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Canadian Foreign Direct Investment: Recent Patterns and Interpretation

by Steven Globerman

Summary

- Foreign Direct Investment (FDI) is a prominent feature of globalization. It occurs when an investor resident in one country acquires management control of an enterprise located in another country.
- FDI inflows improve the efficiency of the host economy, and increases in those inflows suggest that the host economy is a relatively attractive location for international investment.
- FDI outflows are less straightforward to interpret. Efficient multinational companies can increase their revenues and profits by expanding into foreign markets, and increases in outward FDI can therefore signal a healthy investment environment in the home country. However, it might also reflect a deteriorating environment for capital investment at home from which companies are exporting capital investment.
- One reasonable interpretation of available data is that increasing rates of inward and outward FDI identify a relatively favourable domestic environment for capital investment. Conversely, decreasing rates of inward FDI accompanied by increasing rates of outward FDI identify a deteriorating environment.
- An examination of inward and outward FDI flows for Canada from 1990 through 2017 shows that inward FDI flows to Canada relative to other developed countries declined substantially from 2015 to 2017, while outward FDI flows from Canada increased relative to other developed countries over that period.
- This data supports a conclusion that the Canadian economy has become a less attractive location for capital investment in recent years relative to other developed economies.

Introduction

Foreign direct investment (FDI) is a prominent feature of globalization. It is a specific form of cross border capital flow in which an investor that is resident in one economy has ownership control of, or a significant degree of influence on, the management of an enterprise located in another economy. This is distinct from portfolio investments in which foreign investors are passive holders of debt or equity issued in another economy.[1] While there is no unique threshold for determining when a foreign investor enjoys effective control over the management of an enterprise located in another economy, the statistical convention is to consider an investment direct, as opposed to portfolio, if the level of ownership of the foreign investor is greater than or equal to 10 percent of the ordinary shares of the enterprise in which the investment is made (OECD, 2008).

Inflows of either portfolio capital investment or FDI enable a country to increase its investment in productive assets such as machinery and equipment without necessarily increasing its savings. However, unlike portfolio investment, new management techniques, new products and production processes, and new organizational structures typically accompany inflows of FDI. Consequently, the host economy benefits from efficiency improvements, including domestically owned firms that can adopt new technology introduced by foreign investors.[2] These "spillover" benefits from inward FDI are augmented by competitive benefits. Specifically, the entry of foreign-owned firms often increases levels of competition in domestic industries, which leads to additional gains in productivity (Globerman, 1979). In short, inflows of FDI help build and upgrade host country industries. They also connect the host economy to international markets through increased international trade and help drive competitiveness and innovation (UNCTAD, 2018).

A variety of factors influences the attractiveness of any host economy to foreign investors by affecting the expected net (of taxes) profitability of investing in a specific location. The factors vary in importance depending upon the business activity in question. For example, the choice of location for investments in natural resource activities will be heavily influenced by the availability of relatively low-cost mineral deposits, as well as the security of property rights and the royalties and other taxes imposed by the host government. Location decisions in the case of investments in knowledge-intensive businesses are primarily influenced by the availability of educated scientists and engineers, intellectual property protections, income tax rates, and the presence or absence of technology clusters.[3]

While the importance of specific factors varies depending upon the nature of the business, foreign investors are concerned with maximizing their expected return on their investments, as are domestic investors. Since foreign investors typically have a set of locations from which to choose, the degree to which an economy attracts inward FDI reflects expectations of how profitable it is for foreign companies to do business in that economy relative to other economies. It seems fair to characterize a

1 This is a well-accepted definition of FDI as provided in International Monetary Fund (2009).

2 For an extensive discussion of the benefits of inward FDI to the host economy, see Harischandra, Palacios and Clemens (2007).

3 For a discussion of the factors influencing the location choices of multinational companies investing abroad, see Dunning (2009).

country experiencing increased inflows of FDI relative to other countries as promising greater profitability or, in more common parlance, being increasingly competitive as a location for capital investment.

