Economics

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Capital spending and investment in Canada: Seven half-truths and myths

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In mid-September, Canada will host a major summit involving decision makers running large pools of domestic and foreign funds, and the prospects for capital spending in Canada will come into sharper focus. The need to do better than our recent track record is almost a motherhood issue on which nearly everyone can agree. The factors behind that shortfall, including a drop in energy investment after crude prices fell in 2014, a tightening in regulatory policies, a smaller tech sector than our US neighbours, the increasing competition in manufacturing from the likes of China and Mexico, and of late, escalating American tariffs and uncertainties over whether negotiations can at some point lower them, are also well understood.

The opportunities for improvement are also evident. They lie in upgrading productivity in some of our existing export and domestic sectors, adjusting our product mix and supply networks to diversity our target markets, tapping into competitive advantages in resources, and making inroads into fast growing markets in sectors like defence, technology goods and services, and power utilities.

But beyond these broad truths on which there is a general consensus, on issues tied to capital projects and the investment dollars to fund them, Canadian commentators are spinning a mix of other half-truths and outright myths. As an aid to those participating in the upcoming summit, other investors, and policymakers, herein we look at seven commonly repeated half-truths or myths on topics tied to capital spending in Canada, and address the implications for the questions that are likely to be taken up at the upcoming summit and in the follow-up to it.

Business investment drives growth: Half true

This statement, which seems obvious, is actually only half true, if it's interpreted as "A causes B". There is actually a causal relationship in both directions, because better economic growth is one of the drivers for faster business investment, by creating pressure to expand capacity to meet demand. A faster growth rate will often go alongside increased rates of return on business assets.

That two-way causation dates back to Paul Samuelson's "multiplier-accelerator" model of investment, and it's now quite relevant for Canada, in a way that suggests a pick-up for capital spending ahead, particularly if trade-barrier threats can be dialed down.

After winnowing down the population share of non-permanent residents, we expect a resumption of trend-like population growth in 2028 that will increase domestic demand, and spur related capital spending. We're hopeful that, over time, we'll also be past the worst of the downward hit from tariffs. Government policies aimed at spurring resource projects, trade-related infrastructure, and the expansion of Canada's defence sector, should also be adding to trend growth, helping to spur investment spending in the process through the multiplier-accelerator effect. These positive forces are likely to be highlighted in presentations to those at the upcoming summit.

The more investment, the better: half true

All else equal, capital spending will increase GDP and GDP per capita. Capital spending is a component of GDP, and when a project is complete, economic activity is lifted as the new plant, equipment or software generates a flow of output.

But the catch is that "all else equal" is often not the case. The funding for capital projects isn't manna from heaven, and money devoted to a given project will by definition have an opportunity cost, in the GDP benefits there would have been in its alternative use. That's less of an issue for Canada if it's a foreign-financed project, tapping funds that would otherwise have been parked abroad. Domestic funds, however, could have been invested elsewhere, or returned to shareholders, or to taxpayers in the case of government-supported projects, who would have spent or invested elsewhere.

In the case of government funded projects, let's not forget that the defunct Mirabel airport was at one point touted as a growth-generating infrastructure project, but so too were the much more successful St. Lawrence Seaway and hydroelectric projects in Niagara and James Bay. Private sector investments have seen a similar mix of successes and failures.

While all of this seems obvious, we've read numerous "economic impact" studies that count all the jobs and GDP created by a project, but give no heed to where the funding came from, and the jobs that could have been created had it been invested or spent elsewhere.

Last year's federal budget allocated a larger share of its fiscal room towards direct and indirect support for capital projects. Choosing wisely, and allowing the time for that, makes more sense than rushing dollars out the door, even though it means that the full benefits really won't show up in the economy until 2028 and beyond. Patience is a virtue when not all projects will actually lift growth when opportunity costs are included, which we need to remember if September's summit doesn't generate an immediate surge in shovels in the ground.

Canadian non-residential investment was weakened by excessive investment in housing: Myth

We've seen Op-ed pieces in Canada's newspaper of record making the claim that the dollars funding Canada's housing boom in past decades prevented a more robust trend for business capital spending. That theory doesn't hold up in practice; witness the lack of growth in homebuilding in the past couple of years, with no offsetting pickup in business investment.

But it's also mostly wrong in theory, because Canada's financial system is open to the world. Domestic savings don't have to finance all domestic investment, because if there are enough projects that offer strong rates of return, foreign investors can be tapped to finance them. That's not necessarily through foreign direct investment, because corporate Canada can raise equity or debt financing from foreign portfolio investors. What counts is having projects with promising rates of return.

Moreover, while high house prices were part of the flow of funds into residential real estate, the volume of homebuilding is tied to population growth and the resulting need for housing. That population growth is in itself a source of stimulus for non-residential investment spending, because it creates the workforce needed by a growing corporate sector, and boosts domestic demand for goods and services. Until recently, Canada's housing market was, if anything, undersupplied to meet the needs of a growing populace. Work to address that gap, even if it absorbs some government funds that could otherwise go to non-residential projects, can still help create the backdrop for more of the latter.

We need to have a net financial inflow from the rest of the world: Myth, or half truth

Canadian commentators will often bemoan the fact that in some years more investment dollars flow out of the country into foreign assets than we attract in investment from abroad. But in a world of floating exchange rates, for the balance of payments to in fact balance, net capital and financial account flows will simply be the mirror image of the balance in the "current account", which will generally be driven by the country's trade surplus or deficit. Countries with large trade surpluses, like Canada in times where resource prices are elevated, or China in recent decades, will typically be running a deficit in capital and financial flows, sending more funds abroad than inbound foreign capital flows. But remember that Canadian investments abroad will subsequently provide incomes in interest and dividend payments back to our country.

