets of the U.S. subsidiary.

4. concentration of management efforts on ongoing profitable operations.

Management completed the consolidation of the company's organization by directing its resources exclusively into those technical areas which are basically profitable. This process has not been without cost or pain, as the selling and winding up of a division inevitably involves losses of the disposal of inventory and other assets as well as in severance pay and similar non-recurring expenses. Management also concluded that manufacturing activities should be concentrated on scientific instrumentation and, in particular, on devices that can be produced in the company's modern plant in Ontario.

The experience of the geophysical instrument manufacturer, is an excellent example of why most interviewees argued against the strategy of growth through product diversification in Canada/U.S.A.

THE U.S. SUBSIDIARY

Canadian companies which establish subsidiaries normally do so after having exported to the U.S. for a few years. The typical sequence is one of exporting first, usually through distributors in the United States; followed by setting up a sales subsidiary with or without warehouse facilities; which may lead to the establishment of a plant for local assembly and/or full production. At the outset, the U.S. plants may engage in the partial manufacture of the Canadian parent company's product line, the items produced are often few in number and not always the most profitable. U.S. tariff and non-tariff barriers, transportation costs and U.S. customer service requirements are among the key factors which dictate the product mix to be manufactured.

All 25 companies had sales in the United States: in ten cases, 50 percent or more of total corporate sales were realized in the U.S. and only five companies had U.S. sales which accounted for less than 10 percent of total sales (see Table 4). Nineteen of the 25 companies were also marketing their product line outside of North America, and for six of these firms more than one-quarter of their total sales were generated offshore. Geographical diversification is obviously the road to corporate growth, and the U.S. market appears to be the major target for this drive.

All 25 companies invested in some physical operating presence in the United States. Fifteen of the 25 companies had U.S. manufacturing plants, but only 3 of them had more than 1 plant. Of the remaining 10 companies, four were essentially sales subsidiaries which owned/leased/rented warehouse facilities.

TABLE 4

Geographic Distribution of Corporate Sales, Assets and Employees for the Year Ending 1977

(IN PERCENTAGES)

a) SALES

Canada		United States		Other Countries	
90+	(2)	90+	(1)	90+	(-)
75-89	(4)	75-89	(3)	75-89	(-)
50-74	(6)	50-74	(6)	50-74	(4)
25-49	(6)	25-49	(2)	25-49	(2)
10-24	(6)	10-24	(8)	10-24	(4)
1-9	(0)	1-9	(5)	1-9	(9)
0	(1)	0	(0)	0	(6)

b) ASSETS

Canada		United States		Other Countries	
90+	(15)	90+	(1)	90+	(-)
75-89	(4)	75-89	(0)	75-89	(-)
50-74	(2)	50-74	(2)	50-74	(-)
25-49	(2)	25-49	(3)	25-49	(1)
10-24	(1)	10-24	(7)	10-24	(3)
1-9	(1)	1-9	(5)	1-9	(1)
0	(-)	0	(7)	0	(20)

c. EMPLOYEES

Canada		United States		Other Countries	
90+	(10)	90+	(1)	90+	(0)
75-89	(8)	75-89	(0)	75-89	(0)
50-74	(4)	50-74	(0)	50-74	(0)
25-49	(2)	25-49	(6)	25-49	(3)
10-24	(-)	10-24	(7)	10-24	(2)
1-9	(1)	1-9	(4)	1-9	(1)
0	(-)	0	(7)	0	(19)

The geographic breakdown of the assets and employees of the "Group of 25" bears witness to the foregoing finding. Eighteen of the companies had declared assets in the United States, but only in 13 cases could it be considered significant, ie. in excess of 10% of total corporate assets. As for employees, 14 of the companies employed 10 percent or more of total corporate personnel in the United States (See Table 4). The geographic location of the Canadian operations in the U.S. was widespread: 6 in New York State, 3 in the Carolinas, 3 in California, 2 each in Colorado, New Hampshire, and Texas, and one each in Florida, Georgia, New Jersey, Ohio, Pennsylvania, Tennessee, Utah, Vermont, Washington and Puerto Rico.

Management Control

Twenty-four of the twenty-five companies have wholly-owned subsidiaries, and one of them also has a partially, but majority owned subsidiary. The one remaining company has a majority owned subsidiary in which key U.S. personnel have some equity participation. This finding should not be surprising, since the companies are in the small - medium sized category and tend to be owner-managed. Management of such firms like to maintain personal control over their operations,[9] and since their U.S. subsidiaries are relatively young, it was charged that it would not be smart business to go public in the U.S. with an untested and unknown company operation.

