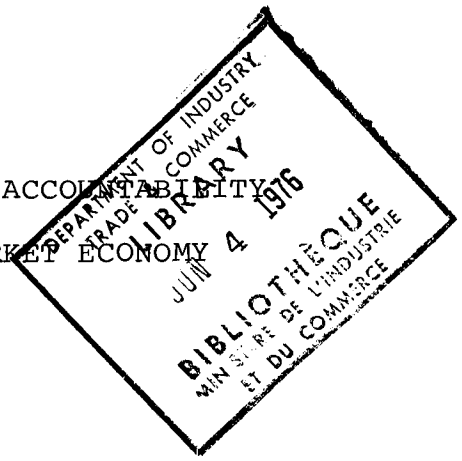
dynamic change and accountability in a canadian market economy

Proposals for a Further Revision of Canadian Competition Policy by an Independent Committee Appointed by the Minister of Consumer and Corporate Affairs

DYNAMIC CHANGE AND ACCOUNTABILITY IN A CANADIAN MARKET ECONOMY



Proposals for the Further Revision of Canadian Competition Policy by an Independent Committee Appointed by the Minister of Consumer and Corporate Affairs

BY

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with

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In Consultation With

Mr. Michel Bélanger
Mr. Reuben M. Bromstein
Mr. William O. Twaits

March 31, 1976

Minister of Consumer and
Corporate Affairs
Ottawa/Hull

Dear Sir:

Your Committee, having completed its task of considering the Stage II Revision of the Combines legislation, submits herewith proposals for such further revision.

L.A. Skeoch

M. Bélanger

R. Bromstein

B.C. McDonald

W.O. Twaits

PREFACE

The tortured legislative development of Canadian combines law between 1889, when Parliament first legislated in this field, and World War II will be familiar to many who read this Report and we do not propose to review it here.* Important substantive and procedural amendments were subsequently passed in the early 1950's and in 1960, but by the 1960's it was widely acknowledged that a fundamental reassessment of policy was required.

In 1966 the Economic Council of Canada was asked to study and report upon Canadian competition policy "in the light of the Government's long-term economic objectives". The Economic Council's Report was issued in 1969, and in 1971 the government introduced Bill C-256, based largely on the Council's proposals, as a further basis for public discussion. An extensive and open dialogue ensued between governments, the business community, consumer groups, economists, lawyers and others. This process of public policy making resulted in the adoption of a two-stage approach to the need for new legislation. Stage one, which was introduced in Parliament in November 1973 and eventually enacted effective January 1, 1976, dealt with those areas on which a substantial consensus had emerged during the 1971-1973 period. Stage two was to result from further study and discussion of the more contentious matters, namely, those of a broader industrial organization nature. This report constitutes that study and hopefully will contribute to the discussion.

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* A brief summary of this history can be found in Report to the Minister of Justice of the Committee to Study Combines Legislation (Ottawa, 1952), pp. 9-14.

In the spring of 1975 the Minister of Consumer and Corporate Affairs asked us, as a group of individuals from the private sector, to consider certain subjects, being the primary areas of continuing difficulty, and to assess the options and make recommendations. The specific matters we were asked to consider were mergers, monopolization, price discrimination, loss-leader selling, rationalization and export agreements and interlocking directorates. Essentially, what we have done in our report is to recommend a broad policy reorientation for this aspect of Canadian industrial organization and to elaborate upon the way in which that policy can be made operational in the context of the subjects we were invited to consider. The Canadian economy and its requirements are unique. Public policies and systems of administration designed by other countries to meet their particular requirements from time to time are interesting and sometimes instructive, but are of little detailed use in designing a system for Canada. We have sought to offer proposals that will most effectively facilitate long-run dynamic change within the Canadian economy, that will encourage the adoption of real-cost economies, and that will discourage restraints which result from mere market power rather than from superior economic performance. These are general but fundamentally important long-run goals. In recommending laws to help achieve them it is of equal importance not to oversimplify the complex workings of a market economy.

In making our proposals for new federal legislation in this field we have not attempted to second-guess the courts as to the restrictions imposed by constitutional law in the 1970's except to take account of the clearest and most firmly established constraints. Our concern has been to deal with the requirements of this nation's economic system as we see them.

We were not requested to consider what further specific amendments, if any, might be made to the conspiracy provisions of the Combines Investigation Act, nor did we concern ourselves directly with matters such as the position of labour under the Act, reciprocal buying, refusals to buy, vicarious criminal liability, or various evidentiary and procedural items that arise from the existing legislation. We did, nevertheless, feel constrained by the interdependent nature of a market economy to comment on some matters that were ancillary to the subjects specifically within our mandate.

In order to assist public evaluation of our proposals we have included "discussion drafts" of legislation covering the substantive matters of widest interest and concern. We have neither sought nor obtained the assistance of professional draftsmen in the government service for this purpose, and the drafts must not be taken as representing current government policy any more than any other part of the report.

This report has been written by Lawrence A. Skeoch, an economist, and Bruce C. McDonald, a lawyer. Each was primarily responsible for writing those portions of the report calling most heavily upon his discipline or knowledge, which placed much the greater part of the burden upon Dr. Skeoch, although they worked closely together throughout the study on the entire report. The three advisory members of the committee met with them, as and when appropriate, to discuss the framework and ideas of the report and to comment in detail upon successive drafts. This frank and open consultative process concentrated more on the substantive content of the report than on the particular form in which ideas or arguments were expressed, and the measure of agreement between the members of the committee was itself remarkable. (Except to the extent of Mr. Bromstein's separate statement), the report reflects the views of the entire committee.

DYNAMIC CHANGE AND ACCOUNTABILITY IN A CANADIAN MARKET ECONOMY

I

Introduction

INTRODUCTION

Alternative Approaches to Industrial Organization Policy

Concern about the adequacy and relevance of public policy relating to industrial organization and restrictive trade practices has become apparent in a number of countries, not Canada alone, within the past few years. In part, this may represent a response to specific problems in industrial organization, and, in part, it may reflect a broad concern about developments in the economy which derive from a variety of economic and social sources. It may be, for example, that there is a need for more effective economic transformation, generally, in a few sectors, or in specific regions. It may be that there is a desire to develop firms capable of competing in large foreign markets and of meeting import competition with a lower level of tariff protection. It may be that the process of innovation is less vigorous than is desired, that some aspects of the role of the multinational firm have created concern, and so on.

In addition, in most industrialized countries the marked inflation of recent years has raised suspicions that prices are being determined by groups with substantial economic power which are engaged in a contest, not to increase productivity, but to outreach each other in price increases. The winner, like Professor John R. Commons' famous islanders who tried to raise their living standard by forcing each to take in the other's washing at higher prices, is the one who raises his prices first and highest. The problem of inflation is however a multidimensional one, with political, social, and economic roots; the contribution that combines policy -- with its medium-term perspective in terms of calendar time -- can make to its amelioration in the short-run is likely to be limited.

In the longer term, the issue for the business sector becomes that of how significant is industrial market power (monopolistic pricing) as a factor contributing to rising prices. The OECD study* concluded that there were two major areas in which the impact of high levels of market power might be felt: higher profit margins, and asymmetry in the behaviour of prices. With respect to the former, they found that for the United States (but not for European industries as a whole) "there is reason to believe that attempts in a few industries to raise rates of profit at high levels of sales, or to have a lower break-even point, contributed to the rise of industrial prices that occurred."

As for its importance as a cause of rising prices, the OECD experts found that the danger of aggressive pricing to raise profit margins was a limited one.

> "It can add fuel to the fire in inflationary situations. But it is not likely to be the starting cause, nor can it be a cause of continuously rising prices. In this respect, an increase in profit margins differs from an increase in wages; there can be a wage-price spiral but there cannot be a profit-price spiral for the simple reason that the dampening effect of higher prices on output and sales would be immediate when consumers' incomes were not rising. Moreover, a deliberate raising of profit margins is necessarily limited at any time to a few industries - there is no 'profits round'."

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* William Fellner, Milton Gilbert, Bent Hansen, Richard Kahn, Friedrich Lutz, Pieter de Wolff, The Problem of Rising Prices (O.E.C.D. 1961), pp. 69-72.

The more significant problem posed by the existence of high levels of market power is the tendency to asymmetry in price behaviour; that is, that "prices are not only sticky but are readier to respond to a rise in costs or demand than to a fall". This "ratchet effect", although serious, is likely, unless reinforced by other factors, to be short term in character.

To deal with this element in rising prices, the O.E.C.D. experts recommended that action be taken to insure that firms are limited to the size required "for exploiting the real economies of large-scale operations". They also emphasized the importance of effective enforcement of existing programs to restrict the exercise of monopolistic power, and of studies of the pricing practices of large enterprises. They had little confidence in the long-term effectiveness as a price-reducing mechanism of discussions between governmental authorities and industry of proposed price increases. In fact, they felt that such a procedure might reduce downward price flexibility by making entrepreneurs reluctant to lower prices for fear of being unable to raise them should conditions later change.

The growth of foreign competition had made an important contribution to maintaining pressure on prices, and the experts urged that this factor "should not be offset by protective measures or by international cartellisation".

Apart from the influence of high levels of market power in industry on inflation, the O.E.C.D. experts made recommendations relating to both labour and agriculture. With respect to wages, they concluded that:

> "the problem of inflation from administered prices would be minor indeed if a situation were reached in which average wage increases were confined to the limit

> allowed by the average increase in productivity and excess demand pressures were avoided."

Although we perceive -- as is indicated below -- certain practical difficulties in implementing such a productivity-related policy, its general approach is undoubtedly valid.

With respect to agriculture, they found that agricultural prices, during the period covered, had not contributed significantly to rising prices, but they added this cautionary comment:

> "Nevertheless, we are of the view that rigid price support or indexation schemes are undesirable, and policy for agriculture, as much as for any other sector, must be adjusted in the light of the wider economic interests of the economy and of the changes in the circumstances of agriculture, including its own productivity growth and trends in world markets."

Thus, if the contribution of combines policy to the amelioration of inflationary pressures in the short-run is unlikely to be important, in the longer term, effective enforcement of combines policy in relation to all groups in the economy has the potential to make a significant contribution.

Apart from such specific concerns about the impact of monopolistic forces, there has developed a degree of scepticism about the theoretical groundwork on which legislation in this area has been based. Statements to the effect that the purpose of the legislation is to "foster and preserve competition and thus promote efficiency" are to an increasing degree considered to lack operational content. "Competition" is a word that means too many things to too many people.

One writer in this field, Professor Robert A. Solo, has delivered a particularly caustic judgment on "the sterility of economic thought and policy" in this area in the United States.

> "In fact, the attack on monopoly has foundered of its own ineptitude, although the ritual threats continue.... The multifaceted dynamics of technological advance and industrial transformation - the underpinnings of increased productivity - are almost wholly excluded from the normal purview of establishment economics." (Saturday Review, Jan. 22, 1972, p. 48).

Other writers have expressed objections to the use of refined static microeconomic concepts, which they consider not to be operationally relevant to the broad evidence in the specific industrial situation under consideration. Dean E.T. Grether has summed up his views in the following sentences:

> "Possibly in the process of refining concepts, of drawing sharper and harder lines, and, especially, in seeking more exact measures and indicia, we have moved away from reality instead of towards it. Possibly our beautiful taxonomies with their simple logic and symbolism may be doing more for the ego of the craftsmen than for basic understanding and wisdom." (In Oxenfeldt (ed.), Models of Markets, p. 140.)

K.W. Rothchild leans in the same direction with his rather discouraging comment on oligopoly

analysis that it is "better to be vaguely right than precisely wrong."*

Doubts about the adequacy and significance of refinements in theoretical analysis and awareness of the multi-dimensional character of many of the issues in industrial organization policy, suggest the need for caution in tinkering with the institutional and organizational structure of the economy. Where reasonably clear-cut problems can be detected relating to such basic elements as flexibility and adaptability in the economy and the related area of artificial barriers to entry and change, then prompt and effective remedial action is obviously called for. With experience, we may reasonably expect to build up effective policies to deal with such matters, not only in the area of combines policy, but in tax policy, tariff policy and other areas as well. In general, this is the type of analysis which calls for a combination of sophisticated theory and operational practicability, particularly since it relates to likely future developments. Forecasting, a Dane has said, is difficult - particularly about the future. Indeed, determining what changes have taken (and are taking) place and identifying the forces that have caused them always presents a serious challenge. This is, of course, one element that makes economic history such a fascinating field of study.

It is perhaps worthwhile to remind ourselves that the earliest and basic task of economic theory was to demonstrate and analyze the interrelations by which a market system joined individuals and groups in society to the origin and distribution of the social product. The most important function of economic analysis was to show how a social

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* "Price Theory and Oligopoly", Readings in Price Theory (American Economic Association, 1960), p. 464.

phenomenon results from individual acts, how market, quantity and price flow from the behaviour of thousands of buyers and sellers in accordance with rules of economic rationality. This emphasis on the interconnection of the various elements in the total economy of a country is what continues to make economic theory so relevant to the analysis of policy problems - even if the psychology employed was oversimplified and the adjustment processes more subject to friction and rigidities than was frequently assumed. After all such allowances are taken into account, such a theory still creates awareness of the effects of any policy decision on all groups in society, not merely on some special interest group that may be backing it. It is all too easy to forget that the market economy involves an organic and historical process that conditions developments over the entire economy* and through extended periods of time. Because we cannot, as a practical matter, trace the actual steps by which the process is carried out, there is a tendency to overlook the fact that rigidities and protected positions in one sector of the economy are likely to have an adverse effect on other sectors - say, export markets - which are apparently unrelated. Even apart from the impact on individual markets, rigidities have a general effect in that great elasticity and adaptability among its various parts is one of the essential requirements of an economic

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* It should be added that nothing can be much more confusing than to treat political states as though they were full-fledged economies. Economy is "political" only in the sense and to the degree that states intervene with taxes, regulations and protection for economic and non-economic purposes. The economic system includes the sources and markets for raw materials, the markets and sources of supply for finished goods and services, and the sources and outlets for capital.

system in which technical and organizational change is rapid. Unfortunately, the bias of governments is to protect established interests rather than to facilitate change. Professor S.H. Frankel argues that:

> "National governments became the bulwark of the status quo in economic affairs, the ready ally of all those who clamoured for security for themselves at the expense of the insecurity of others -- at home and abroad.... They became the bulwark of pseudo-security -- that security, namely, which is based on the inhibition of change in the economic structure. They allied themselves not with the dynamic forces of industrialism but with those who clamoured for protection against it."*

This does not provide a case for a return to something akin to laissez-faire; quite the contrary. The problem is how to facilitate the process of change by policies of general application and at the same time to assist the individual to adjust to the changes that do occur. The cost of change today is very often so great that the individual is unable to meet it. The appropriate approach is, however, not to protect the individual against the change by preventing change but to assist the process of change by, for example, providing certain income guarantees and by developing programs to rehabilitate workers with obsolete skills and local communities heavily involved in declining industries. By innovative policies of this general character, the essential functions of a market economy could be renovated and strengthened.

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* S.H. Frankel, "World Economic Solidarity", The South African Journal of Economics, Sept. 1942, p. 179.

The development of such policies -- and others proposed, for example, in the section of this report dealing with structural rationalization -- are obviously not the primary responsibility of the Bureau of Competition Policy. We emphasize, again, that these should be policies of general application and that they should not take the form of inducements that are directly selective, industry by industry and product by product, since this would amount to detailed central direction by the government.

It is against such a general policy background that the recommendations in this report have been made. It is only realistic to concede that other proposals have been put forward by individuals and groups for very broad changes in the relationships between government and the economy in the area of industrial organization.

It is not possible to undertake a full review and evaluation of all such proposals but there are three broad types of policy that merit brief comment:

(1) that government should exercise a general control and direction over economic decision-making;

(2) that a high degree of reliance should be placed on the "reasonableness" of control groups;

(3) that there should be "guidance" by government in the form of recommendations as to conduct.

Comprehensive Government Control

The twin facts, that there exists a fairly high level of oligopolistic concentration in many industries and that labour unions have achieved high concentrations of economic power, are advanced

as justification for government either breaking up these concentrations of power or adopting thoroughgoing and comprehensive government controls.

If we wish to continue under our present political institutions and with an economy based largely on private enterprise, it is important that oligopolistic concentration should not be greater than is required by real-cost factors. To undertake to keep concentration below levels dictated by such factors would, however, mean, as Fellner has pointed out, that we would be attempting to organize our economic activities with deliberate inefficiency, and that would be a condition difficult to impose in the long-run. There seems little likelihood, however, that real-cost factors would impose such a high level of concentration, but the problem is of such potential importance that action to deal with detrimental mergers and the abuse of monopoly power requires prompt attention.

To attempt to break up unions is neither a desirable nor a practical objective. Unions are not susceptible, as are mergers and monopolies, to tests to determine how far they are based on real-cost considerations and how far on artificial exclusion. At the same time, unions cannot be exempted from facing the test of the abuse of monopoly power any more than any other economic unit or any group exercising joint dominance. Certainly, as Dean Mason has remarked,

> "There is really not much basis in either logic or experience for believing that an unimpeded economic struggle among large-interests groups will lead to socially acceptable results. Government can, in fact, go rather far in limiting the acts of unions in pursuit of their interest without substantially damaging the collective bargaining process. The view that a free enterprise economy implies no

> constraint of the self-interest pursuits of economic units has as little validity for labour as it has for business."*

This conclusion is reinforced by the finding of the O.E.C.D. panel of international economists that,

> "The standard of living of workers has been scarcely affected by changing relative shares but it has been greatly affected by rising productivity."**

Hence, both in the long-run interest of society and of unions themselves, unions must face the test of the abuse of monopoly power in terms of imposing artificial restraints and preventing the achievement of real-cost economies (as discussed in more detail in the merger and monopoly sections of this report). We consider the time long overdue for testing the meaning of the Canadian provision (section 4(1)(a) of the Combines Investigation Act) exempting "combinations or activities of workmen or employees for their own reasonable protection..." -- just as we consider the effective enforcement of merger and monopoly provisions long overdue. A clear line should be drawn between legitimate union activities for improving wages and working conditions, and illegitimate activities which interfere with dynamic change - in such matters as new technology, new organizational methods, and the like. As we argue throughout this report, the cost of

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* E.S. Mason, Economic Concentration and the Monopoly Problem (Harvard U.P., 1957), p. 210.

** William Fellner et al., The Problem of Rising Prices (O.E.C.D., 1961), pp. 322-3.

such change must be borne by society as a whole (which gains from dynamic change) rather than being imposed in undue degree upon those who are directly affected by it. Unions do, in the final analysis, constitute an aspect of economic concentration, and the question is how far such concentration can go and still preserve our present political system. Where there is a variety of economic power groups, and if their operations partly neutralize one another, settlements can still be reached by democratic methods. The recent tendency to rely not on democratic procedures but rather on the action of pressure groups which seek to impose arbitrary terms on society, even if this may mean the suppression of basic freedoms and the breakdown of social peace, does, however, raise extremely difficult problems.

Government not only has the responsibility but it alone, in a democratic society, has the authority to see that institutional arrangements are made that will assure that in this age of big-unit economic organizations no group employs its economic power to undermine the conditions necessary for economic progress and for orderly economic life. Government in a democratic society must equally avoid detailed intervention, although since "self-discipline and sweet reasonableness" will not always prevail, it must reserve the right at times to exercise broad disciplinary pressure.

The validity of Adam Smith's strictures, that state intervention tends to result in large and enduring errors, whereas the errors of free economic enterprise in addition to being more transient in their manifestations and of smaller scale, are likely to neutralize one another; that governments are spendthrifts; and that governments are inherently inefficient in administration because their agents are paid out of state funds and not out of the proceeds of successful administration — these strictures, which are as true today as they were 200 years ago, caution against government direct participation in the management of the economy.

As we argue elsewhere in this report, the performance of government -- not only in Canada -- in managing nationalized or regulated industries, in the selection of private-sector projects for financial assistance, in determining a "correct" level for wages either when intervening in stalemated strikes or for its own employees -- does not engender confidence in the claim that it should assume a major role in economic decision-making for the economy as a whole.

Nevertheless, there is a tendency to maintain that the speed of economic change and the extent and complexity of economic knowledge required by the head of state to enable him to take the speedy action which a modern economy requires cannot be reconciled with the slower processes of democratic discussion and the formulation of laws of general application. From this view, it is a short step to having the government conclude formal or informal economic arrangements with powerful, self-conscious groups in society, and then to present what is more or less a fait accompli to the legislature. A short step in another direction would involve handing over to a technocracy (of economists?) within the government the authority to specify the terms on which the strategic economic decisions for the society would be made. Much of this type of thinking has an intellectual affinity with the view that there is some trick of technique or administration which, if properly understood, would make the economy work in a more orderly, productive fashion than do the untidy, and often disruptive, processes of the market.

Implicit in all these approaches is a belief in a system that is heavily dependent on a small number of very able individuals (in current jargon, an elite) operating at the peak of their competence and under the most favourable conditions. For a number of reasons -- political and social, as well as economic -- it is a sign of greater wisdom and human understanding to rely on a system in which

there are checks and balances which limit the opportunities for any individual to make decisions which affect the whole system. In the real world, there are always indifferent administrators, plausible and over-zealous economists, persuasive but ineffective businessmen and politicians -- some of whom by one means or another appear to be able to get their hands on the levers of power.

In a perceptive comment, Tibor Barna has identified a special situation bearing on this general issue which, of course, is not limited to the business community:

> "A successful businessman has a high degree of imagination but he also has a great sense of reality. The unsuccessful businessman may also be imaginative and energetic; but he fails to distinguish the world of his imagination from reality and he fails to show special skills in using resources. He does not want to obtain the information on business conditions which would be at variance with his world of imagination or, if he is given the information, he shrugs it off.
>
> "The extreme absence of a sense of reality among businessmen is to be found in the greatest cases of fraud in business history. Although they appear as cunning, calculating individuals, they are in fact men living in a world of their own imagination which they are unable to distinguish from reality. They believe in this world with such intensity

> that they can carry others with them until, sooner or later, disaster overtakes them."*

The same analysis applies to the doctrinaire purist, and to the person who believes strongly that "my doxy is ortho but your doxy is hetero" -- whatever his occupation may be. The system should be devised in such a way that extreme views and incompetent individuals have the least possible chance of doing harm. A market economy in which the dynamic variables are kept free, with a fairly freely functioning price system, meets these requirements in greater measure than any other system we know. That government will best promote private economic welfare and economic progress in all sectors of the economy which avoids detailed intervention in the economy with its accompanying scope for power and adopts as "the prime rule of economic policy... that it should grope forward by means of methods which are as general as possible."** The role of general rule-maker is, of itself, sufficiently demanding to test the competence of even the most able administration.

A substantial measure of support for this view still leaves scope for debate about the extent to which concentrated oligopolies do, in fact, reinforce one another. Professor Robert A. Brady, a close student of business power, while pointing out that leading businessmen have become important political figures, went on to emphasize that their economic objectives were not always compatible.

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* Tibor Barna, Investment and Growth Policies in British Industrial Firms (Cambridge U.P., 1962), p. 58.

** Erik Lundberg, Business Cycles and Economic Policy (Harvard U.P., 1958), p. 337.

Profits are often differential gains - gains which represent definite losses to other business firms. Similarly, businessmen frequently cannot agree on tariffs, the exercise of monopoly power, or the price, production and marketing policies of trade associations, and so on.*

Indeed, the basic concept of "economic power" is one lacking clear and effective definition. There tends to be a vague feeling that very large firms or financial interest groups possess the "power" to impose their will on individual markets. Evidence to support such a view is difficult to obtain and assess, but occasionally evidence does come to the surface to raise doubts about its validity. For example, Argus Corporation is frequently identified as one of the major centres of financial power in Canada, with E.P. Taylor as its head for many years. One of Mr. Taylor's pet projects was the creation of Canadian Breweries Limited as the dominant firm in the Canadian brewing industry, with further ambitions for its expansion into international markets. By the early 1950's, he had succeeded, through a lengthy series of mergers, in establishing Canadian Breweries as the dominant firm in Canada with some 65 per cent of the market in Central Canada and with a substantial foot-hold in Western Canada, as well as more modest foot-holds in the United Kingdom and the USA. This position was buttressed by what were claimed to be substantial barriers to entry in the form of economies of scale in production and promotion. Canadian's largest competitors enjoyed, respectively, 18 per cent and 12 per cent of the Central Canada market, with only limited interests elsewhere. Yet in spite of the dominant position

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* Robert A. Brady, The Rationalization Movement in German Industry, (Berkeley, Calif., 1933), p. 370.

of Canadian and the "power" of Argus Corporation in the background, Canadian Breweries steadily lost ground to its smaller rivals, until it dwindled to the smallest of the three, and the firm that had formerly held about 12 per cent of the market climbed to the top position. It was not for want of trying that Taylor and Argus Corporation suffered this devastating and costly defeat. This one incident does not, of course, "prove" the absence of power in large financial organizations; it does suggest that popular beliefs about the advantages of size may require qualification.

In any event, as Fellner emphasizes, in order to deal with such "centers of power",

> "In the economically and politically successful communities few persons would want to substitute a single, all-powerful group for the more or less organized groups with which we are faced. The 'radical' enthusiasm for this extreme degree of concentration rests on utopian stories about the characteristics of the group which would take over. These are in the nature of fairy tales."*

Apart from the political aspects of such a move, there is little likelihood that the present rate of technological and organizational change could be maintained with these over-all governmental controls. Democratic governments by skillful management can promote equilibria among the groups and at the same time protect the interests of the individual. The possibility of opening up domestic markets to outside market pressures should, for example, be of assistance in neutralizing

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* W.J. Fellner, Competition Among the Few, (New York, 1960), p. 326.

concentrations of market power; the exploration of other innovative devices working in the same direction merits special attention.

Reliance on the "Reasonableness" of Control Groups

Since it was introduced by Gerard Swope in 1926, "managerialism" or business "statesmanship" has experienced a fluctuating but persisting level of attention from policy makers, businessmen and academics.* The aspect of this program of most direct interest to industrial organization policy is that relating to prices and wages. Business management, it is claimed, should be concerned with adopting a policy on prices, wages and profits which will be "fair" to consumers, shareholders and employees -- and also, presumably, to other businessmen. In other words, the role of business is to adjust conflicting interests according to some vaguely defined criterion of justice. To the extent that this end was achieved, it would tend to follow that what was good for business would be good for the country. Apart from the question of how this criterion of justice is to be defined, there are certain implications of this position that many would be reluctant to accept. These have been described by Professor M.A. Adelman in the following passage:

> "Responsibility implies authority. If corporate management really has the duty to mediate among stockholders, consumers, and workers, it follows that the typical large corporation charging administered prices has a monopoly, either singly or with a group....

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* See, e.g., James W. McKie, Social Responsibility and the Business Predicament (Brookings Institution, 1975).

"Business statesmanship means that what Congress does on a large scale with farm prices the corporation executive does on a smaller scale with his prices....

"That is the meaning of the large firm as a political organism. To change prices, to introduce or not introduce new products or new methods, to raise or lower output: all this is no longer a matter of what course of acion will be more or less profitable, but which will better suit the criteria of statesmanship....

"Note finally that the act of corporate statesmanship will determine the reward -- the salary and fringe beneifts -- of the statesman. Or it may be an act of joint statesmanship, as Mr. Reuther would wish, both management and labour setting both prices and wages. It may be that justice or sound policy is best accomplished by giving the judge or the policy maker a direct money stake in the outcome of his decision. But I doubt it.

"It seems, therefore, that 'business statesmanship'... turns out to be persuasion to treat large business and administered prices as needing at the very least, government regulation and supervision, perhaps on public utility 'cost' principles."*

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* M.A. Adelman, "What is 'Administered Pricing'?", in Administered Pricing: Economic and Legal Issues (National Industrial Conference Board, Inc., 1958), pp. 24-26.

Professor Eugene V. Rostow also makes the point that "the new corporate morality" may result in prices that undermine the market mechanism and distort the allocation of resources. Such pricing practices could also make the task of monetary and fiscal authority more difficult in controlling general fluctuations of trade.*

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* "To Whom and for What Ends is Corporate Management Responsible?", in E.S. Mason (ed.), The Corporation in Modern Society (Harvard U.P., 1960), pp. 46-71.

Cf., the comment by the Swedish Confederation of Trade Unions:

"We wish to make it clear that this co-ordinating work is not intended to be a method whereby the Government tries to persuade industry to accept social or other obligations that are not commercially justified, but simply a way of trying to co-ordinate structural evolution on economic grounds. If the Government wishes industry to accept non-commercial obligations these must be made the subject of special agreement, and business firms must be compensated for any extra costs that arise in the process." Economic Expansion and Structural Change, A Trade Union Manifesto, edited and translated by T.L. Johnston (London, 1963), pp. 164-5.

Reference will be made from time to time in this report to Swedish policy in industrial organization, primarily because it is a small, private enterprise economy with economic problems not unlike those facing Canada. In economic matters, perhaps the major difference between the two countries - apart from size and lower tariffs in Sweden - lies in the considerably higher level of private ownership of the means of production and distribution prevailing in Sweden. In social policy the gap is wider.

Perhaps of equal importance to the economic aspects, many people would consider it an inappropriate responsibility for private business with its economic resources deliberately to influence the course of the country's social development.

There is insufficient evidence that the market mechanism has lost so much of its effectiveness as to justify such an arbitrary alternative being put in its place. Nor is there any indication of how such "fair" prices would affect adaptability, flexibility, and technical and organizational change in the economy.

"Guidance" by Government

Guidance which takes the form of the notion that government needs additional powers to make ad hoc recommendations on appropriate economic conduct has little to recommend it. The public sector at present has ample devices to render the private sector amenable to its desires. Furthermore, the government has the continuing responsibility to see that institutional arrangements are made that will encourage the private sector to adopt patterns of conduct that will promote dynamic change and avoid artificial restraints. These arrangements are embodied in laws of general application to be interpreted by the courts or by administrative agencies. For example, on the matter of the government holding labour unions and corporations answerable for the economic consequences of their wage and price policies, combines legislation can presumably deal with abuse of monopoly power in pricing, and the extension of some similar form of action to the labour market should not require a major innovation in public policy.

Intervention based on quick administrative decisions should, in principle, be avoided to the greatest extent possible, since it tends to grow of

itself. Legal insecurity is also an inevitable consequence of this type of guidance or direction, as is discriminatory treatment.

Another form of guidance that has been proposed would consist of a continuous monitoring system in which a statistical measure - commonly a price index or a productivity index - would be used as the basis for setting boundary limits for certain strategic decisions. There is an obvious appeal about such proposals, especially in an economy plagued by inflation and stalemated labour market negotiations. The difficulties associated with their use are less obvious but nonetheless serious, especially if they are resorted to frequently as a substitute for the pressures and stresses of the market economy. Where such a measure is seen as a very crude rule-of-thumb to be used only as a last resort, it may do little harm. Where it is capable of technical and theoretical refinement with a view to being applied by a technocracy of economists in detailed economic decision-making - as productivity measures are sometimes claimed to be - the potential damage to the market economy will be serious.

Productivity Measures as a Policy Tool

One measure that is proposed by some policy advisers as potentially valuable for important decisions in public policy - notably those relating to wage policy - is a statistical measure of productivity. There is an obvious policy appeal about a concept which undertakes to measure how efficiently production is carried on, how much output is achieved for each unit of input. Productivity can, in fact, be measured in terms of any one of a variety of inputs that are combined in the manufacturing process into products or output. For a variety of reasons -- that are not necessary to review here -- the input factor most frequently taken as a yardstick is a man-hour of working time. It is essential to keep in mind that, even when

reported in terms of man-hours, productivity includes all elements which can contribute to more efficient use of labour-time in production;* it does not reflect the efforts of labour alone. In practice, it is impossible to separate the contributions of each factor in achieving increases in productivity, hence it is equally difficult to reward each factor according to its exact contribution.

Changes in productivity are not always easy to interpret. Steiner and Goldner explain that,

> "The greatest error that can be made in interpreting productivity measures is to assume that every increase in productivity is an indication that all is well, and every decrease an indication that something is wrong. While productivity increases do result in real benefits, this is not always the case, and it is necessary to go behind the figures to understand the basic economic conditions that have produced the changes."**

Long-period changes in productivity, based on industrialization and technical change, saving and investment, risk-taking and organizational change, and improvement in labour skills, can be taken as evidence of improvement in the economic situation of the industries involved, or of the economy as a whole. Short period changes are more difficult to

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* For a detailed discussion of questions involved in measuring productivity, see Peter O. Steiner and William Goldner, Productivity (Berkeley, Calif., 1952), pp. 9ff., and Productivity Measurement Review (O.E.C.D., Oct. 1961), passim.

** Op. cit., p. 31.

interpret. Productivity in manufacturing increased from 1929 to 1931, for example, due to the fact that employment decreased faster than output. In other cases, a decline in productivity may accompany periods of high level output.

Leaving aside for the moment the question of the usefulness of measures of productivity calculated at different levels of aggregation - whether at that of the individual, the group of workers, the plant, the firm, the industry, or the entire economy - we may examine briefly how the gain from an increase in productivity might be distributed. As background, it should be recalled that much, although precisely how much is difficult to say, of the increase in productivity is social in origin. That is, the educational system, scientific advances, public investment in transportation, and the like, make important contributions to productivity which may affect industries in divergent ways.

The gain in productivity may be distributed according to a number of possible formulae.*

(1) The productivity gains can go to the employees in the form of higher wages.

(2) Higher prices can be paid for raw materials, thus passing on the benefits of higher productivity to the raw materials suppliers.

(3) Prices of finished goods can be reduced, generalizing the distribution of the productivity gain among consumers.

(4) Profits can be increased, if wages, and prices of raw materials and finished goods remain unchanged.

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* See Steiner and Goldner, op. cit., p. 50.

(5) The benefits of gains in productivity can be distributed equally among the factors of production if each factor receives the same percentage increase in payment for its service.

Wage increases may come about in three ways. First, they may take place in accordance with real gains in productivity, in which all groups share. Second, labour may increase its proportion of income at the expense of some other group(s). This possibility is limited by the ability of other groups to defend their share, and also because labour costs are a high proportion of total costs. Third, wages as well as other forms of payment may rise if the price of the product rises. But this route may not confer real gains if the prices of goods and services rise in proportion to the payments to the factors.

"In a time when inflation is a major fear it is not surprising that a wage policy limiting increases to those consistent with advances in productivity should be frequently suggested."*

Even if such a general approach were to be adopted, its application would present a number of problems. Without elaborating upon the details, such problems hinge on the question of whether a number of specific measures of short-term changes in productivity should be used to determine wage differentials in different jobs, plants, firms, industries, and sectors, or whether some over all average measure of productivity, say, for the economy should be used for all wages. Maladjustments will be created no matter which basis is used which

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* Ibid., p. 53.

may seriously interfere with dynamic change and adaptability in the economy. The obvious longer-run connection between returns to the factors of production and productivity cannot readily be translated into specific prices for goods and factors of production in short-run conditions, which is, of course, the problem of current policy.

Furthermore, what is involved in market relationships is not necessarily relative measures of productivity but the "competitiveness" of the firms involved. As Nabseth has pointed out: "Changes take place all the time in the relative frequency of innovation, in the quality of products, in the ability to keep delivery dates, etc., which influence the competitive situation apart from changes in cost."* Favourable performance in terms of such considerations may permit a rise in wage costs per unit of production which may have nothing to do with "productivity". In other words, the yardstick of productivity is neither unambiguous nor reliable. The effectiveness of a firm can always be assessed simply by looking at the results obtained in the marketplace. To rely on a technical measure of productivity to determine costs and incomes in detail carries within it elements of serious rigidity. Even as a rough guide for wage policy it is probably inferior to estimates of the general level of wages that would be consistent with reasonable price stability.

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* Lars Nabseth, "Changes in the Competitiveness of Swedish Industry - Some Reflections", Skandinaviska Enskilda Banken Quarterly Review, (2/1974), p. 71.

Shifting Bases for Policy in Industrial Organization

For some years, Canada, along with many other countries, has been passing through a period of intense self-examination with respect to both economic policy and general social purpose. Although a reasonable concern with social, political and economic health is normal and rational in any society, the recent fondness for continuous pulse-taking might appear to the critical observer to be verging on hypochondria. Our anxiety-makers discover new ailments, real or imaginary, almost weekly - and there are miracle workers ready in almost all cases with their instant cures. The sum of the complaints represents the typical syndrome of over-simplification, that there must always be a villain and a hero in such social and economic relations.

A basic difficulty involved in this pursuit of manifold remedies for ill-defined problems is that there is no fundamental analysis of how the problems are inter-related and how the proposed remedies would interact and affect the economic system as a whole. Cause and effect relationships become blurred and confused in the welter of divergent recommendations. Failing a comprehensive and rigorous conceptual framework, popular discussion tends to lack discipline, to attribute exaggerated efficacy to each new policy measure and transient development - and when, in the longer term, expectations are disappointed, as they frequently will be, to assume that "solutions" would be readily available were it not for the obduracy or malfeasance of certain visible economic interest groups.

The truth - that improvement is at best slow, that we all live under the cold star of scarcity, that wherever there is an argument for government support there is also an argument for government control, and that few economic or social problems are ever capable of final and definitive solution -

finds little support, since it can easily be confused with (or misrepresented as) the unattractive position of the apologist for the status quo, or, even worse, with advocacy of the view that we are the helpless pawns of blind economic forces.

Matters are not made easier by the tendency to interpret developments that are sustained for a few years as representing permanent and irreversible shifts in the nature and functioning of our economic institutions. A period of depression produced theories of secular stagnation based on the assumptions that the rate of population growth was falling off, that there was no longer the same demand for great quantities of staple products, that the supply of capital was increasing more than proportionately to rising income, and that technological change was demanding smaller capital outlays - hence a condition of chronic under-employment of factors must persist. Policy measures appropriate to these assumptions were proposed and adopted: agricultural production was discouraged, interest rates were maintained at arbitrarily low levels to discourage saving and to increase consumption and certain types of investment, and government was assigned a major role in promoting those types of investment which would not result in the creation of new production capacity. There was an accompanying proliferation of theories postulating the decline and fall of the market economy, and its replacement by government planning and control, of various forms and in various degrees. In the post-war years such centralized control schemes fell out of favour, and the market economy and private enterprise made an impressive recovery, not least in Europe. The early 1960's, after a period of recession, witnessed a zealous movement to promote "indicative planning"; to assure, in substance, that industry-wide investment programs did not outrun market opportunities. This proposal has close intellectual ties with the oft-repeated supply-control approach which probably received its most detailed expression in the NRA program in the

United States. A theory that private economic power was pervasively held in check by other centres of power on the opposite side of the market - countervailing power - also enjoyed a transitory popularity.

In Canada, at the close of World War II, the Federal Department of Agriculture, convinced that the international wheat market was facing a permanent decline, also did its best to divert land from wheat production, and signed long-term sales contracts at what, in fact, turned out to be prices far below those that prevailed in the world market. Later, the LIFT program made equally confident long-term agricultural forecasts, again to be quickly reversed by the forces of the market.

More recently, a few years of high prosperity have given rise to pretentious theories about a new post-industrial, affluent society - an age of automation, computers and nuclear reactors - in which the work-ethic and the saving-ethic are demoted to the category of outworn symbols, and the comsumption-ethic and the tenet of cultural self-realization - with the assistance of generous transfer payments - become the conventional wisdom. These views, in turn, now tend to be revised under the shock of food shortages, a world oil cartel and general inflation - and the stubborn refusal of taxpayers and savers to accept the accelerating erosion and diversion of their resources.

The chill light of the cold star of scarcity has, indeed, begun to displace the warm sunshine of ever-rising expectations. As Professor A.C. Pigou remarked many years ago, over-optimism and over-pessimism, when discovered, give rise to one another in endless succession. The consequential stresses trigger the oversimplification syndrome, and culprits are quickly fixed upon.

A balanced view is of all things the most difficult to achieve where economic advantage is at issue. One would suppose, however, that making the course of industrial policy an immediate and perpetual occasion for partisan controversy the surest blockade to industrial progress and efficiency.

Professor Myron W. Watkins has pointed out that there is no dearth of ambitious aspirants "for the calling of economic mortician". Since the economy is a bewildering complex of business enterprises, of government agencies and regulatory bodies, subsidies, cross-subsidies, tax systems and marketing agencies, planning bodies with their "egocentric conviction that the man in Whitehall knows best" (Michael Lipton), professional associations, labour organizations, and so on - the economic mortician has a wide range of plausible maladies and transgressors for selection.

Where accountability cannot be assured on the basis of individual economic units, preferably under direct or indirect market stresses, almost any aberration in conduct or performance can be justified by skillful rationalization. Such evasion is made more difficult if the agencies, firms, or departments, are required to provide relevant information on the details of their operations - although as evidence of performance this falls far short of a continuous market test. Careful analysis is needed to specify the nature and extent of information that is relevant to each situation. This, however, is less likely to present a serious problem than is the prevalent reluctance to provide meaningful disclosure. The attitude of secrecy is almost becoming institutionalized, not alone in the business sector but also in the service industries, professional associations, and, perhaps most

important, in government itself.* "Fiat lux" is too often considered an appropriate admonition to the department of streets rather than a basic precept for all actions affecting the public welfare in a democratic society. Government programs in R & D, in "rationalization", in regional development, in public ownership, are frequently abandoned or simply fail, and, as one writer puts it, "no one asks who or how or why". And if he does ask, his questions too frequently remain unanswered. It is doubtful, moreover, whether busy legislators can give the time and attention that these problems require.

Apart from matters related to accountability in the narrow sense, there is scope for new measures designed to disclose significant developments in the economy. For example, a measure similar to the Swedish "net price index" would appear to possess considerable merit in casting some light on the impact of taxes on prices. This index eliminates from consumer prices the indirect taxation imposed upon consumer goods (including indirect taxes levied on raw materials, capital equipment and the like, used in the production of the consumer goods). Additions to consumer prices would also be calculated for subsidies paid in connection with the production of such goods.

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* It would be beneficial all round if much of the relevant information were collected and analyzed by one or more independent research institutes funded jointly by the private sector and by government on a long-term basis. Government research agencies tend to be more cautious and inflexible in their programs than effective policy analysis often requires; purely private agencies are vulnerable on the score of objectivity - no matter how independent their approach.