The real objective is to have a lot of domestic capital spending in productive projects, however financed. The flow of capital into and out of the country will be the flip side of the current account balance, and will also reflect how large a pool of savings Canada generates in the business, corporate and household sector relative to the scale of opportunities for investment. China, for example, has had a massive boom in capital spending in manufacturing, while simultaneously investing more abroad than inbound foreign investment, due to its large pool of household savings. When resource prices soar and Canada is a world beater on trade, we'll generate a growing pool of income that can both fund such projects, and investments abroad. So the net balance on investment isn't really the right benchmark, it's total capital spending in worthy projects.

We want projects to be financed by Canadians, not foreigners: Half true at best

Ironically, often at the same time as some bemoan the lack of foreign investment here, there are those criticizing foreign investment inflows as not in the national interest, or suggesting that domestic pools of capital, including pension funds, should face regulatory requirements to invest on their home front. That sort of economic nationalism had its heydays in Canada in the 1970s, when the Foreign Investment Review Act was passed with a critical eye on foreign ownership. While such talk has receded, we still hear claims that the weakness in capital spending in Canada is a result of Canadian pension funds placing too many of their investment dollars abroad.

There are few real issues with foreign portfolio investments in Canadian stocks where that doesn't end up creating controlling positions. In some sectors, there's a reasonable debate about whether foreign control conflicts with national security or various regulatory objectives, or could lead to the transfer of key technologies to a foreign parent company that shifts activity abroad, particularly when that foreign company is state owned and may have non-economic motives for doing so.

But in many sectors, a foreign owner has roughly the same incentives as a domestic investor, which is to maximize the economic value of the assets they have in Canada. If it's a mine or a pipeline, for example, it's not something you can move out of the country.

True, for projects that are financed from abroad, the subsequent flow of profits, dividends or interest will be reaped by foreigners. But by tapping into such pools of capital, we can free up Canadian funds to add more foreign assets without constraining overall capital spending in our country. That diversification is likely optimal for a large pension fund in terms of its risk adjusted return, just as the foreign pools of capital can benefit from diversifying into Canada. It's a win-win.

Of course, we don't want either domestic or foreign asset managers to have a misguided bias against Canadian investments. Hence, the potential utility of the upcoming summit and the efforts that will be made to shine a favourable light on opportunities in this country, for both domestic and foreign financial participants in attendance.

Government investments need to be judged only on their return on investment: Half true

When taxpayer money is at stake, or governments borrow for a capital project, you sometimes hear the idea that the decisions should be made by an arm's length agency that will solely focus on the risk adjusted rate of return. That would be a sound argument, but only if "returns" include what economists call "positive externalities".

Some public projects, like a national park, are designed to benefit Canadians more than the fees charged for users. Non-tolled roads do the same. But even where there is a material revenue stream attached, if a government project helps spur other economic activity, it could still provide a strong return to the nation as a whole, even if that's not the case for government coffers alone.

That will be relevant as Ottawa firms up its plans for a new sovereign wealth fund. If it opts to allow individual Canadians to invest in the fund, it could prevent the management team from doing anything other than seeking a maximal risk-adjusted return. That might not be the right benchmark if the purpose is to fund projects that are in the national interest with externalities included, and thereby fill in a gap that the private sector might not address.

Selling an existing asset doesn't generate additional capital spending: Half true

We expect the upcoming summit to include a look at existing assets in Canada as opportunities for acquisitions by foreign and domestic investment funds. On the surface, the sale of an existing asset doesn't directly create an addition to the country's capital stock. But it can still facilitate additions to capital spending thereafter, so the statement is only half true.

For one, selling existing assets, including airports owned by the federal government, has been proposed as one option for raising money for the new sovereign wealth fund. If these assets have a good fit with the investment objectives of the new owners, they could sell at a premium multiple. The government will give up the flow of future income from the assets it sells, but would then achieve a new flow from its equity stake in projects financed by the wealth fund. Moreover, changes in ownership can in some cases put assets into the hands of those who are better able to identify opportunities for additional investments in those facilities.

Climbing to the summit

Canadians aren't alone in holding onto many of these misperceptions regarding capital spending. Nor is Canada the only country that is coming off a lacklustre period for such projects, as other G7 countries also face challenges from slowing demographics and increased competition from China and other emerging markets.

What is encouraging is that Canadians of varying political stripes seem to be uniting behind a common view that more corporate investment, both on its own, and with the support of related government projects, is going to be key to accelerating growth across the country. What we've underscored is that this needn't be in competition with catching up to housing needs, can tap into either foreign or domestic capital, or funds raised from the sale of existing assets, as need be. But it's also not a simply a case of the more the merrier, as capital projects have opportunity costs, and where support from governments is part of the process, need to be chosen carefully to truly add to growth ahead.

A stronger underlying pace to trend economic growth as population inflows pick up again in 2028, will create opportunities for investments tied to meeting domestic demand. Moving past the worst of the one-time hit from trade barriers, and reaching agreements to moderate those barriers where possible, would also create the backdrop for better capital spending ahead, as will government and private sector initiatives to diversify trade and promote the development of a larger defense sector. The upcoming investment summit, by highlighting these emerging opportunities, could therefore be a further key to unlocking interest in Canadian projects in the years ahead.

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