The concern with control is not only reflected in the ownership of the subsidiary, but also in its reporting relationship

to the Canadian parent. Seventeen of the 25 Canadian companies designated a "president" for their U.S. subsidiaries, and of the remaining eight, there were 4 vice-presidents and 4 general managers. Thirteen of the 25 chief executive officers were American nationals, ten were Canadians and two were British. With one exception, the U.S. chief executive officers reported directly to senior executives of the Canadian parent company on all important matters - strategic and tactical. Much of the reporting was done along functional lines, eg., manufacturing, marketing and finance.

The U.S. subsidiaries enjoyed little autonomy, and only 4 of the 25 Canadian companies maintained a formal management contract with their U.S. operations covering such areas as research and development, and exporting. The formal approach was considered unnecessary since all key management decisions were taken in the Canadian parent company. Furthermore, for reasons of taxation and finance, it was felt that the informal approach is more practical since it allows for maximum flexibility to decide when, how much and for what activities the U.S. subsidiary should be charged.

The financial structure of the U.S. affiliates varied substantially from company to company. In terms of the mix of debt to equity, the ratios ranged largely from 2:1 to 10:1. There were also significant differences in the extent to which debt was local or imported. A key finding is that most companies prefer high-debt ratios and a minimum of equity capital for their U.S. subsidiaries, with much of the debt capital raised in the U.S.

The preference for this type of financing is not surprising since many of the firms are privately held, and those that are public are closely held by a few individuals. The pre-occupation with control is a key reason why the U.S. subsidiaries are thinly capitalized and thus highly leveraged. The relative ease of financing in the U.S. is the major reason for borrowing locally. The experience of all interviewees is that the U.S. unit banking system is more responsive to the financial needs of small and medium sized firms, the collateral requirements are less exacting (eg., export accounts receivable and Sec. 88 of the Canadian Bank Act), and the interest rates are generally lower.

Finance

Fourteen of the 25 companies raised most of their capital requirements in the U.S., and of the remaining 11, six of the companies financed their U.S. operations wholly in Canada through the use of corporate funds and debt capital obtained from Canadian financial institutions. The cost of establishing the U.S. subsidiary ranged anywhere from $50,000 to $15,000,000.00, but most of the operations fell significantly below the $1 million level.

The partial or complete acquisition of an existing U.S. operation or the establishment of a new facility are generally the two ways of physically expanding into the U.S. Only three of the 25 companies studied employed the acquisition strategy, while many of the other companies set up their U.S. operations through a combination of lease/rental arrangements. This approach

was the dominant one because it was the least costly and risky. Moreover, it was also one of the few ways in which a Canadian company, financially strapped, could expand its operations into the U.S. The popularity of this approach is readily evident in Table 5 which lists the Canadian companies that have undertaken an investment committment in the U.S. during the first quarter of 1978. The majority of the firms which are small to medium sized opted for the leasing approach; of the two large companies in the group, one used the acquisition strategy, and its two corporate purchases exceeded $100 million. Obviously, the financial strength of this company enabled it to acquire the two U.S. operations.

A few examples may help to illustrate how some of the U.S. manufacturing operations were organized with minimal company financing. A Quebec based manufacturer of product M, for example, set up a manufacturing operation in New Hampshire by leasing a site and building, and by purchasing most of the required equipment and machinery from a bankrupt manufacturer. In addition, the Quebec firm was able to hire an excellent labour force, since the location of its plant was within easy driving distance of where the bankrupt firm had been located. Most of the former employees were still without jobs; they were non-unionized; their wages were 30% lower than in Quebec and their productivity was higher.

Companies whose subsidiaries are largely sales affiliates tend to rent/lease their warehouse facilities. In some cases

TABLE 5

Announcement of Canadian Investment in U.S. Manufacturing Industries *

Firm(s)	Description
John Labatt, Ltd.	Announced plans for a wheat starch and gluten facility in South Carolina
Industrial Knitting Ltd. ..	Has leased a plant in New York state to produce elastic netting
Kingston Spinners	Will manufacture synthetic yarns in Georgia. Initial employment will be 35-40 persons
St. Lawrence Steel & Wire Co. Ltd.	Has leased facilities in New York state and will produce hockey masks
Martin Stewart Ltd.	Will process skins and hides in New York state
Velcro Industries	Announced an expansion of its New Hampshire facilities. Velcro is a producer of hook and loop fasteners
Northern Telecom	Acquired Syco Inc. a Michigan based manufacturer of data processing terminals, for $77 million
C Tech Ltd.	Has leased facilities in New York state and will produce radar and sonar equipment
Mitel	Has leased facilities in Florida and will produce telecommunications equipment
Mitel	Has opened a plant in Puerto Rico to produce printed circuit broards
Northern Telecom	Has acquired Danray, a Texas manufacturer of telephone switching equipment, for about $23 million
R. C. Machine Ltd.	Has leased facilities in New York state and will produce aerospace parts.