It is less straightforward to interpret changes in outflows of FDI. In the case of Canada, outflows of FDI reflect ownership or controlling investments by Canadian companies in assets located outside of Canada. On the one hand, if Canadian companies invest outside of Canada, one might interpret their actions as evidence of greater expected profitability associated with increasing ownership of assets outside, rather than inside, Canada. That is, outward FDI flows might be a signal that Canada's investment environment is becoming less attractive compared to other locations, which would be consistent with also seeing decreased inward FDI. On the other hand, successful multinational companies (MNCs) invest abroad to improve their efficiency and/or to exploit firm specific assets in foreign markets.[4] Their success in foreign markets might, in turn, reflect a domestic environment that is supportive of capital investment and other initiatives that improve productivity.[5] In the latter case, increased outward FDI allows domestic companies to increase their sales and profits, thereby benefiting the home economy. This interpretation of increased outward FDI is consistent with accompanying increases in inward FDI.

The alternative possible interpretations of changes in outward FDI imply that any evaluation of a country's attractiveness to investors that relies upon FDI flows should consider both inward and outward FDI behaviour in conjunction. For example, if one observed that both inward and outward FDI flows increased for Canada, relative to other countries, one might be inclined to conclude that Canada is becoming a relatively more attractive location for capital investment. In particular, firms based in Canada might be leveraging a relatively supportive domestic environment for productivity performance through profitable investments outside of Canada. However, if increases in outward FDI from Canada relative to other countries were accompanied by decreases in flows of FDI into Canada compared to other countries, the pattern would be more consistent with an interpretation that Canada is becoming a less competitive environment for capital investment and for improvements in the productivity of domestic firms.

This essay presents and examines Canadian FDI (both inward and outward) from 1990 through 2017 with a particular focus on how Canada's experience compares to other developed countries, particularly the United States. Our main finding is that Canada's FDI performance changes quite noticeably in recent years from earlier years. Specifically, inward FDI flows to Canada relative to other developed countries declined substantially from 2015 to 2017, while outward FDI from Canada increased relative to other developed countries. This pattern suggests that the Canadian economy has become a less attractive location for capital investment in recent years relative to the United States and other high-income countries. As such, it supports previous research that has called attention to a "competitiveness" problem in Canada insofar as capital investment is concerned (Globerman and Press, 2018).

4 For some evidence showing that outward FDI and domestic capital investment are more typically complements rather than substitutes, see Globerman (2012).

5 Globerman and Shapiro (2005) discuss these alternative interpretations in the context of international mergers and acquisitions.

