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# Micro

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*Micro-Economic Policy Analysis Branch Bulletin*

## IMR Issue

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- **National Political Infrastructure and Foreign Direct Investment**
- **The Productivity Volume: *Productivity Issues in Canada***

## Internationally Mobile Resources: *The Industry Canada Roundtable ...*

In an era of increased globalization, as nations compete for inputs, factors of production have become more and more footloose. Canada competes head-on with the United States (U.S.) to attract internationally mobile resources (IMRs) — foreign direct investment, skilled workers and innovative activities. To sustain strong economic growth, Canada needs to maintain a highly competitive economic environment in order to attract and retain these IMRs. Industry Canada organized a roundtable of experts from Canada and the U.S. to scope out the major policy research issues related to the key topic of IMRs. This *Micro* features highlights of Industry Canada's *Making Canada the Destination of Choice for Internationally Mobile Resources* roundtable held in Ottawa on September 5, 2002.

## *... North American Economic Linkages*

North American linkages also affect foreign direct investment (FDI), which remains one component of the Canadian challenge in attracting IMRs. In an Industry Canada Working Paper, Steven Globerman and Daniel Shapiro analyze the relationships between national political infrastructure — investments in political, economic and legal governance — and increased FDI flows. Their paper will be available at [http://strategis.ic.gc.ca/sc\\_ecnmy/mera/engdoc/02a.html](http://strategis.ic.gc.ca/sc_ecnmy/mera/engdoc/02a.html).

## *... and Productivity*

In another research exercise closely related to North American economic linkages, Industry Canada commissioned a number of studies to better understand Canada's productivity performance, particularly vis-à-vis the U.S. These studies are available in *Productivity Issues in Canada*, the latest volume released under the Industry Canada Research Series. A summary of this volume can be found at <http://strategis.ic.gc.ca/SSG/ra01842e.html>.

*MICRO* will now be published on a semi-annual basis. Each issue will focus on a specific area of policy research. The views expressed in the articles, roundtable discussions, and publications are those of the authors of these communications and do not reflect those of Industry Canada or the Government of Canada.

Winter/Spring 2003

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## Industry Canada Roundtable

### Internationally Mobile Resources: Making Canada the Destination of Choice

On September 5th, 2002, Industry Canada held the roundtable, “Internationally Mobile Resources: Making Canada the Destination of Choice”. Internationally mobile resources (IMRs), which include labour, productive capital, and knowledge investments, play an important role in economic growth, and international competition for these factors has increased their cross-border mobility. Policies to attract and retain IMRs in Canada require a better understanding of the factors that drive IMR location decisions. This roundtable was held to develop a research agenda on IMRs in order to gain such understanding.

The overview for the roundtable was the opening presentation, “Making

*Internationally mobile resources (IMRs) are inputs used in the production process — labour, productive capital and knowledge capital — which are increasingly mobile across national borders.*

Canada the Choice of Internationally Mobile Resources,” by Keith Head and John Ries of the University of British Columbia. This overview paper summarized major policy issues and a number of key policy research questions:

(a) What benefits do the presence of IMRs bring to the host economy, including the considerations of local versus economy-wide spillovers, and cluster formation?

(b) What forces determine the location decisions of IMRs? In particular, when multinational enterprises (MNEs) choose where to locate their research and development (R&D) activities and spending, what are the factors that drive these decisions?

(c) What cost-effective policy instruments can Canada use to attract and retain IMRs?

The roundtable was organized in four sessions: Multinational Enterprises (MNEs) and Foreign Direct Investment (FDI); Labour Mobility; Knowledge Mobility, Domestic R&D and Innovation Activities; and Financial Capital, Corporate Hollowing Out and Interdependencies of IMRs.

## Multinational Enterprises: Policy Formulation and Regionalism

Multinational Enterprises (MNEs), which account for almost all the world’s international foreign direct investment (FDI) and trade, are important to any analysis of IMRs. The hundred largest MNEs account for most of this international trade and FDI. Economic forces — such as factor abundance, scale economies, and trade and transactions costs — impact location and investment decisions of workers and firms, including MNEs. Government policies impact the behaviour and

activities of firms and workers through taxation, subsidies, regulation, education and infrastructure.