*The Conference Board, First Quarter, 1978

they use their U.S. distributors' facilities as a proxy for their own including secretarial services; however, always making certain that the stationary, answering services and related activities are conducted as if a fully integrated Canadian - U.S. operation is in existence.

The Industrial Revenue Bond

The U.S. Industrial Revenue Bond is considered to be an attractive way of financing the establishment of new plants. Three of the 25 companies took advantage of this option, most however were unfamiliar with it, and some of them could have benefited from exploiting this financial instrument.

Industrial Revenue Bonds are securities issued by Industrial Development Authorities for the purpose of purchasing land, and constructing and equipping manufacturing and/or distribution facilities for lease to responsible companies. If a company selects a site for a factory in one of the States which has revenue bond financing, then it may benefit from the following advantages of revenue bond financing:

1. Low Interest Rate - since the interest is tax free to the bondholders, the company pays a lower interest on the bonds. Generally IRB interest rates are 2% below corporate bonds and mortgage financing.

2. 100% Financing of Land, Building, and Equipment - development and financing costs of a project as well as the cost of land, building and equipment may be financed. Most conventional methods of financing, (ie., mortgage financing) require 30% or more of an equity position by the borrowing company. The costs that may be funded include: a) site selection, b) site preparation and site utilities, c) design, engineering

and construction of manufacturing or distribution building, d) purchase and installation of machinery and equipment; furnishing and equipping of office area, e) payment of fiscal, legal and printing expenses of Bond issuance, f) capitalization of interest charges during construction of the project and for a one-year period thereafter.

3. <u>Repayment Schedule Tailored to Lessee Company</u> - it may be level debt service or a variation of this. Generally the shorter the maturity schedule, the lower the total interest cost. Principal payments may be delayed to give the company time to go through the necessary start-up and developmental stages before any substantial payment is made toward amortizing the indebtedness. A twenty-year maturity is considered standard in this form of financing. Balloon or term maturities may also be used. Generally, the bonds are not callable for the first few years, except in the case of damage or destruction of the property or condemnation. Provisions for such events are written into the Lease Agreement, as is the price at which the bond issue may be redeemed after the expiration of the non-callable period.

4. <u>Project Fitted to Lessee Company's Needs</u> - the issuing authority has no control or authority over the construction nor in the ordinary operation of the project by the lessee. The lessee may make structural changes to the building and replace the machinery and equipment within certain limits. There is no restriction on replacement equipment to be purchased with corporate funds. Maintenance of the property and adequate insurance is the direct responsibility of the Lessee.

5. <u>Company May Buy or Lease Project at End of Payment Schedule</u> - a company may continue to lease the facility at an annual rental or to purchase the facility for a nominal sum, if provided for in the lease agreement.

6. <u>Tax Advantages May Be Realized</u> - depending on the state and community, the company may be able to achieve reductions in taxes such as the property taxes.

The only significant disadvantage is the $5,000,000 capital expenditure limit, as set forth by the United States Internal Revenue Code. For a six-year period commencing three years prior to the date of delivery of the Bonds and ending three years after

said delivery, total capital expenditures made by the Corporation at or in connection with the Project may not exceed $5,000,000 irrespective of the source of payment for, or funding of, any such capital expenditures. All capital expenditures for facilities of a depreciable nature made and principally used by the Lessee company are taken into consideration in determining the $5,000,000 limit. However, if the items installed at the project were purchased or acquired by the Corporation more than three years prior to the date of the delivery of the Bonds, they would not be chargeable against the $5,000,000 limitation. When a violation occurs, the bonds' interest become taxable as of the date of the violation.

The conditions and flexibility of the Industrial Revenue Bond is especially attractive for Canadian firms with limited financial means. The Ontario automotive parts manufacturer who recently opened up a new manufacturing plant in the U.S. South pointed out that "this form of financing will not conflict with restrictions on any outstanding corporate debt arrangements and can be accomplished without disturbing the natural market for traditional corporate debt issued or to be issued by the company".

Another manufacturer, this one based in Alberta, offered the following remarks:

> "One thing that helps in the United States is that if you want to put a factory up, you can get a low-interest loan under a bonding arrangement from many of their municipalities. They have very competitive rates there. They seem to have very aggressive local business groups or development agencies, even in small towns. Our factory was built by the business community in a small mid-western town using these bonds, because they wanted us to go to that town."