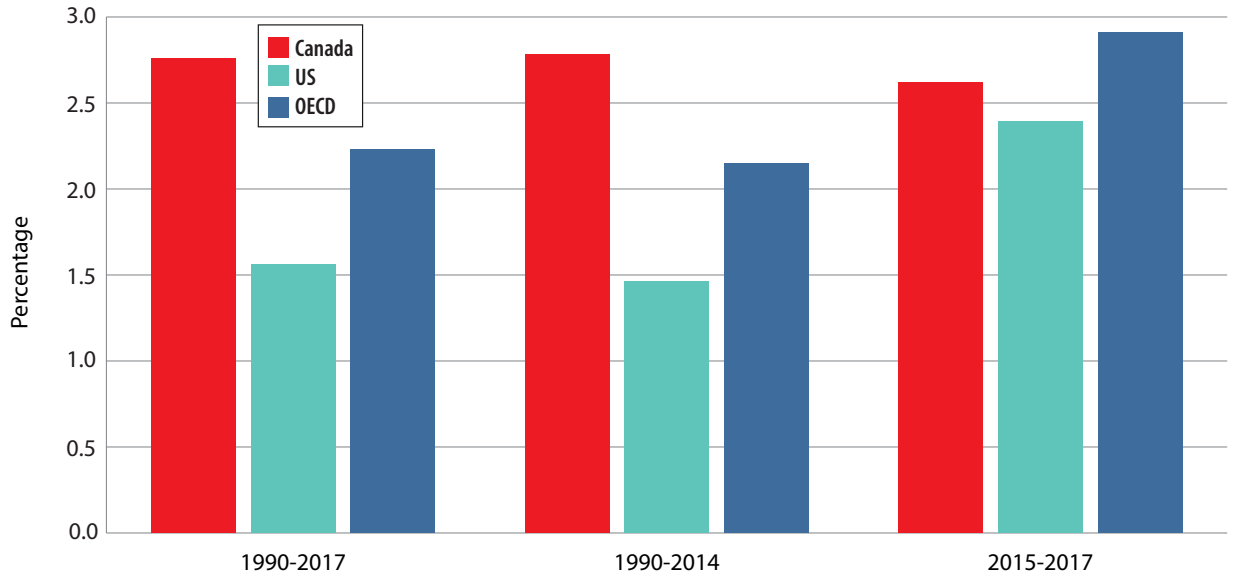
The essay proceeds as follows. Section 1 presents and discusses data on inward FDI flows for Canada, the United States, and the group of countries comprising the Organisation for Economic Co-operation and Development (OECD). Section 2 presents and discusses data on outward FDI flows for the same sample of countries. Both inward and outward FDI flows are measured relative to the Gross Domestic Product (GDP) of the country (or group of countries). One main finding is that inward FDI relative to GDP decreased in Canada compared to other countries in recent years. A second finding is that outward FDI from Canada relative to GDP increased in the same years compared to other countries. Section 3 discusses the degree to which Canada's recent FDI experience is specific to a narrow set of industries or a more general industrial phenomenon. The final section of the essay provides concluding comments.

1. Canada's Inward FDI Experience

Historically, Canada has been a prominent recipient country of inward FDI flows. This observation is supported by the data summarized in **figure 1**, which reports the ratio of inward flows of FDI expressed as a percentage of Gross Domestic Product (GDP) for Canada, the United States and all of the OECD countries including Canada and the United States.[6] The data in figure 1 are reported starting in 1990 to reflect the implementation of the Canada–US Free Trade Agreement in 1989. The implementation of the bilateral free trade agreement could be expected to alter the investment environment in Canada, such that comparisons of data

6 The OECD countries essentially encompass all of the wealthy developed countries of the world. The data for both inward and outward FDI as a percentage of GDP are from The World Bank (2018).

Figure 1: Inward FDI as a Percentage of GDP (annual average)



Source: The World Bank, 2018.

pre- and post-1990 are likely to be misleading.[7] Standardizing the monetary value of inward FDI flows relative to GDP implicitly adjusts for differences in country size and, therefore, the level of economic activity. Larger and faster-growing economies attract more capital investment, both from domestic and foreign investors, than do smaller countries, other things constant (Culem, 1988).

Over the full period 1990–2017, Canada has a higher ratio of inward FDI to GDP than does the United States. Canada's ratio is also higher than that of the OECD as a whole.[8] However, it is clear from the data in figure 1 that recent inward FDI patterns differ from earlier patterns. Specifically, the ratios for 1990–2014 are quite comparable to those for the full sample period. Indeed, the ratio for Canada is slightly higher for the 1990–2014 period than for the full period, while the reverse is true for the United States and the OECD countries. This suggests that Canada's ratio declined relative to other developed countries over the period 2015–2017, and this inference is supported by the data in the last column of figure 1: while inward FDI as a percentage of GDP declined in Canada's case, it increased quite substantially in the cases of the United States and the OECD from 2015–2017.