As a result, it is important to understand how government policies may affect MNE (foreign direct) investment decisions and R&D activities. In 2000, Canada received 4.5 percent of the OECD-wide stock of inward FDI, which, according to Keith Head of the University of British Columbia, is 39 percent more than expected using relative country size

*Foreign direct investment consists of spending in new physical capital (greenfield investment), expansion to existing physical capital (brownfield investment), and mergers and acquisitions (M&As) (change in the ownership of assets).*

as a benchmark. However, Canada’s FDI over-performance accompanied an R&D under-performance, which suggests that foreign multinationals

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investing in Canada opt to do a disproportionate amount of their research elsewhere. On the other hand, Finland, while much smaller than Canada, has attracted rising FDI and R&D activity, and seems to be emerging as a real Northern Tiger.

## *MNEs and Policy Formulation*

A key issue in this area of policy formulation is whether Canada should focus on policies to attract foreign-owned IMRs or on policies to retain domestically-owned IMRs. Larry Schembri from the Bank of Canada argued that we need a policy framework designed to retain domestic IMRs rather than to attract new foreign ones. According to Schembri, foreign-owned IMRs earning high returns already operate in Canada, while potential contributions of new foreign-owned IMRs could be replicated by domestic firms.

spillovers for the Canadian economy. More research is required to determine social gains to Canada from FDI, the interprovincial implications of competition, the impact of government policy on IMR flows, and the effects of North American market integration on IMR flows.

Beaulieu disagreed with Schembri on an assessment of non-economic policy changes required to attract and retain IMRs. Schembri thought that policy makers had shifted their stance regarding FDI in Canada — from suspicion to acceptance — which makes it easier for foreign companies to invest in Canada than in the past. Eugene observed, however, that some government policies still build roadblocks when they create an uncertain investor climate. He pointed to industries in Alberta and southern Ontario that are concerned about the potential impact of Canada's ratification of the Kyoto Protocol.

domestic competitors, suppliers, customers, and the local supply of managerial skills affect what MNEs can learn in one country as opposed to another, this, in turn, may affect their location decisions. Current research at the Rotman School of Management, University of Toronto, grapples with these issues.

## *Regionalism vs. Globalization*

Regional free-trade agreements are one example of how government policy can impact investment decisions of MNEs. Since the introduction of the Free Trade Agreement (FTA) and the North American Free Trade Agreement (NAFTA), Canadian inward and outward FDI flows have grown significantly. Alan Rugman from Indiana University showed that free trade agreements increased intra-regional FDI within the three regional trade blocks formed by NAFTA, the European Union (EU), and Asian countries. However, these increases were not significant. The share of intra-regional FDI increased by only 20 percentage points in the NAFTA and Asian regions over the 1986–1999 period, and by only 10 percentage points for the EU block. Rugman viewed this phenomenon as more consistent with regionalization than globalization. As a corollary, he observed that firms use trade to gain market access between regional trade blocks, while they use FDI to gain market access within trade blocks. Furthermore, only a fifth of the 100 largest MNEs are “global” in the sense that their share of inter-regional sales exceeds 20 percent.

The regionalism enhanced by free trade agreements may limit prospects for increasing our share of trade with Europe, according to Keith Head and

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**“Foreign-owned IMRs in Canada generally raise welfare by increasing the productivity of, and demand for, domestic factors and by creating spillovers through the creation of external agglomeration economies.”**

— Larry Schembri

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Schembri suggested that to attract and retain IMRs, Canada should lower taxes, continue to have low inflation targets, improve health and education services, and expand free international and interprovincial trade. Eugene Beaulieu of the University of Calgary agreed as he too advocated lower taxes and increased investment in education. Beaulieu pointed out that a competitive tax policy package would increase the number of plants located in Canada, and education investment would signal IMRs of Canada's support. Beaulieu also suggested we continue to assess the quantity and quality of IMR