Measures constructed so as to distinguish longer-term trends from short-run developments, particularly in the nature, rate and direction of economic change, warrant much more attention than they have so far received. In the private sector, we would like to know more than we do about the relationship between the level of information available and the degree of spontaneous co-ordination which develops under conditions of fewness; we should also know more about the relationship between information, uncertainty and the willingness to invest.

Free Trade and Dynamic Change

Historically, critics of "monopoly" in Canada - especially producers dependent upon export markets - have identified high tariffs as the foundation and the mainstay of much of the non-competitive conduct that they discern or suspect. This condition is all the more exasperating to them since the remedy, in their view, is simple and direct: adopt free trade. The analogy of tariffs as a dam holding back a flood of lower-priced goods, or, among the more sophisticated, holding back pressures for longer-term adjustment in the scale of Canadian manufacturing operations, which would, if released, achieve lower prices for consumer goods and a more efficient and dynamic manufacturing sector, is one that has many supporters.

In origin, protective tariffs were the obverse side of the coin from the east-west railway system, and thus of the establishment of Canada as a trans-continental political entity*. For many years,

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* See H.A. Innis, Problems of Staple Production in Canada (Toronto, 1933), esp., Chap. I, "Transportation as a Factor in Canadian Economic History"; and Innis, A History of the Canadian Pacific Railway (London and Toronto, 1923).

debates about the magnitude and the incidence of the "tariff burden" provided one of the core subjects of political and academic life in Canada. With the development of political devices designed to "equalize" burdens and opportunities in different regions of Canada, and with shifts in the locus of scarce and valuable resources (e.g., oil and potash), the intensity of the historical "tariff burden" argument has abated somewhat, and the issue of free trade - or, at least, freer trade - has concentrated on questions of industrial organization and longer-run employment opportunities.

Many of these issues are not germane to this report, but there are some easy assumptions that are frequently made about the effects of freer trade in the area of industrial organization that we feel require at least brief comment.

One of the most generally held views about the effects of the substantial reduction of tariffs is that it will result in the effective rationalization of the protected industries, producing plants and firms which will be specialized and closer to minimum optimal scale. In consequence, the firms will be able more effectively to meet import competition as well as to venture forth into the export market with greater success. The available evidence from other countries would suggest that such results cannot be anticipated with confidence.

When free trade was adopted in Great Britain in the mid-19th century, there was clear evidence that British industry in many of its branches was highly efficient and capable of performing successfully in most export markets. There was also a conviction that free trade and low transport costs would, if there were any faltering in efficiency, ensure effective foreign competition, and, with it, the necessary stimulus to develop new industrial skills and methods of marketing. After 1880, with the emergence of German competition, followed after

1890 by American pressure on traditional British markets, this conviction still retained its ascendancy, if not its underlying validity. The stagnating process of economic transformation which in fact evolved suggests in retrospect that free trade and "free" competition, by themselves, were not then equal to (and probably cannot, by themselves, be equal to) dealing with major rigidities in production methods, with the development of new end-products, with the redistribution of manpower, and so on.

Sweden, despite its low tariff level and its closeness to major European industrial centres, has not experienced the degree of change in the size and specialization of its firms that it considers necessary to enable it to compete effectively in export markets. Hence, it has assigned a high priority to the development of structural rationalization schemes to bring about the desired transformation of the economy to enable it to meet the incoming competitive pressure from firms in the expanding EEC, and to compete successfully in that large market as well as elsewhere in the world.

It does not follow that freer trade cannot make an important contribution to the process of economic transformation. The benefits from dynamic change will, however, only materialize in the long run as industry gradually exploits opportunities for economies of scale, for organizational innovations, and for improvements in management efficiency. This suggests that freer trade requires to be used, with appropriate timing, in combination with positive and prohibitory measures to facilitate, and to create pressures favouring, the process of economic change in terms of the firm and the market. As we emphasize in the section dealing with structural rationalization, it is important that this process not be carried out under government direction and control.

We should not, in any event, conclude that free trade is a necessary (and certainly not a sufficient) condition to achieve technological change and specialization in Canadian industry. For example, the Canadian iron and steel industry no longer ago than 1955 was regarded as lagging behind the American industry. In 1955 the price of a ton of steel was higher in Canada than in the USA; in 1965, the reverse was true, making it possible for the Canadian industry to increase exports to and reduce imports from the U.S.* Baumann suggests that the more rapid adoption of the cost reducing basic oxygen furnace for steelmaking in Canada played the major role in this development. The factors responsible for this shift are less easy to identify. It is pointed out that,

> "Canadian economists have stressed the importance of competition from imports to assure the efficient allocation of resources, but the case of the BOP casts some doubt on the contention that dynamic efficiency can be maintained in this way because the U.S. industry appears to have reacted to increased imports with a considerable lag."**

To assure dynamic efficiency in the long run, the author proposes "large scale entry of progressive firms", although he finds it difficult to identify mechanisms to realize this end, with the exception of "the entry of subsidiaries of foreign firms into the domestic market".

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* See H.G. Baumann, The Diffusion of the Basic Oxygen Process in the U.S. and Canadian Steel Industries, 1955-69 (Research Report 7305, Dept. of Economics, The University of Western Ontario, 1973).

** Ibid., p. 24.

Other writers, from a different perspective, come to a similar conclusion; for example, the Chairman of the U.S. Federal Trade Commission, has remarked,

> "The question I cautiously raise is whether multinational investment may not be the long awaited cure for the malady of protectionism - or at least a major part of that cure."*

Certainly, the multinational firm has displayed a capacity to "unlock the door of comparative advantage". Whether the political and other objectives that originally justified the imposition of tariffs are thereby being undermined, or whether freer markets, achieved by the substantial reduction of tariffs or by the action of multinationals in by-passing the tariffs, are consistent with these (perhaps altered?) objectives is an important consideration for public policy. The assumption that the substantial reduction of tariffs, without more, will assure long-term dynamic efficiency in the industries affected cannot at the moment be considered to have support from the available evidence. Such reductions, made in concert with other measures to promote adaptability, flexibility, and long-term change, promise, although they do not assure, more effective market performance in the protected industries.

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* Lewis A. Engman, in an address before the Economic Club of Detroit, April 29, 1974.

A Note on the Limitations of Using Criminal Law

Since 1889, when Parliament first enacted laws relating to conspiracy to restrain trade, the combines laws have taken the form of criminal prohibitions enforced by criminal penalties following trial according to criminal procedures. Resort to the criminal law was quite understandable in the circumstances of 1889, and the continued emphasis on criminal law since that time was considered desirable in view of certain constitutional law decisions. Virtually exclusive reliance on criminal law, however, has been increasingly and widely recognized as a serious obstacle to effective implementation of competition policy. Nor do many types of combines problems fit comfortably within the traditional function and requirements of criminal law. In result, combines law contains various substantive and procedural compromises that have been neither adequate from the point of view of effective competition policy nor desirable so far as the integrity of the criminal law is concerned. For these reasons, the proposals made in this report reflect the decision evident in the 1975 amendments to move away from exclusive reliance on criminal controls. Some new constitutional law questions may be raised in the process, but that is an inevitable consequence of the attempt to improve the effectiveness with which competition policy is implemented.

One of the central difficulties with using the criminal law in this field is that the function of criminal law and the purpose and capacity of the criminal sanction depend upon a substantive prohibition that is defined sufficiently precisely in advance that a person has fair notice, before engaging in the conduct, that it is against the law and the public interest for him to do so. Ideally a widely accepted moral disapproval of the conduct exists in addition to the specific prohibition. Competition law, however, cannot realistically

define many undesirable events except in terms of their economic effect or likely economic effect. Mergers, uses of market power, and price differentials, for example, are desirable, inconsequential, or harmful only according to the market context in which they occur.

The growing complexity of the economy, and of economic analysis, has no doubt contributed significantly to the inability to frame many effective specific laws in this field. It has also contributed to the disappearance of much of the moral force underlying the original enactment of combines laws. The point is that there are situations where businessmen do things that, while they should be prohibited, nevertheless do not warrant the ignominy of criminal charge and conviction.

Not only is the exclusive use of criminal law in this field negative and confrontationist in approach and effect, but criminal procedures are slow, costly and procedurally cumbersome. The publicly imposed sanctions for breach of criminal laws are severe and the procedural safeguards to prevent unwarranted conviction are accordingly more stringent than the comparable safeguards in civil actions. In 1960, Parliament acknowledged the inadequacy of relying exclusively upon the regular criminal courts by conferring jurisdiction on the Exchequer Court (now the Federal Court) to try charges laid under the Combines Investigation Act. The constitutional basis claimed for the 1960 legislation was to help achieve the better administration of the laws of Canada. Perhaps it has helped but the Federal Court must still decide combines cases by applying criminal laws and procedures, and this limits the improvement that can be achieved.

The primary shortcoming of overemphasis on criminal law is the economic ineffectiveness of the judgment and remedy. It is too simplistic to conclude a lengthy investigation and hearing of a

complex industrial situation with an all-or-nothing condemnation on the basis, frequently, of refined jurisprudential notions of agreement and intent that may be largely irrelevant to the businessman and economist. The judgment and remedy are usually (and properly, in the context of criminal law) backward-looking and behaviourally oriented, and pay little concern to fostering desirable market situations. They are, in short, largely unconstructive so far as the economy is concerned.

Criminal law does have a vital role to play in the total enforcement scheme but only in the limited sphere where it can be effective, namely, with respect to conduct that can be defined with a reasonably high degree of precision and that is generally agreed to be contrary to the public interest regardless of its more specific factual context. In those areas of deliberate deviance criminal penalties should be as severe as might be required to stamp out the practice. This may require jail sentences in appropriate cases.

The need to restrict criminal law to matters that can be reasonably precisely defined is underscored by the recent provision for civil damage actions in cases where criminal activity causes private injury, regardless of whether or not a criminal conviction has resulted.

DISCUSSION DRAFT - LEGISLATION

Preamble

Whereas a central purpose of Canadian public policy is to promote the national interest and the interest of all Canadians by providing an economic environment fully conducive to the reduction of the real costs of providing goods and services, by expanding opportunities relating to both domestic and export markets, and by encouraging innovation in technology and organization;

And whereas one of the basic conditions requisite to the achievement of these ends is the creation and maintenance of a flexible, adaptable and dynamic Canadian economy, making it necessary to promote conditions which will stimulate and facilitate the movement of talents and resources in response to market incentives whether such incentives are short or long-run in nature; conversely to reduce or remove barriers or hindrances to such mobility except where such barriers may be inherent to achieving real-cost economies; and to protect freedom of economic opportunity by discouraging the predatory exercise of economic power and by reducing the need for detailed public regulation of economic activity;

And whereas the existence of such a market economy may only be effectively ensured by general laws of general application throughout Canada, which laws are administered in a consistent and uniform manner.

DISCUSSION DRAFT - LEGISLATION

Objectives of the National Markets Board*

In exercising its powers under this Act the Board shall, so far as possible and subject to the other sections of this Act, seek to give effect to the following general policies:

1. To facilitate market-oriented adjustment and transformation in the structure and methods of producing and distributing articles and services in Canada in response to the initiatives of persons engaged, or who wish to engage, in industrial, trade or commercial activities;

2. To facilitate the achievement of real-cost economies in the production of articles and services in Canada and in their distribution within Canada and abroad;

3. To prevent the use of market power for the primary purpose or with the primary effect of reducing or foreclosing market rivalry;

4. To eliminate barriers to the entry by any person into a business, or market of his choosing where the barriers are not justified by law or by real-cost economies leading to superior economic performance;

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* For a detailed discussion of the structure and the functions of the proposed National Markets Board, see the section, "A Specialized Adjudicating Body".

5. To promote the removal of rigidities in production, distribution and pricing practices in the various sectors of the economy;

and shall seek to limit its orders to those of an enjoining nature rather than requiring a particular business enterprise or trade to act in a specific manner, so far as this may be reasonably consistent with implementing the above stated policies.

II

Issues in Market Organization

II - 1. MERGERS

Merger Activity

Merger activity is, in considerable measure, a reflection of changes in the size and shape of business concerns as they adjust to continuous changes in the market. These changes are the product of technological, organizational, managerial, and other factors, both domestic and international. There are, in fact, many possible reasons why two or more firms, if joined together, may perform more effectively in the market and so have a higher value than if they pursue independent existences. Such consolidations, as will be developed later, are likely to be more important for small unenterprising economies than for large, dynamic economies. It is, however, safe to assume that for both the vast majority of mergers are of interest only to the concerns innvolved in them. It is equally certain that there will be some mergers that are of interest to public policy. It is the identification of such mergers, the criteria on which they should be evaluated, and the prohibitory, conditional or other remedial measures that may be required to bring them into conformity with the public interest, that are the subject of this area of public policy.

The record of merger activity in Canada is available in something approaching full coverage for only the limited period of 1945 through 1961.*

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* Grant L. Reuber and Frank Roseman, The Take-Over of Canadian Firms, 1945-61 (Ottawa, The Queen's Printer, 1969). The data collected on acquired companies relate to companies for which the amount paid exceeded $10,000, hence, a certain number of the recorded acquisitions must border on the irrelevant.

A less detailed compilation, available for the years 1900-1948, is still of some value in indicating general trends in merger activity.* For the years after 1961 no data comparable to either of these compilations is available.

The usefulness of registers of numbers of mergers is limited since the interest of public policy is in a specific merger in a specific industry, or multi-industry, setting. Nevertheless, they have some value for a given country in providing a general view of past trends and possibly of emerging tendencies. Comparative data for Canada and other countries, if available, may also indicate whether there is evidence of parallel merger developments among them or whether each has its particular merger profile depending on its size, its public policy, and other factors, including even the personalities of some of its leading businessmen.

The point of dimishing returns in such historical surveys is, however, quickly reached in the context of the concerns of this report. Whether or not high levels of merger activity are correlated with the levels of industrial stock prices, stock market trading, new business incorporations, and the like is of peripheral importance. It would be of greater value if we had studies of such functional issues as:

(1) the interrelationship, if any, between technical know-how, technical progress, patents and the growth of business, and the level of merger activity;

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* See J.C. Weldon, "Consolidations in Canadian Industry, 1900-1948", in L.A. Skeoch (ed.), Restrictive Trade Practices in Canada (Toronto, 1966 pp. 228-279).

(2) the influence of marketing policy on vertical and horizontal integration - and on the level of merger activity;

(3) whether mergers are a more common feature of industries undergoing growth acceleration, or whether merger movements result from an abrupt retardation in high growth rates;

(4) what are the effects of barriers to entry, taxation policies, and the like on merger activity;

(5) whether rising costs and deteriorating business conditions tend to speed up the structural recasting process and thus force significant numbers of firms to seek to sell out.

These are longer-term projects which we recommend - along with detailed post-merger evaluation studies - for consideration by the research section of the Bureau of Competition Policy. Such studies could make an important contribution to the better co-ordination of merger policy with other aspects of public policy. At present, we can assume that effective progress is being made by the securities marketing agencies in eliminating the "fast-buck" mergers of irresponsible promoters that figured so prominently in some earlier merger "waves" and contributed in no small measure to subsequent poor performance in a number of product markets.* Basically, we want to be sure that significant changes in the size and shape of business concerns by the merger route represent adaptations to technological, organizational and other market influences,

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* A number of the 1900-14 mergers, in particular, created corporate structures having such adverse consequences.

rather than being induced by inappropriate tax or other public policies, or being the product of private projects to impose artificial restraints on the market.

Some Features of the Merger Record

Over the period 1900-1961* there were at least two, and probably three, major concentrations of merger activity in Canada. Although it is difficult to make precise comparisons because of uncertainty about the coverage of the data for earlier years and because of changes in asset values and the size of the economy, it appears that the consolidation movement of the 1920's occupies the pre-eminent position. According to Weldon, for the years 1900-1948,

> "The period 1925-29 of itself accounts for about 35 per cent of the record as measured by number of consolidations and enterprises absorbed and about 45 per cent as measured by volume of consolidations. If allowance is made for an upward bias in the latter figure (asset figures probably being somewhat inflated relative to the period as a whole) and for a downward bias in the former figure (consolidations apparently being somewhat larger than average in this period) it is reasonable to say that about two-fifths of the consolidation movement occurred in this five year span."**

Another major peak located in 1910-1911 also contributed a number of mergers which exercised an important influence on the shape of the Canadian

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* See Tables A-1 and A-2 in the statistical appendix to this section.

** Weldon, op. cit., pp. 232-233.

industrial landscape. Finally, beginning in 1959, the number of mergers increased substantially and reached a record level in 1968 when, according to a preliminary count, 159 Canadian companies were taken over by foreign firms, and 230 Canadian companies by other Canadian companies.*

The striking thing about the two early merger movements (1900-1914 and 1921-1930) was the degree to which they altered the configuration of the Canadian economy in a long-lasting manner. In some industries most of the major firms were brought together; in others whole masses of smaller firms (in the case of Canadian Canners Ltd., 53 firms) were taken over. Nothing of such relative importance has occurred in recent years.

According to the Report of the Royal Commission on Price Spreads,

> "In the earlier period from 1900-1914, consolidations affected from 30 to 40 subdivisions of Canadian industry: particularly the coal, iron and steel group (15 cases), the pulp and paper group (18 cases), and the packing and canning groups (8 cases). In the period 1921-1930, the industries chiefly affected were brewing, canning, dairying, pulp and paper, construction materials, and the grain trade." (p. 28).

Other industrial subdivisions were also affected in lesser, but still significant, measure: tobacco, fish curing and packing, meat products, cotton textiles, asbestos and products, gypsum

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* These figures for 1968 are quoted in the Report of the Committee of the Ontario Securities Commission on the Problems of Disclosure Raised for Investors by Business Combination and Private Placements (Toronto, 1970).

products, petroleum and its products, non-ferrous smelting and refining, cement, and paints, pigments and varnishes.

To put matters in perspective, it appears certain that the characteristic consolidation of the post-war period involves fewer enterprises and that, in total, the post-war consolidations are of much smaller relative significance in changing the industrial structure than were the consolidations of earlier periods. These conclusions are reinforced by the large increase in the number of firms from 27,229 in 1945 to 106,309 in 1961.

Reuber and Roseman have pointed out that the total number of Canadian mergers from 1945 to 1961 (1,826 in all) was equal to about 1.8 per cent of the number of Canadian companies in 1961.* On a different basis, taking the number of employees in the total number of mergers between 1945 and 1961 - they concluded that "something like 2.6 per cent of the industrial labour force was involved in international mergers... and about 2.9 per cent of the industrial labour force was involved in domestic mergers."**

It is of interest to note that Professor M.A. Adelman concluded that for the United States the assets of the industrial mergers completed in the 3½ years January 1951 - June 1954 amounted to about two per cent of the total corporate assets (in the middle of 1954) in the industries covered by the study.*** Professor Robert A. Solo has also

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* Op. cit., p. 36.

** Ibid., p. 37.

***Reported in an address to the American Management Association, October 31, 1956, "The Current Wave of Mergers Analyzed".

reported that from 1940 to 1947 some 2,500 firms disappeared through mergers, constituting five per cent of the assets invested in manufacturing and mining.*

In the United States, recent years have seen a significant increase in a quasi-merger form of organization, the joint venture. The summary of the data on joint ventures recorded by the Federal Trade Commission for the years in the mid-1960's is contained in the following quotation from the News Summary of the FTC, February 27, 1967.

> "The Commission for the second year recorded joint venture activity involving participation of American companies in both domestic and foreign projects. The total recorded in 1966 equalled 218 as compared to 171 in 1965. Of the 1966 total, 72 were joint ventures between U.S. companies only, and of these, 49 were to operate in the United States and 12 in foreign countries. There was no information as to country of operations for 11 of the joint ventures.
>
> There were 146 joint ventures representing co-operation between U.S. and foreign companies. Of these, 125 were to operate in foreign countries and 10 in the United States. The country of operation for 11 was not reported.
>
> Nearly three-quarters (72 per cent) of the joint ventures formed last year [1966] were engaged in manufacturing activity. The chemical industry had the largest number of new joint ventures

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* Robert A. Solo, The Political Authority and the Market System (Cincinnati, 1974), p. 266.

(46), with those formed to participate in the mining industries being second in total number. These two industry groups together represented one-third of the new joint ventures formed last year."

For Sweden, a somewhat broader set of measures of merger activity is available, although for differing periods of time. Bengt Ryden provides the following summary:

"The extent and momentum of the wave of mergers can naturally be measured in a number of different ways. One method is to relate the production of the merged companies to the total output figures for industry as a whole or for the specific branch. During the 1958-62 period the sales of the merged companies represented one-third of the total value of production in industry. Solely during the years 1963 and 1964 the corresponding figure was 40 per cent. No estimate is yet available for the last two years [i.e., 1965 and 1966], but the steep increase in the number of mergers, and the conspicuous participation of major companies in this wave, suggests that the share is not less than 50 per cent. Even if we correct for double-counting and other sources of error, this would mean that something like three-quarters of the value of total Swedish output has been influenced by amalgamations over the past ten years."*

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* Bengt Ryden, "Concentration and Structural Adjustment in Swedish Industry during the Postwar Period", Skandinaviska Banken Quarterly Review (1967: 2), p. 54.

Another method is to relate the number of mergers to the total number of industrial companies in the country. The total number of industrial enterprises in Sweden in 1966 was 37,000 (as against 106,309 firms in Canada in 1961).

> "This means that the roughly 2,000 companies that have participated in various forms of amalgamation since 1958 represent only 5 per cent of all industrial companies in our country. The approximately 700 companies which have been purchased over the same period do not even constitute 2 per cent of the total. If we eliminate companies employing fewer than five persons, which many consider as belonging to the crafts rather than the industrial sector, the figures are still low. The corresponding shares are then 12 and 4 per cent, respectively, of a total of 17,000 companies."*

From these data Ryden concludes,

> "... the figures reveal that a great number of small companies have not yet participated in the concentration process, which can be interpreted as meaning that industrial concentration is as yet only in the initial stages of what is probably going to be an intensive development."

A report in Index** provides some details about mergers and collaboration agreements in Sweden in 1968.

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* Ibid., p. 54.

** Index (Svenska Handelsbanken Economic Review), No. 2, 1969, p. 8.

> "The number of mergers and long-term collaboration agreements in Swedish industry during 1968 was the next highest for the postwar period. A total of 292 agreements of various kinds were concluded. Of this number, 125 were total mergers and 45 partial mergers between Swedish companies. In addition, 15 Swedish companies bought foreign firms and 18 foreign companies took over Swedish companies. Finally, 47 collaboration agreements between Swedish companies were registered and 42 between Swedish and foreign companies.
>
> . . .
>
> Total mergers between Swedish firms affected 2.1% of industrial workers in Sweden last year. For the four-year period 1965-68 the figure was 10%."

To revert to the Canadian situation: in terms of (1) relative merger numbers (and their limited effect in bringing together the leading firms) in the post-war years as against the earlier merger movements, (2) the large post-war increase in the number of firms, and (3) also keeping in mind the dimensions of merger and joint venture activity in Sweden and the United States, it would appear that the general merger movement in Canada has not given rise to any important consequences for the economy.* At the same time, there have undoubtedly

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* We may well echo Professor Adelman's conclusion for the United States: "The next time you hear that official Washington is worried about mergers swallowing up small business, or leading to greater concentration, remember the devastating question in the Book of Job: 'Who is this that darkeneth counsel by words without knowledge?'"

been a significant number of mergers that the Canadian economy would have been better off without. It is not so much the number of mergers that gives cause for current concern as the nature of a comparatively small number of those that have occurred. In fact, in order to maintain and improve the international competitiveness of some Canadian industries we may over the next decade require an increase in the number of "good" mergers, partial mergers, and quasi-mergers* (that is, joint ventures and what Swedish authorities refer to as collaboration agreements or agreements on co-operation). To the dedicated combines economist a single "bad" merger is one merger too many, and, unless prohibited, its harmful influence may, indeed, persist for many years. Nevertheless, the present situation does not call for a crash anti-merger program; what is called for is a more sophisticated approach to merger analysis than Canadian jurisprudence has permitted to develop; and to this subject we will return later in this section.

Merger Activity by Industry Sub-Divisions

The data on merger numbers already quoted relate in the main to overall levels of merger activity; it remains to examine briefly the extent to which merger activity tends to be concentrated in certain industry sub-divisions. Ideally, we

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* For legal purposes a merger may be a merger, whether it involves the complete operations of the participating firms or only a portion of their assets; for economic analysis and public policy the recent tendency for multi-product or multi-process firms to sever a section of their operations to unite with another firm (or a section of another firm) in a "partial merger" or a "joint venture" may very well possess special significance.

should like to be able to discover (1) the number of mergers by industry sub-divisions, (2) the percentage which the number of merged firms constituted of the total number of firms, and (3) the percentage with the turnover (or the number of employees) of the merged firms constituted of the total for the industry sub-division.

Such information, if available, would make possible significant inter-country comparisons not only of the degree to which mergers were affecting the "structure" of similar industry sub-divisions in each country but also whether the different countries involved in the comparisons were undergoing a similar cross-sectional merger experience (and thus were responding to similar technological and organizational influences), or whether each country tended to pursue a distinctive and independent merger course. Unfortunately, the information for such inquiries is available only for Sweden; the Canadian data are the most seriously inadequate of those for the three countries of interest to this report. However, the data are still of interest and they are set out in Tables A-3, A-5, A-6 and A-7.

In order to provide a manageable picture of the major areas of merger activity in each country, those five industry sub-divisions showing the highest number of mergers are listed, supplemented, where the information is readily available, by calculations showing the proportions of mergers to total firms in the sub-division, and the merged companies' turnover as a percentage of the total for the sub-division.

Even though the definitions of the sub-divisions may differ slightly from country to country, the rough dimensions of the picture that emerges are probably fairly reliable. In making comparisons, it should be kept in mind that the approximate relative economic sizes of the three countries are something of the following order: Sweden - 1, Canada - 3 and USA - 30.

are probably fairly reliable. In making comparisons, it should be kept in mind that the approximate relative economic sizes of the three countries are something of the following order: Sweden - 1, Canada - 3, and USA - 30.

The five most active (in terms of numbers of mergers) industry sub-divisions account in the case of Canada and the USA for about 55 per cent of all mergers; in the case of Sweden for about 75 per cent (part of which may be due to the broader definitions of the sub-divisions employed). What is genuinely astonishing in the case of Sweden is the percentage which the merged companies' turnover accounts for in the total turnover for the sub-division concerned - and this in a period of only nine years. Figures ranging from 95 per cent to 30 per cent for broad industry sub-divisions are beyond our range of recent experience.

In order to provide a crude comparison of per-annum merger activity by country by leading industry sub-divisions, Table 1 brings together data for the five most active divisions.* Even on a basis which makes no adjustment for differences in economic size it is apparent that Canadian merger activity is far below the Swedish level. Adjusted for relative country sizes, Canada's level of merger activity appears to be roughly one sixth of the Swedish level, and about one half of the USA level (with the exception of the first rank industry

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* The data from Table 4 were not used since they refer only to "large" mergers in the United States, that is mergers which must involve an acquired company which had assets of at least $10 million at the time of acquisition. The cut-off point for Canadian mergers was $10,000.

sub-divisions).* Even making allowance for a very large margin of error in the statistics the result are still impressive.

Turning to the cross-sectional comparison, there are (in terms of numbers of mergers) three industry sub-divisions which appear among the top five "merger-active" groups for each of Canada, Sweden and the United States. These are:

- metal working, machinery and engineering,
- chemicals,
- food.

Pulp and paper or paper products is the fourth most active sub-division for Canada and for Sweden; electrical machinery is the most active group for the United States, and electrical products just misses the sixth position for Canada by three mergers. Tests of the level of merger activity other than on the basis of numbers of mergers would, if they were available, undoubtedly reshuffle the relative positions of the leading industry sub-divisions, as is indicated by the Swedish data (Table 3).** Nevertheless, even allowing for this possibility, the broad pattern of merger activity by industry sub-division would continue to display a high degree of similarity among the three countries. In view of the differences among the countries in size, in tariff

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* The adjusted numbers for the first rank industries are: food and beverages (Canada) - 130, electrical machinery (USA) - 171. It is probable that the total for Canada will include more small firms than does the total for the USA.

** Although if "Beverages" and "Foodstuffs" were combined in the Swedish classification of industries into one sub-division, as is the case for Canada and the USA, the shifts would be minor.

Table 1

Number of Mergers Per Annum By Industry Sub-Division*
(Unadjusted for economic size of country)

Sweden (1958-66)	Canada (1945-61)	U.S.A. (1961-71)
I	I	I
Metal working, machinery and engineering (35.5)	Food and beverages (13.2)	Electrical machinery (170.6)
II	II	II
Chemicals and chemical products (9.5)	Chemicals (4.3)	Machinery, except electrical (125.2)
III	III	III
Foodstuffs (8.0)	Metal Fabricating (4.1)	Chemicals (105.2)
IV	IV	IV
Pulp and paper (7.0)	Paper (3.8)	Food and kindred products (90.6)
V	V	V
Textiles and clothing (6.7)	Printing, etc. (3.4)	Transportation equipment (73.0)

* Derived from Tables A-3, A-5 and A-7, as summarized in Tables 2, 3 and 5.

Table 2

Canada - Number of Acquired Companies, 1945-61
(Classified by manufacturing industry)*

	Number of Acquired Companies (i.e., total foreign mergers plus domestic mergers)
I	
Food and beverages	225
II	
Chemicals	73
III	
Metal fabricating	70
IV	
Paper	65
V	
Printing, etc.	57
VI	
Non-metallic mineral products	53

The five largest industry categories account for approximately 55 per cent of the companies acquired by all 20 manufacturing categories.

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* Based on Reuber and Roseman, The Take-Over of Canadian Firms, 1945-61, Table 4A-3, pp. 70-71, as reproduced in Table A-3.

Table 3

Mergers in Swedish Industry* 1958-66

No. of mergers in Sweden (complete and partial)	Mergers as a % of no. of companies, 1962	Merged companies' turnover as a % of total value of output in the group	
		1958-62	1963-64
I Metal-working, machinery and engineering (320)	I Chemicals and chemical products (34.1)	I Beverages (75)	I Beverages (95)
II Chemicals and chemical products (86)	II Pulp and paper (25.8)	II Foodstuffs (46)	II Chemicals etc. (54)
III Foodstuffs (71)	III Beverages (11.6)	III Metal-working, etc. (33)	III Metal-working, etc. (48)
IV Pulp and paper (63)	IV Metal-working machinery and engineering (6.0)	IV Chemicals etc. (31)	IV Non-metalliferous, etc. (45)

(cond't)

* Based on Bengt Ryden, op. cit., p. 52 and p. 55. See Table A-5.

Table 3 (cond't)

No. of mergers in Sweden (complete and partial)	Mergers as a % of a no. of companies, 1962	Merged companies' turnover as a % of total value of output in the group	
		1958-62	1963-64
V Textiles and clothing (60)	V Non-metalliferous quarrying (5.3)	V Pulp and paper (30)	V Pulp and paper (33)
(The five largest categories in column 1 account for approximately 75% of all mergers in the 12 manufacturing sub-divisions)			Printing & allied industry (33)

Table 4

United States - Number and assets of large manufacturing companies acquired, by industry of acquired company, 1948-1971.*

Number of acquisitions	Assets of acquired companies (millions)
I Machinery, except electrical - 219	I Machinery, except electrical ($8,600.5)
II Food and kindred products - 157	II Petroleum and oil products ($8,592.4)
III Chemicals and allied products - 140	III Primary metal industries ($7,810.8)

Note: A "large" merger must involve an acquired company which had assets of at least $10 million at the time of acquisition.

(cond't)

* Based on Mary Ann Comps, et al., Large Mergers in Manufacturing and Mining, 1948-1971, (Federal Trade Commission, Washington D.C., 1972), Table 3, p. 8. See Table A-6.

Table 4 (cond't)

Number of acquisitions*	Assets of acquired companies** (millions)
IV Electrical machinery - 122	IV Food and kindred products ($6,970.9)
V Primary metal industries - 120	V Chemicals and allied products ($6,851.0)

* These five industry categories account for approximately 46% of all mergers included in the 20 industry categories. "(Paper and allied products is seventh, with 101 mergers)".

** These five industry categories account for approximately 52% of the total assets of all 20 industry categories.

Table 5

United States - Number of Manufacturing Concerns Acquired, by Industry of Acquiring Company, 1961-1971.*

	Number of acquisitions
I	
Electrical machinery	1,877
II	
Machinery, except electrical	1,377
III	
Chemicals	1,157
IV	
Food and kindred products	997
V	
Transportation equipment	803

These five industry categories account for approximately 55 per cent of all concerns acquired in the 20 manufacturing categories.

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* Based on Amelia Lucas, et al., Current Trends in Merger Activity - 1971. (Federal Trade Commission, Washington D.C.), Table 3, p. 10. See Table A-7.

policy, in anti-trust policy, in foreign investment, and in the role of government, the roughly parallel shape of their merger-activity profiles by industries suggests some interesting speculations.

First, it would appear that a significant proportion of domestic mergers constitute a response to specific functional influences of international reach. Whether these influences tend to be technological, organizational, or simply price-based, is difficult to say. The food and beverage industry may, for example, respond to domestic influences as well as to the demonstration effect of organizational changes adopted in foreign countries,* rather than to any direct price pressures from abroad. For other industries such as chemicals, metal fabricating and pulp and paper, some combination of scientific, technological and price elements may predominate, encouraged by the growth of world trade and the integration of markets. The method by which the international influences are transmitted is also of interest, whether by the multinational corporation, by the licensing of technology, by the full or partial merger (the latter of which appears to be experiencing a high rate of growth), or by joint ventures or similar quasi-mergers involving foreign firms (also apparently growing at a rapid rate) - all are matters of importance to an understanding of recent developments and probable future trends. Other factors which are discussed in the section dealing with structural rationalization - such as steep wage cost increases, taxation policy, social program costs - while probably of across-the-board importance, may re-inforce and expand tendencies having their origins in specific industries.

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* On the basis of personal inverviews with executives in the Swedish food industry, the writer can confirm that marketing innovations in the USA were of basic importance to the restructuring of Swedish food distribution.

Basic to an understanding of what are the strategic factors in merger evolution and thus to the development of more meaningful policies - both general economic policies that affect incentives to form mergers and specific policies involving the evaluation of individual mergers - is the provision of much more relevant information on the process of change and adjustment in this area. The primitive state of the data currently available makes possible the adoption of interpretations often little above the level of ritual responses.

Merger Policy

Merger policy cannot be formulated as a set of general principles relevant for all countries. A large, dynamic economy providing ample growth opportunities, with an aggressive, enterprising business community, and with flexible and adaptable institutional arrangements, can rely on indifferent, perhaps merely symptomatic, criteria to identify undesirable mergers. Nor need the body responsible for making the identification possess special qualifications or high sophistication in economic matters; the market process will, itself, sort matters out effectively. For example, the United States has relied on a merger policy based on a simplified version of market structure interpreted by the regular courts. However, both the market and the number of firms in that country are so large, and the economy so dynamic, that if the courts prohibit a merger that may be justified economically or approve a merger which cannot be justified economically, little damage to the public interest will ensue.

A small economy does not enjoy the same elbow-room in policy making. A few bad merger decisions may strengthen monopolistic elements unduly or they may inhibit the development of firms of sufficient size to undertake production and marketing effectively in a world context, and to participate, at least as a partner, in the complex process of innovation.

However, a small economy (or a stagnating larger economy, for that matter) does have some room for manoeuvre in merger policy if it is prepared to adopt policies which will alter the reaction pattern of the economy. For example, it may be obliged to apply a stringent merger policy if the forces making for change are sluggish and lacking in dynamism because of inappropriate or over-cautious general economic policies, because of apathetic and unadventurous management performance, both possibly re-inforced by historical circumstances. On the other hand, it can adopt a much less exacting merger policy if effective and persistent pressures for adjustment exist or can be created, if entry of new firms is made easier, if more aggressive and creative management can be encouraged, and if general economic policies are designed to facilitate change rather than to protect the status quo.

Fundamentally, the preferred approach is to develop policies to alter the reaction pattern of the economy so as to promote economic development and dynamic change rather than to attempt to "fine tune" merger policy in such a way as to sort out comprehensively and with precision the mergers that are undertaken. The more general policy re-orientation proposed in the introduction is not only less interventionist but the by-products of its adoption are important on a broad front, since they flow from the continuing pressure of more flexible and adaptable market behaviour. Furthermore, the burden on merger policy will be greatly reduced if such pressures can be maintained, and the scope of merger policy will be narrowed accordingly.

The Jurisprudence

The jurisprudence on mergers in Canada, derived from the only two full-scale merger cases to be considered by the trial courts - the beer case and the western sugar case - provides little assistance in formulating merger policy. What

these cases appear to establish ("appear" because the decisions were not taken to the appellate courts) is that (1) a merger which virtually eliminates competition is illegal, unless (2) it can be justified in terms of advantages conferred on certain segments of the industry (such as sugar beet growers in the sugar case) without, at the same time, assessing the broader implications of the merger, or unless (3) its prices come under public scrutiny (such as a provincial liquor board, as was claimed but not conclusively demonstrated in the beer case) again without assessing the broader impact of the mergers on either the firms being merged or on the public.

The distressing irrelevance of these criteria requires no detailed demonstration. That, we believe, will become sufficiently clear in the analysis which follows; at this point we refer only to the failure of the courts to undertake even the most primitive balancing of technical and organizational values against the creation or reinforcement of artificial constraints. These considerations are, of course, much more significant in a small economy - particularly one facing the prospect of entry into, or competition from, a world-wide market - than would be the case for firms in a large, dynamic economy.

Stated generally, merger policy in a country of intermediate size, such as Canada, has to involve an analysis of both the primary and the secondary consequences of mergers,* and, if these

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* Briefly, the term "primary merger consequences" refers to the probable impact of the merger in creating or reinforcing artificial economic restraints; the term "secondary merger consequences" refers to the probable real-cost economies and the longer-run dynamic consequences of the merger. For further discussion of these factors, see below.

are adjudged, on balance, to be unfavourable, to explore the possibility of altering the economic reaction pattern by, for example, changes in tariffs, in tax policy, in patent rights, in reducing barriers to entry, and the like, so that the impact of such changes will ensure the effective protection of the public interest. If such offsetting actions are not feasible, or are not acceptable to the merging firms, the merger should be prevented. That is, policy should have both a positive and a prohibitory dimension, with basic reliance on shifting market pressures and on opportunities to maintain flexibility and adaptability in the economy. The penultimate resource to protect the public interest in the case of completed mergers will reside in the prohibition of the misuse of high levels of market power (see below), but this, although useful, is less likely to serve as an effective spur and incentive to more dynamic behaviour than is the working of the broader influences already referred to; and the final remedial resource for detrimental completed mergers would require the dissolution of the merger or the divestiture of some portion(s) of it.

Basic Elements of Policy

Before developing specific proposals for merger policy, it will be helpful in understanding their broader implications to outline briefly the conceptual framework on which the proposals are based.

In general, we will argue that the broad thrust of policy with respect to firm size should be (1) to permit the growth of firms (even involving the reduction of the number of firms) based on real-cost economies, including static economies of scale, but emphasizing those advantages relating to technological progress, product variation and organizational change; and (2) to discourage expansion of firm size (or the maintenance of firm size against new entrants) which results from the exploitation of artificial restraints.

This is a broad objective with which there is likely to be general agreement. In the interest of analytical clarity the situations in which these factors come into play can be broken down into a few categories which provide a rough framework for the application of policy (as well as a shorthand scheme of reference).

Fellner, for example, distinguishes three broad situations in which it is profitable and possible for firms to grow to "appreciable size in relation to the market".*

Case 1: This category covers those situations in which big firms possess real-cost advantages (that is cost advantages not derived from discriminatory buying power) over smaller firms. This category can be further sub-divided into: Case 1a, in which the real-cost advantages of large size derive from lower production costs, and Case 1b in which the real-cost advantages flow from superior marketing performance resulting in a more profitable relationship between sales cost and revenue.** Placing a limit on growth in the size of firms which is based on such real-cost advantages would mean that the firms would be forced into cost-of-production functions which are more costly than the most economical functions available. In pure

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* W.J. Fellner, Competition Among the Few, pp. 44-50.

** Including selling cost in real-cost advantages does not imply that interference with selling techniques is necessarily undesirable. On the dynamic level, barriers created by certain selling techniques may require consideration. Cf., Fellner, ibid., p. 45; also Joe S. Bain, Barriers to New Competition (Cambridge, Mass., 1956), esp. pp. 114-145.

Case-1 situations price cannot, in a period long enough to permit new entry, rise beyond a level determined by technological and organizational factors and by consumer preferences. In other words, "oligopolistic exploitation" in such instances cannot go beyond the limits set by the real-cost advantages of size.

In a large, dynamic economy where market pressures and opportunities operate with vigour, public policy can limit itself to a determination that Case 1 requirements are not exceeded, and, as already suggested, this may even be done on an elementary structural criterion, such as the share of the largest firm (or of the four largest firms) in the sales in a specified market. In a small economy, particularly where protectionist influences are strong, not only may special policies be required to facilitate the development of firms of Case-1 size (see the section on structural rationalization), but if dynamic change is to be encouraged after Case-1 size firms are achieved, public policy will have to be concerned in some industries with creating changes in the economic environment which will maintain market pressures on these larger firms. Static scale considerations are not alone an adequate aim for policy.

Case-1 considerations do not exhaust the factors that contribute to bigness relative to the market. Large size may give rise to real-cost disadvantages, but despite this it may be profitable for firms to grow to such a size if the associated disadvantages can be offset by other advantages. These situations comprise Fellner's Case 2 category. The offsetting advantages may derive from such sources as: cost advantages resulting from discriminatory buying power, selling price advantages related to oligopoly power, or, for influential inside groups, gains derived from financing mergers and managing bigger units.

