Outline of Proposed Modifications in Price and Profit Guidelines under the Anti-Inflation Act

May 25, 1976

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Outline of Proposed Modifications in the Guidelines for the Restraint of Prices and Profits

Price developments since the Anti-Inflation program was introduced have been encouraging. Analysis of the application of the present guidelines indicates, however, that modifications are needed in order that they will continue to provide a basis for effective price control in the future. The modifications summarized here will increase the overall effectiveness of the price restraint and ensure that the degree of restraint which was originally intended will be achieved. They will also provide a more even distribution of restraint among firms.

The impact of the present guidelines on individual firms varies widely. Some firms are not subject to adequate restraint on their future pricing decisions. By contrast, other firms are subject to excessively severe restraint, to the point where the pricing action necessary to ensure compliance could have seriously harmful effects not only on these firms, but also on their competitors. If action is not taken to overcome these problems, while maintaining overall restraint on prices consistent with the objectives of the program, increasing difficulties will be encountered.

Both the choice of rules available at present to firms and the impact of the various bases in the existing rules have led to difficulties.

Under the present guidelines for the non-distribution sector the impact of the unit cost rule (Section 16) can be very different from that of the product line or the overall net margin rules (Sections 17 and 18). Under Section 16, the base against which compliance by a firm is determined is unit profits in its fiscal year prior to the introduction of the program, or unit profits on or about October 13, 1975. On the other hand, the base for the net margin test in Sections 17 and 18 is the five fiscal years prior to October, 1975. The effective difference between the bases under the two rules can be very substantial indeed, with the result that broadly similar firms find themselves in widely differing positions under the present guidelines.

Even within an existing single rule, the position of individual firms is not necessarily the same. The impact of the five-year base that is available under Sections 17 and 18 can vary greatly among firms, depending on their own experience during those years and in the subsequent period up to the introduction of the program. Thus a firm whose net margin was significantly higher in 1975 than on average during the five years included in the base may be subject to very substantial restraint in relation to its position at the start of the program. At the other extreme, a firm whose margin had tended to decline and was lower in 1975 than over the preceding five years may have available very substantial room to raise prices before the guidelines impose a limitation.

The rule for distribution activities provides for only one base, the 1974 fiscal year. Nonetheless, the impact of that single base varies among firms.

A Uniform Net Margin System

The best way to overcome the problems noted above is to establish a uniform type of rule to which all firms will be subject. The one approach having general application among firms is a net margin rule of the same character as in three of the four existing rules. The net margin rule is an effective technique of price restraint and provides broadly similar treatment to all. It should be noted that companies having roughly 80 per cent of the gross revenues of all businesses subject to mandatory compliance are now subject to the net margin rules. The basic net margin test will apply at the level of the total operations of the supplier.

However, suppliers having both distribution and non-distribution activities will be required, as at present, to treat these two activities separately. The distinction must be maintained in order that these different kinds of business may be subject to rules appropriate to each kind of activity. The calculation of the overall net margin test will be made separately for distribution and non-distribution activities.

This overall net margin test provides the best assurance of general pricing restraint consistent with the objectives of the program. However, many firms sell a variety of products and customarily organize these products into product lines. It is necessary to maintain a product line rule in order to tie permitted price increases to related cost increases. For both distribution and non-distribution activities, firms that have not already established product lines for purposes of the program will be required to do so where this is appropriate. Firms that have already established product lines will be required to maintain them. A margin test will also apply to these product lines.

Because pricing practices are different in distribution than in non-distribution activities, different margin tests will apply to product lines in the two activities.

> In distribution businesses, the test for product lines will be on the basis of gross margins. A gross margin test is used for distributors in the present rules, but it applies at the level of the distributor as a whole rather than to product lines.
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> For non-distribution businesses, the product line test will be a net margin test.

(A gross margin is the difference between the price which the distributor receives and the price which the distributor pays for the goods he sells. The pre-tax net profit margin is the difference between the price received by the firm and all the costs which it incurs. As used here, the terms refer to these margins expressed as percentages of sales.)

The Base Periods and Compliance Tests

All firms will be able to use, as base periods, either the five fiscal years prior to October 14, 1975 (specifically the base now used in Sections 17 and 18), or the most recent fiscal year ended prior to May 1, 1976. Either base may be selected for each product line net margin and for the overall net margin.

Excess revenue, that is, revenue in excess of that permitted by the guidelines, will continue to be the basis of assessing whether a firm has complied with the guidelines.

Firms will be required to calculate excess revenue, both on the overall basis and by totalling excess revenue for their individual product lines. Excess revenue for compliance purposes will be the larger of these two amounts.

The degree of restraint on prices is determined by the percentage figure which is applied to the relevant margin in the base period. Under the present net margin rules for non-distributors, that figure is 95 per cent. The new base period provisions would result in an easing of the total restraining impact of the program if the permissible margin were maintained at 95 per cent of the base period margin. In order to ensure restraint consistent with the objectives of the program, the percentage for non-distribution activities will be reduced to 85 per cent, at both the product line and the overall level.

For distribution activities, the gross margin for product lines will be 100 per cent, the same as in the gross margin test that now applies to a distributor's total business. The net margin applied to the total distribution business of a supplier will be 95 per cent. The introduction of distribution product lines will give distributors the opportunity to improve their overall gross margins through the choice of base periods and changes in the mix of their product lines.

Deductions from Excess Revenue

Excess revenue arising from the application of the margin rules may be reduced by deductions which recognize unacceptably low base period operating results and, in the case of non-distributors, from the application of specified pricing and productivity rules. The specific provisions dealing with these two important questions will be detailed at the time the draft regulations are released.

Interim Pricing and Prenotification

The changes outlined above will provide an improved basis for the continuing control of prices. The basic pricing rule will continue to be that firms must price their products in such a way as to avoid excess revenue. The prior notification system that has been used by the Board is an effective monitoring technique and has increased the pricing discipline on firms. This system will continue to be used but the Anti-Inflation Board intends to substantially increase the number of firms that are required to give it prior notification of price increases. The prenotification procedures will require careful and complete elaboration by the supplier of any prospective developments that he may advance to justify price increases.

Restricted Expenses

It is proposed to amend the rules for "restricted expenses". Charitable contributions will be deleted from this section, as will expenditures for research and development that are certified by the Department of Industry, Trade and Commerce for 100 per cent deductability under the *Income Tax Act*. Political contributions will be added to the list of restricted expenses.

Other Proposals

Trappers and Fur Farmers

Trappers and fur farmers are to be made expressly exempt from the application of the guidelines. This will place them in a position parallel to farmers and fishermen whose farm gate or wharf-side prices are exempt from the controls.

Construction

The provision whereby construction prices established through competitive bidding by firms employing less than 500 persons are exempt will now apply to all firms in the construction industry which are subject to the Anti-Inflation guidelines.

Land

To ensure the continued availability of land for development, and to apply the guidelines more fairly, a revision is being made to apply the guidelines only to the appreciation in land value since October 14, 1975.

Implementation

The draft regulations will be issued shortly. It is intended that the new guidelines will become effective in July. The amendments will include transitional rules which will recognize that price actions may have been taken prior to May 26, 1976 which were allowable under the old rules but which would generate excess revenue under the new rules.