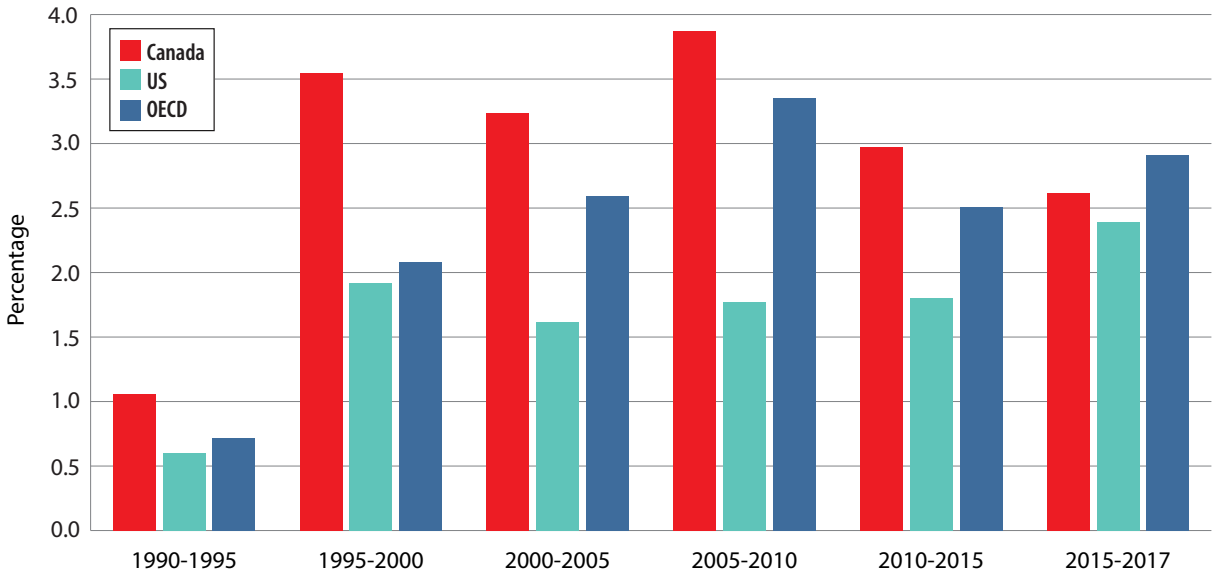
Figure 2 breaks down the period from 1990 to 2017 into sub-periods to assess whether the recent experience of 2015–2017 is unique. While Canada's ratio is higher than the US ratio in every sub-period, the US ratio is closest to the Canadian ratio in the 2015–2017 sub-period.[9]

7 For evidence documenting the substantial effect that the Canada–US Free Trade Agreement had on industrial productivity in Canada, see Trefler (2004).

8 The hypothesis that there is no difference between the Canada and US ratios can be rejected with 99 percent confidence. The hypothesis that there is no difference between the Canada and OECD ratios can only be rejected with 80 percent confidence.

9 The Canadian ratio of inward FDI to GDP is only 10 percent higher than the US ratio from 2015–2017. The next closest sub-period is 1980–89 when Canada's ratio is about 30 percent higher than the US ratio

Figure 2: Inward FDI as a Percentage of GDP (annual average, various periods)



Source: The World Bank, 2018.

Canada's ratio of inward FDI to GDP is higher than that of the OECD in every sub-period save 2015–2017. The data presented in figures 1 and 2 therefore support the concern expressed in a number of earlier studies that Canada's investment environment deteriorated substantially in recent years compared to other developed countries.[10]

It might be noted that while Canada suffered a significant absolute decline in inward FDI flows in 2017, so too did other developed countries. Specifically, the US dollar value of FDI inflows to Canada in 2017 was approximately 65 percent of the value in 2016. For all developed countries, the US dollar value of FDI inflows in 2017 was around 63 percent of the 2016 value. To this extent, the 2017 Canadian experience with inward FDI was not unique. However, the comparison is less favourable to Canada when the period 2015–2017 is compared to the preceding three years. In Canada's case, FDI inflows over the period 2015–2017 were approximately 63 percent of the value of FDI inflows over the period 2012–2014, whereas the same statistic was approximately 139 percent for all developed economies.[11] This further illustrates Canada's relatively weak performance in attracting inward FDI over the past few years.[12]

10 Globerman and Press (2018) discusses other studies and present some original research. It is noteworthy that the convergence of the inward FDI to GDP ratios for Canada and the US post-2014 occurred while the growth rate of GDP from 2014 to 2017 was faster in the US than in Canada (11.8 percent and 7.4 percent, respectively). This underscores that the convergence of the ratios is due to a decrease in the growth of inward FDI to Canada relative to the US.