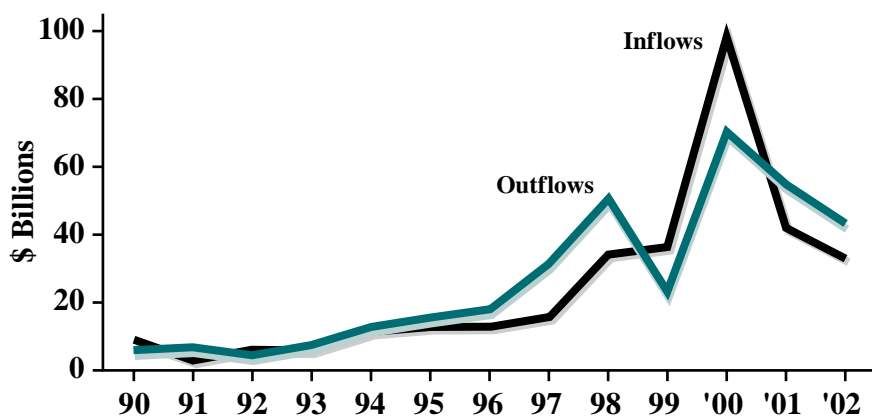
Wendy Dobson of the University of Toronto views MNEs as learning organizations. She pointed out that an analysis of the factors that drive an MNE's decisions may shed light on Canada's paradox of R&D under-performance vs. FDI over-performance in a way that the traditional analysis of MNEs as “black boxes” does not. Furthermore, if the presence of strong

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**“... multinational enterprises should be viewed as learning organizations.”**

— Wendy Dobson

**Canadian Inward and Outward FDI Flows**



Source: Industry Canada compilations based on Statistics Canada data

John Ries of the University of British Columbia. They believe that the U.S. will remain our chief supplier of FDI, and firms will centralize production in their home country, or resort to “branching”, as tariff barriers are eliminated. Edward Safarian of the University of Toronto cautioned against this pessimism, however, noting

that U.S. firms responded to the 1967 Kennedy Round on tariff reductions by revamping their product lines abroad rather than by closing their overseas production. He also noted that the share of foreign ownership in Canadian industry and the Canadian share of global FDI diminished since the FTA/NAFTA. Since MNEs tend to be better

at gauging consumer preferences across regions, investment decisions may be explained by product variety and specialization.

Attracting IMRs to regions in Canada remains one of the main policy challenges, argued Donald Wagner of the University of Prince Edward Island. His analysis discovered an asymmetry in the mobility of resources within Canada. Atlantic Canada has a disproportionately smaller share of R&D investments and of total FDI than other Canadian regions. Government policies should promote industrial cluster formation in areas of low population density and examine survival requirements for firms in remote locations. The experiences of countries such as Ireland, Finland and Singapore may provide insights. In conclusion, Wagner highlighted the importance of finding out what governments can do to support firms in remote locations, whether clusters are becoming more important, and the reasons for R&D clusters in economic hubs.

## Human Capital: Mobility and R&D

**H**uman capital mobility — the movement of highly skilled workers — is an important issue in the study of IMRs. A well trained and educated work force attracts and retains competitive firms, which in turn create long-term employment opportunities. Investment by firms in physical capital, training, innovation and research and development (R&D) enhances productivity and attracts more highly skilled workers, completing this virtuous cycle.

Any policy development with respect to IMRs should take into account the complementary relationships between human capital mobility and FDI, R&D and trade — a point emphasized by Dwayne Benjamin of the University of Toronto.

### *Human Capital Mobility – The “Brain Drain” and the “Brain Exchange” ...*

The loss of highly skilled domestic workers has been a long issue of concern for policy makers around the world. In Canada, much of this concern centres around the “brain drain” of Canadians to the U.S. The fact that Canada loses a disproportionate share of its highly skilled, highly paid workers to the American market also has implications for Canada’s tax revenue base, which in turn finances government policies, such as education and infrastructure development, that attract and retain IMRs.

According to Benjamin, Canada loses more than just numbers of degrees from the emigration of Canadians, since human capital represents entrepreneurial skill and expertise as well as education and knowledge. Simply increasing the quotient of highly skilled immigrants to compensate for emigration is not a solution, since immigrant human capital is not a perfect substitute for native-born human capital. Workers also embody firm-specific and culture-specific knowledge, which enhances economic spillovers and increases the costs associated with their loss when they leave. As a result, net immigration data, which averages the effects of immigration and emigration, is likely to underestimate the social costs of labour mobility. However, these costs are difficult to formalize in models and quantify with data.