Community involvement is apparent and real. In the case of the auto parts plant, at the time the ground breaking ceremonies took place, the participants included the Mayor of the small town (a community of 45,000), an official of the Enterprise Development Division of the State, the President of the Construction Company, a former Mayor of the community, a local judge, the President of the U.S. subsidiary, a Mayor of a neighbouring town, and a Minister of the First Baptist Church. Since the opening of the plant, the working relationship between the Canadian owned subsidiary and the local community has been excellent; in other words, mutually rewarding. In the opinion of the President of the Canadian Company, Americans appear to have greater respect for the contribution of the "free enterprise" system than do Canadians.

Manufacturing and Warehousing

Fifteen of the 25 companies had manufacturing plants in the U.S., and 3 had multiplant operations. The 3 included a steel producer, a mobile home manufacturer, and a telecommunications equipment manufacturer. The square footage of these plants ranged from a low of 4,000 to a high in excess of 200,000 with most concentrated around the 100,000 mark. The staff employed at these plants were as few as 10 in one instance, and as many as 800 in another. In only 3 cases were the U.S. subsidiary operations, in size and output, bigger than their Canadian parent.

These 3 companies included an Ontario based steel producer, a Quebec hardware manufacturer, and a British Columbia aircraft

designer. The steel producer has one mini-steel mill in Canada, but two in the U.S. While the combined output in tonnage of the U.S. mills exceeds the Canadian total, the plant staff employed in both countries are comparable in size. In the case of the hardware manufacturer, U.S. acquisitions and the concentration of their manufacturing activities in one new large plant has made the American operation bigger than the Canadian. However, as in the case of the steel producer, the size of the Canadian labour force exceeds that of the U.S. The difference may be explained in terms of the relatively more modern U.S. plants, and the greater degree of specialization because fewer products are manufactured, and their productions runs are significantly longer than in the Canadian parent operations.

The aircraft example is a special case. The company was incorporated in 1970 to build a prototype STOL aircraft. In 1971 management decided to produce the prototype in the State of Washington to qualify for FAA certification and because aircraft expertise was readily available from BOEING in Seattle. Thus, the Seattle operations became significantly larger than the total equivalent Canadian base. The original idea was to do the manufacturing in Canada, once the prototype flew. In 1974, however, management decided that manufacturing should also take place in the U.S. because of a lack of Canadian government financing, and the higher costs of manufacturing in Canada.

The plane few in 1975, but has yet to be certified. Management estimates that it requires about $5 million to get into commercial operations, and is presently trying to raise this money.

The subsidiary in the U.S. had to qualify as a U.S. citizen in order to meet the standards for FAA certification. A cosmetic change was made to satisfy this requirement, while still making certain that the Canadian parent retained control of the operation. The gist of this requirement and its satisfactory resolution can be quickly gleaned from the following two paragraphs:

> "Following the first flight it was noted that the Subsidiary did not qualify as a "United States Citizen". Under the pertinent United States statute, a United States citizen, as far as a corporation is concerned, is defined in effect as a corporation, incorporated under the laws of the United States or any State thereof, or which the President and at least two-thirds of the directors and other managing officers are United States citizens and of which at least 75% of the outstanding voting shares are owned or controlled by United States citizens.
>
> The matter was discussed at length with the regional counsel for the Federal Aviation Administration who advised that the aircraft could be transferred to and registered in the name of an individual United States citizen and held by him on behalf of the Parent or it could remain registered in the name of the Subsidiary if the necessary action was taken to qualify the Subsidiary as a United States citizen. The regional counsel further advised that it would be in order for an individual or corporate United States citizen to hold the aircraft in trust for and on behalf of the Parent and indicated that it was a common practice for aircraft manufacturers to have a subsidiary or a company of convenience so that new aircraft on leaving the production line could be registered in its name pending sale and registration in the name of the ultimate purchaser."

The question regarding incorporation in the U.S. was viewed as straight forward by the interviewees. Twenty-three of the 25 companies incorporated their subsidiaries as U.S. companies, while

the remaining 2 registered them as branches of the Canadian firm. The major reason for the latter option was to offset the U.S. branch losses against the total profits on the Canadian operation. It was pointed out, however, that once profits were realized in the U.S., the "branch" status would be changed to a U.S. incorporated citizen.

Ten of the 25 companies were largely sales subsidiaries with warehouse facilities. The structure of this type of operation is simple. For example, an Ontario manufacturer of bicycles leases a 30,000 sq. ft. warehouse in New Hampshire to stock his Canadian made products. An inventory of approximately one million dollars is maintained in the warehouse, and is used to help finance the company's U.S. operations. The Ontario firm holds an option to lease/purchase 4½ acres of land adjacent to the warehouse facility. The present site could be converted into an assembly/manufacturing plant which is the direction management hopes to take in the future. At this time, all major U.S. orders are serviced by the company's two plants in Ontario and Quebec. The New Hampshire warehouse is limited to servicing repeat orders for a narrow line of bicycles, while maintaining spare parts for all Canadian products exported to the United States.