11 These estimates are the author's calculations from data provided in UNCTAD (2018: Annex Table 1). By way of additional comparisons, inward FDI flows for 2015–2017 were almost double the inflows for 2012–2014 in the case of the United States and around 23 percent higher in the case of the European Union.

12 Others have also made this point. See, for example, Grubel (2018).

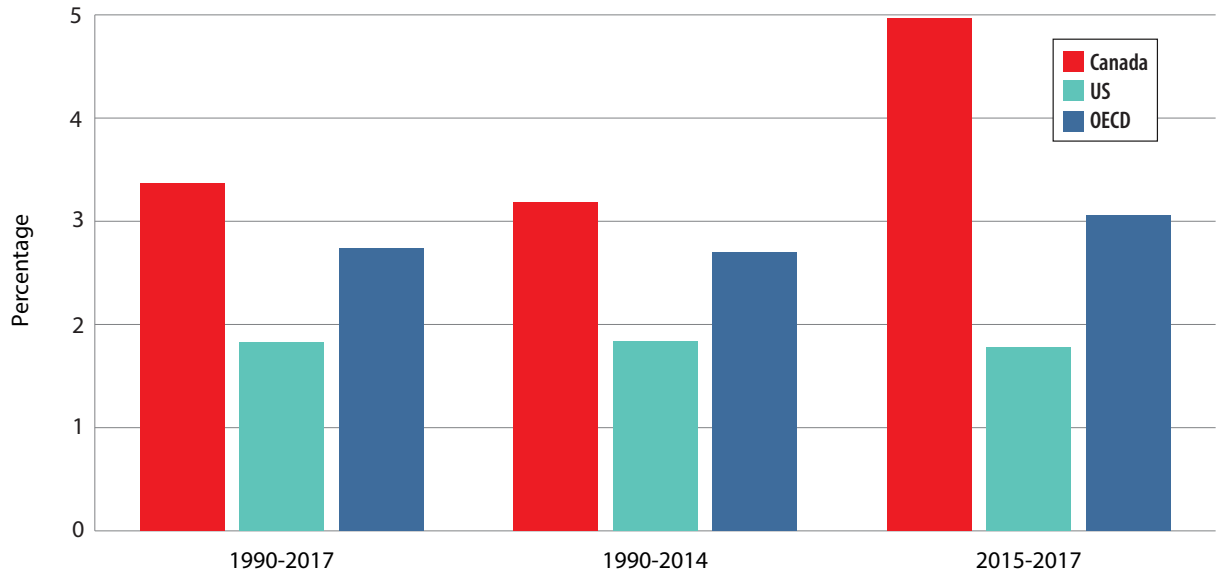
2. Canada's Outward FDI Experience

Figure 3 reports outward FDI as a percentage of GDP for Canada, the US, and the OECD for the full period 1990–2017, as well as for 1990–2014 and 2015–2017. It is apparent that Canada has been more "outward FDI- intensive" than the US or the OECD for the full period, as well as for the two sub-periods.[13] However, Canada's "outperformance" by this measure is substantially larger for the 2015–2017 sub-period than for the 1990–2014 sub-period. Specifically, Canada's ratio of outward FDI to GDP is almost three times greater than the ratio for the US during the period 2015–2017, while it is less than two times greater during the period 1990–2014. Canada's ratio of outward FDI to GDP is 162 percent higher than the ratio for the OECD for 2015–2017, whereas it is only 118 percent higher than the ratio for the OECD for 1990–2014.