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**“We should ignore the reasons why Canadians move to the U.S. in favour of focussing on the factors influencing the mobility of Americans within their own country.”**

— Dwayne Benjamin

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Sound policy development requires a better understanding of the social costs and benefits of labour mobility. Understanding the settlement patterns of migrants and the reasons behind their migration would assist in this development. Benjamin noted that Canadian migrants to the U.S. generally settle in the same U.S. locations as inter-state American migrants. As a consequence, study of the factors that affect the mobility of Americans within their own country would add insight into the Canada–U.S. brain drain. Benjamin also noted the need for occupational data on migration flows to help such research.

The study of movers and stayers in Canada would lend insight into human capital mobility issues facing policy makers. It assesses what types of people remain in Canada, what types leave, and what kinds of policies are likely to attract and retain skilled workers. According to Simon Fraser University’s Don DeVoretz, it makes sense to look at the stocks and flows of highly educated people to and from Canada, which make up the “brain exchange”. DeVoretz specializes in the study of this brain exchange, which he suggested was a simpler method of studying mobility due to the abundance of data and literature concerning movers and stayers in Canada. DeVoretz claimed that Canada, as a nation, acts as a human capital entrepot. Many immigrants to Canada already possess a certain level of human capital, while others wish to acquire it. Canada has succeeded in attracting highly skilled workers. The problem, however, is that policies must be implemented to retain them.

DeVoretz also suggested that some of Canada’s current policies do not always serve to *both* acquire *and* retain highly skilled workers. He examined, specifically, language training and citizenship policies. Canada is an attractive location for immigrants seeking to develop and market human capital because it provides two key services. The first is free language training to all those who require knowledge of an official language to gain access to high-quality jobs or education. The second service is a passport with Canadian citizenship. Free language training increases the incentive to immigrate to Canada, while citizenship provides immigrants with the ability to move freely to other markets.

Policy development should also take into account the loss of high-skilled workers and R&D workers as a result of the phenomenon of “hollowing out”. This phenomenon occurs when a firm — Canadian or foreign-owned — shifts its head office out of Canada, with a corresponding loss of high-value employment. Corporate hollowing out and the loss of high-skilled managerial talent increased dramatically when high-technology start-up firms increased in number. However, Larry Schembri from the Bank of Canada suggested that research in this area should focus more on corporate operations rather

than head office movement itself (e.g. movement of senior executives and R&D personnel).

## *R&D Location Choice*

Canada under-performs the OECD average in attracting private R&D. The U.S., Germany, and Japan collectively performed 72 percent of the OECD R&D funded by industry, which demonstrates that the distribution of R&D activity is highly skewed. Though Canada earned only 3.3 percent of the OECD’s share of gross national income (GNI) in 2000, it boasted almost six percent of the OECD’s population of workers with a post-high school education. However, Canada claimed only 2.6% of the OECD’s population of university graduates which is less than its GNI share.

The movement of knowledge across national borders and the domestic production of R&D and innovation activities are all influenced by factors such as foreign ownership, R&D incentives and clustering. Jeff Bernstein of Carleton University suggested that new knowledge transmission between locations could be as important as creating a new product or process for the first time — which blurs the distinction between the introduction and adoption of new ideas. He discussed the spillover effects of R&D, which cause the benefits from an innovation to extend to other individuals and groups, even across borders. But the knowledge benefits from international spillovers require that domestic or indigenous R&D is “in the game”, since international spillovers are not perfect substitutes for indigenous R&D. As a result, international spillovers may reduce the requirement to attract

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**“... it is inappropriate to look at R&D tax incentives in isolation from the overall impact of a nation’s tax regime.”**

— Iain Cockburn

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IMRs and, at the same time, IMRs can also be a transmission channel for these spillovers.

The location choice of R&D activities is affected by a country's overall tax regime, as well as specific tax incentives. This was a point made by both Bernstein, and Iain Cockburn of Boston University. Bernstein concluded that Canada needs to better understand the determinants of international R&D location decisions, including tax incentives. Cockburn discussed some of the factors that could influence the

R&D location choices of MNEs. He suggested that the important but poorly understood phenomenon of "clustering" needs further research. The recent decision of Novartis to relocate its entire global drug discovery efforts from Basel to Cambridge, Massachusetts, exemplifies the significant influence of clusters. The role of intellectual property (IP) rights also requires more research. However, Cockburn pointed out that evidence of a positive association between stronger IP rules and R&D investment is hard to find, though faster-better-cheaper IP

institutions should be promoted. For example, he suggested that Canada move to automatic acceptance of U.S. patent grants with a fast and low-cost domestic process.