Five of the 10 companies were sales subsidiaries which subcontract some of their distribution and warehousing activities to U.S. distributors. These distributors, however, functioned as an extension of the Canadian companies' operations in the

U.S. The facade used was to make the U.S. customers believe that they were dealing with a U.S. based operation.

FINDINGS AND ANALYSIS

The probable impact of the Canadian-U.S. business arrangements on the Canadian economy can be highlighted in the context of the employment and balance of payments effects.

Employment Effects

Three employment effects can be readily identified. First, there is the production displacement impact on employment in Canada. The assumption here is that employment would have occurred in Canada had the production of the U.S. subsidiaries been carried out in Canada. The assumption underlying the production displacement effect was questioned in 15 of the 25 companies interviewed; namely, those that engage in some manufacturing activity in the U.S. This was done by ascertaining the corporate motives which prompted these firms to establish U.S. manufacturing affiliates.

As previously noted, the key reasons were largely market considerations and the choice was rarely between expanding production in Canada and producing in the United States, but between supplying the U.S. market or dropping out. The dynamics of this choice is illustrated in the following example, but the end result is not typical.

Ontario Shoe Company Limited

Ontario Shoe Company (OSC) manufactures and sells footwear, and is considered to be one of the three major Canadian producers with an annual sales volume of approximately $23 million. In 1970 OSC's management made the decision to establish a U.S. manufacturing operation in Buffalo. The decision was explained in terms of the high U.S. tariff rate that was applied against imports - 37½% ad valorem duty. OSC could not compete in the U.S. market because the cost of manufacturing in Canada was at least as high as in the U.S.

OSC had developed a unique technology in boot manufacturing, and the design was aesthetically appealing, especially compared to U.S. made boots. For these reasons, management decided to overcome the tariff wall by establishing a manufacturing plant in Buffalo. A building was leased and 140 people were employed at the time the plant was officially opened in 1971.

Since the company's technological capability was based in Toronto, as was the equipment and machinery which produced the "slush-molded plastic boot shells", management concluded that it should export these shells to its Buffalo plant, where they would be finished for the U.S. market. At that time, these shells were imported into the U.S. at a duty of 12½% ad valorem. Further, the "cost of that portion of the article which takes place in Canada, including duty at 12½% and freight, comprises 34.8 percent of the costs thereof". Thus, approximately 2/3 of the cost of completion was expended in the U.S., and 1/3 in Canada. OSC

was able to compete with U.S. manufacturers under these tariff conditions. Management, however, had every intention of eventually developing a U.S. molding technology in their Buffalo plant.

By the third year of operation, in the Winter of 1973-1974, OSC had realized bookings valued between $3½ and $4 million. Shortly thereafter, (August 5, 1974) OSC received notification from the U.S. Customs Service (Department of the Treasury) that it was ruled that OSC plastic boot shells were considered to be lined, and thus were classifiable under provisions which rendered them dutiable at the rate of 37.5 percent ad valorem. Moreover, the decision was made retroactive for eight months which meant that OSC had to "shell" out $89,000 for orders in hand. The boot shells were priced at $2.00 per unit.

The U.S. customs decision made it impossible for OSC to continue its operations in Buffalo. It honoured all of its orders, but immediately discontinued its partial U.S. manufacturing operations. The 140 U.S. employees, with the exception of some sales personnel, were "let go". Financial constraints prevented OSC from expanding its U.S. base into a fully integrated manufacturing operation.

In spite of the plant closure, management decided to fight the customs decision, and on November 21, 1975, it received a letter from the Department of the Treasury to the effect that:

> In this instance the amount of finishing required after importation is substantial. Noting the court cases alluded to, we are constrained to hold that the boot shells in issue rather than being unfinished for tariff purposes are parts classifiable under the provision for wearing apparel

> not specially provided for, of rubber or plastics in item 772.30, TSUS, and dutiable at the rate of 12.5 percent ad valorem.
>
> This decision is being circulated to all Customs officers in order that the merchandise may be classified uniformly at each port at which it may be entered."

OSC, however, decided against re-opening its U.S. plant for the following reasons: problems of re-organization in its Canadian operation demanded management time; there were financial problems; and the Canadian market was being swamped with imports, and competition was fierce. Then in 1977, new market opportunities in Canada resulted from the Canadian government's decision to apply import quotas against offshore suppliers. The president of OSC in his report to the shareholders, claimed that:

> "Effective Dec. 1, 1977, the new legislation will cut imports by approximately one third. This represents mammoth volume and, for Canadian manufacturers, prospects are definitely encouraging."