The relatively large increase in outward FDI as a percentage of GDP for Canada compared to other developed countries over the past few years seems consistent with an interpretation that the relative investment environment in Canada deteriorated. As noted earlier, outward FDI can reflect competitive advantages enjoyed by domestic firms that are partially exploited by acquiring companies based in foreign markets and operating those firms more efficiently and profitably. However, it seems highly unlikely that companies based in Canada became substantially more competitive relative to companies based in other developed countries in a few recent years, especially given earlier evidence that Canada's inward FDI intensity declined relative to other developed countries over the same period.

13 The differences between Canada and the US and Canada and the OECD are both statistically significant at the 99 percent confidence level for the full period. The small number of observations for 2015–2017 precludes doing difference of means tests for the shorter period.

Figure 3: Outward FDI as a Percentage of GDP (annual average)



Source: The World Bank, 2018.

As with FDI inflows, it is useful to see if the behaviour of outward FDI flows for Canada for 2015–2017 compared to other developed countries was experienced in earlier periods. Relevant data reported in **figure 4** clearly indicates that outward FDI as a percentage of GDP for Canada compared to other developed countries reached its highest value in the 2015–2017 sub-period. Specifically, Canada's ratio of outward FDI to GDP was almost three times higher than the US ratio, as was noted earlier. The next closest sub-period was 2000¬–2005, when Canada's ratio was almost two and a half times the US ratio. Canada's ratio of outward FDI to GDP was around 152 percent higher than the OECD's ratio for 2015–2017. This is greater than the relative difference during the 2000–2005 (140 percent) or 1995–2000 (144 percent) sub-periods. Hence, while the 2015–2017 outward FDI experience differs from earlier sub-periods more markedly when comparing Canada to the US than when comparing Canada to the entire OECD, it supports the basic conclusion drawn from inward FDI data. Namely, Canada's economy has become less attractive for capital investment compared to other developed economies in recent years.