The role of entrepreneurs in the process of cluster formation and R&D activities also requires further research, according to Maryann Feldman of Johns Hopkins University. She viewed entrepreneurs as key agents in cluster formation, but the significance of their role in this process is poorly modelled and understood. Government policy influences cluster formation since large anchor institutions, such as government labs or universities, characterize clusters. These institutions create externalities that lead to traffic in ideas, the creation of pools of entrepreneurs, and investment in R&D and innovative activities.

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**"... location can either confer a growth premium or a stagnation penalty."**

— Maryann Feldman

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## *Next Steps ...*

John Ries concluded the IMR roundtable with a list of future research topics: direct and indirect benefits of inward and outward FDI; spillover benefits of FDI; determinants of R&D location choices; cross-border spillover effects of R&D; the role of industrial clusters in attracting and retaining FDI

and R&D; key drivers of industrial cluster formation; complementarities between FDI, R&D and skilled labour supply; the impact of MNE strategies on domestic firms and workers; international trade agreements and policy challenges; social returns to higher

education; and causes and consequences of increased labour mobility.

In consultation with its stakeholders, roundtable participants and the authors of the overview paper, Industry Canada will prioritize IMR research topics and issue a call for papers.

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## Industry Canada Working Paper 37: National Political Infrastructure and Foreign Direct Investment

There is an emerging consensus among policy makers that a country's economic performance is greatly affected by its political, institutional and legal environment, known as its national political infrastructure (NPI). The NPI consists of investments in effective political, economic and legal governance, and though it is largely seen as the responsibility of the government in most countries, it also impacts the size and effectiveness of foreign direct investment (FDI).

Since FDI is known to positively affect growth and productivity, it is important to consider the impact of NPI on FDI flows. Steven Globerman of Western Washington University and Daniel Shapiro of Simon Fraser University developed six new political infrastructure indices to examine the effects of NPI on both FDI inflows and outflows for a broad sample of developed and developing countries. Industry Canada Working Paper No. 37, entitled *National Political Infrastructure and Foreign Direct Investment*, presents their results. In their study, Globerman and Shapiro analyzed the relative importance of NPI and other types of investments in non-physical infrastructure, such as health, education and environment, on these FDI flows.

The analysis demonstrates that the impact of governance infrastructure on FDI flows diminishes as the size of the economy of a country gets larger. This result suggests that developing countries have the most to gain from improvements in governance. The Globerman-Shapiro model confirms that foreign investors are the most attracted to larger national economies, but governance isn't as big a factor in determining FDI inflows to developed countries. However, improvements in governance in larger

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**“Perhaps our most important conclusion is that political governance matters, and improved political governance does not necessarily oblige governments to make large investments of taxpayers’ money.”**

— Steven Globerman, Daniel Shapiro

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economies do have a positive impact by creating conditions for successful domestic firms to expand abroad.

Of the governance indicators considered, regulatory burden and government effectiveness are the most important determinants of FDI flows. In relatively small and poor countries, more open markets lead to increases in FDI inflows. Though outflows of FDI are not related to a better education infrastructure, evidence suggests that improving the human development index for a country generally raises the magnitude of inward FDI. Therefore, improvements in education may have a positive net effect. The research also notes that there is no evidence that regulations and other conditions in support of a sustainable environment result in capital flight.

Examination of U.S. outward FDI suggests that a firm's FDI location choice involves a two-stage decision process. In the first stage, the firm selects FDI candidate countries. In the second stage, the firm makes decisions about the level of investment in each of the selected countries. NPI is a factor in getting on the short list, but the magnitude of FDI is more highly influenced by aspects of the human development index, with larger shares allocated to countries that have higher levels of health, wealth and education.

In high-technology industries, governance infrastructure is less important than wealth and human capital in the first stage of selecting candidate countries. Data on U.S. outward-bound FDI shows that the link between the amount of FDI and wealth, human capital, language, and telecommunications infrastructure is stronger for high-tech industries than for the total sample of industries.