However, to make bigness possible in Case 2, smaller entrants (which, by definition, possess a real-cost advantage) must be kept out of the market by artificial means or by the acquisition of certain exclusive rights. The sort of factors that may serve to keep out smaller entrants are: the possession of scarce natural resources; patents or licences or contracts relating to some specific know-how; discriminatory reciprocal arrangements between the would-be big firms and firms in the preceding or succeeding stages in the structure of production or distribution; and discriminatory arrangements between the firms of an industry and the unions of the same industry. Such influences along with the possible use of cut-throat tactics may keep out smaller entrants and make Case-2 bigness possible. Obviously, some of the factors listed above relate to the possession of exclusive rights established by law (such as patents), but these are of limited duration.* Entry can be eased by eliminating the inappropriate extension of such exclusive rights, by destroying other artificial obstacles, and by prohibiting the misuse of short-run financial superiority for cut-throat purposes. Effective policies directed to these ends would go far to eliminate Case-2 bigness and thus to assure that big firms could not continue in the market unless they possessed real-cost advantages over smaller firms in production cost or selling cost. The total elimination of artificial restraints which make possible Case-2 situations would, however, require very sophisticated enforcement.

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* Furthermore, there is probably some degree of "artificial exclusion" through patent and trademark protection which is necessary to stimulate inventive activity. See the section in this report on industrial property.

At best, the problem of entry in Case-2 is still likely to be more difficult than in Case-1 situations, because the obstacles in the former category are more institutional than technological and market-performance in nature. Hence, entry by "big" firms with effective bargaining power - perhaps with a foothold in another industry - may offer better promise of success in dealing with the institutional barriers. Policy is also complicated by the likelihood that actual cases will often involve a compound of Case-1 and Case-2 situations - what Fellner calls hybrids. The possibilities here are so numerous and varied that generalization is unprofitable, but the bias of policy should be in the direction of encouraging pressures for adjustment rather than in undertaking the detailed restructuring of firms.

Generally, in dealing with issues of size, whether in the context of mergers or of monopoly power, consideration should also be given to the significance of factors internal to the firm, what Tibor Barna has described as "the importance of the human element in investment and growth, as compared with the importance of economic factors such as markets, prices and supplies of factors of production."* An innovative and effective firm is not merely the product of a set of technological conditions and structural relationships. Like any large organization, such as a university, a newspaper, a government department, its performance depends on a complex of elements that have been slowly and organically developed. Professor Robert A. Solo has warned us that:

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* Tibor Barna, Investment and Growth Policies in British Industrial Firms (Cambridge U.P., 1962), p. 2. This entire study merits careful attention.

> "These capabilities, developed through accumulated experience and embodied and institutionalized in an outlook and a practice; in a complex of person to person relationships; and in the traditions, morale, and self-images of those who participate, cannot be replicated but can be destroyed on the anti-trust chopping block. Minuses for size in the dogma of antibigness will not do as a substitute for the systematic evaluation of performance."*

Thus the weight and relevance of the broad economic forces which have been briefly considered above must be tempered in applying policy by a consideration of the record of the individual firm. Sluggish performance, resistance to change, a record of participation in price agreements or other restraints, and similar evidence of poor performance would call for stringent application of the economic criteria.

Favourable performance in terms of innovation, the price-quality record, growth, development of outstanding managers and other personnel, and so on, would call for caution in breaking up, or restricting the expansion of, such an effective organization.

Finally, a form of quasi-monopoly in which an atomistic group is organized in a scheme which is adopted in the interests of the individual units and is enforced or authorized by an outside agency, can be distinguished as Case-3 restriction.

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* Robert A. Solo, The Political Authority and the Market System (Cincinnati, 1974), p. 353.

The organizing agency may be a private group (such as the Proprietary Articles Trade Association),* or a group of producers who depend on the individual units for sales outlets (such as in resale price maintenance), or the government which intervenes in favour of the economically weak or the politically powerful. Entry may be restricted, output controlled, and prices maintained in agriculture by quota allotments, numbers may be limited in certain professions, trade agreements reached by collective bargaining may be enforced, and so on.

Arguments put forward in support of such restrictions commonly run in terms of the inequity of a competitive group bargaining with other groups in a partly monopolistic or oligopolistic economy, of the imperfect mobility of the resources involved in certain industries, and the like. Such arguments may sometimes be valid, but as Fellner has observed "obviously they will be put forward in many more instances than those in which they are justified". Such Case-3 arrangements tend to develop a vested interest in their controls; as a consequence, immobility of resources will be intensified, and entry will not take place on the basis of comparative market effectiveness. Further discussion of these matters will be deferred to the section dealing with monopoly.

The Analysis of Mergers

Although the time available for the preparation of this report does not make possible the illustration from Canadian business experience of at least some of the major criteria that would be relevant for the public-policy evaluation of mergers in the Canadian economy, a broad outline of

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* See L.A. Skeoch, Restrictive Trade Practices in Canada, p. 99.

the matters requiring consideration may be of value in defining the complexity of the issues to be appraised by the National Markets Board, and the range of factors that business firms should be aware of when contemplating mergers of "significant" proportions.

On the basis of the earlier discussion, four stages in the process of merger evaluation in the Canadian economy can be specified:

(1) The identification of "significant" mergers, involving:

- the definition of the appropriate market;
- analysis of the "structure" of the market.

(2) The analysis of the primary merger consequences of "significant" mergers - and if these are unfavourable,

(3) The analysis of the secondary merger consequences - and if these are on, balance, unfavourable,

(4) The analysis of changes in the economic environment in which the merged firm will operate which will be required to ensure the effective protection of the public interest.

Before expanding in general terms upon each of these "stages" of analysis, a brief comment on the types of merger to which they could appropriately apply should be made. It is our view that a precise and detailed taxonomy of mergers is of very limited value in the application of public policy; each merger is in an important sense sui generis, and few special "tests" can be devised which would apply exclusively to each category into which mergers might be classified. The best case for

special analysis -- and this only marginally so -- might be those mergers involving foreign ownership, whether by Canadian firms taking over firms abroad or by foreign firms taking over Canadian firms. Brief reference to that category will be made below. For the remainder, a broad classification may be useful for convenience of reference since the literature on mergers makes rather extensive use of such categories.

It is conventional to divide mergers into three broad groups: horizontal, vertical, and conglomerate. It is also customary to assume that in a merger one firm integrates fully with one or more other firms, what is sometimes called a full (or total) merger. More recently, however, partial mergers, in which one firm takes over a branch or section of another firm - both of them frequently multi-product or multi-process firms - have become more common, as have quasi-mergers, such as joint venture and long-term collaboration agreements. These latter developments, important as they undoubtedly are on the dynamic level, have received little attention from research or policy analysis in Canada. Reference is made to them in the section of this report dealing with structural rationalization, but no attempt will be made to include them in the following classification of mergers.

Horizontal mergers are usually defined to include those in which the products of the firms involved fall in the same product, spatial and functional markets. This category has been enlarged to include product extension mergers where similar products or those with close functional (production and marketing) relationships are involved; and further enlarged to include geographical market extension mergers.

On the analytical level, horizontal growth via the merger route (or by internal expansion) may create Case 1 oligopoly, on the assumptions that plant was previously too small to give optimum

technological yields, that the available firm-administration was underutilized and hence could effectively administer more plants, or that the plant was too small or the firm had too few plants to achieve the most favourable relationship between selling cost and demand. On the contrary, such horizontal mergers may create plants and firms that exceed these optimum relationships, although they will be unable to maintain such an uneconomically large size unless they can rely on the support of artificial restraints; in other words, a Case 2 situation.

Vertical mergers are those involving firms previously or potentially in a buyer-supplier relationship; acquisitions which add to the production-marketing process (as a firm buying a loan company to finance consumer purchases) would also be included.

Real-cost advantages may result from vertical mergers (or from vertical growth), but vertical mergers (or growth) cannot create Case 1 oligopoly. Such mergers can, however, become a device for establishing Case 2 oligopoly with its associated artificial restraints.

Conglomerate mergers -- a much less popular form of merger activity currently than was the case a decade ago -- are sometimes defined as those mergers that are non-horizontal and non-vertical. A classification which distinguishes three broad subcategories may, however, be of more significance for public policy:*

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* See Geoffrey Thornburn, Conglomerate Mergers and the Growth of Sales Revenue in Canadian Industry, 1954-1967 (M.A. Thesis, Queen's University, 1969).

1. diversification mergers in which the acquiring firm enters a new product market, with slight or no direct substitutability or complementarity between the products of the two firms, but in which the acquiring firm is able to adapt its existing supply of factors, its production or its marketing framework;

2. conglomerate mergers in which there are no apparent concentric production or marketing functions, and hence economies of scale are unlikely; usually these are situations in which a firm enters a completely different line of business;

3. pure investment mergers which comprise all cases in which a financial or investment company has purchased a controlling interest in a firm solely as an investment and with no apparent operational function.

Diversification mergers may contribute to the development of "bigness" which is a hybrid of Case 1 and Case 2 oligopoly. As already suggested, in such cases public policy must be particularly concerned with the types of artificial restraint that tend to be characteristic of Case 2 oligopoly, while preserving the Case 1 elements. There is, in addition, an extensive, if inconclusive, body of writing on the relationship between diversification and dynamic change, especially with respect to innovations. In its present state, unfortunately, it provides little in the way of firm guidelines for public policy.*

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* See S.G. Clarke, Diversification, Product Mix, Change and Competition (Ph.D Thesis, Queen's University, 1971), for a discussion of the literature in this area and an examination of the relevant issues for a major Canadian industry.

The conglomerate merger may encourage what have been described as "semi-feudal attitudes" towards smaller competitors based on the length of its purse as it spreads its activity across many products and through a wide geographical area thus raising Case 2 oligopoly issues. At the same time, to the extent that a single industry represents only one component in a firm's total operations, interfirm dependence may be reduced. The decreased sensitivity of conglomerates to the actions of rival firms may, in fact, promote an aggressive strategy. In this sense the conglomerate type may encourage dynamic change in technology and in organizational arrangements. Both diversification mergers and conglomerate mergers may also spread risks in a way that facilitates high-risk pioneering. The stakes thus become very high for the economy and for individual industries and enterprises, and the public policy decisions become extremely complex.

Pure investment mergers per se do not raise industrial organization issues of concern for public policy. On another level, some of the more extreme examples of this category of merger have, through the creation of top-heavy finance structures and indulgence in accounting gimmickry, caused the term "conglomerate" to have a harsh ring on the ears of the public. Other more responsible investment mergers may, at the same time, raise issues of relevance to the matters currently being explored by the Royal Commission on Corporate Concentration. That area lies beyond our terms of reference.

Procedure in the Analysis of Mergers

We have proposed four stages in the analysis of mergers. It is not the intention of this report to prepare a guide for practice in applying this analysis but some amplification beyond that already

developed in the general discussion of the principles underlying the basic elements of policy may be helpful.

(1) The identification of "significant mergers".

A central element in analyzing the impact of a merger is the identification of the pertinent market within which it occurs. It would obviously simplify things if an over all classification of "markets" could be devised which would then be used as a basis for exploring elements of structure and behaviour. Unfortunately, the pertinent market is not something that can be defined apart from the analytical needs of the specific problem under consideration.

The Alcoa case in the United States has often been pointed to as representing the difficulties of defining a market in what is, on the surface, an apparently simple situation, that of "the aluminum industry". In that case, Judge Learned Hand said that if a company occupies 90 per cent of the relevant market, that would be enough to constitute a monopoly, but that it would be doubtful whether 60 or 64 per cent would be enough, and certainly 33 per cent would not. It would be possible, however, to define the market to coincide with each of the three percentages he set out as bench marks.* Alcoa's production of virgin aluminum ingots represented 90 per cent of the ingots used by all fabricators of aluminum products produced in the United States; at the same time, Alcoa's production amounted to two thirds of all aluminum available, that is secondary and scrap aluminum as well as virgin ingots; and if the same broad definition of the market were adopted but Alcoa's percentage was

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* See Mark S. Massel, Competition and Monopoly (The Brookings Institution, 1962), p. 238.

based solely on its sale of ingots to others, its share would be approximately one third of the market.

There are, in fact, many possible dimensions involved in defining a market but rarely will it be necessary to combine them all, or even a large number of them, in an individual case. The question is that of selecting that dimension, or that combination of dimensions, that appears best suited to illuminate the issue under analysis.

The basic principle is to take full account of competition among products and of the position of buyers as well as sellers. This, in turn, may involve: the physical characteristics of the product(s), the end uses of the product(s), cross-elasticity of demand (where an approximation to this measure is feasible), methods of production and the ease of shifting production capacity from one product to another, sellers' costs, relative prices, geographic limits, stages of marketing, time limits, integration and stages of manufacture, and actual and potential competition. Each of these criteria could also be qualified or extended.

In order to assess the probable impact of a merger the issues may be further complicated by the fact that the firms are diversified in the products they produce, or that they are involved in combined production-marketing operations, so that their actions are not limited to one "market", however defined. Their decisions may in some cases be directed to long-term objectives that escape the narrow confines of market analysis, such as stability of rate of return. And so on.

Despite these complexities, careful and sophisticated market analysis will in most cases provide valuable insights into the economic context within which the effects of the merger will be felt, even though nothing approaching mathematical precision may be possible.

When the market is adequately defined (or when the market-related elements are explored as fully as possible), it is important to obtain an assessment of the degree of market power possessed by the firms undertaking the merger. Market "structure" is considered to be basic to deriving such an assessment. Dean E.S. Mason has warned that market power is an elusive quantity, and that,

> "It is not possible nor will it ever be possible by calculating market shares, dividing price minus marginal cost by price, or other hocus pocus, to present an unambiguous measure of the degree of monopoly. Market power has many dimensions."*

Even the six dimensions of structure commonly discussed by economists: concentration, product differentiation, barriers to entry of new firms (scale economy, absolute cost, and capital requirement barriers), growth rate of market demand, price elasticity of market demand, ratio of fixed to variable costs in the short run -- do not exhaust the list. Indeed, more important for public policy than these factors may be the extent to which dynamic change is occurring in the market.

For the purpose of identifying whether or not a merger is significant - that is, whether or not a merger will be investigated - it will not be necessary to undertake a detailed inquiry into these matters. A "first approximation" is all that is required, and in arriving at that approximation emphasis should be placed on such strategic elements as barriers to entry, growth rate of market demand, and evidence as to the nature and extent of

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* E.S. Mason, "Market Power and Business Conduct", American Economic Association, Dec. 29, 1955.

dynamic change. If an unfavourable verdict is arrived at on these grounds, a decision to challenge the merger would be appropriate.

On familiar grounds, an exemption might be granted in the event that a failing company is involved in the merger. The exemption should not, however, be automatic. If the industry were contracting and the process of adjustment required that some firms should be eliminated, the process of cost and price adjustment might very well be hindered if another firm were to enter by the merger route.

An exemption might also be granted to an otherwise doubtful merger if the industry was involved in a structural rationalization program. Indeed, more detailed investigation might indicate that a merger could contribute to the erosion of entry barriers and to speeding up the process of change. Such situations should not be regarded as exceptional, although it does not appear possible to identify them adequately in a preliminary analysis.

Evidence relating to the share of the market affected by a merger is frequently proposed as an important test of the merger's significance. There is a large body of writing on this point, most of it relating to the economy of the United States. It will not be necessary to repeat the earlier points made with reference to its limited relevance in the smaller Canadian economy. In addition, if market share is to be assigned an important test function, the definition of the relevant market becomes a much more sensitive matter than is the case with the functional criteria we propose. As the basis for a very rough sorting out of mergers it may nonetheless, possess some value - particularly in defining minimum levels of significance.

(2) Assuming that the significant mergers have been identified, the next stage in the merger evaluation process is to analyze the primary merger consequences. Such consequences relate to the probable impact of the merger in strengthening or creating artificial restraints. Such restraints cover a wide range and their effectiveness will vary with the circumstances of the individual industry. No complete catalogue is either possible or desirable, in part, because what may be harmful in one case may be a matter of indifference in another; in part, because the combination of artificial restraints may prove to be more important than the nature of each one separately; in part, because a list, no matter how exhaustive, would simply trigger a search by the ingenious for new non-listed methods to achieve the same result.

Examples of broad types of restraints that would be regarded as detrimental have already been referred to in the discussion of Case 2 oligopoly. Central to the entire concept is the importance of prohibiting mergers that may strengthen barriers to entry by, for example, the preclusive acquisition or ownership of resources and facilities, by establishing reciprocal buying-selling advantages, by achieving a merger-based dominant position reinforced by exclusive dealing and tying advantages, and so on through a lengthy list.

(3) If it is established that the merger is unlikely to strengthen or create artificial restraints to a significant degree, the investigation would be discontinued. If, however, a conclusion unfavourable to the proposed merger were reached, it would be necessary to analyze the secondary merger consequences. Here we are concerned with longer-run considerations such as whether the merger may have favourable consequences with respect to reducing barriers to entry, achieving real-cost economies of the type identified in the discussion of Case 1 oligopoly, promoting dynamic change -- perhaps through the impact

of factors internal to the firm -- facilitating the rationalization of industry, promoting the growth and extension of real-cost economies via the industrial migration route, and so on. The analysis would not attempt to establish "specific actualities" but to forecast and appraise reasonable probabilities.

(4) If the secondary merger consequences effectively offset the disadvantageous primary merger consequences, especially those with longer-term implications, the merger would be approved. If not, the analysis would move to the fourth stage, that of examining the possibility of altering the reaction pattern of the industry by changes in the economic environment. Such matters as tariff changes, the divestiture of certain operations or segments of the firm, the substitution of joint ventures for certain parts of or functions of the firms in the proposed complete merger, perhaps the licensing of patents on favourable terms, and so on. This stage obviously establishes the basis for a process of negotiation between the Director and the parties to the merger. If they reach an agreement permitting the merger, that agreement would be submitted to the Board for its approval. If no agreement was possible, the merger could be challenged before the Board.

A Non-Discretionary Approach Preferable?

It may be felt by some that the criteria and the procedure we have proposed involve both a considerable measure of uncertainty and a degree of complexity that will make practical administration very difficult. The most common alternative put forward is the adoption of a non-discretionary approach to evaluate not only mergers but monopolies as well. The single yardstick proposed is usually a proxy for a measure of market power (since it is conceded that a direct measure is not available) which would take the form of either a structural criterion, such as a concentration

ratio, or a performance criterion, such as an average profit rate over a period of, say, ten years. It is recognized that such a formula will sometimes result in the prohibition of mergers which would confer net benefits on the economy but it is maintained that the saving in cost, direct and indirect, of the investigation justifies the loss involved. At the same time that this demand for greater certainty in the form of a definite set of simple guides is put forward, many of the same individuals and groups complain about the application of per se rules as being excessively dogmatic.

With reference to the structural criterion - measures of industrial concentration - the evidence for its relevance, as already suggested, is widely debated.* If major reliance is to be placed on such a yardstick, the definition of the relevant market assumes very great strategic importance, as has already been pointed out. Furthermore, as Massel has emphasized, "A concentration percentage is only one indicator of a market situation. Competition among a small number of competitors can be very strong, while competitive forces can be weak in an industry with many competitors."**

Professor Clair Wilcox, after reviewing the technical uncertainties involved in the calculation of concentration measures, concludes:

> "The significance of the resulting ratios is obscured, too, by the fact that they pertain only to the largest three, four,

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* See, for example, Harold Demsetz, The Market Concentration Doctrine (AEI - Hoover Policy Study 7, 1973); and Harvey J. Goldschmid, et al., Industrial Concentration: The New Learning (Boston and Toronto, 1974).

** Massel, op. cit., p. 194.

> six, or eight units, and do not reveal whether the members of such groups are dominated by a single firm, or approach equality of power. It should be noted, finally, that the indexes of concentration are not indexes of monopoly. They may reveal the consequences of monopolistic restriction or exclusion or those of competitive innovation, market development, and reductions in cost and price. They may conceal the influence of potential competition, and the presence -- on the other side of the market -- of countervailing power. The studies of concentration are suggestive, but they fall far short of proving the monopoly that they are often said to prove."*

A measure of profits - a subject that we will explore further in the section on monopoly - provides an equally insecure major indicator of market power. It has been repeatedly explained that low profits might conceal an inefficient monopoly (or firm with high market power) or one that is deliberately permitting its costs to drift up to escape public attention, while high profits might indicate an active, innovating firm in a risky field, which is undermining static, routine performance in a number of markets.

Thus, reliance on a single, or on, say, two, major tests of market effectiveness could result in overlooking a combination of "secondary" factors, or in a misinterpretation of the major signals themselves, that would cause a prosecution to be initiated that would destroy effective dynamic pressures in some markets or that would validate the continuation of artificial restraints in others.

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* Clair Wilcox, Public Policies Toward Business (Homewood, Ill., 1960), pp. 302-303.

The procedure that we have proposed if applied effectively by sophisticated lawyers and skilled economists should separate the relevant from the irrelevant criteria, thus shortening the appraisal process. The "simple" criteria employed in the trial of the Canadian merger cases cluttered the trial record with masses of inconsequential material that certainly did nothing to clarify, and probably helped to obscure, the essential issues.

Massel has summed up the considerations effectively in the following comment:

> "While analysis of competition may seem complex, it does not differ from other fields of economic inquiry or, for that matter, other disciplines. No single yardstick will do in the analysis of inflation, aerodynamics, corporate reorganizations, or medical ills....
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> "Every discipline seems to require the application of skilled judgment to determine which criteria are important for a specific problem. No methodology seems to provide automatic flags to signal the significant aspects of a problem. In this respect, the selection of indicators of competition is no exception....
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> "For the immediate future we must use a full kit of tools, rather than rely on an all-purpose one."*

And, as we have argued, such considerations assume even greater importance for a smaller economy than for a larger, dynamic one.

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* Massel, op. cit., pp. 196-197.

Mergers and Industrial and Organizational Migration in a Multinational Setting*

Over the past decade the literature on the multinational corporation and foreign mergers has grown at a formidable rate, reflecting both an acceleration in the spread of the multinational and a resurgence of nationalist sentiment. No attempt will be made to summarize or survey this material, in part because to do so would require an account exceeding in length this entire report but basically because our present interest relates to broad questions of adaptation and change required by the transition from an international to a world economy.

We begin with the conviction that the Canadian economy will to an increasing degree become integrated into a close-knit global economic system. Canadian economic units will have little choice but to undertake production and trade under the terms and conditions that such a system imposes. The so-called "domestic" and "service" sectors will be no more immune from the need to adapt to such pressures in a market economy than will the "international" sector, since the former sectors determine in significant measure the costs and the availability of resources, including investment capital, which condition the effectiveness of the international sector.

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* The expression "industrial migration" was used by Marshall, Southard and Taylor (Canadian-American Industry) to describe the two-way movement of industrial capital across the Canadian-American border. The broader expression is used here to refer, in addition, to the co-ordination of production and marketing over a number of countries, and to the use of the partial merger and the quasi-merger.

It is dangerous folly to believe that there is an alternative system of organization which Canada can adopt, insulating itself from world economic forces, developing its own innovations, fixing incomes on the basis of purely domestic log-rolling or pressure tactics, withholding its resources from world markets while insisting that such markets must continue to supply its needs, and much more in similar vein. Few nations have been able for long to avoid the necessity of reconciling the demands of internal and external balance in their economies. To pursue such an independent course requires an economy, large and well endowed in terms of resources, capital availability and markets, with advanced technological skills, and an appropriate institutional framework that will generate policies which among others, will limit uncertainty to tolerable levels, and will provide incentives equivalent to those available elsewhere. Perhaps France in the mercantilist period and the United States in its high-protectionist stage might be regarded as successful transient examples; if so, the circumstances accounting for their success have long since vanished.

Indeed, the consequences of indulging a belief that such a reconciliation is unnecessary are so clear that they have been identified as "the English sickness". At a minimum, mobile resources will seek opportunities elsewhere; and those unable to shift their site of operations will regress into competitive avoidance of domestic economic burdens, thus intensifying economic and political conflicts. Assuming that the need for continuous adjustment to a world economy is accepted as an essential condition of avoiding grave social and economic problems, what can be said in brief compass about the role of the multinational corporation, or more accurately the role of mergers or quasi-mergers in the multinational framework, in this process?

To provide a sense of perspective, it is important to recall that multinationality in firms is not particularly new. The confines of small national markets caused Swedish, Dutch, German and British firms to move beyond their national borders as early as the turn of the century. The smallest of these, Sweden, had companies such as SKF, the LM Ericsson Telephone Company, ASEA and Alfa-Laval with production subsidiaries established abroad well before the first world war. The special Canadian-American industrial investment pattern began its development at an even earlier date. By 1936, Marshall, Southard and Taylor pointed out that:

> "Canadian-owned companies in the United States are from 10 to 12 per cent of the number of American companies in Canada and employ 12 per cent as much capital.... The Canadian industry in America is therefore larger, proportionately, than is American industry in Canada. It is, of course, obvious that because of the much greater economic size of the United States, it does not at all follow from these percentages that the impact of Canadian industry in America on American economy is comparable with that of American industry on Canada."*

Despite its early origins, multinational enterprise has undergone significant changes in its magnitude and its nature in recent years. The multinationals have built up resources and organizations to scan the entire world in planning their production and marketing programs. Heilbroner has

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* Herbert Marshall, F.A. Southard, Jr., and K.W. Taylor, Canadian-American Industry (1936), p. 177, (re-published by McClelland and Stewart Limited, Toronto, 1976).

pointed out that they are making international investment and production - not the export of goods - the major economic channel among the main capitalist nations. Taking the ten leading capital-exporting nations together, for 1967 their combined total exports came to $130 billion, while their combined overseas production amounted to $240 billion.*

The areas of operations of the multinationals have also experienced a fundamental shift. Originating in such fields as oil, bananas, coffee, rubber, copper, the multinationals have recently shifted to manufacturing and high technology production in the advanced areas of the world.

Perhaps the most striking evidence of this shift has been the recent large increase of direct foreign investment in the manufacturing sector in the United States, where wages are high but the market is very large. Well-known firms such as Michelin Tire Corporation, Sony Corporation, Japanese textile companies such as Toyobo Company Ltd., and Kanebo Ltd., Volvo, Siemens Corporation, and the like, are representative of the large firms that account for a considerable proportion of this rising tide of investment. Smaller firms from smaller countries, feeling the constraints of their limited markets, are also participating in the movement, not only to invest in the United States market but in the EEC as well. At the same time, the flow of American investment abroad continues but with the same shift from the underdeveloped world to sophisticated manufacturing in the advanced areas.

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* Robert L. Heilbroner, The Economic Problem Newsletter, Vol. 2, No. 1, p. 3.

Of the range of influences accounting for these investments, one or two may warrant brief comment. Many of the large companies possess either special technical skills or strong public reputations for their products which can give them an important edge when they attempt to enter a foreign market. They may, as a result, be able to afford to pay more to acquire a local firm as a base for their operations than can local investors.

The investment may also enable the foreign company to adapt more rapidly to changing conditions in the new markets. As has been observed by many students of foreign direct investments, it is not a question of exporting manufactured goods or of manufacturing abroad. The alternative does not really exist. Howe Martyn has pointed out that to develop the full potential of foreign markets it has been necessary to send production men, advertising men and sales managers into the foreign country.*

Loibl, writing about foreign investment by both the German chemical industry and the American chemical industry, has remarked,

> "In the sphere of competition between the chemical companies such factors as applied techniques and technical service play a growing part. It is possible to fulfill these functions adequately only if one has at its disposal own production plants in the various markets. Speed and efficiency in adjustment and consultation are imperative. In accordance with this, there are relatively narrow limits for expansion by

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* Howe Martyn, International Business Principles and Problems (New York, 1964) p. 55.

> means of the export.... For all domestic chemical companies in industrial countries, the foreign and overseas markets become more and more important. Turnover abroad, and production abroad, grow faster than turnover at home, and the share of foreign investments by the chemical industries in total investments goes up all the time....
>
> "Among European chemical investments outside the country of a company's domicile, the American market is becoming an ever growing target.... Quite clearly the trend of the chemical industry leads towards an 'international chemical market' with 'multi-national companies'."*

A Swedish writer has commented in similar vein about Swedish multinationals,

> "As a rule, the establishment of foreign subsidiaries has been necessary to secure a stable export market which - in turn - supports production and employment at home.**

Furthermore, a Swedish study makes it clear that employment and sales have risen much faster in the foreign manufacturing subsidiaries of Sweden

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* Klaus - Michael Loibl, The American Chemical Industry in the EEC", Intereconomics, No. 11, 1970, pp. 356, 360. (This article contains excerpts from a study, Die US-Direktinvestitionen in der EWG-das Beispiel der Chemieindustrie.)

** Marcus Wallenberg, "The Impact of Multinational Corporations on Development and International Relations," Skandinaviska Enskilda Banken Quarterly Review, 4/1973, p. 128.

than in Sweden itself.* (See Table 6). Even making allowance for some margin of error due to differential rates of inflation in Sweden and abroad, the difference in growth rates is still of significant proportions.

Table 6

Industrial Employment and Sales in Sweden and in Foreign Manufacturing Subsidiaries of Swedish Companies 1965-1970.

(Preliminary figures.)

	1965	1970	Change 1965-1970 %
Swedish industry abroad			
Number of employees	146,600	182,400	24
Sales Kr.m.*	8,470	15,980	89
Total assets Kr.m.*	7,840	17,830	127
Industry in Sweden			
Number of employees	988,500	988,460	0
Sales Kr.m.*	76,750	110,930	45

* Current prices

* Lars Nabseth, "Slower Rise in Productivity: Serious Problem or Temporary Phenomenon?", loc. cit., 2/1972, p. 58.

Nabseth goes on to make a point of importance not only to Sweden but to all smaller countries:

> "Very often, the alternative to Swedish production abroad is not production in Sweden, but production by an entrepreneur from another country who perceives an existing market opportunity. By foregoing foreign production in such cases, we risk both the loss of exports to foreign subsidiaries as well as eventual remittances of profits. In addition, foreign production permits spreading research and development costs on larger volume production, which increase Swedish industry's competitive strength on both export and domestic markets."*

The impact of foreign investment, whether inward or outward, on research and development, and on the process of innovation, has been a matter of much public controversy and, if rumour is true, one that has had a strong influence on Canadian policy on inward foreign investment. The Canadian view apparently holds that foreign-owned subsidiaries do little research in Canada and, as a result, discourage the development of a research and development "industry" in Canada, and, in consequence, make more difficult the growth of a sophisticated manufacturing sector here.

The issue is often posed in over-simplified terms. It cannot be seriously maintained that major technological innovations would be readily achieved but for foreign ownership. When the production of a new aircraft engine is beyond the unaided scope of a highly sophisticated British firm that has specialized in that area; when the

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* Ibid., p. 61.

combined resources of Great Britain and France can produce a new aircraft - whether it will be a successful innovation remains to be demonstrated - only after great travail and unimagined cost; when the communist countries must enter into joint ventures with capitalist firms to achieve successful and efficient automobile production; when efficient farm machinery production requires coordinated engineering and production facilities spanning a number of countries and two continents - then to believe that but for foreign ownership Canada could independently make major technological and production break-throughs betrays a degree of ingenuousness that is not easy to credit. We prefer to assume that such a belief does not have serious support as a basis for formulating policy.

The more modest argument maintains that foreign ownership prevents the development of an R & D "industry" which would, but for that foreign control, achieve technological results much more to the benefit of the Canadian economy than those that would flow from the foreign ownership. The evidence for such a broad conclusion is also far from persuasive.

The outcome of recent government programs designed to promote R & D activities in Canada at a cost of vast millions to the treasury warrants little optimism. The initial confident forecasts of their contribution to the development of new technology, new products and of new industries in Canada have recently been discreetly muted. This is not adequate; before undertaking further intervention, direct or indirect, in this area it is important to have an open, objective analysis of that costly project. Accountability demands no less; potential guidance for future policy makes such an analysis doubly necessary. If a government agency is to be authorized to exercise authority to determine which inward foreign investments are to be permitted, we should first clarify the factors accounting for the nonfulfillment of the promise of the R & D program, the inauspicious record of the

DREE program, and the troubled performance of too many of the provincial support and investment programs. Otherwise, policy will owe more to faith than to experience and rational analysis.

The issue, of the relation between inward investment and domestic technology, has been intensively examined in both Europe and the United Kingdom. The general conclusion of the official British study is that the argument to the effect that the alternative to developing an independent European technological community is economic decline and complete domination by the United States "is wrong, and misleadingly over-simplified".*

The concluding paragraphs of that study merit quotation:

> "... Clearly the force of the chapter is not to suggest that new techniques and improved products are unimportant to the British economy. They certainly are. But this is not the same as saying that in all instances it is profitable for us to do the research. Research comparative advantage should be pursued like any other comparative advantage. We believe that in the past there has been an unwise emphasis on completeness of invention, on favouring large recognisable projects. Whereas it may be in only certain aspects of these projects that we actually have an advantage. And in research, of all areas, the goal of autonomy is likely to

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* M.D. Steuer, Peter Abell, John Gennard, Morris Perlman, Raymond Rees, Barry Scott and Ken Wallis, The Impact of Foreign Direct Investment on the United Kingdom (Dept. of Trade and Industry, London, H.M.S.O., 1973), p. 36.

be a particularly costly one. In many areas it will pay to leave the activity alone altogether and buy the products. In many inward direct investment is to our advantage. Then there are cases where production here under license makes sense, and finally in some areas it will be efficient for us to do research. The success of civil servants and politicians in deciding which is which has not been great up to now.

To summarize, a closer look at the inward investment implications for United Kingdom technology suggests that the familiar a priori arguments, both for gain and for loss, are not very persuasive. Where hard work on a particular case may show that one or the other favourable or unfavourable effect has indeed taken place, generalizing from this work across the economy is not warranted. The kind of view quoted in the first paragraph, that an independent technology is essential to our prosperity and the avoidance of American domination, is romantic nonsense. It is often more profitable to apply an invention than to create one. The United States steel industry is not dominated by Austria though it employs in a fundamental way a technique first used there."*

Loibl, in his study of foreign direct investment in the chemical industry in the EEC, concluded that expenditure on research and development by American subsidiaries was largely limited to maintaining small research laboratories overseas geared to the development of applied techniques and

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* Ibid., pp. 46-47, emphasis added.

trouble-shooting in connection with customer service. Recent years have, however, seen the development on a limited scale of basic research in certain fields abroad. Loibl did not, in any event, consider the "basic research issue" as being of great importance:

> "The internal exchange of know-how has for the technological development within the EEC essentially the same significance as though research were carried out by subsidiary companies directly. Foreign subsidiaries are after all the best media for a know-how inter-change. The effect is faster, and reaches deeper, than in the case of export or manufacture under license."*

Moreover, American competition did encourage "stronger market research efforts all round by the European chemical industry".

Wallenberg concluded that because Swedish domestic markets were small and competition in them was very keen, foreign subsidiaries were limited to the production of very sophisticated types of products.

> "Consequently, what foreign manufacturing subsidiaries in Sweden contribute to the economic development of our country is principally the introduction of new technologies, competitive pressure on domestic and other foreign manufacturers operating in Sweden, etc."**

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* Loibl, op. cit., p. 357.

** Wallenberg, op. cit., p. 128.

Policy Implications

There are persuasive reasons to believe that in manufacturing and high-technology production the new-product oligopoly will continue to be the most important market form in the forseeable future. The most dynamic industries will also be found in this sector rather than in the services sector or in the resources sector. The manufacturing and high-technology industries will be influenced by (and will extend their influence to) developments taking place beyond purely national horizons unless hampered by state intervention. The determinants of performance -- in particular the long-run aspects of performance -- in such circumstances are complex and many-faceted. The capacity to respond flexibly and promptly to unforeseen technological, organizational and marketing changes at home and abroad will be the minimum requirements for successful survival. Few nations possess, independently, the resources in entrepreneurial ability, in production skills or in breadth of markets to provide the opportunities and to maintain the pressures needed to assure continuing effective performance. Hence the issue of mergers, partial mergers or quasi-mergers is certain to assume a significant role in policy relating to this sector.

In substance, "good" merger policy involves the relevant agency in predicting the longer-run effects of certain limitations on (or extensions of) the firm's planned production and marketing designs within a non-static framework. In order to do so in a coherent fashion it is essential to have a broad theory of dynamic industrial and market behaviour in a domestic-international context. This we have attempted to provide in this report. One aspect of merger policy that is basic, in our view, is the conviction that intervention in a dynamic, long-run context should avoid detailed tinkering with elements of structure and behaviour and should rely primarily on eliminating artificial restraints and on maintaining pressure for adjustment from as

many directions as is feasible, but without resorting to extreme policies advanced by the doctrinaire purists.

It is this broad approach which causes us to view the procedure and the principles employed by the Foreign Investment Review Act with serious concern. As we have explained in some detail, the Canadian jurisprudence on mergers was (and still is) in a serious state of disarray, with respect to domestic and international mergers alike. It is, therefore, understandable that some action was deemed necessary; FIRA is not, in our view, the appropriate response.

We consider it seriously deficient on a number of counts. First, there is no well developed theory (or, if that term is preferred, "rationale") of industrial and market behaviour and performance in the domestic-international context to guide and illuminate decisions for the private sector and to test the validity of the decisions made by the enforcement agency. So far virtually all we have by way of a general rationale is the statement contained in the First Annual Report of the Commissioner of the Foreign Investment Review Act, 1974-75, in which, under the heading "Analysis of Benefits to Canada", five sets of factors are listed for consideration in determining whether a proposed takeover of a Canadian business enterprise is likely to be of significant benefit to Canada.* These five sets of factors have been further broken down into ten requirements in a statement by the Minister.**

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* These are the five criteria set out in subsection 2(2) of the Act.

** See, e.g. "Gillespie Raises FIRA's Veil", Financial Times of Canada, March 10, 1975, pp. 23-24.

"Ottawa is applying 10 criteria to applications under the Foreign Investment Review Act. Last week, there was some evidence of what priority it attaches to them. In approving 13 foreign takeovers, Industry Minister Gillespie reported the number of firms meeting each of the 10 requirements as follows:

" Criteria	No. of firms meeting them*
1. Compatibility with industrial and economic policies.	13
2. Improved productivity and industrial efficiency.	13
3. Increased employment.	10
4. New investment.	9
5. Improved product variety and innovation.	8
6. Canadian participation (as shareholders, directors, managers).	8
7. Increased resource processing or use of Canadian parts and services.	8
8. Enhanced technological development.	7

* Out of 13.

9. Beneficial impact on competition. 7

10. Additional exports. 4"

These criteria are unduly concerned with short-run considerations; furthermore, since they are not functionally co-ordinated into a coherent, integrated analytical formulation, policy decisions tend to take the form of ad hoc intervention in matters of detail, amounting in some cases to second-guessing the management. The longer-run aspects of mergers or quasi-mergers in rationalizing production and marketing are neglected; in fact, the issues discussed in the section of this report dealing with structural rationalization receive no meaningful attention.

As a general proposition, the more specific the requirements imposed by the state on the acquiring firm, the more responsibility is placed on the government to adopt compensating or supporting actions in the event that the operations of the firm or of the relevant indusry encounter difficulty. The restructuring of the textile industry and the experience of some of the provincially-supported firms that have run aground are cases in point.

The effective performance of a firm over time has little to do with specific undertakings to do certain things such as* "to invest the proceeds of the sale in new industrial and commercial projects in Canada" or "to increase the range of oil field industrial equipment and services the firm

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* The quoted statements were listed in the article referred to in the immediately preceding footnote as being supplied by the Minister of Industry, Trade and Commerce as the basis for FIRA decisions in specified cases.

offered", or to "promise expansion and commit itself to making a public offer of its stock in Canada", or "to extend the upper range of electric motors manufactured in Canada to 12,000 horsepower", or "to develop engineering expertise and undertake research and development in the field of traction equipment", as specified by FIRA, but on the ability of the firm to adapt to changing technology, organizational methods, market demand, and the like. As Tibor Barna has expressed it in his perceptive study of Investment and Growth Policies in British Industrial Firms:

> "Growth requires the constant internal reorganization of the firm. This is partly because environment changes and the firm, if it is to adapt itself, may have to produce different commodities or use different processes. But change in size is itself a reason for reorganization. The firm, like a child when it grows, does not grow equally in all dimensions but has to develop a different internal organization to deal with different functions." (p. 42)

One of the most important elements in the progress of the firm (and of the economy) is "the personal characteristics and attitudes of management".

This emphasis on the quality of management brings up the matter of the weight which FIRA attaches to the willingness of the foreign acquiring firm to accept "increased Canadian participation as shareholders, directors and managers" but particularly in "key management positions".* Now, one of the scarcest "factors of production" in any country is high-level management skill, and in Canada particularly the demand much exceeds the

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* See Annual Report 1974/75, FIRA, p. 9.

supply. The significance of management in the context of inward foreign investment has been concisely summarized by Barna:

> "An interesting feature of the development of competitive pressures is the role of foreign firms operating in the United Kingdom. The general effect of their intervention appears to be an acceleration of industrial growth. This takes place not only through direct competition, including a more rapid introduction of new products, but also indirectly through emulation of techniques in administration, marketing and even financial control. Examples can be found of British firms offering employment to men trained in the practices of foreign firms operating in the United Kingdom (usually in another industry) in order to introduce those practices in their own firms."*

This view has been supported by other writers on foreign investment in the United Kingdom and Europe.

To put any significant number of Canadians in the "key management positions" of incoming foreign firms is likely to do more for Canadian self-regard than for Canadian economic performance. Canadians should reasonably expect, over time, to move into such positions, depending on their performance; they should expect nothing more. Commitments to make such immediate appointments as a condition of FIRA merger approval would be counter-productive.

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* Barna, op. cit., p. 52.

Although all of the ten requirements specified by FIRA are riddled with ambiguity* -- especially the three dealing separately with "improved productivity and industrial efficiency", "innovation", and "enhance technological development" -- we will limit our final comment on these detailed items to that requiring a "beneficial impact on competition".

The evaluation of this requirement is, we understand, carried out by the Bureau of Competition Policy; and an adverse finding on this count is usually of over-riding weight in the assessment of any foreign takeover. Competition is a word that means many things to many people. Since the analyses prepared by the Bureau are not made public** - in contrast to its practice in connection with domestic mergers - it is impossible to analyze them to determine if they are consistent with the general approach we recommend. It is possible to conceive of situations in which the adverse effects of a proposed merger on "competition" would be so serious as to outweigh all its probable favourable effects in other respects. It is equally possible to conceive of situations where the adverse competition effects would be offset by compensating advantages, or could be offset by changes in the environmental circumstances of the industry in question.

In general, in view of the patent inadequacies of the FIRA approach, we can perceive no pressing reason of principle or expediency why the analysis of foreign mergers or joint ventures should not be

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* As are the relative weights to be assigned to each of the ten requirements.