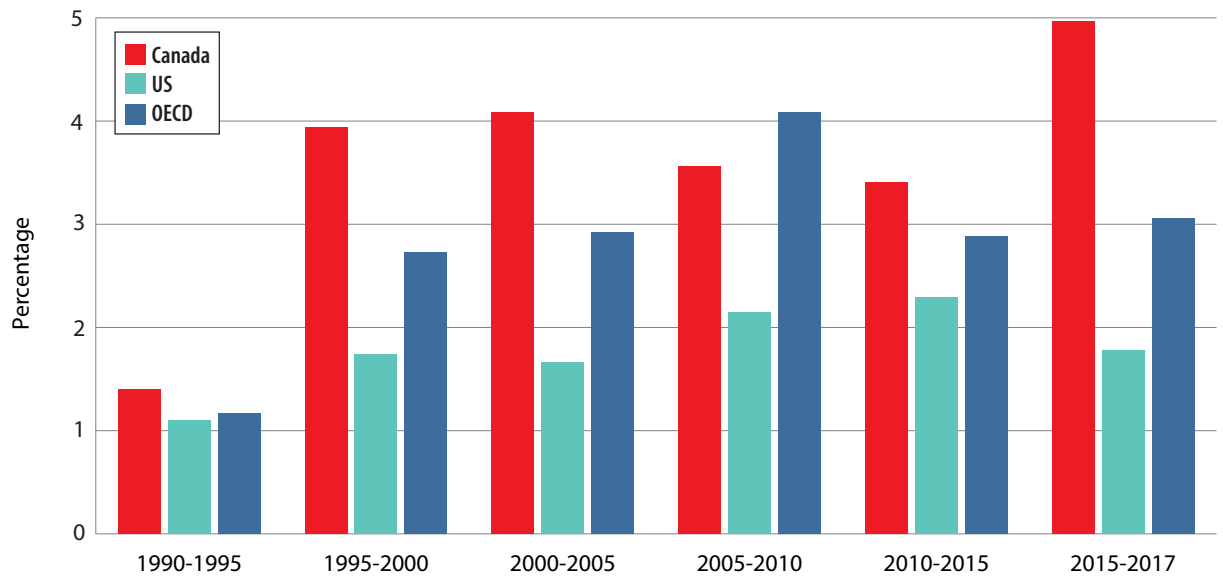
Sectoral Patterns

It is informative to consider whether Canada's overall FDI experience in recent years reflects the performance of a few specific industries or whether it is more broadly based. In this regard, the substantial decline in the price of crude oil post-2014 could be expected to reduce both foreign and domestic investment in Canada's energy sector.[14] While public policy in Canada has little effect on world oil prices, transportation capacity problems associated with pipeline approval delays have led to a widening gap between realized prices in Canada and world prices, which does reflect policy decisions that arguably further weakened the attractiveness of investing in Canada's energy sector.

With respect to inward FDI for Canada, the two main host industries are mining and oil

14 The price of crude oil on the world market declined from around US$105 per barrel averaged over the period 2011–2014 to around US$48 per barrel averaged over 2015–2017. See <https://www.statista.com/statistics/262858/change-in-opec-crude-oil-prices-since-1960/>.

Figure 4: Outward FDI as a Percentage of GDP (annual average, various periods)



Source: The World Bank, 2018.

and gas extraction and manufacturing (Statistics Canada, 2018a). Together, these two sectors accounted for approximately 50 percent of the total book value (or stock) of foreign direct investment in Canada in 2014. Perhaps not surprisingly in light of declining prices for crude oil mentioned earlier, the book value of foreign direct investment in the mining and oil and gas extraction sector in Canada was absolutely lower in 2017 than in 2014. Specifically, the book value in 2017 was about 93 percent of the book value in 2014. The stock of inward FDI was also absolutely lower in 2017 than in 2014 in the case of the manufacturing sector. The book value for manufacturing was around 88 percent of the book value in 2014.[15] Other industries besides mining and oil and gas extraction and manufacturing also experienced decreases in the book value of inward FDI between 2014 and 2017. They include utilities, construction and retail trade. Hence, Canada's FDI performance over the period 2015–2017 does not exclusively reflect declining profitability in the oil and gas sector.[16]

The finance and insurance sector accounts for the single largest share of the book value of outward FDI for Canada. Its share was almost 37 percent in 2014. Mining and oil and gas extraction accounted for an additional 21 percent. The book value of outward FDI for finance and insurance in 2017 was approximately 28 percent higher in 2017 than in 2014. In the case of mining and oil and gas extraction, the book value of outward FDI in 2017 was only about 1 percent higher than in 2014. In fact, every Canadian sector identified at the two-digit level using the North American Industrial Classification system had a higher book value of outward FDI in 2017 than in 2014. On an overall basis, the book value

15 The largest decline in the manufacturing sector was experienced by the primary metal manufacturing industry. For this industry, the book value of inward FDI in 2017 was only about one-third of its 2014 value.

16 Conversely, the stock of inward FDI increased by about 36 percent in the case of wholesale trade and by approximately 38 percent in the case of finance and insurance.

of outward FDI was almost 33 percent higher in 2017 than in 2014, whereas the book value of inward FDI in 2017 was only about 11 percent higher than in 2014.

For reasons discussed earlier in this report, the faster growth in the book value of outward FDI than for inward FDI post-2014 is more suggestive of a decline in Canada's attractiveness as a location for capital investment compared to other countries than of an improvement in the competitiveness of Canadian companies compared to companies headquartered elsewhere.