In order to take full advantage of the opportunity, OSC is devoting all its resources to exploiting the Canadian market to its fullest potential. In the meantime, the U.S. affiliate functions as a sales subsidiary.

The OSC example is a particularly interesting one. First, it shows that different tariff rates apply to different stages of production and that U.S. customs decisions may be interpreted

differently at different times. Problems with U.S. customs have been experienced by a number of the interviewees who received different tariff rate decisions at different U.S. border locations for the same type of product.

Second, OSC's management opted to promote growth through geographical diversification in the face of a limited domestic market. This strategy is common to many of the companies studied. The uniqueness of the OSC example lies in the fact that Canadian commercial policy, through the introduction of import quotas, helped expand the size of the Canadian market, and for this reason discouraged OSC to consider re-opening its U.S. plant in Buffalo.

The second major employment effect has to do with export stimulation. The literature on direct foreign investment indicates that a significant amount of domestic employment is generated through the production of goods which result from the establishment of overseas affiliate operations. The U.S. Department of Commerce notes three reasons why foreign investments stimulate U.S. export trade.[10]

First, a significant part of the overseas investment is made through an export of U.S. capital equipment which usually requires some continuous supply of replacement equipment. This generalization does not apply to our group of Canadian companies. The equipment and machinery employed in the Canadian parent company plants were largely sourced in the United States, Europe and Japan. Thus, it is not surprising that most of the equipment and machinery installed in the U.S. subsidiaries were leased

or purchased from manufacturers based in the United States.

Second, U.S. studies show that many U.S. parent companies export parts and components for further assembly. This situation is apparent in our sample of companies because most are engaged in partial manufacturing activities in the U.S. Third, an important volume of U.S. exports to foreign affiliates is resold with minimal assembly activity. Again, this finding applies to our sample of companies, but to an even greater extent.

The sales organizations of the U.S. subsidiaries are more effective than non-affiliated U.S. distributors in merchandising Canadian made products in the U.S. The existence of U.S. sales facilities, warehouses and trained personnel help to facilitate not only the affiliates assembled and/or manufactured goods, but those of the Canadian parents as well. Furthermore, the Canadian parent companies were a significantly more important source of the U.S. affiliates' imports than a customer for their(U.S.) exports.

The third major employment effect has to do with whether the establishment of U.S. subsidiaries provide job opportunities for Canadians in the U.S. The major difference between the "home-office" employment effect and the "displacement" and "export stimuli" effects is that in the case of the latter two, the occupational coverage largely consists of semi-skilled and skilled occupational classes. In the case of the former, the jobs are primarily managerial, clerical and professional.

Most U.S. subsidiary personnel were recruited in the United

States. With few notable exceptions, minimal employment in Canada was created for companies which service the operations of Canadian parent firms with U.S. subsidiaries. These firms engage in such activities as engineering, public relations, law, management consulting, finance and banking. U.S. provincialism and nationalism, superior expertise, lower rates and Canadian ignorance of U.S. laws were among the reasons offered for employing U.S. firms in support of Canadian activities in the United States.

Balance of Payments Effects

If the investment from Canada merely displaces exports that emanate from Canada and would have continued, the investment makes very little contribution to Canada's balance of payments. If, however, the investment results in servicing a market which cannot be serviced by Canadian exports, or which would otherwise be serviced by another foreign firm, then the contribution to the Canadian balance of payments is much greater.

The corporate reasons for establishing U.S. manufacturing facilities have been examined. By highlighting the impact of such investment on the Canadian company's manufacturing and exporting activities, one can gain some appreciation of the differing effects this type of investment may have on Canada. For a start, one key benefit generally associated with U.S. outward investment is only minimally realized; specifically, an increase in the export of Canadian made machinery and equipment,

and related support services. The explanation offered is that Canada lacks a sophisticated secondary manufacturing capability, readily evident in the foreign made equipment and machinery installed in Canadian plants.

Companies with manufacturing affiliates tend to reproduce their operations in the United States. During the initial phase of setting up the U.S. subsidiary, parent company exports may increase significantly because of the expanded and more aggressive activities of the company's U.S. sales organization. Canadian exports will include both finished products as well as components to be assembled in the U.S. plant. However, as the U.S. subsidiary strengthens and expands its manufacturing capability, increasing reduction in exports from the Canadian parent is likely to take place.