** This is not a matter in which the Bureau of Competition Policy has any choice.

carried out in the same manner as applies to domestic mergers. We strongly recommend that if our proposals for the handling of domestic mergers are adopted that the same method should apply to all forms of inward foreign mergers, partial mergers and quasi-mergers.*

There would, even if this were done, remain some problems in relation to the operation of multinational firms (not limited to those situations where multinationality was achieved by the merger route) which may require special consideration: matters such as the remission of profits from one branch to another, pricing of products and services in intra-firm transactions, special forms of price discrimination, and so on.

The Director of Investigation and Research is actively engaged in a broad program of international co-operation designed to deal with restrictive business practices and anti-competitive behaviour at both the North American level and the O.E.C.D. level. Detailed accounts of these activities are provided, for the North American program in the Report of the Director for 1970 (pages 21-23), and for the OECD program in the Report of the Director for 1974 (pages 11-17).

Although much is being done, it is clear that a new, and as yet unpredictable, chapter is opening in the long history of the relationship between business and the state.

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* In the section on advance clearances, we suggest certain changes in the handling of foreign mergers if the FIRA remains in force.

Statistical Appendix

Tables A-1 to A-7

Table A-1

Number and Volume of Consolidations and Number of Enterprises Absorbed, 1900-1948, Canada

(Volume in Millions of Dollars)

	Consolidations		Enterprises Absorbed		Consolidations		Enterprises Absorbed
	No.	Vol.	No.		No.	Vol.	No.
1900	3	6.2	5	1925	31	173.4	79
1901	3	43.0	10	1926	33	149.1	69
1902	2	2.7	45	1927	46	147.5	86
1903	1	7.0	4	1928	87	206.5	179
1904	3	5.2	3	1929	74	179.9	148
1905	7	13.9	27	1930	44	112.0	74
1906	10	14.3	21	1931	26	35.5	37
1907	5	3.6	10	1932	16	6.8	16
1908	3	9.6	7	1933	18	77.8	21
1909	10	40.4	40	1934	14	17.2	19
1910	25	58.8	73	1935	16	14.8	22
1911	28	45.6	46	1936	12	5.4	16
1912	22	21.9	37	1937	9	7.9	11
1913	12	34.0	25	1938	13	12.3	16
1914	2	2.1	7	1939	10	5.3	13
1915	7	10.8	8	1940	7	6.6	8
1916	9	32.9	9	1941	6	7.6	6
1917	9	12.8	11	1942	12	13.7	12
1918	4	9.2	5	1943	18	30.5	21
1919	13	18.4	21	1944	25	28.7	29
1920	15	45.5	16	1945	30	36.0	56
1921	5	48.0	7	1946	32	37.3	49
1922	9	2.6	9	1947	16	22.7	20
1923	18	49.2	52	1948	18	25.9	20
1924	9	15.3	9				
				Total	847	1,913.4	1,534

Notes: The volume of consolidations is derived in the following manner: each consolidation is weighted by the gross assets (less depreciation) of the enterprises absorbed in consolidation. Where such weights are not available, nominal minimum weights are attached. This procedure is used because enterprises for which assets figures cannot be obtained are usually (though not always) small: hence bias in weighting is reduced to a minimum. Nominal weights are required for less than one-fifth of the consolidations. This proportion of nominal weights is somewhat higher in the early years than in the later years, but not sufficiently so to produce a significant bias. No effort is made to deflate the volume figures by a price index.

Source: J.C. Weldon, "Consolidations in Canadian Industry, 1900-1948", in Skeoch (ed.), op. cit., p. 233.

Table A-2*

Number of Acquired Firms and Number of Canadian Firms, By Year 1945-61

Year	Total	Foreign Acquisitions of Canadian Firms by U.S. Firms		Number of Domestic Acquisitions	Number of Domestic Firms	Ratios x 100 (2)/(6)	Ratios x 100 (5)/(6)
(1)	(2)	(3)	(4)	(5)	(6)	(12)	(13)
1945	23	17	20	51	27,229	.08	.19
1946	15	11	9	64	30,442	.05	.21
1947	13	10	9	32	34,087	.04	.09
1948	14	8	12	39	35,960	.04	.11
1949	11	5	6	27	37,467	.03	.07
	76	51	56	213	33,037 (av.)	.24	.67
1950	9	7	6	36	40,545	.02	.09
1951	19	14	14	61	43,365	.04	.14
1952	17	16	10	59	45,777	.04	.13
1953	25	21	14	68	49,745	.05	.14
1954	43	29	24	61	54,434	.08	.11
	113	87	68	285	46,773.2 (av.)	.23	.61
1955	56	45	32	78	59,773	.09	.13
1956	54	38	34	81	67,480	.08	.12
1957	35	27	19	68	73,823	.05	.09
1958	60	36	46	80	80,770	.07	.10
1959	66	53	46	120	88,804	.07	.14
	271	199	177	427	74,130.4 (av.)	.36	.58
1960	93	67	52	110	97,549	.10	.11
1961	86	69	63	148	106,309	.08	.14
	179	136	115	258	101,929 (av.)	.18	.25
Total	639	473	416	1,183			

Source: Table A-6 excluding firms in X and Y categories; Taxation Statistics, Department of National Revenue, Figure in column 6 includes both profit and loss companies.

* Grant L. Reuber and Frank Roseman, The Take-Over of Canadian Firms, 1945-61 (Ottawa, 1969), p. 32.

Table A-3

The Take-Over of Canadian Firms, 1945-61*

Number of Acquired Companies, 1945-61
Classified By Manugacturing Industry

Year	Manufacturing Industry																			
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
A. Total Foreign Mergers																				
1945				1				1	1	4			2			2	2		3	
1946	3	1			1					1			1				1			
1947	1												1			1	1		3	
1948	3							1					1	1	1	1				
1949											2					1	1		2	
1950													1	1	2	1				
1951	2		2		1			3		1		1		1						
1952	3				1							1	1			1	1	1	1	1
1953								1		4	1			3		3			3	
1954	3		1	1	1		1	1		3				1	1	5	2	2		1
1955	2		2	3			1	3		3		1	5	3	2	5	2	1	3	1
1956	2			1	1				1	3		1	3	1	1		1	3	4	1
1957	1						1			4		3		1	6	1	3		3	2
1958	6	2	1	1	1			2					4		2		3		2	2
1959	4			2	2	3	2	2		3		1	6	2	2	4	1		6	2
1960	6	1		1			1	2		1	2		5	5		3	2	2	8	7
1961	5			3			1	1	1	4	1	2	1	5	2	3	2		9	1
Total	41	4	6	15	8	3	8	17	3	31	6	10	31	24	19	34	22	9	47	18

continued...

B. Canadian Companies Acquired in International Mergers

1945				1				1	1	3			2			1	2		1	
1946	1	1								1			1				1			
1947	1															1	1		2	
1948	1							1					1		1					
1949											1						1		2	
1950													1	1	2	1				
1951	2							2		1		1		1						
1952	3				1							1	1				1	1	1	1
1953								1		3	1			1		3			3	
1954	3			1	1		1			2						2	2	2		
1955	2		1	3			1	3		2		1	5	2	2	3	2	1		1
1956	2			1	1				1	2		1	2	1	1		1	2	3	1
1957							1			2		3		1	4	1	2		2	2
1958	5	2	1		1			1					1		1	1	1		1	1
1959	3			2	2	3	2	1		2			4	2	2	1	1		4	1
1960	5			1			1	1		1	2		4	2		3	2	2	5	7
1961	5			3			2	1	1	3	1	2		3	2	3	2		6	1
Total	33	3	3	12	7	3	8	12	3	22	5	9	22	14	15	20	19	8	30	15

* Reuber and Roseman, op. cit., pp. 70-71.

continued...

Table A-3 (Cont.)

Leading Characteristics of Merging Firms

Year	Manufacturing Industry																		
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
C. Domestic Mergers																				
1945	23				1	1	2	2		2	1		2		1		1			
1946	21			1	3			4		1		1	1	2	2	1	1		1	
1947	10			1				2						1	2				1	
1948	7			2	1	1		1			2						2			
1949	3				1		1	1		1	2	1	1			1				1
1950	5									1	3	1	3	2		1	1	1	1	2
1951	6			2			1	4			2		3		2	1		1	2	1
1952	9		1	2	2		2	3		1	3	1	2	1		1	1			1
1953	14							1	1	3	2	1					2			1
1954	8			2		1	1	1	1	4	4	1	2					1		1
1955	14		1		1	2		2	1	1	3		2			2	1		1	
1956	11				4			1		5	2	1	5		1	1	3			1
1957	6		1	1	1					3	10			2			3	1	2	1
1958	9				2			2			1	2	4		1	1	1	1	3	2
1959	14			3	5	2	2			6	7	2	5			2	3	1	8	1
1960	6				2	1		3		10	5		4		1	3	4		2	2
1961	18		1	1		1		1	2	3	4	2	5	3	1	2	8		5	2
	184	0	4	15	23	9	9	28	5	43	51	13	39	11	11	16	31	6	26	16

Manufacturing Industry

1. Food and beverages
2. Tobacco
3. Rubber
4. Leather
5. Textiles
6. Knitting mills
7. Clothing
8. Wood
9. Furniture
10. Paper
11. Printing, etc.
12. Primary metal
13. Metal fabricating
14. Machinery
15. Transport equipment
16. Electrical products
17. Nonmetallic mineral products
18. Petroleum and coal products
19. Chemicals
20. Miscellaneous

Table A-4

Mergers and other forms of cooperation in Swedish industry, 1958-66*
(No. of amalgamations and agreements on cooperation)**

Type of measure	1958	1959	1960	1961	1962	1963	1964	1965	1966
Acquisitions and mergers of companies in Sweden	22	17	49	55	58	73	86	147	162
Purchase of parts of companies in Sweden	4	1	7	2	18	20	21	15	39
Agreements on cooperation in Sweden	11	9	16	21	23	21	18	25	48
Swedish acquisitions of foreign companies	1	6	2	4	5	4	10	12	14
Foreign acquisitions of Swedish companies	-	3	2	4	10	4	5	10	14
Agreements on cooperation over the borders	4	6	16	27	30	25	23	21	19
Total	42	42	92	113	144	147	163	230	296

* Bengt Ryden, "Concentration and Structural Adjustment in Swedish Industry during the Postwar Period", Skandinaviska Banken Quarterly Review, 1967: 2, p. 52.

** The term amalgamation is here used in the economic sense to devote total and partial mergers and consolidations.

Table A-5

Mergers and agreements on cooperation in Swedish industry, 1958-66, by industrial group*

Industrial group	No. of mergers in Sweden (complete and partial)	Mergers as a percentage of the no. of companies, 1962	Merged companies' turnover as a percentage of the total value of output in the group 1958-62	1963-64	No. of agreements on cooperation in Sweden	No. of mergers and agreements on cooperation over the borders
Metal-working, machinery and engineering	320	6.0	33	48	86	137
Non-metalliferous quarrying	50	5.3	23	45	14	3
Timber	48	2.0	4	4	16	0
Pulp and paper	63	25.8	30	33	14	27
Printing and allied industry	17	1.8	5	33	1	4
Foodstuffs	71	3.3	46	27	10	18
Beverages	19	11.6	75	95	4	7
Textiles and clothing	60	3.6	15	19	15	32
Leather, furs and rubber	18	4.3	17	15	1	9
Chemicals and chemical products	86	34.1	31	54	15	41
Electricity, gas and water	8	4.1	-	-	12	1
Building	15	0.5	-	-	4	6
Total industry	796	4.5	31	40	192	279

Sources: Table 1, Register of Companies and industrial statistics.

* Bengt Ryden, ibid., p. 55.

Table A-6 -- Number and assets of large manufacturing and mining companies acquired, by industry of acquired company, 1948-1971, U.S.A.

Industry of acquired company	Number of acquisitions	Percent	Assets (millions)	Percent
Food and kindred products	157	9.5	$6,970.9	9.3
Tobacco manufactures	5	0.3	567.0	0.8
Textile mill products	90	5.4	2,580.2	3.4
Apparel	37	2.2	2,438.4	3.2
Lumber and wood products	43	2.6	1.147.4	1.5
Furniture and fixtures	20	1.2	439.1	0.6
Paper and allied products	101	6.1	5,093.8	6.8
Printing and publishing	55	3.3	1,261.2	1.7
Chemicals and allied products	140	8.5	6,851.0	9.1
Petroleum and oil products	57	3.4	8,592.4	11.4
Rubber and plastics products	31	1.9	571.6	0.8
Leather and leather products	14	0.8	272.9	0.4
Stone, clay, glass, and concrete products	68	4.1	1,893.4	2.5
Primary metal industries	120	7.3	7,810.8	10.4
Fabricated metal products	113	6.8	2,692.4	3.6
Machinery, except electrical	219	13.2	8,600.5	11.5
Electrical machinery	122	7.4	4,428.7	5.9
Transportation equipment	92	5.6	6,386.5	8.5
Instruments and related products	38	2.3	1,164.6	1.6
Miscellaneous manufacturing	34	2.1	829.2	1.1
Mining	94	5.7	4,251.2	5.7
Ordnance	3	0.2	255.9	0.3
Total	1,653	*100.0	75,099.1	*100.0

* Percentages do not add to 100.0 due to rounding.

Source: Bureau of Economics, Federal Trade Commission.

Mary Ann Comps, et al., Large Mergers in Manufacturing and Mining, 1948-1971. (Federal Trade Commission, Washington, D.C., 1972), Table 3, p. 8.

Table A-7

Number of manufacturing and mining concerns acquired, by industry of acquiring company, 1961-1971, U.S.A.

Major industry group 1/ of acquiring company	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970 2/	1971 3/
Total 4/	954	853	861	854	1,008	995	1,496	2,407	2,307	1,351	1,011
Manufacturing	780	744	716	712	826	841	1,261	1,948	1,766	1,045	760
Food and kindred products	73	56	67	69	86	69	95	133	155	109	85
Tobacco manufactures	5	5	6	6	5	9	5	5	13	9	3
Textile mill products	31	22	37	25	34	27	22	64	56	22	19
Apparel	20	37	25	30	42	37	45	68	44	25	18
Lumber products, except furniture	10	12	21	6	13	15	24	45	49	29	22
Furniture and fixtures	5	9	8	6	11	14	16	37	26	19	11
Paper and allied products	28	23	16	14	27	21	36	44	47	31	16
Printing and publishing	46	31	31	24	30	23	33	60	78	42	44
Chemicals	86	108	78	103	89	105	123	153	145	108	59
Petroleum	10	25	14	19	24	13	10	12	14	6	9
Rubber and plastics	18	15	14	13	20	15	29	45	30	26	17
Leather products	7	9	6	9	6	6	7	29	27	15	11
Stone, clay, glass, and concrete	24	22	15	15	24	27	35	68	58	43	31
Primary metals	34	36	35	39	28	33	65	135	105	57	51
Fabricated metal products	57	32	46	45	63	50	87	143	128	54	46
Nonelectrical machinery	87	73	88	72	87	102	155	259	214	153	87
Electrical machinery	122	113	109	116	117	145	257	332	309	145	112
Transportation equipment	47	56	46	56	59	64	103	133	124	71	44
Instruments & related products	50	42	28	34	36	50	92	133	96	49	42
Miscellaneous and ordnance	20	18	26	11	25	16	22	50	48	32	33
Mining	50	32	55	39	47	42	56	84	94	83	76
Other	124	77	90	103	135	112	179	395	447	223	175

1/ As defined in Standard Industrial Classification Manual, 1957 and 1967, U.S. Bureau of the Budget.
2/ Revised.
3/ Preliminary.
4/ Same as in Table 2.
Source: Data limited to mergers and acquisitions reported by Moody's Investors Service, Inc. and Standard and Poer's Corporation, Bureau of Economics, Federal Trade Commission.

Amelia Lucas, et al., Current Trends in Merger Activity - 1971 (Federal Trade Commission, Washington, D.C., 1972), Table 3, p. 10.

DISCUSSION DRAFT - LEGISLATION

Mergers*

(1) In this section, "merger" means the acquisition by one or more persons, whether by purchase or lease of shares or assets or otherwise, of any control over or interest in the whole or part of a business of another person.

(2) The Director may apply to the Board for an order under this section with respect to any merger or proposed merger, provided that any application with respect to a merger is brought within one year of the time the Director first learns of the merger or the merger becomes a matter of published record, whichever is sooner.

(3) Where, on application by the Director, and after affording every person with respect to whom an order is sought a reasonable opportunity to be heard, the Board finds that a merger or proposed merger is or would be contrary to the public interest, the Board shall make an order directing any person or persons who have been afforded a reasonable opportunity to be heard to dissolve the merger in such a manner as the Board prescribes, or not to proceed with the merger, or only to dissolve or not to proceed with the merger in specific circumstances, as the case may be.

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* This Discussion Draft was prepared solely to seek to assist in the consideration of the main substantive recommendations on this subject in the report. By omitting a full formulation of all related recommendations in the report we do not mean to ignore those recommendations.

(4) In determining whether or not a merger or proposed merger is or would be contrary to the public interest, the Board shall consider the evidence in the following manner and with the following effects:

(a) unless the Board is satisfied that the merger or proposed merger will, with reasonable probability, have the effect of creating or enhancing artificial restraints in a market to a significant extent, no order shall be made under subsection (3);

(b) if the Board is satisfied that the merger or proposed merger will, with reasonable probability, have the effect of creating or enhancing artificial restraints in a market to a significant extent, but is also satisfied that such effect will, with reasonable probability, be on balance offset by real-cost economies or by the diminution of artificial restraints other than those referred to in subparagraph (a), also resulting from the merger, no order shall be made under subsection (3);

(c) if the Board is satisfied that the merger or proposed merger will, with reasonable probability, have the effect of creating or enhancing artificial restraints in a market to a significant extent, and also is not satisfied that such effect will, with reasonable probability, be on balance offset by real-cost economies or by the diminution of artificial restraints other than those referred to in subparagraph (a), also resulting from the merger, the Board shall make an order under subsection (3) directing the dissolution of the merger or directing that it not be proceeded with, as the case may be, unless

(i) there appear to be circumstances which would bring the matter within subparagraph (a) or subparagraph (b), in which case the Board may make an order under subsection (3) conditioned upon the existence of such circumstances; or

(ii) the merger involves a failing business or is part of a structural rationalization scheme, in which case the Board need not make an order under subsection (3).

II - 2. MONOPOLY

Introduction

There is a tendency to regard monopoly as being a phenomenon of comparatively recent development, the product of the growth of the large corporation, bringing in its train high levels of control in individual markets and an undue concentration of power in the hands of a relatively small group in the economy. This condition is compared, unfavourably, with what Earl Latham has described as "a fable that begins with the Golden Age of small enterprisers, diffused political power and a small militia, all dwelling secure in the automatic equilibrium of small components".*

In fact, the idyllic picture of an early decentralized, self-correcting, atomistic economy with its benevolent guardianship of the rights of the consumer is as much a matter of myth as is the menacing picture of the ubiquitous large monopolist exploiting small, weak competitors and equally defenceless consumers.

The perpetuation of such stereotypes complicates the analysis of what is at best a most intricate and intractable problem, that of identifying positions of high levels of market power, assessing their significance in an interdependent market economy and attempting to devise remedies. As will be explained, monopoly power cannot necessarily be equated with bigness; hence the definition of relevant markets and the identification of the degree to which high levels of monopoly power may be exercised in local, national or world markets,

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* Earl Latham, Political Theories of Monopoly Power, (University of Maryland, College Park, Maryland, 1957), p. 8.

requires complex analysis with rather blunt tools. The conditions which permit the exercise of monopoly power also require analysis, whether they derive from technological and organizational economies, from control of scarce resources, from "natural" monopoly conditions, from cartel-like controls, from the requirements of professional competence in certain fields, or from the imposition of government controls. Indeed, some close observers of monopoly insist that governments -- local, provincial and federal -- are, themselves, the chief creators and protectors of monopoly; that without government sanction or support, monopoly positions would be undermined.

Historically, monopolies were, in fact, largely the creatures of the State. As Adams and Gray have observed:

> "The Statute of Monopolies [1624] altered, rather than ended, the national grievance. While attacking monopolies, it left loopholes through which corporations could safely pass. While imposing limitations on the royal prerogative, it symbolized a willingness to have monopolies - provided Parliament alone granted them....
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> Throughout the seventeenth, and for the better part of the eighteenth century, cities, boroughs, guilds, corporations, and trading companies continued to exercise their monopolistic restrictions; and the common law continued, by and large, to protect their customary monopoly privileges."*

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* Walter Adams and Horace M. Gray, Monopoly in America, the Government as Promoter (New York, 1955), p. 35.

After an interregnum of uncontrolled competitive enterprise resulting from the revolt against the detailed regulation of economic activity by the mercantilist state -- what may properly be described as the "pure" laissez faire period -- there developed newer forms of business combination based on the interpretation that laissez faire included the freedom to monopolize as well as to compete. This, in turn, gave rise to attempts by the state to regulate some of the more visible monopolies -- "businesses affected with a public interest" -- in terms of the public utility concept. For the purposes of these introductory comments, it may merely be noted that this policy measure has met with little support among confirmed believers in a competitive economy. Professor Henry C. Simons, for example, held that "Unregulated, extra-legal monopolies are tolerable evils; but private monopolies with the blessing of regulation and the support of law are malignant cancers in the system."* More recent analyses, although couched in less vehement language, attest to the ineffectiveness of the regulatory process. To be fair to Professor Simons, it would also have to be conceded that government-sponsored restraints have accounted for many of the worst examples in the rogues' gallery of restrictive practices.

The extent to which governments have imposed, authorized or protected various forms of monopoly power, by direct regulation, by establishing cartel-like controls of production and marketing, by enacting local ordinances to protect local suppliers and contractors, and so on -- particularly during the post-depression period and the post-World War II period -- bids fair to challenge the web of monopolistic arrangements during the eighteenth century.

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* "The Requisites of Free Competition", American Economic Review, (March, 1936), p. 74.

At the same time, a big-unit economy, in business and labour, has taken form in many sectors of the economy. The argument is sometimes advanced that in the long-run private monopoly, even when properly defined, tends to break down -- barring government support. Consumers, recalling Keynes' well-known dictum, may find scant comfort in such assurance.

Professor Clair Wilcox, in his brilliant study, Competition and Monopoly in American Industry, for the Temporary National Economic Committee (1940), did profess to see a pattern of instability in both competition and monopoly:

> "In those industries which appear normally to be competitive, competition is constantly breaking down. Competitors continually seek to limit competition and to obtain for themselves some measure of monopoly power. They enter into agreements governing prices and production. They procure the enactment of restrictive legislation. For a time they may succeed in bringing competition under control. But these arrangements, too, are constantly breaking down. Competitors violate the agreements. Associations lack the power to enforce them. New enterprises come into the field. Restrictive statutes are invalidated by the courts or repealed by the legislatures. The lines of control are repeatedly broken and reformed. The facts that describe the situation existing in such an industry today may not apply to the one in which it will find itself tomorrow.
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> In those industries that appear at any time to be monopolized, likewise, monopoly is constantly tending to break down. Human wants may be satisfied in many

> different ways. Shifts in consumer demand may rob the monopolist of his market. Invention may develop numerous substitutes for his product.... The monopolist may suffer, too, from the lack of the stimulus to efficiency - which is afforded by active competition. His originality may give way to inertia, his energy to lethargy.... Government finally, may intervene. Legislation may forbid practices that were once allowed. Enforcement may catch up with violations of the law. For one or another of these reasons, few of the great trusts that were formed near the turn of the century now possess anything approaching absolute monopoly power. But few of the fields that were then monopolized have become effectively competitive. Combinations have been dissolved, new competitors have arisen, and competition has been restored, only to give way to a succession of devices designed for the purpose of dividing markets and maintaining prices. Here, again, the lines of control are repeatedly broken and repeatedly reformed" (pp. 308-309).

In a dynamic economy, this process of attack and counter-attack may very well be relied on to prevail; in more static economies -- as the section dealing with structural rationalization makes clear -- public policy may have to adopt a more positive posture to maintain pressure for continuous adjustment. At the least, Wilcox's analysis cautions against adopting too short-run an approach to the working of dynamic elements in the economy.

In any event, monopoly power is not something new and ominous in the history of western industrial society. As Latham has remarked, "A

political scientist... tends to receive rather skeptically the dawn-of-discovery tone with which some economists have pronounced the stalest clichés about power."*

Although it would be unwise to become complacent about monopoly power in the private sector, appropriate policies with respect to new mergers, effective enforcement of policies to discourage abuse of monopoly power, and the development of policies to promote change based on real-cost economies, will go far to keep monopoly elements within tolerable limits.

The rigidities created by government-authorized or government-operated monopolies will, however, present special problems, at least as long as public-sector monopolies enjoy immunity from the range of policies available for application in the private sector. In an interdependent market economy, detrimental monopoly behaviour will be transmitted to other branches of the economy whether the detriment originates in the public or in the private sector.

Identifying Monopoly Power

Monopoly, in the sense of a single and sole seller having complete control of its market price since there is no alternative source of supply of goods in its market, is rarely encountered in practice. In theory, the monopoly can adjust its price up or down while limiting or expanding its sales volume and thus choose the most profitable price relative to its costs. With such assumed control, it can be demonstrated that the monopolist will produce less and charge more than an atomistically

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* Earl Latham, op. cit., p. 3.

competitive industry with similar costs would do. Hence, it is concluded, the monopolist will restrict output and earn excess profits.

The ability of a monopolist to act in accordance with such a formula would depend in a fundamental sense on its power to control supply (or, in the case of a monopsonist to control the buying side).* The classic basis for monopoly was probably the control of the only source of supply, either because it was the sole natural source for the product, such as a salt mine or the only body of ore available, or because the market was isolated by high transport costs. Indeed, so profitable was the exploitation of some resource monopolies, such as salt, that they were appropriated by the head of the state. A more modern example based on the power to control marketing would be found in the monopoly of the sale of alcoholic beverages by the state.

There is a tendency to equate monopoly with absolute bigness but this is misleading; it is the size of the seller relative to the market and to its ability to use power to restrain, block, obstruct or exclude entry or the offering of alternatives in the medium-term or in the longer-run, that is important. This power will rarely be absolute (except, perhaps, in a few so-called "natural monopolies"), so that what we are concerned with is degrees of market power. Where market power is high, we tend to refer to it as monopoly (or monopsony) power. Its identification in the operative sense involves all the complexities already referred to in the measurement of market power.

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* There might, of course, be considerations relating to public policy intervention, fear of encouraging a search for substitute products, and the like, that would deter the monopolist from pursuing the excess profit route.

The Temporary National Economic Committee (T.N.E.C.) in its Investigation of Concentration of Economic Power, referred to the matter of local monopolistic power in the following quotation:

> "'There is a tendency,' writes A.A. Berle, 'to idealize the early nineteenth century and to assume that small business and the prices it charged were the result of competition. As far as I am able to see, there is little, if any, foundation for this. The village store, the village blacksmith, the village grist mill, were all monopolies. Until the advent of the automobile, they charged conventional or administered prices which were not elastic. The people of the village could not go many miles to the next town. In a large measure this is still true in small towns. Such competition as there has been, curiously enough, came from large scale enterprise; mail order houses, and later the chain stores. The theory that prices were adjusted by competition under the old small scale production in small towns, as far as I can see, simply never was generally true, despite some nostalgic reminiscences which are indulged in today.'*
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> "The development of transportation and communication in recent years has unquestionably reduced the isolation of local

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* A.A. Berle, Jr., "Investigation of Business Organization and Practices," Plan Age (September 1938), p. 186.

Source: T.N.E.C., Monograph No. 21, Clair Wilcox, Competition and Monopoly in American Industry, (1940), p. 112.

> markets and has accordingly impaired the monopolistic position of the retail tradesman in the country town. But a few relatively isolated communities, with their petty monopolists, remain. In all local markets, moreover, there are trades whose character is such as to restrict the area within which competition may occur. Many small towns are served by only one or two bankers, butchers, plumbers, pharmacists, undertakers, hotels, garages, coal dealers, ice plants, and lumber yards. These enterprises may be tiny when compared with those that dominate an urban or a national market; the situations differ in degree but not in kind."

Professor Adelman has also pointed out that the power to deny adequate alternatives to buyers (or to sellers) bears no simple relation to the size of the business concern.

> "For example, the law recently passed by Congress giving automobile dealers certain grounds upon which their suppliers may be sued is obviously designed to give the dealer control over the number of cars he will permit to be sold in his territory, and to reduce the alternatives to the buyers of getting (through so-called bootlegging) cars from other territories. So the law will strengthen the local monopoly position of the auto dealer, to the tune probably of several hundred million dollars a year; and the fact that the law was passed in the name of safeguarding 'competition' may be regarded as semantics, or comic relief, or what you will. Similarly, the recent boosting of retail gasoline prices throughout the Northeast, in the face of growing inventories, by means of 'fair

> trade,' is a solid if unofficial achievement of the Senate Small Business Committee, which proclaims it is aiding 'competition'. In economists' language it is strengthening the monopoly position of gasoline dealers and -- to a lesser extent, and unintentionally -- of their suppliers. These and other Congressional projects may be the best in the world. In the prevailing climate of opinion, big business is regarded with suspicion and small business with indulgence. My point is merely that competition and monopoly mean different things to different people, including economists."*

It is not, of course, necessary that laws be passed to permit the exercise of such monopoly power; much depends on the vigour of competition in the economy. In Canada, the practice of resale price maintenance was never specifically legalized (in contrast to the situation that prevailed until 1951 in the United States); in fact, the Proprietary Articles Trade Association in the drug store field and the Fair Trade League in the grocery trade discontinued their formal operations in 1927 when it was clear that they would be challenged under the Combines Investigation Act. Nevertheless, the evidence in the Joint Parliamentary Committee hearings in 1951 on the legislation to ban the practice indicated that resale price maintenance had been in effective operation in a number of fields for many years. Legalized enforcement powers were not needed to make the system work; the "loner", the maverick, who is determined to challenge established systems

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* M.A. Adelman, "The Current Wave of Mergers Analyzed," An Address to the American Management Association Special Conference - Mergers and Acquisitions, October 1, 1956.

of marketing by new, lower-cost methods, was not a conspicuous figure in Canada until the new methods had been developed elsewhere.

In view of the decline in wholesale and retail margins and of the enhanced pressure on suppliers for lower prices that followed the banning of resale price maintenance in Canada, it would appear safe to conclude that the cost to consumers of this element of monopoly power alone had been in the range of several hundreds of millions of dollars per year.

These brief references -- which do not by any means exhaust the list -- make it clear that small economic units may, given appropriate circumstances, exercise substantial monopoly power. It is, however, the large firm or group of large firms in a highly concentrated market, that is generally considered to exemplify "monopoly" and to pose the most serious threat of misuse of monopoly power.

In part, this is probably due to the "visibility" of the firms in question. The principle involved in well spelled out in the following comment by F.M. Scherer:

> "To illustrate, we need only consider the wrath of President John F. Kennedy in April of 1962, when the Chairman of the United States Steel Corporation informed him that U.S. Steel would lead a potentially inflationary price increase. No such anger was displayed over the contemporaneous behaviour of the middle Atlantic coast construction industry,

> where hundreds of decentralized negotiations led to arranged wage bargains which deviated by a much wider margin from the President's anti-inflation guidelines."*

Even if large absolute size or a high concentration measure creates in the public mind some apprehension about the possible existence of monopoly power, more is obviously needed before public policy can come into play.

There will be cases in which firms of very large absolute size may have only a modest share of the vast markets (not necessarily domestic in scope) in which they compete. There will be firms that are very large and also possess high levels of market power based on superior technology and organizational efficiency. There will be others that might be regarded as "artificial contrivances" which achieved their size and market power by employing extraneous means and devices based essentially on artificial restraints, and which maintain their position by the coercive use of monopoly power.

Generalizations from empirical cross-sectional investigations of size and innovation performance, size and barriers to entry, size and scale economies, have so far related to larger economies and the results even there have been so inconclusive that it would be hazardous to conclude that firms below a given size (or a given market share) consistently presented no monopoly problems, or that firms above a given size (or market share) could be reliably presumed to present such problems.

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* F.M. Scherer, Industrial Market Structure and Economic Performance (Chicago, 1973), p. 11.

One alternative -- and the one most generally favoured -- is to look at performance criteria derived from theoretical considerations to sort out those firms with high levels of market power. The yardsticks most generally favoured are prices and profits; high prices and excessive profits are assumed to go hand in hand with monopoly power. Not only does the elimination of such consequences of monopoly power appear to possess economic advantages but it also appeals to the public's sense of equity and fair play.

There are, however, difficulties in this general approach. First, prices and profits perform vital functions in a market economy. "Fair prices" are usually calculated on a formula relating to "costs" -- often derived implicitly from public utility regulation. The consequences of adopting such a basis for prices have been examined in the section of this report, "Cost Justification and Economic Behavior", and it will not be necessary to repeat that analysis here. It is sufficient to point out that such "fair prices" are inconsistent with the role assigned to prices in a dynamic market economy.

With reference to "excess" profits, the difficulty is to identify what portion of the profit total is a return to monopoly power. Accounting profits are a compound return for past performance and an incentive to future action. Profits may represent, in part, a return to superior entrepreneurial performance; in part, a return for the assumption of risk; in part, a return to monopoly power; in part, a return for anticipating an increase in market demand. The prospect of high profits may provide an incentive for technical progress, as it may also encourage new entry into the market. Profit control, in the attempt to eliminate the monopoly-return element, would involve complexities that are frequently overlooked in calculations which employ an average rate of profit for a selected group of industries or,

alternatively, "reasonable" costs of the firm, as a norm, and which define returns above that level as "excessive". If pressed very far, such an approach would bring the entire mechanism of signals and incentives of the market economy into question.*

The consequences of adopting a "fair return" test run much deeper, however. The assumption of the "excess profits" test is that if profits are "low" monopoly power is not a problem. On the contrary, as Wilcox has observed,

> "A low return on capital is entirely consistent with a monopolistic pricing policy."**

It should by now be generally recognized that the standard evils attributed to monopoly -- high prices, excessive profits, predatory activities designed to destroy weaker rivals -- are rarely the defects of present-day monopolists. Those who hold high levels of market power are as conscious as anyone else of the charges normally brought against them and they go to great lengths -- including some overindulgence in public relations -- to avoid anything that would arouse public disapproval. It

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* It is, of course, conceivable that a firm might obtain control of a scarce resource and erect such effective entry barriers against substitute products that it could charge extortionate prices and earn excessive prices for a prolonged time period. Such remote possibilities should not, however, be considered a major concern of public policy; they could, in any event, be dealt with under the misuse of monopoly power section. General legislation prohibiting "excess profits" is not the appropriate remedy.

** Clair Wilcox, T.N.E.C. Monograph No. 21, p. 153.

may be that monopolists charge prices that are too low rather than too high. This saves them from the charge of exploiting the public and has the added virtue, from their point of view, that it discourages prospective entrants, thereby sustaining the lower profit over a longer time period and restraining dynamic change with its potential disturbing consequences. It has, for example, been pointed out that British consumers for years did not need to fear oppressive price exploitation; what did affect them adversely was the slow accumulation of economic maladjustments, difficult to detect and impossible to prove. Nor would it be easy to establish that monopolies earn unreasonable profits, in part, because the "reasonable profits" concept itself presents major difficulties, as already indicated. Many monopolists, far from engaging in predatory activities, might very well be accused of the opposite strategy -- of maintaining an umbrella over the rest of the industry and applying a rule of "live and let live".

The substance of this position was well expressed years ago by Sir John Hicks in the succinct comment:

> "The best of all monopoly profits is a quiet life."*

It is possible that some such pattern of monopoly behaviour helps to account for empirical estimates that the welfare loss produced by monopolistic misallocation is "miniscule".** The author

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* John R. Hicks, "Annual Survey of Economic Theory: The Theory of Monopoly," Econometrica (January 1935), p. 8.

** One commentator has remarked that if these estimates are correct, "economists would be better off fighting fires or termites than monopoly".

of one of these empirical analyses relating to Canada and the United States goes on to draw certain policy implications from his findings:

> "Programs to assist farmers, labour, and small business have been defended as attempts to compensate these groups for monopolistic exploitation. Monopoly profits are what is meant by monopolistic exploitation, and their small estimated size in the aggregate deprives the argument of much of its force....
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> "It may be that antitrust policy originates as much from a protest against unfair advantages accruing from monopolistic positions as from the belief that monopoly profits are large. If such resentment is the principal basis, antitrust action should be accompanied by programs aimed at the removal of monopolistic advantages possessed by groups of workers, independent professionals, and others, for otherwise it is highly discriminatory."*

While both these broad policy views may be defended on a number of grounds, it is doubtful if the consequences of "benign" monopoly behaviour can be assessed in terms of the relationship of price to average variable cost, as the empirical estimates of the burden of monopoly undertake to do. In fact, large firms that constrain their behaviour for fear of being investigated as monopolies (even if their profits would otherwise be high for what might be entirely appropriate "economic" reasons) will use price and profit levels as discretionary

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* David Schwartzman, "The Effect of Monopoly on Price", The Journal of Political Economy (August 1959), No. 4, p. 361.

conduct variables. Instead of maximizing profits, they may attempt to maximize sales subject to a profit constraint at a "defensible" level* -- such as that permitted to monopolies under state protection and regulation. The basic problem that such constrained firm behaviour presents is that it tends to slow down the rate of dynamic change and reduces the flexibility and adaptability of the economy - consequences very difficult to identify and even more difficult to remedy.

If a shift in public attitudes could be achieved restoring profit to its role as an incentive to, and a reward for, more effective market performance,** the result should be more innovative, enterprising conduct on the part of firms which would then keep their "excessive" profits - if they could earn them - in pecuniary form rather than dissipating them in various cost-increasing activities within the firm with a view to making it appear that they were not highly profitable, as the anti-profit bias encourages them to do. The role

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* See K.D.H. Kaplan, Joel B. Dirlam, Robert F. Lanzillotti, Pricing in Big Business (The Brookings Institution, 1958), esp. pp. 127-200.

** Tax policy could contribute to this end. A proposal by the Swedish Confederation of Trade Unions is of interest on this point: "In the case of company taxation, we recommend a change-over in whole or in part from the existing taxation of net profits to taxation on the basis of gross expenditure, primarily because the taxation of net profits helps to preserve the structure of enterprises through the particular reliefs it provides for less expansive and less profitable enterprises". Economic Expansion and Structural Change, A Trade Union Manifesto, edited and translated by T.L. Johnston (London, 1963), p. 170.

of public policy would then be to prevent such firms from entrenching or exploiting their market power by artificial restraints or abuse of their dominant positions. Rewards would be made for and confined to superior economic performance.

It is apparent that monopoly power -- in the sense of high levels of market power -- may be found in the private sector in firms of large size or of small size, depending on market circumstances. Problems of defining the relevant market, analyzing market structure and market power would, of course, be as serious and as important here as in merger analysis. There are no reliable criteria of absolute size, of levels of concentration, of performance in terms of "reasonable" prices or profits, which will clearly identify monopoly situations.

Even concepts of minimum optimal scale which would, presumably, enable us to establish some minimum justifiable absolute firm size are difficult to specify. Engineering estimates by themselves are of little assistance, especially when longer-run perspectives are involved -- as should be the case for public policy. The large corporation participates in a number of different markets,* which will be integrated in different ways for different firms. It may be involved in R & D programs, generating innovations or operationally relevant information; it may be involved in advertising and distribution to reach a mass of consumers; it may be involved in integrated production, backward to raw material sources and forward to final markets; it may be involved in floating securities and in providing mass credit facilities for its marketing operations, and so on. Each firm

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* Cf., Solo, The Political Authority and the Market System, pp. 187-188.

in the industry may be composed of a different combination of functions, and the combination may change over time, hence the search for an optimal scale of operations for each industry runs the danger of becoming merely a formal, academic exercise. Certainly, it provides little effective assistance as a general criterion in either monopoly or merger policy.

The preferred approach would be to define "dominant firms" and then to examine how that dominance was maintained or extended (and perhaps how it had been achieved). These considerations will be deferred to the section on public policy for monopoly.

As has been stated already, most of the more enduring, and some of the more inflexible, monopolies are not found in the private sector but under government protection and regulation. A rough classification of the over-all monopoly sector, public and private, may be of assistance in sorting out the extent of the monopoly process.

1. Government as monopolist.

   - This category includes both those situations in which the government originated the monopoly and those in which it nationalized private firms to form a monopoly. Although this category, through the interdependence of markets, has significant importance for the effectiveness of other segments of the economy, it is essentially beyond our terms of reference. This sector has recently received a good deal of attention, much of it unfavourable, on the score of its economic performance. Perhaps the initiating influence was provided by Robert Brady in his provocative study, Crisis in Britain (Berkeley, 1950).

2. Case-3 monopoly situations.

- The organization of small economic units into organizations exercising high levels of market control, or the enacting of legislation isolating markets in such a way as to enable small firms to operate in substantially closed markets (as in some municipal building codes, and the like) - these developments have become an increasingly important element in the functioning of the economy.

- Of those Case-3 situations in which governments, particularly federal and provincial governments, authorize, enforce or permit the exercise of monopoly powers, the agricultural marketing boards are perhaps the most visible and the most important; others include municipal agencies which oversee the operation of taxicabs; indeed, there is a host of economic activities at all levels which are "protected" by the, literally, hundreds of boards that pursue their existences in greater or less obscurity.

- Professional associations, such as those of lawyers, medical doctors, accountants, and others, are authorized by government to exercise functions with respect to the qualifications and conduct of their members. It might be observed in passing that powers to control numbers, directly or indirectly, in any professional group constitute a clear interference with the movement of the talents into areas of their choice. Efforts to suggest "appropriate" fees should also receive short shrift in a market economy.

- Labour unions are properly included under this heading. Reference has already been made to their impact in the Introduction.

- Guild-type controls in many of the service trades, such as barbers and hairdressers, have seen a substantial growth in recent years under government authorization, but without accountability being required or public information being provided.

- Trade association activities may qualify as Case-3 situations; they are infrequently authorized by government. The activities of these organizations cover such a wide range that generalization about them is difficult, although they range from the clearly desirable to the clearly detrimental from the viewpoint of the public interest.