Globerman and Shapiro's findings challenge the assertion that Canada receives more FDI than average due to our close physical proximity to the U.S. For a country of its size and infrastructure, Canada receives less FDI and has more outward flows than predicted by their model. They suggest that further investigation may reveal unique features of the U.S. economy that may reduce Canada's attractiveness for North American-bound FDI by other countries.

Globerman and Shapiro's evidence also shows that improved political infrastructure contributes to a “virtuous circle” of economic growth, especially for developing countries. Furthermore, to improve regional trade and investment agreements, clusters of nation states that emerge as recipients of specific types of foreign investment benefit from harmonizing features of their political infrastructure across their political jurisdictions.

## Industry Canada Research Volume: Productivity Issues in Canada

Productivity growth is the fundamental driver of long-term improvements in real income and living standards. As a result, the slowdown of productivity growth in Canada and the widening productivity gap with the U.S. generated a great deal of research interest and public debate. The slowdown began with the first oil price shock in 1973, when productivity growth declined sharply in all OECD countries, including Canada. But in addition, throughout the 1990s Canada's productivity growth lagged significantly behind that of its largest trading partner, the U.S.

*Productivity Issues in Canada* is a collection of studies commissioned by Industry Canada to better understand the dynamics of productivity growth in Canada and the reasons for Canada's relatively poor productivity record over the last two decades. Someshwar Rao of Industry Canada and Andrew Sharpe of the Centre for the Study of Living Standards edited this latest research volume,

### Key findings in the productivity volume:

- The Canada–U.S. productivity gap grew in the past two decades as the U.S. total factor productivity growth outpaced Canada's growth.
- In the 1990s, two industries — electronic and other electrical equipment, and industrial machinery and equipment — accounted for most of the growing Canada–U.S. productivity gap.
- The “big three” productivity drivers/levers were investment in machinery and equipment, human capital development, and openness to trade and investment.
- Over the 1989–95 period, tariff reductions under the FTA/NAFTA raised Canadian labour productivity by 0.6 percent per year in the overall manufacturing sector, and by 3.2 percent per year in the most affected industries.
- From 1985 to 1995, Canadian-controlled firms had multifactor productivity levels 19 percent lower, on average, than foreign-controlled firms operating in Canada.
- Service industries, such as trade and finance, are finally experiencing improved productivity growth due to extensive investments in information technologies.

released under the Industry Canada Research Series.

The 25 papers published in the volume are organized into six main sections: productivity trends and

determinants; innovation and productivity; investment and productivity; global linkages and productivity; productivity in the new economy; and social aspects of productivity.



## INDUSTRY CANADA RESEARCH AND PUBLICATIONS

### RECENT RELEASES

Working Paper No. 36: *Foreign Direct Investment and Domestic Capital Formation*  
by Walid Hejazi and Peter Pauly

Working Paper No. 37: *National Political Infrastructure and Foreign Direct Investment*  
by Steven Globerman and Daniel Shapiro

Discussion Paper No. 12: *The Irish Economic Boom: Facts, Causes and Lessons*  
by Pierre Fortin

*Trade and Investment Monitor 2002*

### FORTHCOMING

#### INDUSTRY CANADA RESEARCH SERIES

Volume 11: *North American Linkages: Opportunities and Challenges for Canada*,  
General Editor: Richard G. Harris

#### DISCUSSION PAPER SERIES

Discussion Paper No. 11: *Social Policy and Productivity Growth: What are the Linkages?*  
by Richard G. Harris

Discussion Paper No. 13: *Services in the New Economy: Research Issues*  
by Brian R. Copeland

### DISTINGUISHED SPEAKERS

25 April 2003 **Michel Poitevin**, Université de Montréal  
on *The Progressivity of Equalization Payments in Federations*

2 May 2003 **Alan Krueger**, Princeton University  
TBD

16 May 2003 **Avinash K. Dixit**, Princeton University  
TBD

30 May 2003 **Arvind Panagariya**, University of Maryland  
TBD

13 June 2003 **Edward Prescott**, University of Minnesota  
on *Why do Americans Work so Much and Europeans so Little?*

Spring or Summer 2003 **James M. Poterba**, Massachusetts Institute of Technology  
TBD

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