This seems to be a common "happening"for a number of corporate interviewees whose U.S. manufacturing operations have been in place for some years, ie., in excess of five. The cause is explained in terms of the tendency for Canadian companies to replicate their operations in the U.S.; specifically around product lines previously exported to the United States. At first glance, this appears to be a "miniature replica" scenario in reverse, involving Canadian parent companies. There is one major difference: if the subsidiaries in the U.S. are successful, they are anything but "miniature" compared to the scale of their parent company operations in Canada because of the size of the U.S. market.

The interviewees' U.S. experience were not universally profitable. Some encountered serious difficulties such as a Quebec manufacturer of radio telephone systems who closed his plant in New York and had the following observations to offer:

> "Quite a few small Canadian firms which recently opened assembly-manufacturing subsidiaries in the U.S. closed them down because of high and unforeseen costs which arise from running a plant in another country, even if it is next door to you. These costs are seldom realistically computed and often exceed the benefits gained from the lower wages paid to U.S. workers. But the most important lesson learned is that if you phase out your U.S. production from your Canadian plant to the new U.S. operation, unless the gap in production is filled with new domestic or export business, parent plant costs will increase and the subsequent result will be an increase in over-all manufacturing and sales costs, and a deterioration in the financial capability of the company."

In the case of Kartash Products, it was previously noted, the company felt it had to manufacture in the U.S. or face the prospect of losing its U.S. market to its competitors. Management recognized that the loss of production to the Canadian plant would have to be made up by increasing its offshore sales. This option was not so apparent to some of the other interviewees who elected to limit their U.S. operations to warehousing and assembly, even under the threat of losing their sales to U.S. based manufacturers.

A differential impact on Canada's balance of payments will also occur with the type of financing undertaken. Where the U.S.

investment is financed largely from sources in the U.S., there will be little initial outflow affecting Canada's balance of payments. At the same time, there will be little inflow of earnings on the equity invested by the Canadian firm. Both the debt/equity ratio in the capitalization of the U.S. subsidiary and the source of debt and equity will affect the flow of capital between Canada and the U.S.

In our group of companies, there is a high proportion of debt to equity, with much of the debt raised in the U.S. This means that Canada will not receive much in the way of earnings on the investment for some time. In fact, there appears to be a net outflow because most of the affiliates were recently established, so it is too soon to tell whether they will be profitable, and some are already experiencing serious difficulties requiring further financial assistance. These conditions partially explain why few companies maintain formal contractual agreements with their U.S. subsidiaries regarding the transfer of technology, and its form of payment to the parent.

CONCLUDING REMARKS

International business expertise was common to all companies. The senior executives interviewed generally believed that in order to sustain their competitiveness in Canada they had to achieve sales success in the United States. Partly in response to this concern and challenge, our group of small and medium sized companies established U.S. subsidiary operations. While the moti-

vation for such investment may be viewed as being part of a defensive marketing strategy, it is equally important to recognize that the formulation of this strategy was accelerated by deteriorating economic and political circumstances in Canada.

The establishment of the U.S. subsidiary normally took place after exporting for a few years to the U.S. market. Initially, most of the subsidiaries were sales and warehousing operations, leading to assembly, partial or full manufacturing organizations. Since the firms in question were generally small and recent U.S. corporate entrants, only a few had U.S. plants which manufactured in full their Canadian developed and designed products. Most, however, hoped that success in the U.S. would lead them in this direction, ie., the opening up of a "manufacturing" plant.

The U.S. subsidiaries were tightly controlled by their Canadian parents, and all key decisions were made by executives in Canada, particularly those involving financial outlays. While the amount of capital invested outside of Canada by our group of companies was not significant, two important observations can be made about such investment in terms of its impact on small business in Canada.

First, the financial resources of small and medium sized firms are generally limited. Thus, if a company expands into the U.S., its financial ability to pursue similar investment opportunities in Canada will be constrained, because it will have had to mortgage most of its assets in support of its U.S.

project. Raising the capital in the U.S. may reduce the impact of such investment on capital outflows, but it will hardly improve the financial capability of the Canadian firm to raise capital in Canada or elsewhere for other investment undertakings.

Second, the limited size of the Canadian market and the general reservation about growing through product diversification prompts small and medium sized firms to consider investing in the United States. If such a decision leads to the establishment of a manufacturing plant in the U.S., the former Canadian-U.S. export business is normally transferred to the U.S. operation, however slowly. The new "gap" in Canadian production can be either filled through an increase of Canadian or offshore sales. If this result is not forthcoming, the competitiveness of the Canadian firm can be jeopardized, particularly at a time when its resources are strained because of the competing demands emanating from its newly established U.S. subsidiary. A number of the firms interviewed closed their U.S. plant operations for this reason, and their experiences have not gone unnoticed.