3. Private monopolies.

- The unregulated monopolies, both large and small, are those with which the combines legislation is generally concerned.

- The regulated private monopolies have become to an increasing degree in recent years the focus of a great deal of critical analysis. Brief reference will be made to some of these views.

Although this classification does not exhaust the list of the types and varieties of monopoly power in the economy, it does indicate their ubiquity and suggests something of the role of government in facilitating their creation and protecting their continued operation.

Public Policy

The basic concern of public policy in this area is to assure so far as possible that monopoly power is not used in such ways as to interfere with dynamic change and with the achievement of real-cost economies. Since the position of monopoly power is now in existence, the question may legitimately be raised as to whether public policy should not aim at the elimination of the base of that power. There may be situations that call for dissolution of a firm possessing a high level of market power (or, at least, the divestiture of some parts of it), as we do propose, but, for reasons that impress us as being conclusive, such a policy is of very limited value in the arsenal of policy measures.

The prescription to break up existing centres of monopoly power encounters a number of difficulties.

First, such a policy should be applied in a non-discriminatory fashion, and it will clearly be difficult to apply to labour, the professions, and to agriculture.

Second, as Professor Corwin D. Edwards has pointed out,* large plants (and possibly also large multiplant enterprises) may be the source of economies of scale, even if it is not possible to specify the relevant limits. In small countries, "efficiency and power often seem to be joint attributes".

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* Corwin D. Edwards, "The Future of Competition Policy: A World View", California Management Review (Summer 1974), p. 120.

Third, to break up large, successful firms may have adverse "internal" effects on the operation of the firm, and its demonstration effect may be adverse since the desire of a firm to grow bigger is "a healthy incentive toward good business conduct".

Fourth, the international aspects of such dissolution proposals are difficult to assess. Large firms appear to be necessary to operate effectively in international markets, and prospective developments in the international economy may warrant even larger firms.

Fifth, the prohibition of the abuse of monopoly power will go far to eliminate the most readily identifiable undesirable aspects of the conduct of large firms. Since the "abuse" concept is a relatively flexible one, it can be adapted to deal with many aspects of conduct much more readily than would be possible in the case of a direct attempt to dissolve the firm.

Perhaps the most fundamental argument against any general move to dissolve monopoly power is that advanced by Professor Edwards:

> "The desirability of substantial improvements in structure is, to me, obvious. But to entrust the task of planning to a few planners involves the difficulty inherent in such public planning -- that structural foundations of the future will be shaped to the values of a few persons and in disregard of everything of which the planners were inadequately aware,

such as unforeseen developments in technology, in economic organization, and in social institutions".*

Therefore, what we propose, in substance, is that dominant firms be prohibited from engaging in forms of conduct which constitute the abusive use of monopoly power.

A dominant firm may be defined as one that is capable within broad limits of choosing its rate of profits (or its share of the market) undeterred by the consideration that rivals may compete away these profits by offering better terms to customers. This is a functional definition of dominance which we regard as preferable to a statistical market-share definition. This latter approach may be acceptable in a large economy but in one of medium size, such as Canada, we can see no realistic way in which a percentage market share could avoid being both too large and too small.

There is no way to define "abuse of market power" in such a way as to make the definition exhaustive of the category.** Perhaps a very

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* In a forthcoming article, "Public Policy Toward Big Business: What Should We Have Learned in Forty Years?", The Journal of Economic Issues.

** Important laws that require a high degree of generality and elasticity in order to be realistic and pragmatic are not unfamiliar in our society. Two everyday examples were referred to recently by Morden, J. in James More and Sons Ltd. v. University of Ottawa (1975), 5 O.R. (2d) 162 at 172: "Just as the categories of negligence are never closed, neither can those of restitution. The principles take precedence over the illustrations or examples of their application."

general definition would specify abuse by a monopolist as including all forms of competitive action not based on superior economic performance. In more detail, the National Markets Board would look for evidence of such behaviour as: preclusive acquisiting or ownership of resources and facilities; deliberated exclusion; reinforcing a dominant position by exclusive dealing and tying arrangements, or by refusal to deal; predatory discrimination; a design to forestall competition and to hold its monopoly position by other than the achievement of real-cost economies; the use of reciprocal buying-selling advantages, and the like.

If a case of misuse of monopoly power was proved, the Board would issue a remedial order. In serious cases, action to neutralize the firm's dominant position by changes in tariffs, or by other appropriate measures, could properly be recommended by the Board. Finally, persistent abuse by the firm would justify dissolution or divestiture.

Action to deal with monopolies operating under government authorization or supervision impresses us as being of at least equal urgency to that required in the private sector.

For example, the process of regulating "natural" monopolies has been adjudged "lame and impotent". The "reasonable rate of return on cost" principle has been condemned as promoting unnecessary investment, discouraging efficiency, and failing completely to provide incentives for imaginative, innovative conduct. Furthermore, some regulated industries have engaged in merger activity which has not been obliged to withstand the "survival" test of market pressures. In still other cases regulated firms have established subsidiaries, or developed supply connections with other specific firms, to provide them with their equipment or supplies. In some cases, real-cost economies may be realized by doing so but, lacking

the market survival test, the public cannot be sure. It would be appropriate if all firms under public regulation were required in their procurements to obtain competitive bids not only from non-related national firms but from foreign suppliers as well.

For broader considerations, we recommend that regulated industries should be deemed to be generally subject to combines legislation, and to be exempted from it only when

(1) the restrictive conduct is specifically imposed by the legislation; and

(2) the restrictive conduct is actively supervised by independent officials and not by representatives of the participants;

(3) the restraint is necessary to the effective accomplishment of the legislative goal and is the least restrictive means available to achieve the legislative goal.*

Indeed, we recommend that these three principles apply to all forms of monopoly control authorized by government. In particular, we are persuaded that they are necessary in the case of so-called "supply-management" marketing boards. These organizations are, in reality, nothing more than cartels.

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* These principles were proposed in a speech by Joe Sims, Special Assistant to the Assistant Attorney-General, Antitrust Division, U.S. Department of Justice, "State Regulation and the Antitrust Laws", National Association of Attorneys-General, Dec. 12, 1974.

Professor M.M. Knight has defined a cartel in the following terms:

> "A cartel is a legal agreement entered into by two or more business houses in order to regulate their business by fixing the output, apportioning the business among themselves, fixing prices, etc. Besides monopoly, cartels aim at the avoidance of 'continual fluctuations of sales... and periodical oversupply' (Von Beckerath). Cartels are aided by tariffs and other forms of protectionism which limit the national market to national competitors. Monopolies can charge the home market up to the entire fixed costs and dump abroad surpluses at low prices which cover only the cost of the additions to output. [Or at even lower prices if government subsidies are available.]
>
> Types. "Price-fixing, supply-limiting and sales-territory-dividing types are often distinguished. All three purposes are often fulfilled by the same cartel. The joint sales agency is the commonest device for all purposes. Where legal, it effectively imposes the conditions of the monopoly agreement." (Introduction to Modern Economic History, p. 158.)

This is almost a precise description of a supply-management marketing scheme. In view of the virtually universal condemnation of the cartel form of production and marketing control -- not least in the country of its origin* -- it seems decidedly

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* See, e.g., Ludwig Erhard, Prosperity Through Competition (London, 1958), passim.

incongruous to see its revival under a different guise as the preferred policy of the Canadian Government.

One of the most obvious symptoms of the working of such supply management (cartel) schemes is to be found in the varied consequences of the quota system that is central to their very existence. In essence, the valuation of quotas represents the capitalization by market bidding of the future monopoly gains expected to result from the cartel controls. The market process which is deliberately suppressed in production and sale for the consumer market, is manipulated to capture and to perpetuate the advantages of monopoly power.

The process has been well described in the following comment by James Rusk:*

> "If the transfer of quota is handled strictly in a bureaucratic administrative fashion, it is open to all sorts of abuse and favoritism. The Ontario Egg Producers Marketing Board has amply demonstrated this. That is why many boards shy away from transfer by bureaucratic order. The board does not want to go that far in playing dictator to the industry.
>
> If the transfer is through sale and purchase in the marketplace, two other sorts of abuse appear. If unlimited acquisition of quota is permitted, a few men can quickly and legally tie up an industry. That is the way the turkey and broiler moguls in Ontario operate -- with

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* James Rusk, "Quota transfers the dark side of marketing", Free Press Report on Farming, April 3, 1976, p. 2.

> the blessing of the Ontario government -- and, legally, they have far more power than the moguls at General Motors or Ford ever had.
>
> If quota values are allowed to rise to unlimited heights, that is another sort of abuse. To the consumer mind it shows that returns in the industry are excessive. At the producer level, high quota values represent an unconscionable burden on young farmers starting up. At the present value of quotas in British Columbia, a young man starting dairy farming could easily find himself with a $75,000 bill for quota by the time he gets a decent one-man operation on its feet. That is not the sort of thing that any country of free men can be proud of."

The longer-run consequences of such market control schemes are less easy to quantify since they almost inevitably involve the suppression or regulation of dynamic change.

The issues involved in government authorization and supervision of monopolies are far more numerous and complex than those relating to market power in the private sector. It is clear that they require penetrating and sophisticated analysis. We recommend that this broad and varied area should receive the close attention of the Director of Investigation and Research, and that where potentially detrimental developments occur which are beyond the reach of the legislation, he should institute appropriate research studies to clarify their significance for the government and the public. A sophisticated program of enforcement and research could make a vital contribution to ensuring accountability in the public monopoly sector.

DISCUSSION DRAFT - LEGISLATION

Misuse of Dominant Position*

(1) In this section,

(a) "dominant" means the power to choose the rate of profits or share of the market to be enjoyed by the person or group of persons possessing the power, largely undeterred by any existing ability of rivals to compete away those profits or share of the market by offering more favourable terms to customers;

(b) "misuse" means any form of competitive conduct that constitutes, or has the effect of creating or enhancing, a significant artificial restraint in a market, and which is not justified or offset by real-cost economies resulting from that conduct.

(2) Where, on application by the Director, and after affording every person with respect to whom an order is sought a reasonable opportunity to be heard, the Board finds that a person or group of persons occupying a dominant position in a market has misused the power of that position, the board may make an order directed to such person or group of persons prohibiting the continuance of such conduct and containing any other requirement that, in its opinion, is necessary to overcome the effects thereof in the market.

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* This Discussion Draft was prepared solely to seek to assist in the consideration of the main substantive recommendations on this subject in the report. By omitting a full formulation of all related recommendations in the report we do not mean to ignore those recommendations.

(3) Where the Board makes a finding of misuse under subsection (2) and the person or group of persons found to have misused the power was or were subject to a previous order of the Board for a misuse of power in that or a similar market, the Board may

(a) recommend to the Minister of Finance that any duties of customs as are pertinent to the situation be removed, reduced or remitted, or

(b) order that the person or persons divest himself or themselves of such assets and in such manner as the Board prescribes.

II - 3. STRUCTURAL RATIONALIZATION, EXPORT AGREEMENTS AND SPECIALIZATION AGREEMENTS

This family of organizational measures is based, fundamentally, on the conviction that the broad process of economic transformation induced by competitive opportunities and pressures operates so slowly or at such great social and economic cost that positive intervention is required to speed it up and direct it in order to improve the performance of the economy.

Interest in such policy measures has been demonstrated by some of the more mature economies and also by a few smaller economies, although the issues involved differ in important respects. As Svennilson has pointed out,* those countries of Western Europe that had got an early start on industrialization, had built up, in the course of the 19th century, a substantial industrial structure based on the technology in effect at the time. After the turn of the century, and particularly after World War I, the problem of economic growth was not that of extending the traditional technological base but of replacing that structure to accommodate changes in demand and in technology. This process encountered a number of impediments; among the most important were the necessity of creating a new capital structure and the resistance of old physical capital to replacement - and the one reinforced the other.

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* Growth and Stagnation in the European Economy (Geneva, 1954), pp. 10ff. This study was prepared for the United Nations Economic Commission for Europe.

Old machinery can for some time continue to compete on a price basis at levels that do not cover replacement costs. There is also a strong vested interest among established organizations - and this is not peculiar to business - in resisting change and maintaining their positions by drawing on reserves. Governments tend to support such action by granting subsidies and providing protection by tariffs or other forms of restraint.* The entire process will be reinforced if the general rate of growth is slow. Furthermore, since the more recently a country becomes industrialized the more rapid is the process, the newly industrialized countries with the latest technology were widening the gap between themselves and the more mature countries. In turn, this affected the financial position of the older firms, further strengthening the tendencies to stagnation. The whole process became increasingly complex with the introduction of considerations relating to the spread of trade unions and industrial associations, population growth, the strengthening of nationalistic influences, changes in taxation with their effect on the propensity to save, and so on.

For present purposes it is not necessary, however, to go into these matters in detail, particularly since Svennilson has pulled the complex strands into an effective summary:

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* The cotton industries in Britain and in the U.S.A., both of which required downward adjustment, provide an interesting contrast. In the U.S.A., where price and output associations were prohibited, the number of spindles in New England declined between 1925 and 1935 by 50 per cent; in Lancashire, where such associations were permitted, the decline in the same period was only 30 per cent.

"...There developed an ideology which can best be described as a sense of economic solidarity within each national unit....

"The tendency to regard national income as a joint asset which was to be distributed through economic policy found a growing support in economic realities.... In several countries, progressive direct taxation began to assume a considerable weight, and in all countries the redistribution of income through taxation became an important part of economic policy.

"In the second place, the stagnation in world trade and the shrinkage of the international margin for national expansion also brought industries in the same country together. A depression in an export industry immediately had serious effects on the operation of other industries in the same country.... The necessity for concentrating on expansion in the home market also increased the interdependence of industries. The development of individual industries thus became more dependent on the other industries with which they happened to be combined within the same national frontiers. These relations were especially striking in small countries with one or two dominating industries. A change of frontiers would have completely changed the conditions for growth....

"An extension of the co-ordinating activity of the national governments was the natural response to this new situation. Tariffs and subsidies were increasingly used to maintain the competitive position of national industries.

> Subsidies and price control were used to maintain the level of income in agriculture... the building of houses was alternately discouraged and encouraged by similar measures. Progressive taxation and unemployment relief evened out incomes between prosperous and depressed industries. As the State, in this way, increasingly entered as an arbiter as regards the development of different industries and the distribution of incomes, the incentives which could encourage private enterprise or labour to advance the transformation of the economy were, in many cases, substantially reduced or even eliminated" (pp. 36-37).

It was against this background of the spread of rigidities, the steady erosion of market influences, and the persistent spread of intervention by the State in the interest of "national solidarity" - developments that are not entirely foreign to current experience - that demands for the "rationalization" of industry assumed substantial importance in Great Britain and Germany, two countries that were faced with major problems of post-war adjustment piled upon the need for fundamental economic transformation.

Although the achievements of the interwar rationalization movement were neither so substantial nor so long-lasting as to merit detailed review, nevertheless a few highlights may serve to indicate the major features of the program.

The broad objectives of the movement in Germany were straightforward: the improvement in efficiency of productive equipment, raising the growth rate, and "heightening national prosperity". The means by which these ends were to be achieved

included such policies as: systematically introducing standardization, promoting "scientific management", and coordinating and integrating the activities of entire industries (often through cartel arrangements).

It was the last of these policies that tended to become the characteristic feature of the movement. Indeed, Walter Rathenau, one of the "fathers" of German rationalization, went so far as to urge in his Die Neue Wirtschaft,

> "the unification and standardization of the whole of German industry and commerce in one great trust, working under a State charter, and armed with very extensive powers...."

Although the scope of the arrangements actually brought to fruition were much more modest, Urwick reported that in the domestic area of Germany

> "methods have been worked out for uniting central or local Government with commercial interests in combined control of certain forms of undertaking",

and in the international field that

> "agreements in specific industries and between groups of bankers and financiers have increased rapidly in the course of the last few years. Such agreements deal with the de-limitation of markets, combined action for the exploitation of technical processes, unified research, and similar matters."*

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* L. Urwick, The Meaning of Rationalization (London, 1929), pp. 121-122.

The supporters of rationalization had no confidence in the "haphazard and ruthless" forces of competition to achieve the reorganization of industry into units of greater efficiency, and, to some extent, they were probably correct, although the methods they adopted as a substitute proved at least equally disappointing.

One example may be found in the U.K. Coal Mines Act of 1930. This piece of legislation consisted of two parts; Part I conferred upon the industry the power to set up regional organizations through which output would be controlled and compulsory minimum prices established. These controls were to provide a breathing space for the firms to proceed under Part II to carry out a wholesale reorganization of the industry. Instead of reorganization, the schemes for maintaining prices and controlling output became more firmly entrenched as each year went by. Increasingly elaborate schemes were devised to cross-subsidize the inefficient mines by the efficient mines. The Coal Mines Reorganization Commission (1930) worked for nine years with no effect. On the contrary the industry fell progressively further behind the mines in other nations in the improvement of technical methods. Apparently reasoning in a virtuous circle, that if some control would not work more control would, the government eventually nationalized the mines - and the cross-subsidizing continues to the present.

This is not meant to suggest that the "haphazard and ruthless" forces of competition would have been adequately effective in a short period of time to achieve adjustment; positive programs in such situations are undoubtedly called for. This example, reinforced by the unhappy record of the British Industrial Reorganization Corporation, does, however, strongly support the view that imaginative, innovative programs to facilitate economic change on a broad front are of basic importance to a successful program of adjustment in specific industries.

The impact of the complex of factors which Svennilson has identified as contributing to the enfeeblement of the economic transformation process makes it clear that it is impossible to restore vigorous market-oriented performance by tinkering with structural elements in given industries. These changes may be a necessary condition for improvement; they are neither the primary nor a sufficient condition.

Post-World War II Structural Rationalization

Although some of the more mature countries, such as Great Britain, continued from the inter-war period a deep concern with the transformation of their economies for reasons that have persisted from as long ago as the turn of the century, some smaller countries with essentially modern industrial systems have also in recent years displayed a concern about the "structural rationalization" of their economies. Canada, in some degree, spans the two groups. Some of the Canadian industries requiring rationalization date from the early period of industrialization when "infant" industries were granted high levels of tariff protection. Other more viable modern industries in Canada face problems similar to those that have affected industries in the much smaller Swedish economy.

Although "structural rationalization" has tended to become a catch-phrase covering a variety of policies ranging from joint action by business firms (sometimes also including labour unions) to centrally directed structural or sector programs, the problems accounting for such initiatives have, in large measure, a common base. If we keep in mind that many of the inter-war developments inhibiting effective market performance still exercise their baleful influence, we may, for purposes of clarity, classify the factors supporting a case for structural rationalization into two groups: first, those factors that might be considered to originate

in the international business area or, at least to be more or less universalist in impact; second, those factors that are internal to the individual country, such as social and fiscal policies, and the like. In a sense, these "internal" policies may, of course, be patterned on practice in other countries, but with a difference, and that difference may have significant consequences.

External Factors*

A number of factors have caused an acceleration in the adjustment process in industry. The pressures and the opportunities arising from the flow of new technology and organizational methods, together with the increased international specialization resulting from the creation of larger and more closely integrated markets and the growing volume of world trade, have been of primary importance. The spread of innovations between countries is much more rapid than formerly, so that the lead that any country enjoys is whittled down at a rapid rate. This poses problems of adjustment to new conditions that are emanating persistently but unpredictably from all industrialized countries. The alternative of resistance to such changes means declining effectiveness in international markets and falling income levels. There is no system of unemployment relief or economic insurance for states.

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* Two studies of structural rationalization in Sweden have been of assistance in preparing this section, although it follows neither one fully: Torsten Carlsson, "Structural Rationalization in Swedish Industry", Skandinaviska Banken Quarterly Review, 1964: 1, pp. 1-6; Bengt Ryden, "Concentration and Structural Adjustment in Swedish Industry during the Postwar Period", ibid. (1967: 2), pp. 51-59.

The type of market that has developed in the post-war period has also been important. Rising incomes lead to higher levels of demand and this creates more opportunities for profitable investment. But demand is more volatile, and this may confront firms and entire branches of industry with abrupt and persistent declines in demand. Changes in demand and in technology have also made the life cycle of a product much shorter. To retain an old product too long in the product program or to take on a product too late in its life cycle may be dangerous. To achieve a satisfactory degree of adaptability and manoeuvrability requires that a firm carry on its own development work or share that of another, and this may, in turn, involve expansion to a larger and broader base.

More generally, the minimum economic size of a firm with regard to production, distribution, development, and access to growth opportunities appears to be increasing. There is a conviction in Sweden that the majority of the largest firms in that country are still too small to meet these requirements. Even to be a partner in an exchange of technical know-how and organizational methods demands a firm of considerable size, particularly if international collaboration is involved.

The traditional boundaries between sectors of industry - say, the textile and chemical industries - no longer present the same barriers to new entry, as large firms with the resources of finance, management ability, and research capacity can readily establish themselves in new areas. This sharpens competitive pressures. Furthermore, the sector becomes less and less important as a point of reference in deliberations on industrial organization policy issues.

Internal Factors

Although it may be too obvious to require specific mention, a basic consideration in all projects to restructure industry, by mergers, joint sales facilities, and the like, is to increase profitability or at least to prevent its erosion. It is the reasons for and the consequences of this drive for profitability that are of interest for public policy.

A factor of great importance in accelerating the pace of restructuring industry is the steep rise in wage costs, particularly in relation to competing countries. When this factor is combined with the impact of higher taxes and increases in the cost of social programs - concentrated within a relatively short time span - even our traditional products face rising prices and adverse export market opportunities. In addition, there has been a decline in the profitability and self-financing capacity of large segments of industry.

At the same time, to compensate for these pressures, industry must attempt to move into types of production based on more complex forms of technical and scientific research which cannot be so readily matched by other nations. Not only is this tendency likely to require larger firms but it also highlights the importance of adaptability and flexibility in all areas of the economy, not least in the labour sector. In this respect, Sweden has been more fortunate than most countries in that the trade union movement there has been, at least in post-war years, a strong supporter of structural change to facilitate economic expansion.

Assuming that these factors have created pressures for an acceleration in the process of restructuring industry, is there a need for new attitudes and new techniques or institutions to supplement or alter the usual course of adjustment? It is a fact that structural rationalization (under

a different name) is nothing new; it is a continuous process that has been the substance of economic history for years. In a competitive market economics text books explain how, in response to changing technology, factor prices, and final product prices, the process of adjustment proceeds in a "normal" way from one position of equilibrium to another. The proponents of an active rationalization policy maintain, on the other hand, that the problems of adjustment in a rapidly changing economic environment require new policy initiatives not only to facilitate the process of change but to avoid the rigidities which would be the "natural" defensive response to pressure for rapid and radical adjustment.* As already explained in the introductory section of this report, much depends on the flexibility, adaptability, and dynamism of the economy and society in question. The more conservative and rigid the economy the more vital it is to avoid the mistakes of the inter-war rationalization program and to emphasize the importance of decentralized decision-making and the maintenance of pressure for adjustment on firms organized in terms of effective economic performance (as imposed by changing market influences).

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* Even an economy with stationary population and low levels of capital accumulation would be obliged to adjust to changes in demand and technology; from time to time there would also be expanding and stagnating regions in such economies. The danger in such low-growth situations is that structural policy will take the form of preservation subsidies rather than of transition supports.

However, before setting out specifically what we consider the desirable policy measures in the Canadian setting, it may be helpful to survey briefly the highlights of the experience of Sweden with its structural rationalization program.*

Immediately after the war, the Social Democratic Government attempted to organize a Rationalization Commission which would make studies of individual industries with a view to making changes designed to raise their productivity under State direction. Business interests refused to participate in such a commission, and the government lost interest in this approach - particularly as it seemed to entail risk of the adoption of restrictive practices.

Indeed, upon the breakdown of the government proposals for a program of structural rationalization under State direction, legislation on restrictive practices was put forward to promote competition, and competition was relied upon as the motive force of industrial and economic progress, including rationalization. The recent revival of interest in structural rationalization reflects, in part, a feeling that competition, in itself, does not operate with sufficient speed to bring about the necessary changes in industry structure. In some cases, for example, firms faced with a declining demand will exhaust their dwindling resources by competing for a shrinking market rather than devoting their efforts to research and development to open up new markets.

The new initiative with respect to structural rationalization was undertaken in a manner that is rather common in Sweden, by a working group formed

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* Based on the study, Structural Rationalization, (The Industrial Council for Social and Economic Studies, Stockholm, 1960).

under the aegis of the Industrial Council for Social and Economic Studies, composed of six members, four from business and two who were professional economists - although some of the business representatives also qualify as economists. After an extended analysis of the subject, this group produced a report of which a condensed version has been translated into English. It would take more space than is available to review that study in the detail it deserves but a brief sketch may be sufficient to set out the dominant issues with which it was concerned.

To begin with - what does the Swedish group mean by "structural rationalization"? Essentially, the term relates to measures designed to increase productivity* through changes in the structure of a trade or industry by measures taken either collectively by several enterprises or by a group of them - or, in exceptional circumstances, by public authorities.

The working group elaborated in detail upon this definition but reference will be made here only to the meaning assigned to structure. What was contemplated here was the number of enterprises engaged in a "trade", their relative sizes, their location, their type of product and range of production. All these factors were to be considered as being subject to change in the interest of improving productivity.

The measures which could conceivably be employed in bringing about structural rationalization were divided into two broad groups: those having "immediate effects", and "long-term" measures.

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* The term "productivity" is used, not in the technical sense of output per unit of input, but in the sense of more effective performance in a market economy.

In the former category were placed such measures as: mergers and "closing-down" of businesses, setting up of new businesses, the limitation of new enterprises, and the splitting-up of established enterprises. On the demand side, they specified measures such as protection against competition by imports or by substitutes, and the cancellation of existing protective measures. A third group of rationalization measures also having comparatively speedy effects included: cooperation in purchasing, selling, and production.

Among long-term measures there was, first, the collection and distribution of information concerning the trade's supply and demand situation in general. This, it was argued, might encourage changes in the range of products produced; it might influence the plans of firms planning to enter the field, and so on. This information might also be of value in planning mergers or the closing-down of firms. In this general category also belong various types of proposals for providing information on investments, so that each enterprise within the trade may know how much the trade as a whole plans to invest.

Information can also be collected relating only to certain functions of individual enterprises, which can be made available to some central trade organization, for example, regarding research and development; and technical, economic and administrative training. Another form of long-term measure which might be significant for structural rationalization was the adjustment of collective labour agreements which might restrict changes in structure.

Many of these suggestions are by no means novel or original, as the working group was, of course, aware - but they felt it desirable to make a wide and thorough survey.

In assessing the role of these various possible measures, the group laid down three general conditions which cooperation among firms had to meet to be acceptable. These were:

(1) The unit to be created by the restriction of competition must remain exposed to effective competition from without the unit. In other words, competition could be restricted among all Swedish firms within an industry, or between a group of enterprises, only if the products of the cooperating firms faced effective competition from other firms, either domestic or foreign.

(2) Even given this first condition, it should appear highly probable that the firms engaging in the restrictive combination will operate more efficiently as a result.

(3) Firms must not be forced into the cooperating group by threats of boycott or other similar measures, nor should they be excluded from the market by any measure.

The report then undertakes a detailed analysis of each of the policy proposals already outlined and concludes that four types of measures, already more or less fully utilized, are likely to promote structural rationalization. These are:

(1) information services concerning supply and demand;

(2) cooperation in research and development;

(3) cooperation in technical, economic and administrative training and information;

(4) changes in labour agreements and in legislation restricting changes in the structure of a trade or industry.

However, their major emphasis is on a final group of measures which should make it possible to introduce substantial structural improvements in the form of adaptation of capacity and division of labour between enterprises both on the same horizontal level of production and those that are vertically related as well. These measures were:

(1) mergers and discontinuations;
(2) joint sales organizations;
(3) cooperation in production.

It is important to bear in mind that these various activities are to be undertaken by private groups on their own initiative subject to the three general constraints outlined above. Those familiar with combines legislation in Canada will immediately recognize a number of these proposed spheres of activity as ones that are likely to be regarded with suspicion by the combines authorities.

Although the Canadian economy is much larger than the Swedish, the factors calling for some measure of joint activity among business firms to meet the pressures generated by the external and internal forces referred to above, are likely to be as important here as they are in Sweden. For a number of reasons, the prospects for successful implementation of such a program are, however, less promising here.

Canadian business, small and large, has a long tradition of reliance on government for help in solving its problems. A review of the submissions of business associations to governments over the decades makes painfully repetitive reading. This record does not inspire confidence in the capacity of the Canadian business community to undertake an independent program of structural rationalization. Yet the dangers of direct government direction or participation in such a program are great. Mergers, joint sales organizations, and the like, carried

out under the direcction (or urging) of government will, if unsuccessful, feel justified in demanding a measure of state protection, subsidization, or freedom to engage in restrictive practices. Rigidity is likely to be increased rather than diminished.*

Second, the co-operation of labour in programs of technological and organizational reform will be vital to their success. Such co-operation would appear to require both a basic change in the attitude of some sectors of the labour movement and a much more effective program to redeploy workers made redundant by the structural changes and to facilitate the necessary relocation and retraining of workers adversely affected.

Third, the efforts of provincial governments to subsidize or otherwise assist plants and firms organized on uneconomic bases to continue in operation are likely to frustrate more broadly based

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* The attempt in 1970 to rationalize the Canadian textile and clothing industry under government supervision and assistance has clearly been a failure, even in terms of the industry's ability to hold the domestic market, far less to compete in international markets. Predictably, the response is for the Textile and Clothing Board to provide speedier and more effective protection and to develop new industry policies, as well as for the government to intervene further in the rationalization process. (See the summary of the C.D. Howe Research Institute study, The Canadian Textile Policy: a Sectoral Committee Adjustment Strategy?, in The Globe and Mail, January 24, 1976.)

programs of rationalization and specialization.* In a federal system this is obviously a sensitive matter which, unfortunately, gives promise of becoming more rather than less serious.

The possibility that foreign parent firms of Canadian subsidiaries would be subjected to action under restrictive practices legislation in their own countries if the Canadian subsidiary were to participate in one or another form of Canadian rationalization arrangement has been raised. We do not recommend a comprehensive program of advance approval or compulsory prior examination of rationalization arrangements. Indeed, although the occasional undesirable measure might be avoided, the practical problems would be serious. Such a policy would also tend to discourage decentralized economic decision-making, which should basically provide the best assurance that opportunities for effective change are used to advantage. Nevertheless, where the possibility of such extraterritorial problems may arise, the parties to the

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* The late Professor H.A. Innis repeatedly expressed concern about the possibility that there was too much decentralization of power over economic policy decisions in the Canadian political system. The economic problems may now be of such a nature that provincial governments are inadequate to deal with them. It is not so much that more centralized power is required as that centralized power is needed to provide consistent and coherent policy throughout the economy. For a discussion of the question whether a constitution framed to provide political elasticity in a transcontinental economy has resulted in undue rigidity because of insufficient central power, see D.G. Creighton, British North America at Confederation: A Study Prepared for the Royal Commission on Dominion-Provincial Relations (Appendix 2), (Ottawa, 1939).

rationalization program should be able to refer the matter to the National Markets Board for its appraisal. Approval, if granted, would constitute an expression of Canadian public policy which, if necessary, diplomatic negotiation should be capable of validating in an international setting.*

Despite these difficulties, we consider the potential value of rationalization arrangements for a country of Canada's size and stage of economic development to be so great as to warrant provision for them in public policy.

Policy Recommendations

Essentially, the rationalization program should be the product of initiatives by the private sector. The arguments against government initiation, supervision or direction we consider unanswerable, except in very special circumstances (perhaps where the number of participants is so large as to make the negotiations excessively complicated and time consuming). The major contribution of government should relate to the development of programs to ease the impact of the adjustment process on labour, and in working out the manner in which the costs will be divided between the firms and the state.

There should be an implicit (or perhaps even an explicit) obligation on the part of the organizing group, in cases where the agreement relates to a reduction in the diversity of products

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* Special mechanisms already exist for international consultation and accommodation with respect to the enforcement of national competition laws. For a description of the Canada-USA arrangements see Report of the Director of Investigation and Research, 1970, pp. 21-23, and for the OECD program, see the Director's Report for 1974, pp. 11-17.

produced, to give the users of the products a voice in deciding what products will be eliminated. For practical reasons, this would apply chiefly to industrial users or representatives of groups (such as farmers) who use such products for productive purposes. Should the rationalization be challenged by the Director, failure to carry out such consultations might carry adverse implications.

We regard the three basic conditions specified in the Swedish study as necessary and sufficient for the protection of the public as being essential.* Perhaps it should be added that in defining the relevant market in which "effective competition" is to be assessed, the possibility that the merged groups will be operating in a market much larger than Canada should be given full consideration. If it is not so defined, then concentrations of business finance, management and expertise that look big against the Canadian market may well be no more than sufficient to make possible effective performance in that larger league.

It is vital both to an understanding of the operation of the rationalization process and to the analysis of the possible need for new programs to facilitate the processes of economic change, that a full record of the number, nature and scope of the rationalization arrangements undertaken should be on record with the Director's office. This is not for purposes of direction or supervision but for the legitimate and necessary purpose of understanding the operation of a new tool in the public-policy kit. As with mergers, rationalization arrangements may be processed under the advance clearance procedures which we propose; they may also, like mergers, be challenged by the Director.

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* It may be prudent to provide as well that export sales agreements should not be associated directly or indirectly with international cartel organizations.

II - 4. INDUSTRIAL AND INTELLECTUAL PROPERTY*

Legislation pertaining to letters patent of invention, industrial designs and copyright provides temporary rights of exclusive use for the benefit of the originators of the subject matter. These are rights which, except for the limited effectiveness of the general law of confidential obligations and trade secrets, those persons would not otherwise enjoy.

Trade marks are indicia that are used to distinguish, or differentiate, the origin of particular goods and services from the origin of competing goods and services, and thereby to help identify more or less consistent quality for purchasers. Trade marks are protected by common law for the direct benefit of both purchasers and the particular sellers. The primary purpose of the Trade Marks Act is to provide a system of trade mark registration in order to extend the geographical scope of protection beyond the area of actual use, to facilitate enforcement and to facilitate the adoption of non-conflicting trade marks.

Industrial property rights, particularly patents and trade marks, are important to the analysis of many market situations. They can affect market power, its likely duration and ease of entry, and the competitive effects can vary from harmful in one case, to insignificant in another, to beneficial in the next from the point of view of public policy. A patent, or the advertising of a trade mark, can for example be a barrier to entry in one case and facilitate entry or expansion by either a large or small firm in the next case. The

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* For convenience the term "industrial property" is used in this section.

nature, maturity and rate of change of a firm's industrial property portfolio, when seen in the context of the particular industry, may be relevant to the assessment of the future effect of a merger or rationalization proposal. A patented invention, like other innovations*, can reduce the investment required for efficient production and can also influence the definition of the market. The indefinite duration of trade marks can be important, as can the wasting nature of patents, designs and even copyright. The head start provided by a patent can have long-term market effects in terms of distribution networks, an exclusive research opportunity leading to improvements that prolong market dominance beyond the expiry of the initial patent grant, and the establishment of strong trade mark rights.

It is only fortuitous, however, if on the facts of a particular case an industrial property right defines a meaningful degree of monopoly power for purposes of market analysis. It is true that the statutes define exclusive rights, just as the general law of property defines exclusive rights over other subject matter within everyone's common experience. Apart from trade marks, the uniqueness of industrial property rights in preventing others (i.e. competitors) from offering an identical thing to the public or utilizing the same efficient process, and thereby creating an exception to the normal freedom to imitate, reflects the intangible nature of the newly created value. However, the

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* Industrial property law requirements of novelty, originality or utility have nothing to do with the broad institutional or market implications that economists usually associate with the concept of "innovation", although particular patents may contribute to innovations in the broader sense.

statutory tests of protectable subject matter have little to do with degrees of substitutability between unprotected things and protected things. The novelty requirement of patentability, for example, is often satisfied by an invention that produces an already available result by a means previously unknown to society. Nor do product patents necessarily define appropriate product markets for purposes of market analysis, and brand names are even less likely to do so. Further, the legal character of an industrial property right is completely unaffected by changing market conditions. In short, the sense in which industrial property rights are exclusive, or "monopolistic", has no necessary relationship to monopoly power as a concept of competition policy.

This is not to say that a patent, like other particular assets, cannot be the basis of a monopoly in the market. Such a situation may for example exist in high technology industries such as electronics or chemicals where firms hold large portfolios of patents covering basic inventions and many improvements. A patent right or a patent portfolio, however, is only one of many reasons why a person might quite properly be alone or essentially alone in a particular market at a particular point in time. It by no means follows that the very existence of the market power is contrary to the public interest. Quite apart from the probability that market dominance seldom endures for long on the basis solely of a particular patent or patents without at least continued technological development, the questions for public policy in each case are how the power was achieved and how it is being used.

The unique nature of industrial property rights has led to some difficulty in relating public policy pertaining to industrial property, as such, to public policy pertaining to competitive markets. Obviously there is a need for overall policy consistency between the two sets of laws in

terms of underlying rationale and long-term objectives. This consistency cannot be achieved by resorting to simplistic or emotive uses of labels such as "monopoly" and "property" - a discussion in such terms merely denies the variety of, and the need to integrate, the public policy goals and tools in this area.

Public policy as expressed in the Combines Investigation Act should accept as "givens" the private rights conferred expressly or by necessary implication in the industrial property statutes as they exist from time to time. The industrial property statutes should express public policy concerning the bundle of rights and limitations that together define the assets known as a "patent", "registered trade mark", "industrial design" or "copyright". It may be that as a matter of industrial property law the rights granted under the relevant statutes should be strictly construed, but in principle industrial property rights should not be treated differently from any other assets so far as competition policy is concerned. The extent of use of a patent, for example, and the resulting rewards to the patentee, like the case of any other privately owned asset, is largely determined by market conditions and the differential advantages of that asset.

We have not, therefore, in preparing this report, given any consideration to matters of general application relating primarily to the industrial property systems as such. The government is currently engaged in a fundamental review of the industrial property laws. That is the proper place to resolve questions of policy priorities in connection with the underlying rationale of the industrial property systems and we have not

prejudged those issues.* Nor, for the same reason, have we given any consideration to general features of the industrial property systems even though they are of general economic significance. The standard of patentability applied by the Patent Office, for example, is important. So, obviously, is the scope of protectable subject matter. What is the economic basis, if any, for protecting some things and not other things? Is there any justification for extending protection to other efficiency-producing innovations involving, for example, novel purchasing and inventory methods, better personnel

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* A general rationale usually asserted in support of patent systems, for example (and to a lesser extent industrial designs and copyright), is that by providing a special opportunity for profit resulting from exclusive exploitation of the subject matter during the statutory period, a special incentive to invest in experimentation and research and to develop and distribute resulting inventions is provided. An increased rate of invention is said to be further encouraged if a patent creates a spur for competitors to develop equally useful things, and by providing for early public disclosure of the knowledge so that other developments can be built upon it by others. The existence of the exclusive right and the possibility of licensing or assigning it, either in whole or in part, helps attract and make available risk capital to put the invention into productive use to meet such demand as may exist. This rationale for the system, although consistent with the long-term goals of a market economy, has been challenged as lacking in empirical basis or validity, particularly so far as Canada is concerned as a small country in an international patent system. The overwhelming majority of Canadian patents go to foreigners.

management, marketing techniques or new forms of business organization that at present are not protected except perhaps in a limited and fortuitous way by the law of trade secrets? Or, alternatively, should the scope of existing protectable subject matter, or the seventeen year term of protection that was adopted in a different age and for a different economy, be reduced? The speed with which applications are processed and conflicts between applications resolved, so that a patent may issue and the statutory period of protected exclusivity begin to run at the earliest reasonable time, also bear upon performance of systems in which the term of protection runs from the date of issuance. Rules of construction applied to patent grants are important for the same reasons that the scope of protectable subject matter and the standards of patentability are important. The point in the distribution or marketing process at which industrial property rights of control are exhausted is relevant, as are the extent of the right to exclude imports and principles of general application regarding misuse of the rights. There is also a public interest in having patent and other industrial property disputes resolved as efficiently as reasonably possible, so that periods of uncertainty and the costs of dispute are minimized or controlled and do not in themselves become tools of market rivalry or have market effects to any greater degree than is necessary.

We take no position on these questions. Our view simply is that industrial property rights, whatever they may be from time to time, should be treated under the Combines Investigation Act as neither inferior nor superior to any other types of assets. The mere exercise of a general right of ownership, without more, should not attract any remedy or penalty. If that exercise of the right, however, occurs in a context or manner that creates a special exclusionary or anticompetitive effect in the appropriate market and is dealt with generally by the Combines Investigation Act, then remedies

under the Combines Investigation Act should be available. In other words, something more than is contemplated or provided for in the industrial property statute should be required before a remedy could be applied under the Combines Investigation Act.

Similarly, we draw a fundamental distinction between the exercise of a right conferred expressly or by necessary implication under an industrial property statute and a claim deriving only from a contract that involves such a right. Does the contract restrain a person from doing something which, but for the contract, he would be free to do? For example, the Patent Act confers the exclusive right upon a patentee to make, construct, use and vend the subject matter in Canada. It does not confer upon him any right to tie a licensee with respect to the purchase of some other thing not covered by the patent. The tie-in has the "leverage" effect of using a protected position in one market to gain advantage in another market not covered by the patent grant. Except for the license a licensee would infringe, say, the exclusive right to make, and an infringement action would be based directly on the statutory grant. If the licensee breached a tying provision, however, the patentee could not rely upon his patent. He could only seek to enforce the license contract because that is the sole source of the tying restraint. The restraint is not part of public policy as expressed in the Patent Act. The tying clause may or may not have an adverse effect upon competition as defined in the Combines Investigation Act but it should in any event be subjected to the requirements of the Act like a tie involving any other asset.

Industrial property licences should, for the same reasons, be subject to the exclusive dealing provisions of section 31.4 of the Combines Investigation Act which concern contracts with purchasers that discourage or prevent them from

dealing with competing suppliers. The use of licences or assignments of industrial property rights to achieve price maintenance (of anything) is also prohibited by the Combines Investigation Act, and should likewise be subject to the general law relating to price discrimination.