Data reported in **table 1** provide some additional support for this interpretation of inward and outward FDI flows for Canada. Specifically, table 1 reports an index for capital and repair expenditures on non-residential tangible assets in Canada. The index is created using 2009 as a base year. Since we are concerned with a substantial decline in Canada's investment attractiveness in recent years, it is not necessary to create the index for the full period starting in 1990. The results reported in table 1 show that capital and repair expenditures on physical assets relative to expenditures in 2009 peaked in 2014. The index values for 2015–2017 are below the 2014 value. Furthermore, the small estimated increase in the index value for 2018 compared to 2017 suggests that the relatively unfavourable environment in Canada for capital investment continues to persist.[17]

Table 1: Capital and Repair Expenditures, Non-residential tangible assets

Year	Index Value
2009	100
2010	113.4
2011	122.2
2012	129.5
2013	133.1
2014	141.4
2015	130.6
2016	119.5
2017	123.1
2018	124.0

Index: Base year = 2009.

Source: Statistics Canada, 2018b; author's calculations.

Concluding Comments

Inward FDI inflows to Canada decreased consistently post-2014 when measured in current US dollars. Indeed, this source of capital inflow for 2016–2017 was about 47 percent of the value for 2013–2014. Conversely, FDI outflows from Canada were higher post-2014 than in earlier periods. For example, Canadian outward FDI in 2016–2017 was 28 percent higher than in 2013–2014. By itself, these data suggest that the environment for capital investment in Canada worsened significantly in the past three to four years. This interpretation is supported by the data summarized in **figure 5**, which shows a growing divergence between inward and outward FDI flows in recent years. Specifically, figure 5 shows that inward FDI flows, while positive, were progressively smaller in recent years, while outward FDI flows were progressively larger.

Since global macroeconomic factors may also have altered the investment environment elsewhere, it is appropriate to evaluate the Canadian FDI experience in light of the experiences of other developed countries. After standardizing FDI flows for differences in the GDPs of the

17 The 2018 value of capital and repair expenditures reported by Statistics Canada relies on surveys of investment intentions.

Figure 5: FDI Flows (US$ billions)

Source: The World Bank, 2018.

countries being compared, we show that Canada's inward FDI intensity decreased in recent years relative to other developed economies. Conversely, Canada's outward FDI intensity increased relative to the same countries. These findings suggest that Canada's environment for capital investment deteriorated relative to other developed countries in the post-2014 period.

A marked decline in the world price of crude oil certainly contributed to a decline in stock of inward FDI in Canada's oil and gas sector in recent years. However, the stock of inward FDI also declined post-2014 in several other domestic industrial sectors including manufacturing. This observation suggests that Canada's recent FDI experience reflects factors beyond a declining price of crude oil. Specifically, the much faster growth of overall outward FDI compared to inward FDI post-2014 points to a deterioration of Canada's domestic environment for capital investment compared to other developed economies.

Data are available for Canada's FDI inflows and outflows for the first three quarters of 2018 (Statistics Canada, 2019a). They show that flows of inward FDI in the first three quarters of 2018 increased compared to the first three quarters of 2017 by some 55 percent. Conversely, outward FDI flows in the first three quarters of 2018 were only about three-quarters of the value of such flows for the first three quarters of 2017. In isolation, these data suggest an improvement in Canada's investment environment in 2018. How much of this change in FDI performance is due to an increase in the world price of crude oil through the first three quarters of 2018, and how the collapse in that price in the last quarter of 2018 will affect Canada's FDI performance, are open questions. Hence, whether Canada's overall capital investment environment is improving after a worrisome past few years is also an open question pending additional data that permit an international comparison.

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Steven Globerman *is Resident Scholar and Addington Chair in Measurement at the Fraser Institute as well as Professor Emeritus at Western Washington University. Previously, he held tenured appointments at Simon Fraser University and York University and has been a visiting professor at the University of California, University of British Columbia, Stockholm School of Economics, Copenhagen School of Business, and the Helsinki School of Economics. He has published more than 150 articles and monographs and is the author of the book* The Impacts of 9/11 on Canada-U.S. Trade *as well as a textbook on international business management. In the early 1990s, he was responsible for coordinating Fraser Institute research on the North American Free Trade Agreement. He earned his BA in economics from Brooklyn College, his MA from the University of California, Los Angeles, and his PhD from New York University.*

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