The press tends to publicize "outbursts" by executives who threaten to move their Canadian manufacturing operations to the U.S. because of deteriorating politico-economic circumstances in Canada. Of the 25 companies studied only two have either moved their head office or their manufacturing operations to the U.S. In the former case, the head office was moved because of estate tax considerations. In the latter case, the market is in the U.S. and since U.S. government standards determine the potential acceptability of the product, the Canadian firm found it expe-

dient to design and test the prototype in the State of Washington and not in the Province of British Columbia.

Is there any truth to the "allegations" regarding the exodus of Canadian firms to the U.S.? Our findings suggest that there is no exodus. We encountered few companies which seriously contemplated moving their operations "enmasse" to the U.S. The exceptions were essentially one-man operations such as the Ontario assembler of packaging machines who employed some 12 people; leased his manufacturing space and machinery; and exported eighty percent of his yearly sales volume of about $600,000 to the United States. From his perspective he had little to lose, and much to gain from transferring his company site to "Texas", and he offered the following reasons for wishing to make the move:

"-Texas has no State corporation taxes
-Texas has no State personal taxes
-Texas industrial space rates are much lower
-U.S. labour rates are lower and productivity higher
-My major market is in the U.S.A.
-Financing is more readily available in the U.S. at interest rates below 8%
-Despite the alleged unemployment situation, good Canadian workers are almost unobtainable
-High cost of financing in Canada, especially with FBDB, and there is even a penalty on early repayment of a FBDB loan
-Excessive documentation of duty drawback in Canada
-Generally higher Canadian business and personal taxes
-Multiplicity of forms from all levels of government which have to be filled in Canada."

The possibility of more owner-managers of small firms contemplating moving their entrepreneurial talents to the U.S. should not be lightly dismissed. These individuals are easily affected

by both economic and political developments. In the case of the latter, on the psychological level, which also impacts on a company's investment decision-making process, Canadian opinion makers are basically viewed as hostile towards business, especially when profitable; Canadian labour seems to resist changes that are designed to promote Canadian productivity; and government officials, both elected and appointed, appear to be less aggressive in seeking out and expediting business opportunity than their U.S. counterparts.

The lesson to be drawn from these perceptions is that Canadian public policy towards business needs strengthening not merely in terms of financial rewards; it requires some far sighted thinking and action on how best to stimulate and recognize the value of private enterprise at a time when business perception of its own status and worth in Canadian society is at a low point.

FOOTNOTES

1. Statistics Canada Daily, Dec. 12, 1977, p. 3.

2. For a detailed examination of this topic, see I. A. Litvak and C. J. Maule, "The Emerging Challenge of Canadian Direct Investment Abroad", The Business Quarterly, Vol. 43, No. 1, Spring 1978, pp. 24-37.

3. See I. A. Litvak and C. J. Maule "Canadian Multinationals in the Western Hemisphere", The Business Quarterly, Vol. 40, No. 3, Autumn 1975, pp. 30-42.

4. A. C. Cooper, "Incubator Organizations, Spin-offs, and Technical Entrepreneurship", Proceedings of the Indiana Academy of the Social Sciences, 1969, 3rd Series, Vol.4 April 1970, p. 33.

5. United States Tariff Commission, Implications of Multinational Firms for World Trade and Investment and for U.S. Trade and Labour (Washington: U.S. Government Printing Office, 1973), P. 119.

6. Ibid., p. 120

7. See Report to the Congress, Foreign Direct Investment in the United States, Volume 5: Appendix G, Chapter 7: Canada (Washington, D.C., U.S. Department of Commerce, April 1976),pp. G-210 to G-256.

8. See I. A. Litvak and C. J. Maule, "Government-Business Interface: the case of the small technology-based firm," Canadian Public Administration, Vol. 16, No. 1, Spring 1973, pp. 97-109.

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10. See U. S. Department of Commerce, Studies on U. S. Foreign Investment Re: The Multinational Corporation, 1972, Vols. 1 & 2.

TECHNOLOGICAL INNOVATION STUDIES PROGRAM

PROGRAMME DES ETUDES SUR LES INNOVATIONS TECHNIQUES

REPORTS/RAPPORTS

	AUTHOR(S)/AUTEUR(S)	UNIVERSITY/UNIVERSITE	REPORT TITLE/TITRE DE L'OUVRAGE
1.	I.A. Litvak C.J. Maule	Department of Economics, Carleton University.	Canadian Entrepreneurship: A Study of Small Newly Established Firms, October, 1971.
2.	Harold Crookell	School of Business Administration, University of Western Ontario.	The Transmission of Technology Across National Boundaries, February 1973.
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4.	Blair Little R.G. Cooper R.A. More	School of Business Administration, University of Western Ontario.	The Assessment of Markets for the Development of New Industrial Products in Canada, December 1971.
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