The ability to grant industrial property licences is important, particularly to small firms. Any right to grant limited licences that is provided for by the industrial property statutes (as they may exist from time to time), including licences containing territorial and field of use restrictions, should be protected from the possible scope of the refusal to deal and market restriction provisions, so that a licensor is not precluded from achieving a market result by way of licensing that it could have ensured if it were large enough, or wished, to obtain by exercising the right entirely by itself. In other words, those provisions should not be used as bases for compulsory licence applications.

It may be that as a drafting matter it would be sufficient to provide that an industrial property right, as such, should not fall within the definition of "product" for the purposes of certain sections, but the complexities of attempting to provide specifically for the variety of industrial property rights in connection with each substantive provision of the Combines Investigation Act, particularly in view of the pending revision of the industrial property statutes, suggest that as a drafting matter it would be preferable to exempt generally from the scope of the Combines Investigation Act any use of a right provided for expressly or by necessary implication in the industrial property statutes. Questions of construction for the Board (and for the Federal Court, on review) would frequently be the same as would arise in an infringement action.

The licensing or assignment of industrial property rights should, like agreements relating to other assets, remain subject to the conspiracy and merger provisions of the Act. Concentration of the exclusionary power of competing or potentially competing industrial property rights or know-how by horizontal arrangements, rather than by developing it oneself, may occur by means of assignments, pooling arrangements, exclusive licences or cross-licences. These arrangements can but do not always result in productive efficiencies. The rewards resulting from common administration might well reflect more than competitive superiority. Whether or not these horizontal arrangements involve explicit restrictions concerning price, territories or output, and whether the resulting accumulation of rights is held jointly or by a single firm, they restrict the supply of close substitutes by bringing independent productive assets under unified management. They can also reinforce oligopolies and heighten barriers to entry with little or no compensating advantage. They are properly subject to being prohibited, depending on the facts of each case.

Dominant market positions might also be misused, subject to the facts of each case, by exclusionary licensing or assignment practices or restraints that go beyond the rights provided for expressly or by necessary implication in the industrial property statutes. Licence requirements persisting by contract after the expiry of the statutory right, inclusion of "no contest" clauses in licences or unjustified threats of infringement actions are examples of conduct that could, on the facts, constitute misuse within the meaning of the Combines Investigation Act. Similarly, covenants to grant back assignments or exclusive licences could be unjustifiable in particular situations where the licensor holds a dominant market

position.* "High" prices alone do not constitute misuse of industrial property rights any more than they do of a monopoly position in the market, but the rewards for the relevant creativity should not be enhanced by going beyond the legal definition of the right and damaging the operation of a market.

Failure to work a patent can present special problems where dominant market positions are involved. Ignoring the provisions relating to abuses of patents generally that are, and may in the future be, contained in the Patent Act, a special case can be made for compulsory licensing in limited situations under the Combines Investigation Act. A refusal to licence a patent on reasonable terms could in rare cases constitute an unjustifiable restraint on competition if the holder of the right enjoys or benefits from a dominant market position and does not work the patent significantly himself. This might be so, for example, where he acquired the unused right from someone else with the purpose or effect of suppression or market foreclosure.

Failure to work can also constitute an abuse of a patent right under section 67 of the Patent Act. In such situations the Commissioner of Patents is authorized to order the grant of a licence or licences, and if necessary to order revocation of the patent. By virtue of section 27.1 of the Combines Investigation Act the Director of

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* The types of practices referred to here, and others, could only constitute misuse within the meaning of the Combines Investigation Act if in fact they had or were likely to have a significant adverse or exclusionary effect on competition in the appropriate market. Particularly where licensing terms are negotiated separately with each licensor all the terms are interdependent parts of the bargain.

Investigation and Research may make representations to the Commissioner of Patents, and call evidence, at hearings applying section 67.

Power to order the grant of a licence, or power to prohibit the exercise of rights that are expressly or by necessary implication conferred by the industrial property statutes, constitutes a form of divestiture in the same way, although to a different degree, as does an order destroying the right itself. In addition to the failure-to-work situation, discussed above, we recommend that such remedial powers be available to the National Markets Board only on a last resort basis, as is the case of a divestiture power relating to any asset, to deal with a situation where a dominant market position has been misused and divestiture to reduce the market power appears to be the only effective remedy. The prior misuse need not have related to the industrial property rights affected by an order. We recommend below, in the section of this report dealing with administration and adjudication, that divestiture orders be reviewable by the Federal Court on the ground of lack of reasonable necessity for the order or any provision in it.

In view of the above recommendations we further recommend that section 29 of the Act be repealed.

We note that Canada is party to certain industrial property treaties that impose requirements concerning industrial property rights and interference with them under domestic legislation.

We recommend that no special remedial powers be provided with respect to the miscellaneous and limitless types of information, written and otherwise, that are commonly and collectively described as "know-how". Know-how is protected as a private asset by the general law of confidential obligations and trade secrets. Its existence as a

private asset is dependent on controlled secrecy. Contracts dealing with know-how are subject to the common law relating to covenants in restraint of trade, which is to say the restraints will only be enforced by the courts if they are shown to be reasonable with reference to the interests of the parties and also reasonable, or not injurious, with reference to the interests of the public.* Further, know-how and know-how contracts will be subject to the Board's general remedial jurisdiction like any other asset.

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* This is the common formulation of the rule as it is applied by the courts. The courts have seldom refused to enforce such a contract by reason only of its not meeting the "public interest" part of the test.

II - 5. A NOTE ON INTERLOCKS

Overlapping membership between boards of directors and the management groups of different business enterprises is of general economic, political and sociological interest. These overlaps, or interlocks, are, however, only relevant to competition policy to the extent that the enterprises in question are actual or potential competitors or have another connection in the market, such as being in a supplier-customer relationship. Concentration of general economic power by means of interlocks is therefore not of direct concern to competition policy; it is an essentially different matter.

Since the days of the large trusts in the latter half of the nineteenth ccentury there has been some concern about a person serving as a director or senior manager of two or more competing companies. The concern with the horizontal interlock is, simply, that the interlocking person owes a fiduciary duty to each of the companies and the easiest practical compromise whenever a matter arises that will affect competitors, and thereby puts his duties in conflict, is to seek to harmonize the interests of the competitors. Even apart from clear-cut situations, such as when conflict of interest laws might be effective or where outright collusion occurs through the means of the interlock, there is a concern that access to reliable information and involvement in planning and policy-making processes might quite naturally reinforce communities of interest and oligopolies so that the forces of market rivalry would be dampened. For example, a decision on whether, when or where to enter a new geographical market or develop a new product line might be affected.

With respect to vertical interlocks, such as those involving financial institutions which supply capital and credit to other businesses, or

involving distribution chains or suppliers of raw materials, the worry is that longer term preferential relationships will become established on the artificial basis of the interlock. Depending on the industries involved one such "dancing partner" relationship could lead others in the industry to protect themselves in a similar way with the result that independents or new entrants might be effectively excluded, particularly at times of scarcity.

Similar risks are believed to arise from indirect interlocks, where persons from two market-connected enterprises have common relationships with a third company such as a bank, a supplier or customer, or the parent of one of the two companies in question.

In addition to these risks, however, other broad considerations are relevant to deciding what public policy should be towards interlocks in general. First, there is no reliable evidence that interlocks have in fact harmed competitive processes in Canada in any generally significant way.*

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* The potential importance of interlocks between financial institutions and large firms relates to various aspects of the preferential access to funds and the denial of access to competitors of the interlocked firms. Because of the basic significance of finances to the growth and even the survival of firms, such interlocks assume particular importance.

  The Royal Commission on Corporate Concentration is currently examining the relationships between the chartered banks and their corporate customers and financial intermediaries, and between those financial intermediaries. It may turn up some additional evidence concerning the types and effects of management or ownership links between these types of enterprises.

Second, circumstances vary quite considerably between industries, making generalizations extremely difficult. Third, the principle of minimum government interference requires that no restraint be imposed that is not clearly required, and that no more be prohibited than is clearly undesirable. Fourth, managerial skill and entrepreneurial talent are so scarce and so important to economic health that any unnecessary restriction or inhibition against selecting the best people for each particular industry could be counterproductive. Good policy making and management is rather intangible to identify but if one factor had to be selected as being the most fundamental to adaptability and the encouragement of cost saving innovations, that factor would be policy making and management.

The above four considerations place a high onus on those who advocate general legislation limiting interlocks.

It should also be noted that directors and officers of corporations are subject to stringent and firmly established rules of general application relating to conflicts of interest. These rules were developed by the common law and are now supplemented by statute. The common law obligations subject every director, manager, and other officer or agent of a corporation to the fiduciary duty of acting honestly and in the utmost good faith to do what he believes to be in the best interests of the company. This obligation applies to all his dealings with or on behalf of the company and also with respect to opportunities and special knowledge that come to him through his corporate function. Breach renders him liable, at the instance of the company or a shareholder suing on its behalf, for any damage suffered by the company and also to account for any profit or benefit that might have been gained by the director or officer personally. They are, in law, like trustees. The obligation includes a duty to preserve confidentiality (e.g.

of competitively sensitive information) and a duty to disclose potential conflicts of interest including those arising by means of a conflicting duty of loyalty to a person or enterprise that is adverse in interest.

Various statutes dealing generally with corporations have embodied some of these common law obligations (particularly those relating to disclosure, although sometimes in a narrower form than the common law requirements), and have also established new standards of care, skill and diligence for directors and officers. In addition, and together with securities legislation, they frequently require "insiders" who make use of specific confidential information for their own advantage to compensate others who suffer loss as a result.

Laws pertaining to specific industries, such as the Bank Act with respect to loans to corporations in which a bank director has an interest, supplement the general corporate law on conflicts of interest.

To say that conflict of interest rules are relevant to the competitive implications of interlocks is not to say they solve them. Directors and officers are obliged by law to exercise their powers for the purposes for which those powers were conferred. The primary purpose for which they were conferred is to serve the interests of the company. It is not settled as to how far, if at all, duties are owed to shareholders, but it is clear that the interests of employees, consumers and the nation as a whole are not covered by the obligations imposed by the general law on directors and officers. The courts have held that a director of one company cannot be restrained from acting as a director of a rival company, at least for that reason alone, although anyone who does so walks a legal tightrope

by virtue of his obligations to both companies.* It may be that in some cases such as those involving a tight oligopoly he can only remain on that tightrope if he does things that have the effect of reducing market rivalry, and in that event he risks personal criminal and civil liability under the Combines Investigation Act.

Accepting that the formal, functional aspect of an interlock permits it to be distinguished from various other types of personal or business

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* This problem is discussed by the House of Lords in Scottish Co-operative Wholesale Society Ltd. v. Meyer, [1959] A.C. 324, especially at 366-68. The case involved an unusual situation of predatory price discrimination by a parent against its own customer subsidiary in an effort to put pressure on independent minority shareholders of the subsidiary. The common directors of the two companies occupied a completely untenable position. Relief was granted.

There is, however, authority for the view that even where an interlock gives rise to clear conflicts of interest and to personal gain, a company does not have a cause of action where it knew and understood that the director or officer in question would continue to act in all capacities despite the conflict: Atkins & Dubrow Ltd. v. Bell (1957), 10 D.L.R. (2d) 484 at 491 (British Columbia Court of Appeal). According to the Court the only duty was to act honestly and fairly towards each company in all matters involving conflict of interest. The case involved a cooperative sales agency plan for marketing peat moss that was subsequently a subject of antitrust proceedings instituted by the United States government.

relationships that can provide equally good opportunities or incentives for anticompetitive cooperation, there are still difficulties in formulating effective legislation dealing directly with interlocks. Some of those difficulties are as follows:

1. Assuming that the legislation should go beyond interlocking directorates, should there be a limitation with reference to the types of official capacities or functions performed by the person or persons involved? Should it, for example, extend to part-time consultative capacities and management contracts? What about substantial ownership interests alone?

2. Should the legislation deem the identity of persons related through family or partnership ties where reliable avenues of communication may be assumed to exist?

3. Should it specify a minimum degree of power to influence policy?

4. Would it be desirable to condition a general restriction on horizontal interlocks by providing, as does section 8 of the Clayton Act in the United States, that it only applies if the elimination of competition by agreement between the companies would constitute an illegal conspiracy? What about indirect interlocks or potential competition?

5. Should evidence be required of some intent to use the interlock restrictively?

6. Should the legislation be limited to enterprises of a certain minimum size, or to certain degrees of combined market power, with the effect that it might apply to a particular situation at one time but not at another time?

7. Should the legislation apply to interlocks between enterprises that are only market-connected with respect to a small part of their operations?

One thing that is likely is that the more detailed and specific the legislation becomes, the greater the risk of both unnecessary interference and, at the same time, of creating avenues for forms of avoidance that are protected by implication.

The essential difficulty in legislating with respect to interlocks, as such, is that the underlying concern is substantive and yet the rules would look only to a particular formal mechanism. Interlocks by themselves are neither good nor bad; the worry is that they will lead to undesirable practices or effects. Those practices or effects as such are subject to legislative remedy under the Combines Investigation Act, although the argument is that a rule respecting interlocks would prevent some of those practices or effects from occurring in the first place and to that extent would eliminate the slippage that results from delayed or only partial enforcement.

Interlocks have been limited by law in a few specific industries to take account of special risks or actual experience. Section 18 of the Bank Act, for example, forbids directors of banks from holding directorships in other banks or in trust or loan companies, as well as in other corporations the boards of which are more than one-fifth composed of directors of the bank. Section 76, further, places restrictions on ownership or control by banks of other corporations.

Under our general proposals the National Markets Board will have the power, within its general remedial jurisdiction, to prohibit a particular interlock or defined types of interlocks between specific enterprises, in a situation where an undesirable practice or effect has been found to

exist that was or was probably caused or facilitated by the interlock. This power would extend to such interlocks as the Board believes, on the basis of evidence before it, are likely to lead in the future to defined undesirable practices.

These two types of prohibition are probably within the scope of sections 30(1) and 30(2) of the Combines Investigation Act which permit courts to prohibit the doing of any act or thing directed toward the continuation or repetition of an offence or directed toward the commission of an offence. This power also extends to such acts or things as may be necessary to dissolve a merger or monopoly.

As to the desirability of limiting interlocks by special provisions contained in competition legislation of general application we are forced back to the fact that the research to date supports few, if any, valid generalizations about interlocks. The dangers of interlocks probably result more from the particular persons involved than from the interlock as such. Interlocks probably create more risks in some industries than others, and some types of interlocking functions such as a person acting as director of one company and a sales manager of another may be more amenable to abuse than other types. The number, type and pattern of interlocks, and the extent to which they are both vertical and horizontal may also be significant. We do not know.

In our view a statutory prohibition of specific types of interlocks would not be justified in Canadian legislation of general application, at least on the basis of existing evidence. Any prohibition or regulation should be done only on an industry by industry basis either by statute (as in the case of the Bank Act), by a regulatory board with detailed knowledge of and specific jurisdiction over the industry, or as a result of special study.

III

Issues in Pricing Policy

III - 1. PRICE DISCRIMINATION*

Introduction

Price discrimination legislation, devised originally in a period of major economic disorganization to protect the small business sector against the pressures associated with mass buying, has been accompanied during its 40-year existence by a rather uncertain and inconclusive set of changes in the size and organization of markets. How far these changes have had a causal relation, whether of a positive or a negative nature, with the legislation is difficult to say particularly since it has been the subject of little formal enforcement. Only a few developments can be identified with assurance.

In the field which more than any other accounted for its introduction - food distribution - it is clear that the legislation failed to stem the development of major new systems which have emerged to substantially take over at least the large urban market from the small operator. It may appear ironic that one of the innovations which proved to be of basic importance in this process, the supermarket, was originated and carried through its testing period by small businessmen. In fact, small firms have frequently performed this originating and testing function in a number of industry sectors, although they have lacked the necessary capital and managerial systems to carry the innovations to full market success.

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* For a concise discussion of the theoretical and technical aspects of price discrimination, see Discriminatory Pricing Practices in the Grocery Trade (a Report issued by the Restrictive Trade Practices Commission, written by L.A. Skeoch, Ottawa, 1958).

At the same time, the resiliency and resourcefulness of the small business sector have been demonstrated by the current high level of its numbers and the economic areas in which it performs effectively. It is very doubtful if the price discrimination legislation has had much to do with that performance. Indeed, the first section of this chapter would suggest that the prohibitions of the legislation have probably given a strong impetus to forms of vertical integration which have been inimical to the interests of the small business sector, and which have contributed a degree of rigidity to the economic structure in some fields whose longer-run significance it is difficult to assess.

In the first section of this chapter we adopt a pessimistic view of the traditional rationale for that form of price discrimination legislation which attempts to restrict the granting of price differentials deriving from real economic advantages associated with larger volume purchases. Clearly, the restraints of the legislation have not worked to the advantage of the small business sector, and the defensive and protectionist attitudes that this experience has fostered have tended unfortunately to promote demands for still more "equality of treatment". Imposing equality of treatment by law upon situations involving real differences in economic conditions can only result in long-run distortions and persisting maladjustments.

In the second section of this chapter we suggest that the real economic advantages associated with "small" size be recognized and be made more effective by policies of a positive nature. The central hypothesis of this report is that the role of government policy should be not to direct and manage the economy in detail but to facilitate change and thus release and reinvigorate the dynamic forces that have been responsible for the prodigious economic growth that the market-directed, private enterprise system has demonstrated it is capable of achieving.

The strength of the small business sector resides basically in its flexibility, its capacity to experiment with new ideas, its speed of reaction, and the like, not in seeking a form of pseudo-security in the adoption of guild-like controls. The rigidity of neo-mercantilism may promise short-run advantages but it is not, either economically or socially, an acceptable long-run form of organization.

1. Price Discrimination - The Background and Customary Rationale

Price discrimination is a complex area in economic analysis and a controversial area in public policy. As Professor J.M. Clark summed it up years ago:

> "For discrimination is not solely an economic fact. It raises moral and social issues: it is the tool of favoritism and greed and the vehicle of the highest social justice. It may rouse our righteous resentment or our admiring commendation."*

In Canada, the legislation dealing with price discrimination - which was passed in 1935 - was primarily based upon the recommendations of the Royal Commission on Price Spreads. The Commission was concerned, in particular, about the pressures of the "mass buyer" on the small seller as supplier, and on the small seller as competitor. It concluded that such pressures resulted in serious discrimination which created "problems of justice to the individuals subject to discrimination and problems relating to the public interest."

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* Studies in the Economics of Overhead Costs, p. 416.

More specifically, the complaints against the "mass buyer" were classified under two heads:

1. That they depressed the prices of manufactured goods (and so of wages), and of agricultural produce;

2. That they were driving the independent retailers to the wall and these independents should be protected for three major reasons:

   (a) They constitute a valuable social group which communities cannot afford to have wiped out.

   (b) They can defend themselves from 'fair' but not from 'unfair' competition.

   (c) Their elimination will result in growth of monopoly in the retail field.*

The Report went on to point out that there were some economic advantages in "mass buying", although, as already indicated, it adopted a critical view of the pressures which such buyers created and which resulted in lower prices and incomes for some groups. It is important to remember that this assessment was made in the circumstances of the most severe depression in modern industrial history. A more balanced and analytical view of the role of the "big buyer" in recent years is provided in the RTPC Report on Discriminatory Pricing Practices in the Grocery Trade (pages 29-33).

Indeed, it is one of the basic positions of our report that the price discrimination legislation was the product of a period in our economic

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* Report of the Royal Commission on Price Spreads, p. 224.

history in which policy had as one of its chief aims the discouragement of further price reductions and the protection of certain groups from injury inflicted by deep depression at home and abroad. Although it seems doubtful that those policies were well conceived to protect the public interest, their adoption is understandable in the circumstances of the times. Today, the problems are different, and policy should be adapted to the new needs.

The primary thrust of policy in our view should be to promote adaptability and flexibility in the economy, and to provide both pressures and incentives to develop new products and services, as well as new methods of production and distribution, which will more effectively meet the needs and desires of society. Protected positions, whether protected by the government, by custom, or by private organization and manipulation, should be laid bare and be critically examined in the light of these broad purposes; power used to restrain entry and to discipline competitors, not by economic superiority but by financial takeovers, by threat and by predatory behaviour, should be eliminated with firmness and dispatch.

The Case for Protecting Small Businessmen by Price Discrimination Legislation

Today the arguments advanced in favour of formulating price discrimination legislation in terms that will provide protection for the small businessman are essentially the same as those advanced forty years ago.

First, it is maintained that price discrimination which may injure small businessmen will reduce their numbers and, as a result, also reduce competition to the detriment of the public. There are a number of dimensions to this position. There is, first, clear evidence that in some distributive trades the retail and wholesale margins have shrunk appreciably at the same time that numbers of

competitors have declined. That is, reductions in numbers of competitors have been associated with more effective competition. Such evidence is countered by the argument that this condition is temporary and that in the long run when the trade has become tightly "oligopolised", if not monopolised, margins and prices will increase and the public will suffer. This conclusion, in turn, rests on some major assumptions: that small businessmen are particularly devoted to (or, at worst, incapable of hampering) competitive behaviour; that dynamic change will not intervene to take advantage of monopolistic excesses, or, if it fails to so intervene, that combines policy does not possess the potential to deal with abuses of market power.

On the argument that small businessmen are particularly committed to competitive behaviour, the evidence is far from comforting. In Canada, no detailed, formal study of restraints on retail competition has been published. There is, nevertheless, scattered evidence - such as the attitude of the small business organizations to the legislation banning resale price maintenance, to the passage and enforcement of provincial legislation requiring minimum mark-ups at retail and wholesale, to municipal legislation imposing limitations on new entry in certain trades, and so on - which suggests rather less than strong support for competition that puts pressure on costs, prices, and numbers in the trade.

An exhaustive study of restraints upon retail competition in the United States by Professor Stanley C. Hollander,* establishes something of the

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* Stanley C. Hollander, Restraints Upon Retail Competition (1965, Michigan State University); at the time of writing, Hollander was Professor, Department of Marketing and Transportation Administration, Graduate School of Business Administration, Michigan State University.

range and variety of the activities employed by small business organizations for their protection. There is at least "tip-of-the-iceberg" evidence of many of these activities in Canada. It is also worth keeping in mind that many of these practices have persisted in the United States in spite of the relatively high level of anti-trust and anti-restrictive practices enforcement in that country.

Under the heading, "Aspects of Group Activity", Hollander comments:

> "In some aspects, retail and service trade group controls seem to conform to the prevailing notions of monopoly theory, other aspects are somewhat surprising. For example, one common assumption is that price agreements are most likely to flourish when there are only a few sellers, and that the presence of large numbers of competitors is a barrier to agreement. The retail experience does not deny the facilitating effects of small numbers. But the retail and service trade experience shows too that large numbers of competitors can be united. Some of the price controls that we have noted in the barber, gasoline, drug, liquor, food, and other trades have brought together literally hundreds and thousands of firms. Large numbers are not an insurmountable barrier to joint action when some strong unifying force is present.
>
> Another way in which the retail experience is interesting is as a corrective to any notion that a cartel must crumble in the absence of complete unanimity. This notion is only true if (a) the offerings of all sellers, including both the cartel members and the others, are perfect substitutes for each other, and (b) the price-cutting firms can and do

absorb a share of the trade that is large enough to make the cartel members abandon their protected positions to take retaliatory price cuts of their own. This combination of conditions is often absent when a retail group sets out to control competition, and hence the group often finds that it can tolerate a considerable amount of deviation. . . . Many analysts point out, quite correctly, that homogeneity among the dealers encourages agreement. They are right in the sense that it is easier to bring together a group of liquor dealers, or barbers, or independent druggists, than it is to form a combine among people who sell different combinations of miscellaneous products. At the same time, in the actual world where complete unanimity of action is rarely obtainable, some degree of difference among the sellers helps permit group action. . . .

The cases we have looked at also illustrate the importance of control mechanisms, and the variety of control techniques used to enforce retail price agreements. Sometimes mutual self-interest and the fear of competitive retaliation are sufficient to ensure adherence to the group program. . . . More frequent, as we have noted, is the use of pressure or persuasion on an outside agency to enforce the group program. This is why so many retailer price arrangements become vertical plans, with the suppliers placed in the role of enforcement agency. In other cases, as also noted, labour, advertising media, or even the public authority can occupy that role." (pp. 68-70)

Hollander goes on to point out that many constraints, especially those not supported by public authority, do tend to break down in the long run. However, he adds,

> ". . . the tendency of restraints to break down in the long run is small consolation to consumers who live in the short run. . . . And whatever little comfort there is in that thought [of long-run breakdown] can be dissipated by the likelihood of a new, offsetting, competitive barrier to rise in attack on the consumer budget."

He concludes,

> "we need a legislative and business climate that presents the fewest possible barriers to competition and that provides the greatest possible opportunity for the flowering of many types of outlets to serve the public. Our retailing community contains many keen competitors; the environment should be arranged so that they can do their best."

More effective protection of the broad interests of the economy is likely to be found in the hard struggle between new and established methods of distribution and the provision of services, and in the effective enforcement of policies to discourage abuse of market power, than in the attempt to preserve numbers of businessmen by legislation which undertakes to impose restraints on price discrimination (or, more accurately, price differentials) which are inconsistent with broad economic influences.

The second case that is advanced for protecting the small businessman by legislation on price discrimination is, in part, based on ethical considerations, although these are buttressed by

economic arguments. It is maintained that the small businessman is entitled to equality of treatment with large buyers at the hands of suppliers, and that the prevailing price differentials are excessive and are due largely to the abuse of the power of mass buyers.

There can be no denial that similarity of economic circumstances demands equality of treatment. The basic question is whether prevailing price differentials are, in fact, excessive, that is, do they amount to price discrimination; if they do, the appropriate response is clear; if they do not, the question is how far it is possible to go in the interest of supporting the proposed ethical standard without imposing an undue burden on society, or without causing the larger buyers to attain the economies associated with their larger purchases by other, and perhaps less desirable, means.

Although the determination of the question whether price differentials are excessive should, ideally, be carried out by an exhaustive investigation of the economic circumstances of the individual firm quoting the prices, such an approach is not possible here. There are, however, some sources of evidence which provide useful indicators or tests of the general situation prevailing in some industries.

Professor M.A. Adelman, in his perceptive study of the A & P cases,* commented,

> "There is a widespread impression that the Chain Store Investigation of the Federal Trade Commission disclosed much

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* A & P. A Study in Price-Cost Behaviour and Public Policy (Harvard University Press, 1959), p. 152.

> price discrimination in favour of large buyers. The Investigation established no such thing. It estimated that 85 per cent of the differences in selling price between chain and non-chain stores was accounted for by lower operating expenses. Even this was a gross underestimate because the Commission made no attempt to find out whether and to what extent quantity discounts corresponded to cost savings. . . .
>
> As a matter of fact, the economist in charge of the Investigation wrote elsewhere that quantity and related discounts usually failed to make full allowance for cost savings - which means that . . . there was some discrimination, in the economic sense, against the 'preferred' buyers. Another FTC study showed that in 1936 the net return to the sellers of fresh fruit and vegetables was greatest on sales to the chain stores. . ."

Professor Corwin D. Edwards, in an interesting comment,* points out that the excessive differentials that are complained of and which gave rise to the Robinson-Patman Act - as is true of the Canadian legislation - were claimed to be the result of the power of the large buyer to induce discriminations. "It is an anomaly, both in the structure of the Act and in its administration, that violation by the seller has been more clearly defined and more vigorously pursued than violation by the buyer."

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* "Twenty Years of the Robinson-Patman Act", The Journal of Business, Vol. XXIX, No. 3, (July 1956).

Perhaps part of the explanation of this anomaly rests upon the likelihood that if large buyers were entitled by law to "justified" differentials they would demand the full amount of the economic advantages - both on the cost side and on the elasticity of demand side - that could be associated with their purchases. There is persuasive evidence that if they did so, price differentials would increase rather than diminish. As the law stands in the United States, and also in Canada, it is possible and safe for sellers to discriminate against large buyers and in favour of small buyers. However, the action of the independent grocery wholesalers as they came under increasing pressure from the integrated chain store firms, in first eliminating certain small accounts from their customer lists altogether, and then introducing quantity discounts graded according to the volume of purchases, makes it clear that at least some price discrimination against the larger buyers had previously prevailed.* It would appear that when economic pressures become severe, differentials which favour the small buyer, even when the larger buyers do not possess anything that could be described as substantial buying power, are likely to disappear in the rigorous competitive struggle.

This is all the more likely to be the case if the large buyer has the ability to avoid paying prices which he believes do not make adequate allowance for the economic advantages which are attainable on his purchases. As Professor Adelman has made clear in his A & P study, the large buyer can set up his own facilities to provide services or to process products. He can also take over

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* For a detailed example of the cost experience of a number of food wholesalers with retail buyers of different sizes, see J.C. Palamountain, Jr., The Politics of Distribution (Harvard University Press), pp. 15-18.

existing firms and fit them into an integrated operation, in some cases absorbing their entire output, in others continuing to supply some of the firm's previous customers. He may avoid making purchases from the producer of national brands who has a narrow discount range to discourage price-cutting of his branded products, and develop his own private brands.

There is another dimension of the impact of legislation (including but not limited to customary price discrimination legislation) that penalizes firms which expand basically because of superior economic performance. Professor R.A. Solo has expressed the following judgment about this aspect of the A & P cases in the United States:

> "The attack on A & P appeared to destroy the elan of an aggressive competitor, which subsequently, regressed into routinized practice and financial distress, greatly to the detriment of consumers. It is not evident that the cutting down of A & P benefitted the small independent retailer."*

The consequences of these, and other, actions by large firms to avoid the reach of price discrimination legislation designed to protect small buyers can be serious for the long-run development of the industry. Entry is likely to become more difficult for the small firm whether as distributor or supplier; rigidities may increase as a few large distributing firms pursue the integration route and the remaining non-integrated suppliers face limited opportunities for expansion; integration will reduce the scope for secret price cuts which are the precursor of more general price flexibility, and so on.

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* Robert A. Solo, The Political Authority and the Market System, p. 198.

On the question of the contribution of the small business sector in the non-economic sphere, we find ourselves in general agreement with the views expressed by Professor William K. Jones, a member of the White House Task Force on Antitrust Policy. In dealing with the grounds claimed as justifying price discrimination legislation to protect the small business sector, he identified the third ground as follows:

> "The small businessman makes a distinctive contribution to American democracy and thus, for social and political reasons, he ought to be preserved; even at some cost in economic efficiency."

He continued,

> "This, to me, is the worst reason of all. There is no indication that small business is on the decline. Year by year the number of small businesses increases. But, more importantly, I take issue with the proposition that a man who works for a salary is somehow inferior to a proprietor of a small business. Every citizen is as important as every other citizen, and large numbers of consumers, including many poor consumers, should not be compelled to pay high prices so that certain small businessmen - almost invariably more affluent - will be permitted to earn higher profits or perpetuate a business for which there is no economic justification."*

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* (Hearings before the Special Subcommittee on Small Business and the Robinson-Patman Act of the Select Committee on Small Business, House of Representatives, Vol. 1, Oct. 7, 8, and 19, 1969, Washington D.C., p. 107.)

Thus, in our view, a case cannot be made for special price discrimination legislation to protect small business, both because the general grounds advanced for such protection are unpersuasive and also because the longer-run side effects of the attempt to provide it are detrimental to the economy. However, small businesses, along with other business units, are entitled to protection against pricing behaviour that is predatory in nature or is by itself or jointly with other actions part of a pattern of artificial restraint. There is also need for general rules governing price discrimination. (See the section, "Policy Recommendations".)

2. "Structural Balance" and the Removal of Obstacles to the Development of Small Business

It has been argued by Moos* and others that consideration should be given to the possible importance of maintaining a structural balance between small, medium and large enterprise. This hypothesis has not been fully developed but it appears to belong to the general category of theories relating to industrial concentration, although with a difference. A low concentration ratio could as readily reflect the existence of a "large" number of large firms as a mix of a few large firms and some firms of small and medium sizes. In any event, the industrial concentration hypothesis in any of its variants is currently the subject of so much fundamental controversy that it provides a very unstable basis for any important public policy initiatives.

Furthermore, in view of the large increase in the number of small firms during the post-war decades, there may be some question about the

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* S. Moos, Aspects of Monopoly and Restrictive Practices Legislation in Relation to Small Firms (London, 1971).

necessity for state intervention to shift the "structural balance" in any significant degree. Our view, in the context of our general approach, would be that such intervention would not be warranted. But, however that may be, there are unquestionably a number of obstacles to the development of small business that should be removed, not solely in the interest of that sector but, more importantly, in the interest of the economy as a whole. If the reduction or removal or such obstacles should result in the shift of the "structural balance" strongly in favour of the small business sector that shift should be regarded as a rational outcome of broad market influences which would bring the interests of small enterprises into harmony with those of the economy at large. Any proposals to determine a "structural balance" on other than market performance criteria would not command our support.

Although our terms of reference did not specifically direct us to examine the matter of obstacles to the effective performance of small enterprises, our concern with the functioning of markets in Canada perhaps justifies a few peripheral comments on this matter. There appear to be three major areas in which special handicaps exist. The burden of taxation falls heavily on new and small ventures. High taxes can reduce the number of business births by discouraging those who are attempting to accumulate capital with a view to forming new undertakings. They can also restrict growth by making it difficult to finance rapid and risky expansion. Finally, they can affect adversely the ability of small concerns to survive as independent operations by making the gains from a sale or a merger more attractive than the income to be derived from continuing as a going concern. Second, capital is less readily acquired by small enterprises than by large and well-established firms. Although special government agencies have gone some way to overcome this handicap, there appear still to be significant gaps in the coverage

of the capital needs of small firms. Small firms also face the obstacle of being unable to employ or get access to staffs of experts specializing in various aspects of research and administration. The provision of facilities to serve small firms at reasonable cost in such areas as market and product analysis, management and merchandising techniques, and the like, should not be beyond reasonable expectation.

Although it is possible that some new institutional arrangements may prove to be necessary to achieve the elimination of these handicaps, the solution of the problems of co-ordination and communication with respect to the currently available but scattered sources of assistance would appear to be a relatively simple and essential first stage in what should become a high priority project. It is by such means rather than by imposing controls or artificial restraints on the larger firms in the economy that the best interests of the entire community will be realized.

3. Policy Recommendations

Our first choice on policy is to eliminate the present section (34) in the legislation prohibiting price discrimination and substitute for it a general section permitting the National Markets Board to prohibit discriminatory pricing behaviour by either buyers or sellers. In the section of this report dealing with monopoly power we propose, in connection with the specification of the concept "the abuse of monopoly power", that predatory conduct based on high levels of market power be prohibited. The proposal here is of narrower scope.

The legislation would encompass:

(1) the action of a seller (or group of sellers acting in concert) in selling a product or a service (or a joint product-service) at less than the reasonably

anticipated long-run average cost of production and distribution having the effect of adversely affecting competition; or

(2) the action of a buyer (or group of buyers acting in concert) in requiring or inducing a seller to provide a product or a service (or a joint product-service) at less than the reasonably anticipated long-run average cost of production and distribution having the effect of adversely affecting competition.*

The purpose of such a section would be to maintain competitive pressure on buyers and sellers, to promote new methods of producing goods and services, to reduce the need for integration (associated with pressures inherent in the present price discrimination legislation) to achieve the economies linked to larger-volume purchases or

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* The concept of the short and long-run, in the explanation of prices, is a functional one and cannot be defined in calendar time, for it differs from industry to industry. It all depends on the speed with which equipment and labour in the particular case can respond to changing levels of output.

In an industry in which the equipment is of a simple and not very durable character and the labour relatively unskilled, adaptation can take place quickly. Here the "long-run" may be only a matter of a few months.

In industries which require a great deal of complex and durable equipment and which employ highly skilled labour, it may take years, or even decades, for the long-run forces to work out their effects.

sales, but to discourage the exercise of market pressures in a manner not justified by superior economic performance.

Since these general principles constitute the bed-plate of many of the policy proposals in this report, and although they are discussed in other sections as well, it will do no harm and may be of some value to examine them in the present context in further detail.

The concept, "reasonably anticipated long-run cost of production", is crucial to the understanding and the implementation of this section, although not all cases examined will involve its exploration in length or in detail. Some cases will be so obvious as to merit nothing more than horseback observation, others will undoubtedly involve sophisticated analysis.

The reasonably anticipated long-run cost of production (and distribution) cannot be derived from current accounting records. It is prospective rather than retrospective in thrust and relates to those economies that can reasonably be anticipated from larger-scale operations, from the introduction of planned changes in technology, organization of the operations of the firm, and the like. It is not speculative in the irresponsible sense but is based on today's best plan, not today's best practice which is based on yesterday's best plan. Price reductions can be made in anticipation of the introduction of such "best plan"; indeed, price reductions may be essential to achieving a volume of sales needed to implement the new technology or the new system of organization.

It is obviously not the purpose of the proposed cost standard to impose anything approaching in precision the public utility standard of price regulation. What is desired is to eliminate from market conduct the sort of price differentials that clearly have no basis in real economic costs. We

do not attempt to forbid the sort of sporadic price cutting that puts pressure on costs or that encourages an occasional breakdown of oligopolistic coordination without degenerating into the sort of cut-throat price cutting that will result in the disorganization and demoralization of an entire market thus creating a serious adverse effect on competition. We have no reason to anticipate anything like the economic disorganization of the 1930's, nor do we believe that price discrimination legislation would, in any event, cope with the pressures that such economic crises would create. In sum, our proposals do not derive from a crisis background.

This general approach probably sounds more complicated in formulation than it will be in operation. First, however, we should perhaps deal with an objection that will almost certainly arise, that is, that current accounting records provide a solid basis for cost analysis whilst the proposed tests will launch price discrimination policy on an uncharted sea of undisciplined theorizing. To this there are two important answers: first, the so-called certainty of current accounting records is largely illusory, and, second, even if such "accurate costs" could be derived they would be not merely irrelevant but misleading as a basis for economic decision-making.

On the first point, Professor Corwin D. Edwards, commenting on the cost-justification test under the Robinson-Patman Act, has said,

> "The cases in which respondents have offered cost defences have one striking common characteristic: Apparently none of the respondents had devised methods of recording and analyzing costs currently in such a way that management could determine price differences in the light of cost differences. Even the most careful of the cost defences were based upon

studies undertaken for the purpose of developing a defence in a pending lawsuit."*

Effective price-making by a producer obviously does not require the sort of cost records necessary for a cost-justification defence, and this is not solely because of the almost insoluble problems presented by the allocation of fixed and joint costs, particularly in multi-product firms. The issues run much deeper. They are developed, in part, in the study by A.D.H. Kaplan, Joel B. Dirlam and Robert F. Lanzillotti in the study, Pricing in Big Business (The Brookings Institution, 1959). The economic inadequacies of the cost-justification approach (based on current costs) to price-making will also be explored further in the cost-justification section of this report. Our general conclusion is that cost justification based on accounting records is both a static and misleading basis for public policy decisions.

Turning to the formulation we have proposed, there are some effective examples of its application available in the literature of economics. One of the foremost is Professor M.A. Adelman's study of the A & P cases (A & P. A Study in Price-Cost Behaviour and Public Policy, Harvard University Press, 1959); another of equal merit is Carl Kaysen, United States v. United Shoe Machinery Corporation (Harvard University Press, 1956).

Since the cost standard involves a "reasonably anticipated" test, the allocation of fixed and joint costs should present fewer problems than a more rigorous and precise standard would involve. Furthermore, the National Markets Board will be responsible for developing and appraising the cost

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* "Cost Justification and the Federal Trade Commission", The Antitrust Bulletin (Jan., 1956), p. 569.

calculations and it will, therefore, be able to encourage a relevant and consistent approach to the application of the cost standard.

In the application of the criteria of discrimination which we have proposed there are a few supplementary considerations that should be specified.

First, it should be a defence to a charge of discrimination that the lower price (or other benefit) was made in good faith to meet a similarly low price of a competitor, even though the price of the competitor was itself discriminatory. We can, for example, detect no meaningful public purpose in a prosecution such as Carnation Milk.* The exception to this defence would arise in the event that a condition of cut-throat selling developed in the industry or market in question with the result that a state of disorganization had set in. In such an event the Board could prescribe the appropriate relief.

Second, we suggest with some hesitation that the requirement of equal treatment in the sale of goods (and services) of like quality and quantity be retained. It has been pointed out by a number of writers that the definition of "quality" is important but far from easy. If, for example, a manufacturer who produces his own brand along with private brands, is not permitted to differentiate between the two for the purposes of defining "quality", a reorganization of production may be required. The production of private brands may be concentrated in firms not selling under their own brand names. National brand manufacturers may resort to heavier promotional expenditures to increase their own sales to take up the slack left

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* R. v. Carnation Company Limited (1969), 4 D.L.R. (3d) 133.

by the loss of the private-brand sales. If brands are rejected as a basis for a distinction in "quality", there may be an effort to introduce a degree of physical differentiation of products to make them acceptable as being of unlike "qualities". This may result in an increase in manufacturing costs. And so on.

The "quantity" requirement may be used as a facade to refuse discounts on sales of larger quantities on which real economies are realized or to grant discounts on only marginally different quantities.

An awareness by the Board of the possible adverse consequences of the interpretation of the "like quantity and quality" provision should, however, go far to maximize the beneficial aspects of this sub-section.

On the question of whether the provisions of the price discrimination section should be triggered only if a "practice" of discriminating is disclosed, we adopt a pragmatic position. Obviously, if a "cut-throat" situation is involved the Director and the Board would not decline to act until a number of instances amounting to a "practice" occurred in the market in question. In other less extreme circumstances involving alleged illegal discrimination, since the remedies are not of a criminal nature, we feel that the Board should be prepared to consider a case as long as it is of significant proportions whether or not it amounts to a practice. At the same time, every minor instance of discrimination should not, as we have already argued, be considered cause to invoke the powers and processes of the Director's office and of the Board. On the other hand, repetition of the same type of illegal discriminatory behaviour by a given buyer or seller as has been prohibited by the Board in an order against that buyer or seller would call for the application of criminal sanctions.

Finally, we recommend that section 35 dealing with advertising and promotional allowances be retained in its present form but recast to place it within the jurisdiction of the Board. The basic economic and social considerations that originally warranted the passage of this section retain their validity unimpaired to the present.

We consider these proposals to be not only consistent with, but an integral element in our general approach which emphasizes a longer-run outlook based on the encouragement of adaptability and flexibility directed to the achievement of real-cost economies through a market system, and the curbing of artificial restraints, that is, those not based on superior economic performance.

If, for whatever reasons, these proposals are not considered acceptable, our only alternative suggestion is to leave the price discrimination legislation as it now stands. A plausible - although not in our view, an adequate - argument for doing so might be found in the statistics of price discrimination complaints received by the Bureau of Competition Policy. As the figures indicate, the number of complaints has fallen by some 50 per cent within the five-year period, which might be taken as prima facie evidence of a declining concern about price discrimination problems. There are, of course, other possible explanations, such as a growing conviction that the legislation, because of its limited enforcement record, is ineffective to deal with discrimination

Number of Complaints by Fiscal Year

1970-71	-	20
1971-72	-	24
1972-73	-	19
1973-74	-	11
1974-75	-	9

issues. But however that may be, these statistics can by their nature cast no light on the indirect consequences of the legislation which impress us as being of substantial importance.

As we have already explained we consider the present legislation to be the product of a set of economic circumstances remote from those now prevailing and to be poorly designed to serve the broad public interest. Nevertheless, we would regard it as less dangerous than proposals for precise cost justification requirements based on accounting records. Not only would such an approach impose an economic criterion that would be at cross purposes with a flexible, dynamic economy, it would be expensive for all firms, and it would clog the enforcement agencies with lengthy proceedings about essentially irrelevant matters in market price behaviour. Of these two inappropriate policies, we hesitatingly choose the lesser, that is the present price discrimination legislation.

APPENDIX

A Note on Price Discrimination and Predatory Pricing

The common assumption underlying legislation on price discrimination is that a size (or a market-power) differential between buyer and seller permits the larger (or more influential) participant in the bargaining process to impose "unfair" (or, less commonly, uneconomic) buying or selling terms on the other (the smaller or weaker) participant. That is, the discrimination in price represents the exploitation of the weaker member in the bargaining process by the stronger. Exploitation may, indeed, be the outcome in some cases but as indicated in the price discrimination section the available evidence does not support such a generalization.

In the economic analysis of price discrimination a different approach is adopted in that it is assumed that the objective of the seller (or buyer) in employing price discrimination is the independent maximization of his profits. The analysis runs, briefly, as follows: if a seller can subdivide his market into two (or more) groups of buyers such that those in one group are prepared to pay a relatively high price for his product without reducing significantly the amount they purchase, whilst the other group (groups) will buy very little at the high price charged the first group but will be willing to extend the amount purchased very substantially as prices fall to lower levels, the seller may find it will increase his profit to establish separate prices in each sub-market rather than fix a single price in both markets.*

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* For a more detailed discussion of this analysis, see Discriminatory Pricing Practices in the Grocery Trade, pp. 9-46.

The broader consequences of this type of discrimination may be desirable or undesirable. Depending upon the circumstances of the individual case, price discrimination may improve or it may worsen the allocation of resources; it may be used to achieve full-capacity operation; it may make possible economies of scale or it may impair the attainment of such economies; and it may enhance excessive profits with undesirable effects on income distribution but possibly with favourable effects on economic progress.

In an attempt to bring all types of price discrimination under one classification for purposes of public policy, Professor J.P. Miller has suggested* that there are three different principles of behaviour that may be adopted by firms:

(1) the "independent maximization" principle, the type in which the individual seller attempts independently to maximize his profit (just discussed);

(2) the "collusion" principle, by which a common course of action with regard to prices is adopted, as in some basing-point systems (see below);

(3) the "predatory" competition principle, by which, for example, local price cutting by large firms is used to eliminate smaller competitors or to force them to come to terms.

This third type is more likely to be found in pricing by a large seller against a small seller of the same product rather than in pricing between

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* Unfair Competition (Harvard University Press, 1941), pp. 125-6.

seller and buyer, although the latter relationship is more commonly assumed in discussions of price discrimination.

The forms that predatory discrimination can take are numerous and complex, ranging from tacit collusion by a "continuous impending threat to smaller price-cutters", to direct local price-undercutting, and the like; their general purpose being to consolidate or extend a position of market power. A few cases may reveal their purpose and effect on their face; with most, however, the problem of disentangling motives and effects and of devising appropriate remedies presents serious difficulties.

Some of the issues involved may be illustrated by brief reference to a not uncommon type of case, the use by a large seller of territorial price cuts to discipline small local competitors. In such a case is is important to determine the extent of the price cuts and the period during which they were thus maintained; whether the price cuts were made defensively; whether the price cuts were so severe and maintained for so long as to eliminate the local competitors or to weaken them so seriously as to render them incapable of providing effective competition; and whether the accused firm has a record of engaging in systematic price-cutting in selected areas.

Assuming that a finding of predatory pricing is made, the shaping of an order to prohibit the illegal conduct, which will not at the same time restrain vigorous and healthy competition, presents problems. The order should not require a national seller to charge a single, uniform price in every market throughout the country, nor should it prevent the firm from undercutting in selected local markets, although it should prevent the major seller from undercutting <u>all</u> its smaller competitors in a particular market. The remedial order should further make it clear that the major seller

is not precluded from making price reductions in a market where competitors maintain a uniformly high, monopolistic price, or from making temporary promotional price reductions to gain entry into a concentrated local market.

Other types of predatory price-cutting will, of course, raise different issues, but common to them all is the problem of maintaining vigorous competition based on real-cost advantages but prohibiting price-cutting (or other predatory practices) designed to preserve or extend a position of market power.

DISCUSSION DRAFT - LEGISLATION

Price Discrimination*

(1) In this section,

(a) "price discrimination" means

(i) the action of a supplier, or group of suppliers acting in concert, in supplying a product at a price that is less than the reasonably anticipated long-run average cost of production and distribution; or

(ii) the action of a customer, or group of customers acting in concert, in requiring or inducing a supplier to supply a product at a price that is less than the reasonably anticipated long-run average cost of production and distribution; or

(iii) the action of a supplier or customer in participating in a supply transaction in which the price for the product, at the time of the transaction, is not also available from the supplier to competitors of the customer in respect of the supply of a product of like quality and quantity;

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* This Discussion Draft was prepared solely to seek to assist in the consideration of the main substantive recommendations on this subject in the report. By omitting a full formulation of all related recommendations in the report we do not mean to ignore those recommendations.

where such action, whether or not it amounts to a practice, has an adverse effect on competition.

(b) "price includes any discount, rebate, allowance, price concession or other advantage;

(c) "reasonably anticipated long-run average cost of production and distribution" includes reference to any prospective economies that will reasonably and probably result from the planned adoption of a changed scale of operations, from the introduction of planned changes in technology, from changes in technology, from changes in the organization or operations of the firm, and like matters, but it does not include any such economies that are merely of a speculative nature;

(d) "long-run" means a period of time of sufficient duration to permit a major change in the method of operation of the firm or industry;

(2) Where, on application by the Director, and after affording every person with respect to whom an order is sought a reasonable opportunity to be heard, the Board finds that such person has engaged or is engaging in price discrimination, the Board may make an order directed to such person prohibiting him from continuing to engage in such price discrimination and containing any other requirement that, in its opinion, is necessary to overcome the effects thereof in the market or to restore or stimulate competition in the market.

(3) It shall be a defence to an allegation of price discrimination that the lower price was made in good faith to meet a similarly low price of a competitor, even though the price of the competitor was itself discriminatory.

(Sec. 35 Repeat Section 35 as it now stands, subject to the necessary amendments to place it under the jurisdiction of the Board as a civil matter.)

III - 2. BASING-POINT PRICING

Delivered pricing systems cover a wide variety of arrangements, differing in their technical provisions, in their purpose, and in their economic effects. A blanket price system, or some other system of "meeting competitors' prices in remote places", may be adopted, or extended, with a view to increasing the scale of production. At the other extreme, a delivered pricing system may constitute an essential element in a collusive pricing arrangement, and so on. Realistically, each case should be analyzed on the facts peculiar to it and on the surrounding economic circumstances. However, for establishing broad public policy guidelines a clear general distinction can be made between co-operative formula pricing and unsystematic area pricing on the basis of individual efforts to expand sales. The latter category raises no policy issues;* the former may or may not depending on the form it takes and on the circumstances in which it operates. The specific system of this general type that has attracted the greatest policy interest and the most detailed analysis is basing-point pricing.

Basing-point pricing has been the subject of a substantial body of economic writing, some of it rather contentious in character. The practice has involved questions of price discrimination; it has also been assigned a facilitating role by some writers in patterns of price leadership and price agreement; and it has been involved in the issue of meeting competitors' prices. Other writers question the view that basing-point pricing is necessarily indicative of anti-competitive behaviour

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* Except, of course, in cases where unsystematic area pricing may be an element in a predatory pricing plan.

but rather consider it to be evidence of the working of a complex group of influences in oligopolistic markets which possess certain well-defined characteristics.

Although there are a number of variants of basing-point pricing, the essential feature of the practice is that delivered prices are set by adding transportation costs between a fixed base - not necessarily the seller's plant - and the buyer's plant to a uniform list price. The delivered price in all cases includes transportation costs from the basing-point, hence there would be no difference in the price charged no matter which seller made the shipment. The single basing-point system, such as the Pittsburgh-plus system in the U.S. steel industry, is now rarely encountered. Under that system all steel producers used the one point as their basing-point for delivered prices for certain steel products. Those prices included freight costs from Pittsburgh, even if the buyer's plant was located next door to the plant of the seller so that no freight cost was involved. Other arrangements involve setting up several basing-points with prices stated for each point; or in another variant each mill is designated as a basing-point, in which case delivered prices are the lowest sum of mill price plus transport cost available from any mill.

When a producer makes a shipment by a cheaper method of transportation than the schedule of rates employed by the group of sellers provides for, or when he makes a charge for delivery from a basing-point which is farther from the buyer than is his own plant, he collects "phantom freight". He is able to do so because under this system other sellers will not undercut the basing-point prices.*

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* Although it is conceded that there is some secret price-cutting under this system, apparently varying with the state of the market, its extent is a matter of debate.

When he makes a charge for delivery from a basing-point which is nearer to the buyer than is his own plant, he "absorbs" freight. If his plant is not located at a basing-point, his "mill net realization" varies with the amount of "phantom freight" and "freight absorption" involved over the geographical range of his sales. The resultant "cross-hauling" and inter-penetration of market territories are considered by some observers as clear evidence of monopolistic waste, although, as will be explained, this is, taken by itself, an over-simplified position.

There are also other variants of the delivered pricing practice: uniform delivered prices over the entire country, used by some or all of the sellers of a given product; zone pricing, pricing f.o.b. mill with various kinds and degrees of freight absorption, and so on.

However, before examining the economic aspects of basing-point pricing, it may be worthwhile to review briefly the available evidence on the extent of basing-point pricing and other delivered-price practices. In Canada, there is no detailed catalogue of industries employing such practices available, although basing-point pricing has figured prominently in some combines investigations. In one case, the Report of the Restrictive Trade Practices Commission recommended, among other things, that the basing-point pricing system in the marketing of sugar in Western Canada be supplemented by an f.o.b. Vancouver system;* in another case, the Commission recommended, among other things, that the delivered price system employed

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* In this case, Regina v. British Columbia Sugar Refining Co. Ltd. et al. (1960), the accused was found not guilty, hence no remedial action was called for.

in the distribution and sale of metal culverts and related products through much of Canada should be discontinued.* It is common knowledge that a basing-point system has been in use for some years in the sale of cement and of certain metal products. Systems of delivered prices, some covering the entire country, for many manufactured products have also been in use for years. These are, however, only surface indications of the scope of the practice, and evidence from more detailed surveys in the United States suggests that delivered price systems are in wide use.

The Temporary National Economic Committee, in Monograph No. 21, Competition and Monopoly in American Industry (1940) (pp. 147-148), reported that delivered price systems were at that time employed in about sixty industries. In thirty of these, such systems had been employed for some years. Included in this category were the following products: asphalt roofing, bath tubs, cast iron pipe, cement, coffee, fertilizer, gasoline, lead, linseed oil, lumber, newsprint paper, power cable and wire, salt, snow fence, sugar, tiles, turbine generators, and zinc. Anther thirty industries adopted delivered pricing systems as part of the NRA codes under government sponsorship. Among the industries included were: automobiles and auto parts, builder's supplies, business furniture, china and porcelain, coal, construction machinery, food and grocery products, glass containers, ice,

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* In this case, Regina v. Armco Drainage & Metal Products of Can. Ltd. et al. (1959), the accused pleaded guilty but in the order of prohibition issued by the court, although the firms were required not to repeat or continue the offence, no reference was made specifically to the delivered price system.

lime, lye, paint and varnish, paper and pulp, paper bags, ready-mixed concrete, storage and filing equipment, and vitrified clay sewer pipe.

Basing-point systems have, in the past, been found as well in international trade in such products as steel, cement, oil, coal, paper products, zinc, copper, and others.

Even granting the possibility of some considerable changes in pricing practices since these lists were compiled, it seems highly likely that a very important segment of industry employs either a basing-point system or some variant of delivered pricing in Canadian domestic and international trade. Hence, changes in public policy, either to promote or to modify the use of such systems, should be made with due caution. The broad forces shaping economic performance in most industries are certainly to be found in technological and organizational changes, in the quality of management, and in the maintenance of pressure for adjustment from domestic and world sources, but it is not unlikely that pricing systems influence as well as reflect the ways in which production and marketing are organized.

Carl Kaysen has outlined the general features of industries that commonly use basing-point pricing or some variant of delivered pricing:

1. The product is highly standardized; in basing-point pricing it is usually homogeneous so that the output of the various producers is perfectly substitutable.

2. The product is low in value per unit weight, thus transport costs constitute a significant proportion of delivered price.

3. Capital investment in a plant of optimum scale is large both in total and per unit of output. The plants often operate below

capacity because of large cyclical fluctuations in demand. The production equipment is specialized and long-lived, thus exit from the industry either by shifting to other products or by allowing the plant to "die" is difficult. Bankruptcy merely shifts the plant to different ownership.

4. The market demand for the product is generally inelastic at and below prices which correspond to output at substantially less than full capacity. The demand for the product of a particular producer is elastic, provided his price cut is not matched by other producers.

5. Since the market structure is commonly oligopolistic, awareness of rivals' reactions to price cuts or other moves by an individual seller to improve his position is so sensitive as to discourage such experimentation.*

In these circumstances secret price cuts are the most that can be hoped for, and there is disagreement as to the extent of such cuts in practice. It is not, of course, the identity of the prices that is so much a matter of concern as the level of the identical prices.

This level is, in part, a function of the economic consequences of the basing-point system in the circumstances of the specific industry, and, in part, a function of the nature and vigour of the bargaining pressure exerted by the buyers on the basing-point sellers. If the buyers can

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* Carl Kaysen, "Basing-Point Pricing and Public Policy", The Quarterly Journal of Economics (Aug. 1949), pp. 289-314.

effectively play off one seller against the others, and, particulary, if the buyers can pose the threat of entry by backward integration into the basing-point sector, the level of the identical basing-point price will be effectively reduced. On the other hand, if the buyers are weak or poorly informed, or if firms in the basing-point sector can integrate forward and gain substantial control of the buying sector, the level of the basing-point price will clearly be higher. Hence, the effectiveness of the general market organization in the industry and of the policies enforced by the combines administration will have much to do with the economic impact of the basing-point system.

There is the further matter of the operation of the basing-point system and alternative systems in the specific industry under consideration. Professor W.J. Fellner has pointed out* that whilst the basing-point system results in the charging of phantom freight in some circumstances and freight absorption in others thus discriminating among buyers, discrimination could also arise in the pricing employed by a group of independent, non-collusive local monopolies. Such monopolies would charge no phantom freight but they would absorb freight in some unpredictable fashion. They would not charge uniform mill-net prices to each customer since that result would only emerge if there were a great many mills in each centre of production. Instead, their prices would be as unpredictable as those of a fighting, differentiated oligopoly. There would also, of course, be discrimination through freight absorption under a freight equalization system and under zone pricing. Hence, the effect on discrimination of prohibiting basing-point pricing would be difficult to forecast with precision.

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* Competition Among the Few, pp. 298-303.

The effect of abolishing basing-point pricing and the enforcement of f.o.b. mill pricing on production costs also presents problems. Such a policy would result in a shifting of output; there would be expansion in some areas, contraction in others, with perhaps new entry. The real question is whether these shifts would result in an increase or a decrease in real unit costs of production, or whether, perhaps, costs would remain unchanged. The effect on unit transportation costs of strict f.o.b. mill pricing is predictable: such costs should be reduced as importing areas will tend to expand and exporting areas to contract.

The net effect of these two influences on total unit real costs may then, presumably, be derived. If the freight saving is precisely offset by a rise in real production costs, there may still be some advantage in adopting f.o.b. mill pricing since the price discrimination among buyers will be eliminated.

The importance to be assigned to such a consideration depends, obviously, on how thorough-going policy is to be in prohibiting uneconomic price discrimination generally. If policy is to require that all buyers should receive the full economic advantages associated with their purchases, that is, that price differentials must reflect economic price discrimination, no more and no less, we would assign substantial importance to the price discrimination element in the equation. However, this would require a major realignment of general policy which would impinge upon many dimensions of public policy and not merely on the area of industrial organization. As a result, we do not lay great stress on the price discrimination element in the public policy appraisal of the basing-point system.

Basically, the test should be whether the substitution of some system of freight absorption for a basing-point system will reduce real costs

(the net result of production and transportation cost changes) and increase output. In more specific terms, it would be necessary to assess the impact of substituting some system of non-co-operative pricing for basing-point pricing on the economies of scale in production and distribution in the industry, and on transportation costs. Some attention should also be directed to the probable effect of the substitution on the dynamic variables in the industry. (This test can be applied to other types of co-operative formula pricing as well.)

It will not be possible to make an industry competitive in the formal sense by merely substituting mill base quotations for the basing-point system since such a change does not eradicate the characteristic underlying monopolistic character of the industry, which is derived, in large measure, from the elements that Kaysen has described and which are, in many cases, essential to the efficient operation of the industry. The contribution that a prohibition of the basing-point system can make to more competitive pricing, although not negligible, should not be overstated. As Fellner has summed up the case:

> "The general argument that the basing-point system is bad because it is a typically non-competitive feature is unconvincing. In an industry consisting of local monopolies, competitive pricing could be enforced only by prescribing the methods of pricing, not by prohibiting a specific method of charging freight. Local monopolies with overlapping territories tend to absorb freight and, even if they are forced to charge uniform mill-net prices to their customers, they tend to develop spontaneous co-ordination in the setting of their prices. Competitive pricing could be enforced only by prescribing the level of specific prices

> in accordance with competitive norms. This of course we are not prepared to do" (p. 303).

Another writer has expressed the central point succinctly:

> "Under competition only mill base prices govern; but not every situation in which mill base prices govern is competitive."

Some writers go as far as to maintain that basing-point systems and price leadership are merely symptoms rather than contributing causes of monopolistic behaviour. It would, however, be more accurate to identify the practice of basing-point pricing as one of a number of arrangements that facilitate tight oligopolistic co-ordination. Appropriate public policy would have as its purpose the weakening of such co-ordinating influences in order to make some contribution to more independent, dynamic behaviour by the oligopolists by means that do not result in real-cost losses. Action to strengthen the bargaining position of the buyers, as already suggested, would stand high on the list of desirable measures; somewhat lower on the scale would come the use of alternative systems of absorbing freight where such systems would result in a decrease in real unit costs (or, at least, would leave such costs unchanged).

Finally, the public record provides ample evidence that a basing-point system has been employed in more than one case as a facilitating device in a conspiracy to fix prices, as well as to restrict competition in other respects. Where such an offence is established, in addition to the usual penalties of a fine and an order of prohibition, it is important to require that all buyers be given the option of buying on an f.o.b. plant basis for a period of sufficient length to bring about the effective replacement of the basing-point pricing arrangement by a much weaker form of oligopolistic

awareness. Other familiar devices to promote uniformity of pricing, such as advance public indications of planned price changes ("telegraphing"), and the use of standard pricing formulae, should also be restrained. The growth of large firms should be based on real-cost advantages, and their continued dynamism should be fostered and stimulated by discouraging tight oligopolistic co-ordination.

III - 3. LOSS-LEADER SELLING

Complaints about loss-leader selling tend to occur, not at a steady rate or in a predictable pattern, but in concentrated outbreaks followed by periods of comparative quiet. Leaving aside for the moment the matter of defining "loss-leader selling", it can be said that the causes of these accusations are numerous and complex, and are usually associated, fundamentally, with significant changes in economic circumstances. Popular justifications for such charges, usually in terms of alleged predatory intent on the part of those using loss-leaders, appear, on the basis of factual investigation to be comparatively rare, although not unknown.

First, loss-leader complaints have been closely tied to the development of new technology, new systems of retail distribution, and to changes in the law relating to marketing practices. Second, price cutting associated with periods of recession and depression has given rise to loss-leader charges. Third, periods of product scarcity and high profits in retailing with resulting excessive entry have been followed in the subsequent period of instability and adjustment by accusations of loss-leader selling. Fourth, there have been examples of short-lived trials of strength among large firms to establish relative degrees of "toughness" in which genuine loss-leader behaviour has occurred. Finally, there appear to have been scattered instances of predatory pricing behaviour, although not of recent occurrence, which might qualify for inclusion in the loss-leader category.

Before examining these sources of loss-leader complaints in more detail, it is necessary to review briefly the varied definitions of the expression under consideration.

The Meaning of Loss-Leader Selling

In the searching and comprehensive inquiry by the Combines Branch and the R.T.P.C., which was begun in 1952 and completed in 1955, involving an extensive research inquiry, public hearings, and the publication of two voluminous studies - The Green Book on Loss-Leader Selling, and the R.T.P.C., Report on an Inquiry into Loss-Leader Selling - one of the most difficult issues to resolve was the definition of the term "loss-leader selling". The Green Book required approximately 60 pages to review the definitions and characteristics of loss-leaders as reported by retailers, wholesalers, manufacturers, chain stores, co-operatives, and trade associations. It is not necessary to repeat here the complexities and even the categorical disagreements contained in that inventory of opinions, although it is instructive reading for anyone who still believes that a plain, uncomplicated, elemental definition of the concept is either possible or desirable.

It is perhaps sufficient to note that those who favoured strong action against loss-leaders tended to advocate a definition of the practice as a sale at anything less than the "regular" price, or at less than the net acquisition cost plus the average markup for the trade in question. Those who favoured the freer functioning of the market system tended to define it as a sale at less than acquisition cost.

The former definition, which has much in common with the banning of price-cutting by "professional ethics" in some trades, and with the preparation of price manuals or guidebooks by many trade associations, suffers from a number of economic defects. First, the "average" markup calculated from the array of individual firm markups reported to the reporting agency, governmental or private, is of very limited significance for a competitive market economy. Stated crudely,

approximately half of the individual markups will be above the average and half will be below. An examination of the actual spread between the highest and lowest values for a number of trades made it clear that the maximum figure was a number of multiples of the minimum figure. This is not surprising since selling costs in different stores vary with differences in the efficiency of management, amount of service extended to customers, store location, and other conditions of retailing.

If an "average" markup for the trade in question were to be adopted as the bench-mark of loss-leader selling, it would follow that roughly half of the sellers would be guilty of loss-leader selling if they sold at their individual markups. The social and economic desirability of passing on to the consumer in the form of lower prices a considerable proportion of the fruits of business economies is now generally accepted. The low-cost seller should not be prevented from using his advantage to increase his turnover by quoting lower prices and thus lowering his cost still further. He cannot, of course, be expected to lower prices unless he anticipates that such action will also result in an increase in his total profits. But the dead hand of tradition and orthodox pricing, as represented in the sanctity of an "average" trade-wide markup, may prevent the individual businessman, or indeed an entire industry, from realizing where self-interest really lies.

In fact, the shortcomings of an average markup figure even as applied to the operations of a single seller go beyond the general point already made. Allegations of loss-leader selling usually relate to one or two items in the total range of items sold in a store; obviously, the concept of loss-leaders applying to all items in a store would be self-contradictory since the basic hypothesis of those opposing the price cuts is that one or a few items are sold at a "loss" in order to induce customers to come to the store and purchase other

items at excessive markups. The items chosen as loss-leaders are assumed to be either standard products (such as sugar) which are in general demand, or widely-advertised branded goods with a high turnover; canned olives, for example, would not be a promising loss-leader item. Information obtained in the loss-leader inquiry indicated that such products, because of rate of turnover or historical practice were commonly sold at lower markups than those applying to other articles in the retailer's stock. Hence, to identify as loss-leaders even all items sold at less than the average markup of the individual seller would throw a significant number of items into that category which, because of the interdependence of demand in the sale of goods at retail, it would be poor management practice to shift to a higher markup level. In other words, the below-average markup items are, as a rule, so designated for good commercial reasons.

In sum, to require something closely approaching a uniform markup rate for all items - which would tend to be the effect of classifying items sold below the average markup as prohibited loss-leaders - would be very unwise since there are marked variations in rate of turnover and in costs of selling from store to store and from item to item. Such a test would introduce a static, rigid element into commercial practice; in a flexible market economy it is very difficult to segregate something called loss-leader selling from normal, aggressive price competition.

Other less restrictive definitions of loss-leader selling would prohibit* sales at less than the buyer's net acquisition cost (as already suggested), sales at less than a specified minimum markup, or sales involving predatory or "cut-throat" price-cutting.

The Development of New Marketing Practices

Grouped under this general heading will be not only the emergence of new systems of retail distribution and the development of new technology, but also changes in marketing practices based on changes in the law relating to resale price maintenance.

So-called loss-leader selling goes back very far in the history of retail competition. As early as 1884 the Dominion Grocers' Guild was formed to prevent price-cutting and to set "fair" resale prices in the grocery trade. At that time, sugar was the product in which price-cutting was concentrated; that is, it was what would now be called a loss-leader. The historical record does not clearly establish whether large retailers or small were responsible for initiating the price-cutting.

In the 1920's and 1930's - the period which saw the origin and widespread use of the term loss-leader - the development of chain stores and the expansion of the large department stores were accompanied by extensive price-cutting, which was

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* All proposals for prohibiting "loss-leader selling" customarily exempt end-of-season and end-of-line sales, sales of obsolescent goods, sales of damaged goods and the like. There is, inevitably, a grey area involving one-cent sales, introductory sales for new products, store-opening sales, and so on.

intensified with the onset of the major depression of the 1930's. In Canada, the Price Spreads Investigation of the 1930's included loss-leader selling within its range of subjects. It concluded that "an actual loss is nowadays seldom experienced on most leaders", and that because there were "legitimate reasons for reducing prices" on slow-moving stock, surpluses of perishables, out-of-style and out-of-season stocks, "they complicate the definition of what constitutes a loss leader and make difficult its simple prohibition". Instead, they concentrated their attention on discriminatory pricing (which is discussed elsewhere in this report).

Certain western provinces, in response to complaints from small-business groups, did introduce minimum markup legislation, primarily for grocery products. The effect of such legislation, if any, must have resulted from its mere presence on the statute books since there were, apparently, no prosecutions.

On the positive side, many independent merchants responded to the pressure of the new marketing methods by forming voluntary chains and meeting the price cuts directly. Indeed, had it not been for the added impact of the depression, the response of the small business organizations would undoubtedly have been more effective and the loss-leader issue would not have taken on the rather emotional overtone that it acquired in the 1930's and to some extent retains to this day.

The next major change in marketing methods was what is now known as the supermarket, although in their early days they were referred to as "cheapies" (and in other derogatory terms) by the established chains. These new stores were introduced by, and for many years the majority of units were controlled by, independent operators. The two-to-four unit category accounted for most of the stores in operation. Their appeal was their

over-all low prices based on almost primitive facilities. There was little complaint about loss-leader selling in the early stages of their development. It is worth noting, however, that their growth took place during the generally expansionary powt-war period. As the chains converted to the supermarket format and upgraded their facilities, pressure on the non-supermarket independent, especially in large urban centres, became intense. Charges of loss-leader selling, especially in cigarettes, milk and bread became common.

The cigarette case, which was a direct consequence of the ban on resale price maintenance, has been examined in detail in the report of the R.T.P.C. on loss-leader selling. The substance of the case - which should be referred to for the full analysis - was that the reduced prices were made even more profitable by the manufacturers granting the chains wholesale buying terms, although the prior regular markup provided the chains with generous margins in comparison with margins on other items they sold; a shift in buying habits from single-package purchases to carton purchases further enhanced the advantages of reduced selling prices. At the same time, there was little evidence that reduced selling prices for cigarettes caused consumers to increase their purchases of other items. It should be noted that the difficulties of independent retailers were not eased by the tobacco manufacturers, since they declined to extend wholesale buying terms to groups of retailers. On the whole, it is difficult to detect anything in the actions of the chain stores in this instance that could realistically be described as loss-leader selling, or that could be regarded as contrary to the public interest. In fact, this case provided clear evidence that the legislation on price maintenance was working in the direction its framers had intended.

Price-cutting in milk marketing has usually been related to the introduction of new techniques and methods of distribution or the establishment of a new firm in a market. Perhaps the chief innovation that has had a causal relation to price cutting has been the introduction of the larger-than-quart size container, especially the three-quart jug. Not only has this led to price-cutting between the firms introducing the larger jug and the firms still selling quarts and half-gallons, but it has also brought about a shift between home and store sales. The interaction between these two factors has led to a streamlining of distributive operations by all dealers. Innovations in transportation and refrigeration have also tended to break down the separateness of markets. Highly mobile dealer operations have, except where restrained by regulatory agencies, promoted the erosion of established price structures. Specialized distributors, concentrating their operations in dairy products, have added a further element of pressure.

It is obvious that price structures should be sufficiently flexible over time to reflect and encourage changes in technology which may reduce costs and prices. These cost and price reductions are the very essence of progress in the industry. To attempt to control or inhibit them by legal action, industry co-operation or regulatory decrees, amounts to imposing a degree of rigidity that is in the interest neither of the industry nor of the consumer.

As with milk, so also with bread, new systems of marketing involving privately-owned bakeries supplying a considerable proportion of the needs of some of the supermarket chains, a major shift from house-delivered bread to in-store sales, improvements in transport facilities making it possible to move baked goods over considerable distances, competition among wholesale bakers for supermarket

chain accounts, and the like, have put pressure on traditional margins, pressure which from time to time has erupted in sharp price-cutting incidents.

However, again these are part and parcel of the process involved in realizing the fruits of change and in encouraging further experimentation with new marketing methods.

There are, nevertheless, persisting claims that bread is being sold at extremely low margins, if not as an actual loss-leader, in order to attract customers into the store to purchase other items. These claims are difficult to assess since they are virtually never documented in detail. The loss-leader inquiry conducted by the combines authorities did, however, examine one clear instance of bread being sold as an actual loss-leader (i.e., below net acquisition cost) for a period of one week, in which detailed information on all the relevant dimensions of the incident, both on sales of bread and sales of other items, was documented. This information need not be repeated here, but the conclusion of the Report is worth noting:

> ". . . the fact that chain store "A" had a very large increase in its sales of private brand bread during the week of reduced prices does not appear to have had any continuing effect in relation to the proportion of total sales which it secured in competition with other chains. Further, the information presented does not indicate any significant change in the total business of the four chain stores."

One of the important factors accounting for this outcome was undoubtedly the immediate matching of chain store "A"'s price-cut by the other major chains. The differential advantage hoped for from a loss-leader item is quickly neutralized when the price is matched by other sellers in the market.

Price Cutting and Recession

It has already been suggested that the impact of changed distribution methods in the 1930's was exacerbated by the impact of the depression. Indeed, in past recessions one of the characteristic features of economic behaviour has been the widespread reduction of prices. Although recent recessions have shown little evidence of such a pattern - indeed, quite the contrary - some industries have been squeezed between rising costs and static or declining demand. The result has sometimes been declining prices and the emergence of losses.

In retail distribution there have recently been charges of price cutting accompanied by demands for action to prevent sales below cost in order to preserve established dealers. Similar demands have come from other sectors of the economy and some sort of average cost argument has been adopted as a bench mark for prices in case after case.*

Perhaps the most sophisticated attempt to adopt such an approach was that made by the National Industrial Recovery Act in the United States in the 1930's. Industry-wide codes established formulae for determining prices and prohibited price-cutting. As Professor F.C. Mills has pointed out (Prices in Recession and Recovery) the results were quite perverse:

> "Aggregate production of manufactured goods and total employment, in man hours, made no net gains under the codes . . . . The codes . . . apparently served to

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* See the discussion of the cost justification concept elsewhere in this Report.

> deprive consumers at large of the benefits from the substantial gains in productivity that had been made after 1929; these benefits were reaped largely by those engaged in the manufacturing process."

In a private enterprise system, the argument that public policy should diminish competitive pressures for the sake of preventing losses and bankruptcies would be reasonable only if we were prepared to provide other devices designed to check improvident expansion, to eliminate the incompetent, and to wipe out overstated values. The adoption of such an alternative, however, could only mean that present-day businessmen were out of sympathy with the rules of the market system.

Competitive Price Cutting

In New York City, in 1951, probably the last of the exaggerated instances of loss-leader selling - amounting to a caricature of price-cutting - occurred. The Schwegmann decision, invalidating the non-signer clause in the state resale price maintenance acts in respect to inter-state trade, was handed down by the Unites States Supreme Court in May 1951. There followed some modest price cutting by R.H. Macy and Company, which was immediately matched by a number of other large, powerful retailers. This simple beginning rapidly escalated into a trial of strength among these large retailers, which reached such absurd levels that Sunbeam Mixmasters were sold for as little as nine dollars against the "fair-trade" price of more than fifty dollars. Other "fair-trade" items sold at equally exaggerated reductions. When it became clear that every cut would be matched or exceeded, that no firm could gain an advantage in reputation as a low-price seller, the price-cutting ceased. Thereafter, the price reductions, particularly in large and small electrical appliances, became the province of the discount houses with their minimal service operations.

Excessive Entry and Price Cutting

The matter of the significance of the influx of substantial numbers of retailers into the post-war seller's market, especially in the area of electrical appliances, was intensively explored in the combines administration inquiry into loss-leader selling. The concensus was that the pent-up, excessive demand of the immediate post-war years, and the fixed margins under resale price maintenance made selling the product almost effortless and highly profitable. As demand tapered off, competitive pressure first expressed itself in the granting of very high trade-in allowances, since r.p.m. made price cutting inadvisable. However, in spite of the opposition of suppliers, secret price cutting was also on the increase. With the banning of r.p.m. on December 28, 1951, price cutting became open and direct, and with the passage of time it deepened and intensified as the excessive numbers of dealers attempted to survive in the shrinking market. Complaints of loss-leader selling became common, although price cutting at no time approached the extremes experienced in some cities in the United States.

Gradually, the dealers came to the conclusion that their problems were due to two factors: excessive numbers in the trade and excessive margins under r.p.m. (see Hardware and Metal and Electrical Dealer, July 18, 1953). In such circumstances, banning price cutting could contribute little to the longer-run adjustments that were obviously required.

Against the background of this review of the highlights of the loss-leader discussion - as well as of the more detailed inquiry conducted by the combines administration - we can assess briefly the three additional proposals that are commonly put forward to limit loss-leader selling.

1. The prohibition of sales at less than the buyer's net acquisition cost.

This proposal has attracted few advocates, for a number of reasons. First, the exhaustive Canadian loss-leader inquiry turned up only one or two scattered, short-lived instances of such pricing, divided roughly equally between chains and independents. Second, advocates of the control of price cutting, even if such below-cost pricing were more common, generally find the degree of "protection" provided by such a prohibition totally inadequate. It is not a law prohibiting selling at a loss that is desired but a law requiring selling at a price that will provide a "reasonable" profit.

2. The prohibition of sales below some specified minimum markup, varying from six to eight to twelve per cent in the retail grocery field.

These statutes, which are not uncommon in the United States, in general do not prohibit sales below the specified cost level unless they are made with intent to injure competitors or deceive purchasers. However, where injury or deception is the result or effect of such sales, they are declared by the statutes to have been intended to injure or deceive, and in many states a prima facie case arises or there is presumptive evidence of intent on the mere making of a sale below the specified "cost". The statutes also exempt certain types of sales (clearance sales, sales of damaged goods, sales of perishable goods, sales made in good faith to meet competition) from their prohibitions. As the loss-leader survey pointed out, the legislation, although in effect in thirty states, had experienced only very limited enforcement, and, where an attempt was made to enforce it, the results had been mixed.

In one state, a statutory presumption of intent to destroy competition had been held unconstitutional, and it was therefore necessary to prove actual subjective intent. This largely undermined effective enforcement; it was stated that for the statute to accomplish its intended purpose, it would be necessary to impose criminal sanctions upon sales below cost, irrespective of intent, and this it was felt would not receive public support.

In another case, it was found that the exemptions from the prohibitions of the act made its enforcement by prosecution "almost impossible". In another, it was stated that the scope of the legislation was very limited, since with more expensive items the practice of granting trade-in credits "pretty much avoided" the purpose of the law.

In one state, the use of "diplomacy, tact and reason" had discouraged "indiscriminate price cutting" but the enforcement agency had "never completely eliminated" the practice.

In another state, where only one case had been litigated under the Unfair Sales Act, the Court observed in its judgement:

> "There are some indications . . . that the statutes are used by the large sellers against the small sellers to prevent local price-cutting, rather than protecting the small seller against a concerted campaign of underselling by the larger units."

In Canada, only three provinces had (1966) minimum markup legislation. Inquiries directed to the attorneys-general of those provinces indicated that, to that time, no prosecutions had taken place under the legislation. Doubt was expressed by the attorney-general of one province that such legislation was constitutionally valid.

3. The prohibition of "cut-throat" pricing.

"Cut-throat" prices - although virtually never defined by those advocating their prohibition - may be meaningfully defined as prices below the long-run real costs of production. This latter concept has an important place in economic analysis: it is ex ante rather than ex post in nature and purpose. It relates to prospective costs which are realized through interaction between prices, sales volume and dynamic change, whether in forms of organization or in technology. The relevance of such analysis for policy has been brilliantly demonstrated by Professor M.A. Adelman in his study of the A & P case. Prices which may be adjudged to be "cut-throat" in relation to past costs (which is what is shown by accounting records) or even current costs, may, in fact, be highly profitable prices in terms of long-run real costs. The "low" current prices may be a basic element in the achievement of a future volume of output or sales that makes possible, and creates an incentive for, changes which, in turn, shift costs to a lower level.

The difficulty in dealing with this type of problem, as Professor J.M. Clark pointed out, is that if trades secure protection against a short-term condition of demoralization resulting from economic change, "they probably tend to over-reach themselves", and in the process, impose undesirable rigidities on the economy. The issue of "cut-throat", or predatory, pricing is examined further in the section dealing with price discrimination.

Conclusion

In sum, price cutting - including a range which would be regarded as loss-leader selling by some individuals and trade associations - is almost invariably an integral element in the process of realizing for society the economies of technological and organizational change and of

providing incentives and pressures to continue the processes involved in the transformation of the economy. Concentration on the short-run aspects of price cutting is a result of the real and painful pressures that economic change imposes. The costs of attempting to relieve those pressures by prohibiting price cutting are insignificant only to those who believe that a consequence sufficiently deferred becomes no consequence at all. In reality, the long-run costs of prohibiting price cutting, although not readily identifiable as specific consequences, will certainly assume damaging proportions. It does not follow that the costs of economic change should be concentrated on those on the shadow side of the market, as has already been argued; enlightened and innovative general economic policies designed to ease the process of change must become a first priority of public policy. In general, it is to such policies that those concerned with "excessive" price cutting should look for assistance in the process of adjusting to change, rather than to the uncertain and socially costly prohibition of "loss-leader" selling. It is never good policy to deal with symptoms rather than with causes.

III - 4. COST JUSTIFICATION AND ECONOMIC BEHAVIOUR

Recent years have seen a widespread tendency by economic interest groups to advocate (or to adopt) a cost justification approach to price determination. In the case of public utility regulation, of course, the practice of basing prices on "cost" plus a "reasonable" profit goes back to the turn of the century. The early confidence in such a formula has long since evaporated; indeed, it has been described by Walter Adams as ranking "among America's least felicitous experiments in economic statecraft". Despite this almost universal appraisal, the calculation of current accounting "costs" as justification for price increases has been resorted to by agricultural marketing schemes, by trade associations, by manufacturing firms possessing high levels of market power, by retailers and wholesalers, and so on through a lengthy list.

Sometimes, as in the case of public utility regulation, the costs employed are those relating to the specific monopolist under scrutiny, in other cases it may be the costs of a group of "representative" agricultural producers, the costs of an "efficient" distributor, the average costs of a group of sellers, a standardized cost formula calculated by a trade association, or costs determined by still some other procedure. In almost all cases, these calculations are claimed to be of a defensive character. If, for example, the domestic or international market provides a price substantially in excess of any remotely realistic "cost" estimate, the claim is advanced that in a market economy a seller is entitled to the going market price - and the associated high profits - but when the market price falls to levels that fail to fulfill the aspirations of the seller he then advances the argument that he is entitled to a price that will cover his "costs and a reasonable profit" -

along with the supporting market restraints needed to realize that price. Or, in a period of inflation, the seller may offer such cost figures as a defensible basis for at least raising his prices equally and simultaneously with those of sellers of other goods. In practice, this tends in a deflationary or in an inflationary period to result in a process of "leap-frog" pricing. The process for both periods of rising and falling prices has been well described by the distinguished labour economist, John R. Commons, as follows:

> "All of them [producer-sellers] were waiting for each other to be squeezed by falling prices, and so they were in much the same position as the famous islanders who eked out a precarious living by compelling each to take in the others' washing. All of them were trying to make precarious profit by going around the circle of taking it out of each other as buyers at falling prices.
>
> Or, when the opposite movement occurred and prices were rising... they were trying to take their profits and wages out of each other, instead of taking it out of themselves as efficient producers. This time it resolved itself into the precarious circle of taking it out of each other by rising prices."*

These attitudes - based on comparisons with the most-highly paid groups in the economy or with their counterparts in nearby countries - apply with equal generality to the sale of labour services, to professional fees, to commissions and to other forms of remuneration. Short-run accounting costs, or some proxy for them, become the basis for administering prices of goods and services, and such prices are defended with vigour as being

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* Institutional Economics, p. 798.

"fair" and "reasonable" and as providing the individual seller, the industry or group concerned with an income equal to that of other groups in society.*

From a historical perspective, such attitudes resemble rather closely those that prevailed under the guild system. Prices and wages were supposed to be "just". The central idea was that the prices

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* The emphasis on industry cost averages, as in some agricultural marketing schemes and trade association standards, introduces an added comlicating element. Cf., J.M. Clark, The Social Control of Business:

> "In fact, if competition followed the will of the majority in the trade - phrase of speciously democratic sound - it would not be competition, but monopoly. Rule by the majority in a trade is precisely the thing the public is most anxious to prevent."

Some evidence of the statistical limitations of attempting to derive an industry-wide average from individual firm data is provided by the Committee on Price Determination of the National Bureau of Economic Research:

> "Even in areas in which costs are kept the reported costs of identical items may vary amazingly between firms. During the period of the National Recovery Administration evidence presented concerning the paint industry showed that the range of cost variation for identical items was between 500 and 600 per cent." Cost Behaviour and Price Policy (New York, 1943), p. 285.

should enable each group to live in accordance with its fixed status. In arriving at such prices scarcity and many other factors were taken into consideration.

No guild group or person was permitted to refuse service (e.g., to strike). Profiteering was strictly forbidden, as were forestalling (going out and buying goods before they reached the market), engrossing (cornering the market), and regrating (holding goods for a higher price without doing anything to increase their value). "Unjust" price differences were prevented by giving each member of the guild the right to share a purchase made by any of his fellow members, and at the same price.

To make such a system of monopolized occupations work, production was controlled in the most minute detail. The price of each kind and grade of product was set by public authority, and only certain groups were allowed to produce, sell or buy. Methods of production were precisely specified, as were numbers of apprentices and journeymen.

The whole system of regulated monopoly was maintained in the interest of stability, with a "suitable" living for all the various classes of people. Subsequent social history abounds with political and social programs which look wistfully backward to the lost social values of regulated community life and forward to their recovery without sacrificing the higher standards associated with the continuous adjustment and change inherent in a competitive, enterprise economy. That, of course, is the rub.

Instances of economies in which the goals of fixed status (or other protected positions) and distributional equality have been placed ahead of the goal of rising levels of national efficiency without a consequential adverse impact on living standards are singularly difficult to discover. On the basis of current analysis and experience it

would appear that in both the mid-term and in the long-run the relative strength and prosperity of different industrial and national groups will be determined in an overwhelming degree by the flexibility and adaptability which they display in meeting an ever-widening range of technical and organizational change. To base prices and claims to income on short-run accounting costs (or on a "right" to equal income increases without reference to market realities) whether of an individual firm or of some "average" or "representative" group, is certain to impede the process of transformation in the economy. This retrograde tendency cannot fail to be powerfully reinforced by schemes to support these cost-price relationships by quotas, limits on entry, restraints on technological change, and other such controls that undermine the market adjustment process.

In addition to these basic reasons for challenging a short-run cost-justification approach, there are other considerations of a narrower and more technical nature that merit comment. In a blanket condemnation of the short-run average cost approach, Professor Malcolm P. McNair, Harvard University, has remarked:

> "Actually the doctrine that the only fair prices are those which are based on costs, and that price differentials which cannot be justified in terms of costs are therefore unjustly discriminatory, is bad economics and impossible accounting."*

He goes on to argue that such an approach essentially denies the economic function of price by leaving the price-making function largely in the hands of the seller, and depriving the demand side

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* Law and Contemporary Problems, Vo. IV, No. 3, p. 337.

of any significant role in the pricing process. This contributes to a failure effectively to explore the potentialities of elasticity in lower strata of demand. Prices based on average accounting costs are also conducive to downward price rigidity, in part because the seller fears that once he reduces his price he will encounter adverse public reaction to any proposed price increase, hence he rarely reduces a "cost justified" increase*, and in part because the seller may believe that price inflexibility insulates him from the impact of market forces.

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* A prime example of this upward ratchet effect is found in the recent pricing behaviour of the Canadian soft drink manufacturers. According to a report in The Globe and Mail, Nov. 18, 1975, p. B1:

> "Profit was squeezed during the rise in the price of sugar from $18 to $74 a hundredweight between October, 1973, and August, 1974, forcing four catch-up product price increases that deterred growth in consumption. However, sugar is now down to about $28 and the higher product prices remain giving the bottlers greater margins to take care of continuing increases in their costs for containers, fuel and labour....
>
> "Profit in the Canadian industry is hard to estimate as most of the companies are wholly owned subsidiaries of U.S. firms or privately owned, but a report on the U.S. industry states: 'The bottle industry is recording record profits, essentially as a result of the reduction in sugar prices.'" (Emphasis added.)

McNair also emphasizes that the manufacturing costs of a particular commodity as determined by accounting procedures do not by any means have the precision or validity, and certainly not the economic significance, that legislators tend to suppose. The arbitrariness inevitable in allocating fixed and joint costs accounts for part of this difficulty of interpretation but perhaps more serious is the problem of sorting out "the numerous and varied interrelations of commodities from a sales standpoint."

Oswald Knauth, in his book, Managerial Enterprise - Its Growth and Methods of Operation, deals further with the role of cost accounting in pricing and other aspects of business policy:

> "Cost accounting is a direct offshoot of managerial enterprise.... Executive decisions require the particular computation of costs appropriate to the particular situation.... The proper formula must be selected in accordance with the practical application of policy and not according to abstract theories. The pulsing necessities of business must be met by definite acts. An estimate of costs is a valuable but slippery tool....
>
> "... The price conditions the organization itself. It is an integral part of the whole. There is no criterion by which a price can be judged right or wrong except the success of the business and the social benefits it brings. And these two may or may not coincide. Another price might have activated an expansion of demand giving the concern an equal or greater profit. There is ample room for argument, tests, and differences of opinion." (pp. 104, 124).

The limited significance of cost calculations in price and policy making is also emphasized by Eli W. Clemens,

> "Typically, the determination of average costs (or standard costs plus a margin for overhead and profit) is a function of the cost accountant in the lower echelons of management. Cost analyses, however, represent only the basic data from which price and production strategy is plotted in light of other factors by top flight management. In different terms, average costs are significant to those in the management hierarchy who follow policy, but not necessarily to those who make it. To top management some circumstances might dictate pricing or the addition of a product at only a little above what the cost accountant's statement indicates to be marginal costs. Other circumstances might lead management to reject suggested additions to the product line that cover average costs several times over. To some extent the solution of the problem... turns on the period assumed for analysis. The longer the period for which strategy must be plotted, the greater becomes the percentage of total costs which must be characterized as marginal.
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> "... Normal profits, necessary to a firm's long-run existence, are obtained only in so far as average revenues under multiple - product production are equal to average costs. This condition can only be attained by the continuous process of invasion and cross-invasion of

> markets, by shuffling and re-shuffling of prices and markets, which are so characteristic of economic activity."*

Statements of unit "cost of production" as a basis for prices have been characterized as representing nothing more than an expression of the aspirations of the producer (seller). In the sense that the producer laid out his expenditures in the hope and anticipation of earning a return on them, this statement is largely true. This reasoning applies as much to an investment in education as to an investment in bricks, mortar and machines. However, such investments are inevitably more or less speculative in nature, although each investor understandably hopes that his product will be scarce and in strong demand thus pushing the price far above the highest conceivable cost. If it turns out that the product is plentiful or if an effective substitute for it becomes available from a foreign or domestic source the price may be driven down below the "cost" of the most efficient producer.

As Howard Clark Greer has succinctly summarized the process:

> "In a free economy no seller is 'entitled' to a price which will cover his costs. He is entitled only to the price the market affords. He must learn to live on the price or quit. He cannot burden the buyer with excess costs: he must absorb them himself...."

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* The Review of Economic Studies, Vol. XIX (1), No. 48, pp. 8-9.

> "On the other hand, wide profit margins are eagerly accepted, actively exploited".*

Despite the fact that there is no virtue in low or "reasonable" profits, per se, and there may be great virtue in high profits earned in an open competitive field, there has been an almost universal attempt among Canadian sellers of goods and services to promote the notion that all they want is a "fair" and "reasonable" price, fee, salary, or profit. Few, if any, are prepared to admit that they are seeking or are willing to accept the return they can earn in a competitive market, be that return extravagant or negative - even if they would have the full weight of dynamic economic theory behind them in such a posture.**

Part of this emphasis upon the "fairness" of the price asked is no doubt a cynical attempt to exploit in the mind of the public the favourable connotations of the word "fair". The expression "fair trade" was not, after all, devised to provide a more accurate description of the practice of resale price maintenance. Nevertheless, there seems to be something more to it than a public relations gambit.

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* Howard Clark Greer, "Cost Factors in Price-Making", Harvard Business Review (July-August, 1952), p. 45.

** Cf., the following comment by David McCord Wright: "From the point of view of dynamic economic theory, the 100 per cent profit of a new and rapidly expanding firm, in a risky field, may be more justified than the 5 per cent profit of the stationary legal monopoly which is merely operating in a fixed groove." (Capitalism (New York, 1951), p. 167.)

Although written in a different context, the following statement by Greer sums up the essential rationale of this "fairness" approach:

> "Among the most popular of the notions about fairness in pricing is the idea that a seller is 'entitled' to a price which will cover his cost, plus a 'reasonable' profit. Few propositions gain readier acceptance, particularly among persons supposedly sophisticated in business matters. It seems reasonable that a fair price should reflect the cost of production, that no one should be required to do business at a loss, that everyone should receive suitable compensation for his efforts.*

Another possible use of a short-run cost justification calculation - perverse though it may be for economic policy - is that it may provide an essential element in presenting a rationalization for a policy or a decision. The Committee on Price Determination has referred to this consideration as follows:

> "It may be necessary, for example, for a business organization to justify an action before the courts, an arbitration board, or certain other concerns. This function of costs has developed particularly since the N.R.A., the growth of Fair-Trade Practice laws, and the

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* Greer, op cit. At the time of writing this article, Greer was Vice-President of the Chicago, Indianapolis and Louisville Railway, and had been President of the American Accounting Association.

> Robinson-Patman Act. Costs have a precise and final appeal to legislators and the public, to whom the ambiguities and shades of possible meaning are not always apparent. Hence an appeal to costs (a supposedly unprejudiced piece of evidence) may frequently serve the useful purpose of justifying a policy or action."*

In Canada the notion that the public interest would be well served by arrangements among sellers which assured "stability" and "fairness" of prices and profits, received a very substantial impetus from the experience of war-time controls. The overall success of that undertaking - although there were some notable mishaps - produced among a number of its administrators a degree of zeal to pursue the objectives and practices of that agency in the private sector in peacetime that today is difficult to comprehend.

It should not be necessary again to explore the inadequacies of this short-run cost approach to price policy, although the combines authorities can testify to its persistence. For more than a decade they were obliged to devote much of their effort to the elimination over a wide range of industries of the belief that arrangements designed to fix "reasonable" prices and profits were not only legal under the combines legislation but also represented desirable economic policy in a wider sense. In fact, on this latter issue the debate still continues on a scattered front, perhaps as much within the public sector as in the private sector.

It is not, of course, the purpose of these comments to call into question the conceptual validity or the impressive short-run achievements of the war-time price controls. Desperate problems

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* Cost Behaviour and Price Policy, p. 27.

demand desperate remedies. However, it is vital to be aware that such remedies often have carry-over effects which persist long after the problems they were designed to meet have disappeared. Apart from the vested interests which these remedies bring into being, the creation of an alternative conceptual framework and an institutional structure for decision-making in the economy, if permitted to become embedded in public policy, is almost certain to present formidable obstacles for the regeneration of a market-directed, private enterprise system. Agricultural marketing policy and public utility regulation are already near the point of no return. Other governmental agencies which assess economic performance in terms of cost justification criteria - of which we have currently a number of extreme examples, some of which enjoy considerable public support - are contributing to the steady erosion of the market- oriented sector. To prevent further erosion, and, if possible, to reverse the trend, is a redoubtable task for the combines administration.

Finally, and by way of digression, we refer to a proposal, that has received some attention in the United States,* which involves the use of a cost-justification approach to the assessment of predatory pricing situations. The substance of the Areeda-Turner proposal is that if a monopolist's pricing in a market in which he has "monopoly power" results in "a price below reasonably anticipated average variable cost" (it) "should be conclusively presumed unlawful". The discussion in the article makes it clear that the cost concept employed is short-run in nature.

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* Phillip Areeda and Donald F. Turner, "Predatory Pricing and Related Practices Under Section 2 of the Sherman Act", Harvard Law Review, Vol. 88, pp. 697-733.

On the surface, this is an attractive route out of the morass that so frequently surrounds cases of predatory pricing. For a number of reasons we find the proposal undesirable and probably unworkable. First, because of its short-run basis, the price concept is based on current accounting data, and it is, therefore, static and retrospective in effect. As we have argued elsewhere in this report, we prefer the long-run marginal or long-run average cost approach because of its fundamental anticipatory bias, thus making it possible to make allowance for planned changes in scale, in technology, or in organizational methods. This consideration we regard as decisive in rejecting the Areeda-Turner proposal.*

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* Cf., The following statement by the Committee on Price Determination:

> "A decision with respect to price structures applies to a future period; the costs significant to this price decision are not those which prevailed in the past.... Nor are costs based upon engineering or technological standards decisive for pricing. The significant costs, rather, are those which may be expected to prevail in the period for which prices are being considered. In the preparation of costs for pricing decisions, standard costs or those of the past period may be taken as a starting point and modified in view of probable changes in factor prices, technical efficiencies, and conditions of operation." (Cost Behaviour and Price Policy, p. 27.)

(Footnote continued at bottom of next page.)

Second, Areeda and Turner state that the relevant cost concept for their analysis would be marginal cost, but "recognizing that marginal cost data are typically unavailable", adopt the average variable cost measure as the closest available substitute. The difficulty with this decision is that it is based on cost measures as set out in economic texts; in fact, marginal cost as employed in business decision-making is something different from the formal definition, and this makes the substitution of the average variable cost measure for marginal cost as the "test" of predatory pricing open to serious question.

Some of the differences between the "real" and the text-book concepts of marginal cost are well set out in the following statement by Clemens:

> "Marginal cost is something more than its ascertainable and measureable elements. Risk and the additional cost of management, both of which are substantial, are marginal costs. Conceivably marginal cost must include a certain minimum amount which the businessman considers

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* Cf., also Rowley's comment on the change in the pricing system employed by the British Iron and Steel Board:

> "The Board decided that its pricing system should be designed to encourage capital development in the steel industry. To this end, prices should take account of the operating and capital costs of hypothetical new plants, incorporating the most modern new techniques and operating at a high level of efficiency." (C.K. Rowley, The British Monopolies Commission, (London, 1966), p. 301.)

> necessary profit. When he says that the profit on a certain additional piece of business is 'not worth his time and trouble', he is giving expression to a very real concept of marginal cost. The writer also agrees with Professor Machlup's position that too rigid a definition of marginal cost would trap its users into unrealistic and untenable positions."*

Third, since average variable cost as a percentage of total cost can vary greatly depending on the extent of capital intensity characterizing the different industries, different tests of predation would be employed. In industries where average variable costs constitute a very small proportion of total costs, only a major price cut would push the monopolist into unlawful behaviour. It cannot be assumed that the destruction of capital values involved before that point was reached would be a matter of indifference for public policy. On the other hand, where average costs account for a very high proportion of total costs - as, say, in meat packing - only a slight price reduction would trigger a conviction for predatory pricing. The price rigidity that such a result might well engender would not necessarily be in the public interest.

Concluding Comment

On the whole, we conclude that a short-run cost justification approach to price determination, whether adopted by private groups independently or with the sanction of public authority, is inimical to the operation of a market system and, in a broader sense, is inconsistent with the operation of a dynamic, flexible economy. Not only does it

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* Clemens, op. cit., p. 8.

lend support to established cost-price relationships but it tends to pass on in pre-ordained fashion any cost increases instead of having the shifting stresses of the market bring pressure to bear to modify such increases. The short-run cost-justification approach weakens the forces working for the introduction of new technology and new forms of business organization; it weakens the role of prices and profit in allocating resources and places the emphasis on direct intervention to shift resources. By insulating substantial sectors of the economy from market pressures, it concentrates the burden of adjustment arising from economic change - and change does still go on in some sectors of the economy and in some areas of the world - on the remaining shrinking area of the economy occupied by the market-oriented industries.

IV

Administration and Adjudication

IV - 1. A SPECIALIZED ADJUDICATING BODY

A. General Considerations

Three basic and unavoidably related issues must be resolved in deciding how to implement policies such as have been recommended in this report. Those issues have been discussed vigourously in Canada in connection with the proposals for new legislation put forward since the release of the Economic Council's Interim Report on Competition Policy. They have to do with the degree of specificity of the standards and criteria set out in the statute, the types of evidence and judgements required to apply the standards and criteria, and the character of the decision-making body.

We have given these interdependent questions very careful attention, and believe that the structure of decision-making powers proposed in this section of the report guarantees fair adjudication, minimizes the extent to which private initiative might be frustrated either by the law's delay or by "bureaucratic red tape", and strikes the best balance between dispersing the power of economic decision-making under the statute and the need for consistently perceptive decisions.

This report sets out the policy we believe will maximize the long-run flexibility and effectiveness of the Canadian economy. We have also formulated principles, standards or criteria for general application, in as precise a form as we are able without being unrealistic, that can be applied to arrive at reasonable decisions in specific situations. All of this, however, depends critically upon the existence of a decision-making authority capable of dealing perceptively and impartially on a case-by-case basis with the complex questions of fact and remedy that will frequently require analysis and prescription.

More generally, the principles and criteria for decisions are such that a wide range of evidence may be relevant to the issues presented, and an adjudicating body is required that accommodates the sometimes conflicting procedural objectives of efficiency (i.e. speed, accuracy, low cost, authority and finality) and fairness (i.e. adaptability, simplicity, informality, impartiality and principles of natural justice).

The policy framework we have recommended cannot in our view be most effectively or adequately implemented by the structure of adjudicative powers currently existing under the Combines Investigation Act. Our proposal is that the courts should continue to play a vital role but that the powers to make binding substantive decisions recently given to the Restrictive Trade Practices Commission, as well as adjudicative power respecting mergers, misuses of market power, price discrimination and rationalization, specialization and export agreements, should be placed in the hands of a new body and that the Restrictive Trade Practices Commission should cease to exist.

The case for placing these additional powers in the hands of a specialized adjudicator is very strong. Canada simply cannot afford not to make every reasonable effort to maximize the inherent capacity of its economy to adapt and transform itself, spontaneously and without government intervention, in response to natural market signals. As has been stressed above in this report the long range implications of any alternative, both to the business community and to the consumer as such, are not entirely clear but the resulting waste, frustration and growing general dissatisfaction would gradually, in all probability, lead to solutions not compatible with at least the basic economic goals of public policy as we perceive them.

If Parliament were to enact the proposals in this report it would be enacting a policy in considerably more articulate terms than is currently done by the Combines Investigation Act. We also doubt that a policy designed for general application to all trade and commerce in Canada for the foreseeable future could be made more specific than we propose without too great a sacrifice in its scope and effect. Canada cannot afford even the few per se, limitist rules applied in the United States; more refined decisions are required that respond more fully to the facts of each case and to the requirements of the Canadian economy.

We are keenly aware of the many reasons that lead some people to advocate more specific statutory criteria than we have found it realistic to adopt, and that lead them also to advocate leaving all decisions affecting the rights of persons up to the courts. A comprehensive set of rules capable of more or less mechanical application holds obvious attraction and may be feasible, or required, for matters such as criminal liability where the goals of public policy tend to be more immediate. But insofar as such laws would be patently inadequate to achieve broader long-range goals we should obviously not rely on them to do so, no more than criminal sentences can be imposed without regard to the sometimes complex requirements of the individual case. Predictability is not the paramount, let alone the sole, concern of the law. In matters of public policy one cannot afford not to be effective, and mechanical codes of legal rules regulating market economies are as inadequate as mechanical models of economic behaviour, structure or performance.

One of the general criticisms levied at Bill C-256 and subsequent proposals was that they were not specific enough. (They were also criticized for being too detailed and categoric in some respects, leaving no room for exceptional cases.) The view has been expressed that unless the

governing standards and criteria are set out with a high degree of specificity and predictability in the statute, Parliament is abdicating its responsibility to make policy and is forcing "non-justiciable" issues upon the courts. Whether a matter is felt to be justiciable or not comes down to what one perceives to be an acceptable role for the judiciary in our general system of government. It is a matter of degree, and the concern is that if the courts are required to make decisions that require judges in effect to express subjective opinions on broad economic or political matters they will thus become involved in controversy. This in turn is felt to undermine the respect for judicial impartiality and the general prestige of the judiciary to the overall detriment of its effectiveness as a governing institution.

Given any degree of generality in any rule, and the need for a person to make an authoritative judgement as to whether and how it applies to a given set of facts, it can of course be said in a broad sense that that person is making "policy", whether he is a judge of a superior court or anyone else. But it is clearly impossible to remove all scope for this type of judgement, or choice, and a good deal of it takes place daily in our courts, particularly at the appellate levels. Where room for judgement is left there is both room for honest disagreement and room for uninformed or bad judgement as well as for good judgement.

The degree of generality with which statutory standards are expressed can, in some cases, reflect upon the willingness of the legislators to come to grips with their policy-making function. Since its inception, however, competition policy has been one of those subjects where general statutory standards constitute intelligent and responsible policy making. Highly specific standards amenable to more or less mechanical application would, at least for an economy like Canada's, inevitably prevent both

more and less than they should. Also, as a distinguished American antitrust counsel and scholar commented recently, "the quest for certainty inevitably leads to rigid rules which are not responsive to social and economic change."*

It would not concern us from a justiciability point of view to have the regular courts apply the general standards we have proposed; we are more concerned with the effectiveness of such an allocation in view of the general lack of familiarity with the subject matter on the part of many judges, the degree of their consequent willingness and ability to come to grips with the necessary types of evidence and issues, and with the relatively slow speed and high cost of proceedings in the regular courts. This is not, or course, to deny that some judges have performed in an entirely commendable way under the existing legislation. Indeed, if our recommendations are implemented we will continue to rely upon the courts for criminal prosecutions and civil damage actions as well as for judicial review. It is simply that on the whole a specialized adjudicating body would be in a better position than the regular judiciary to make the judgements required under the laws we propose. In the words of Lord Diplock, once a member of the Restrictive Practices Court in the United Kingdom, "Judges are not economists and the judicial process is not suited to determining where the balance of economic advantage lies."**

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* Milton Handler, "The Inevitability of Risk Taking in Antitrust", (1975) 9 Georgia Law Review 743, 745.

** Foreword to J.P. Cunningham, The Fair Trading Act 1973 (London, 1974), p. vi.

On the other hand, if and to the extent that the power to make difficult judgements is proposed to be given to some body other than an established superior court, some critics argue that "discretionary" power is being given to a body not subject to "the rule of law". Those criticisms relate to the same degree of generality with which the statutory tests are formulated as gives rise to the justiciability issue. They also relate to the effectiveness of legal safeguards against arbitrary, unsupported, or unreasoned decisions. We venture no comment as to whether or not those criticisms were deserved by the proposals at which they were levied in the discussion in Canada over the last few years. We do, however, subscribe fully to the underlying concerns of the critics and have given effect to those values so far as can be done within an acceptable framework for economically realistic decisions.

Adjudications in most areas of law, including laws relating to market economies, result from a reasoning process that is based on an underlying objective, hypothesis or philosophy about what one is trying to protect or achieve. Whether or not the major premises underlying the reasoning are discussed openly, or they are merely articulated or their presence even acknowledged, their existence and guiding effect is an unavoidable feature of the decision. We believe it will be useful to express, in the form of legislative objectives, basic policy directions the decision maker should consider in making its decisions. These express legislative objectives will limit and direct the power of the decision maker in a general but fundamental way.*

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* A proposed draft of guiding objectives is set out at pages 41-42 of this Report.

In addition to the necessary generality of the statutory standards, the complexity of the issues of fact and the evidence must be considered. An appropriate definition of the market, for example, is fundamental to an assessment of the market effects of a practice, and it can be a very fine question where, for example again, multi-product enterprises or technologically dynamic sectors of the economy are involved. The evidence on market definition, on the market effects of practices and on any relevant economies can range through historical and statistical trends, marketing practices, sources, of supply, production processes, patent portfolios, and cost figures. A keen sense of relevance and informed judgement is required to sift the evidence and put it in perspective. The difficult issues of fact are not of the historic variety typically presented to courts, but are more in the nature of future prediction or economic forecast. Hypotheses about the future behaviour of businesses, industries and markets may be required that might properly differ from case to case. The use of precedent becomes somewhat more sophisticated than in usual court proceedings because industry comparisons are difficult to make and situations change over time. Only the overall policy objectives remain constant.

The process of subjecting facts to laws frequently involves, as here, both legislative action and case-by-case decisions. No one disputes that statutes should be conceived and framed only in the light of all relevant knowledge including that produced by the appropriate social sciences. It follows that insofar as it is unwise for Parliament to legislate precise criteria amenable to more or less mechanical application, the institutions that must make the sometimes difficult case-by-case decisions should have the capacity to utilize the relevant knowledge and also to take due account of whatever imperfections may exist in it so far as each particular case is concerned.

It is a complex, mobile and expanding body of knowledge and the best possible judgements merely stand the best chance of being right. They must of course be made as the need arises, but rigidities in decision making, resulting from ingrained personal convictions not open to reconsideration or qualification even in the light of further knowledge, must be guarded against as much as rigidities in the economy itself. In short, we must have a decision-making body capable of utilizing the available knowledge and at the same time of assessing the limitations of that knowledge when it is invoked in support of an attempt to curtail particular business activities.

For combines matters in Canada an indispensable element of this institutional capacity is the ability of the decision-maker to make informed and experienced assessments of the complex evidence and questions of fact that will be presented to them. We believe this important public need will be met to the highest attainable degree if the assessments and decisions are made, at least in large part, by persons qualified by their experience in or knowledge of the general subject matter.

Over the last thirty years the United Kingdom has wrestled with the question of the form of the adjudicating authority to which matters of economic and business judgement, such as characterize this field, should be submitted for decision. The attitude of British industry is particularly instructive. In 1948, the Monopolies and Restrictive Practices Commission was established to investigate and report to the Board of Trade on matters referred to it by the Board of Trade. The public interest criteria formulated to guide the Commission in its assessment were so general and of such a variety that, in effect, little guidance was given. The Board of Trade possessed certain remedial powers. Within a short time a belief developed that the Commission investigations took too long, were too inquisitorial in nature, and were

too much influenced by academic theories rather than business experience. Further, too much uncontrolled remedial power was felt by some to be left in the hands of government bureaucrats. In 1956 Parliament, responding to the views of industry that greater speed, consistency of standards, demonstrated impartiality and decisions based on the evidence presented in each case, were required, established the Restrictive Practices Court to exercise jurisdiction over restrictive agreements, which was transferred from the Commission. The Restrictive Practices Court is headed by superior court judges but also has lay members who are "qualified by virtue of their knowledge of or experience in industry, commerce or public affairs".

Since shortly after establishment of the Court, however, British industry has increasingly complained of overly rigid interpretations of the legislation, the imposition of unrealistic conditions on agreements, and hearing processes that are too slow and costly and too much characterized by technical procedural wrangles that are inappropriate for complex economic problems. From the businessman's point of view at least, the Court's decisions proved to be no more predictable than the reports of the Monopolies Commission. In 1971 the Confederation of British Industry called for an end to the Restrictive Practices Court and a return to the Monopolies Commission. It also urged that the Commission be reconstituted to ensure business experience on it, and that procedures be instituted to ensure each person the opportunity to know and confront the allegations and evidence against him.*

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* For further elaboration of the C.B.I. preferences see J.A. Farmer, Tribunals and Government (London, 1974) at pp. 31-32.

The need to legislate effectively for a modern and complex society such as ours has, for purely functional reasons, led to a growth in the number and variety of specialized adjudicating bodies outside the regular courts. In each of the important fields of energy, transportation, labour relations, communications and land use control, for example, we have become accustomed to public policies stated in very general terms indeed, being applied by specialized decision-makers. The desired expertise for analysis and judgments is outside the range of usual personal or judicial experience, and develops or results only from years of understood business experience or learning; it rarely, if ever, results from a few hours of evidence and argument, even to an able mind. Development and maintenance of expertise is, moreover, a continuous and cumulative process.

There are ways of course of ensuring that decision-making processes in these specialized bodies are fair, and we deal with this matter below in this section of the report. But the specialization of the decision-maker himself adds an element of fairness, for he is not as dependent as he might otherwise be upon the parties, with their own differing resources, experts and degrees of experience, for his understanding of the basic conceptual framework within which to appraise the specific fact situation at hand. There is also a greater likelihood of underlying consistency in the decisions.

We have concluded that while a specialized adjudicating body is required to administer new laws relating to mergers, misuses of market power, price discrimination and rationalization, specialization and export agreements, the Restrictive Trade Practices Commission is not the appropriate agency. We considered the possibility of a second agency in addition to the Restrictive Trade Practices Commission but concluded it was preferable to terminate the existing Commission, discontinuing some

of its functions and transferring the others to the regular judicial institutions and the new adjudicating body. In addition to a general reluctance to proliferate public agencies, there is a functional overlap between the new jurisdiction given to the Restrictive Trade Practices Commission in 1975 and the powers we propose be given to a specialized adjudicator, particularly with respect to misuses of market power, so it is desirable to locate the jurisdiction in the same body.

Why not simply add to and subtract from the powers of the existing Commission, instead of replacing it entirely? The basic reason is that the Commission was not originally created or structured to make binding determinations of rights and obligations. It received this power for the first time in 1975. We propose such a reorientation of the overall role of the agency that it would be preferable, in our view, to start afresh. We propose termination of the two basic historic functions of the Commission, namely its role as an intermediate hearing body between investigation and criminal prosecution and its role in general or research inquiries, and the transfer to the regular judicial institutions of the third historic function, that of supervising the use by the Director of Investigation and Research of his compulsory investigative powers under sections 9, 10, 12(1) and 17(1) of the Act. In view of the important new substantive civil jurisdiction to make binding orders conferred by the 1975 amendments, which we propose be extended significantly, we believe it is essential to disassociate the specialized adjudicator as much as possible from the departmental policing and policy making functions. Every reasonable step should be taken to ensure both the fact and the appearance of an independent and impartial adjudicator.

The Commission's role under the existing Act to function as an intermediate hearing body between the Director's decision that an offence has been

committed and any decision to prosecute has not, in our view, been an entirely successful experiment. We believe this is at least partially attributable to the types of functions the Commission has been required to perform, and to the complete lack of statutory guidance as to the nature of the "public interest" against which section 19(2) requires the Commission to appraise the effect of arrangements and practices. Perhaps not surprisingly, many of the Commission's reports have tended to emphasize legal analysis more than economic analysis, due in part at least to its obligation under section 19(3) to draw conclusions as to legalities, and to that extent the Commission has functioned largely as a powerless appellate body reviewing the Director's own legal conclusions without bringing a different or, necessarily, a more expert perspective to bear upon the facts. This does not appear to be what the MacQuarrie Committee intended to happen in the establishment of the Commission.

In addition, the Commission's intermediate hearing role, with the obligation to write a report for publication, adds significantly to the already extensive delays in proceeding with cases. Some of the delay is inevitable but in part it results from the limited capacity inherent in the small membership of the Commission.

The Director has a large professional staff which presumably appraises "the effect on the public interest" of the practices involved as part of his setting of priorities for allocation of the enforcement budget, and this together with the delays and use of additional resources resulting from Commission involvement appears to be the primary reason why, in recent years, the Director has been increasingly by-passing the Commission, even for cases not subject to a six-month limitation period, and submitting his evidence directly to the

Attorney-General of Canada under section 15.* This incidentally also eliminates what may in fact be the major benefit of Commission hearings, namely, a pre-trial discovery by accused persons of the case against them as disclosed in a formal statement of evidence and by witnesses at the hearings. The costs of Commission involvement cannot, however, be justified by this feature alone.

Nor can Commission involvement be justified on the basis that the influence of its report is necessary to persuade other government agencies that remedies other than criminal prosecution are required in some cases, or to force the hand of the Attorney-General by publishing the results of an investigation that would otherwise remain confidential, or by endorsing a recommendation of the Director in cases of alleged criminal activity where other government agencies have been involved in a peripheral way.

The underlying problem giving rise to Commission involvement in the criminal enforcement process has been that the Combines Investigation Act applies criminal law controls to types of activity that are not appropriate subjects for criminal law. Criminal law, its procedures and its remedies cannot be made realistic for mergers, for many types of exercises of market powers, or for many types of oligopolistic behaviour, but in an effort to help criminal controls work Parliament framed the legislation with a degree of generality quite foreign to basic criminal law principles, seeking to have a critical part of the assessment performed by the Commission although without giving it any guidance as to the nature of the public interest.

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* The Director set out the considerations he takes into account in making this decision in Report of the Director of Investigation and Research for the year ended March 31, 1975, at p. 21.

The Commission's role in general or research inquiries should be terminated for two reasons. First, the research function can and should be performed entirely within the Bureau of Competition Policy. The Bureau has a large professional staff, whereas the Commission has none and must rely entirely on the personal expertise of the commissioners. The benefits of Commission involvement have been to provide an opportunity for industry to reply to the Bureau's work, which we suggest below be handled in another way, and to bring the personal judgement and prestige of the commissioners to bear on the research, which should not be necessary if the research is properly done in the first place. We recommend that the research as done by the Bureau stand or fall on its own.

The second reason, and probably the more important one, is the interest in having the adjudicating body, which is charged with making decisions on the basis of evidence before it, completely divorced from general research and policy making. This separation of the research function from the adjudicating function is important to public confidence in the independence and impartiality of the adjudicating body.

The third historic function of the Restrictive Trade Practices Commission, that of supervising the use of compulsory investigative powers by the Director of Investigation and Research under sections 9, 10, 12(1) and 17(1), is an important function that should, we propose, be transferred to the normal judicial institutions. We do not feel as strongly about removing this third function from the Board as we do about the first two, and it may be felt that for considerations of convenience and expertise the supervisory responsibility and power should be left with the chairman of the Board or another member designated by him, but on balancee we favour removing it from the Board. Compulsory investigative powers may be used in connection with matters that eventually will come before the Board

for decision, and continuation of the existing responsibility in the Commission or the Board appears difficult to justify as an exception to the general principle of separation. It would create an unnecessary potential for unfairness or a feeling of unfairness.

With the disappearance of the three historic functions performed by the Commission, and in view of the new responsibilities to exercise important powers of adjudication and impose civil remedies, we are firmly of the view that the Restrictive Trade Practices Commission should be discontinued. It is fundamentally important both that the adjudication body be completely divorced from broad policy making and from concepts of crime and criminal enforcement, and that the public see it as such. Its entire orientation would and should be different from that of the Commission in the past. Instead of being involved with concepts of criminal responsibility, its sole concern should be to implement the objectives of a market economy specified in the legislation. Even the adjudication powers given to the Commission by the 1975 amendments should be exercised against the newly formulated principles, standards and criteria we recommend in this report. We believe it to be important to the public regard with which the specialized adjudicative body is held that it not be associated with the past functions and responsibilities of the Restrictive Trade Practices Commission.

B. The Board: Powers and Safeguards

(1) Composition. We envisage replacing the Commission with a specialized adjudicative body constituted as a superior court of record, that for the sake of convenience in this report we have called the "National Markets Board", composed of a superior court judge of some years judicial experience as full-time chairman, a minimum number of four additional full-time members on terms not

exceeding ten years in duration, and a minimum number of four part-time members on terms not exceeding three years. Each member would be eligible for reappointment at the end of his term. All members should be Canadian citizens ordinarily resident in Canada. They should be persons with broad experience, and they should come from a diversity of backgrounds. At the very least, the members between them should have broad experience and expertise in large and small business, economics, law and public affairs. The majority of both the full-time and part-time members should have had extensive private sector experience (as distinguished from, though perhaps in addition to, civil service or university experience). They would each, of course, be expected to act impartially and in no sense as a representative or advocate of any particular interest.

The type of Board we envisage can be described in part by a statement made about the Monopolies Commission in the United Kingdom in 1969 by Anthony Crosland, President of the Board of Trade. After stressing the complexity and variety of issues with which the Commission had to deal, and the understanding and judgement required to find the facts, perform the analysis and make the assessment, he said:

> "A great deal hangs on their decisions, which can affect the efficiency of British commerce and industry for years to come. I regard it as vitally important that the members of the Commission should be people of great ability and distinction - in industry, commerce, finance, law, academic life, public service - who can focus on these problems a wealth of combined experience."

Lay members on both the Restrictive Practices Court and the Monopolies Commission in the United Kingdom have been distinguished individuals and have earned uniform and widespread respect (as indicated) for the quality of their contribution.

It is almost trite that on specialized subjects good experts are better than courts but bad experts can be much worse. We should stress that we place more faith in experience and informed common sense than in cloistered "expertise". The responsibilities we propose for the Board are formidable but we are confident that if the matter of appointments to the Board is treated as seriously by the government as are appointments to judicial office, we will have a Board capable of making perceptive and realistic decisions and making the statute work to the long-run benefit of the country. If, however, the government in making the appointments were to be influenced by any grounds other than personal qualifications for the job, the results could be considerably more damaging than leaving the law as it is.

The importance of this recommendation cannot be overstated. It is the crux of our proposals concerning administration and adjudication and is central to the success of most of the substantive proposals. The government does not enjoy an altogether distinguished reputation for its appointments to boards and commissions in the past, and it is this fact that underlies a degree of public unease about a specialized adjudicating body in the field of competition policy. By contrast, the government's record and reputation for judicial appointments is excellent and we believe that if the Board's functions are treated with the same respect in making appointments, and if the scales of remuneration are comparable, it will result in a Board that will deserve and enjoy general public confidence.

We envisage the Board functioning with physical facilities, clerical support* and so on that reflect the significance of its responsibilities. The prestige and contribution of the Board will, however, within a fairly short time, be determined by its performance record in the use of its powers. Our proposals concerning the composition of the Board follow from the need for it to act fairly and expeditiously, and to make decisions that are economically perceptive and commercially realistic.

It is largely a matter of indifference whether an adjudicating body such as we propose is entitled a "court" or not. In the United Kingdom the Restrictive Practices "Court", for example, has lay members, must weigh all the evidence in light of the special knowledge and experience of the appointed members, and can be challenged in the regular courts only on questions of law. What is crucial is that the adjudicating body have jurisdiction to make binding orders, following a hearing governed by principles of natural justice, and not be influenced by or subject to ministerial or other governmental influence or direction. It must be independent. However, in view of the qualifications of its members, the nature of its jurisdiction and its power (which we propose below) to admit evidence that might not be admissible by the common law rules of evidence, it seems more in accord with Canadian practice not to call it a "court".

The matter of a quorum for Board hearings and decisions has given us some concern. It is important to avoid the risk of bad decisions resulting

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* For example, as is the case with an increasing number of superior court judges, Board members may find it useful to have the assistance of capable recent university graduates for a year or so following graduation.

from the views of one person with only a limited type of expertise, and it is also desirable to avoid needless dissipation of Board resources by having panels that are unnecessarily large for the more straightforward matters. We have concluded that a minimum quorum of three, including at least one full-time member, should be required for all hearings and decisions. We considered, and rejected, the idea that if, after a hearing, a panel of three were unable to reach a unanimous conclusion, the evidence should then be read by two additional members and a decision made by five members. Instead, we recommend that the Board, either on application or on its own motion, be permitted to enlarge panels to any number of members for the hearing of any particular matter. This would ensure that important cases, including those that raise new types of questions for the first time, receive proper and thorough consideration. For example, it may be that for matters involving mergers, misuses of market power or rationalization proposals, or where particularly severe remedies are requested, panels of five or even more members would be thought desirable.

It is hoped that the number of members, the mix of their backgrounds and perspectives, the provisions relating to quorums, and the possibility of a regular change in the membership will prevent balkanization of any ingrained convictions or abberational views that might otherwise become established with a more centralized power. Changing panels with differing perspectives or backgrounds on each panel would achieve a certain amount of the dispersion of personal power that currently results from use of the regular courts.

By setting minimum numbers of members rather than maximum numbers it is hoped that cases can be dealt with thoroughly without any significant backlog building up. Short-term flexibility in this respect, which may also be necessary to handle

expedited matters such as advance clearances, proposed below, would be provided by the ability to add part-time members.

The terms of the members should be staggered to avoid disruptive turnovers in the membership as a whole. This could be accomplished by varying the terms of the initial appointments.

We considered the additional possibility of providing for ad hoc members to sit only for the purposes of a particular case. This was because of a concern that has been expressed by some businessmen that certain industries are so complex that a matter involving such an industry might not be fully understood by a Board panel, even with the help of expert witnesses, unless a specially knowledgeable person were appointed. We have no serious objection to such a proposal but we do not recommend it because we believe the concern is overstated. In any other type of dispute, and apart from commercial arbitration, such a company or individual would be before a single judge in the regular courts. Also, the Chairman of the Board could take factors such as special knowledge requirements into account in composing panels and assigning cases to them. Part-time members, too, mean that a wider range of expertise can exist within the Board. If provision were to be made for ad hoc Board members, particular attention would have to be paid to the selection process.

(2) Functions and Powers. As has been indicated, the Board would have substantive civil jurisdiction relating to mergers, misuses of market power, price discrimination, and rationalization, specialization and export proposals, in addition to the decision-making jurisdiction given to the Commission by the 1975 amendments.

It is fundamental that persons with these powers exercise them in complete independence and on the basis of evidence submitted to them by the

parties as assessed in the light of their own general experience and knowledge. The specialized body we propose is a substitute for the regular courts and is not a regulatory agency in the American tradition of having legislative, adjudicative and executive functions rolled into one and the same body such as is the case, for example, with the Federal Trade Commission. Accordingly, we propose that the Board not have the power to initiate proceedings, have no capacity or responsibility for general research into economic matters or types of practices, not engage in general rule-making and be completely removed from the criminal law functions performed by the Bureau of Competition Policy and the courts.

Some specialized agencies, such as the provincial and national energy boards, have power to initiate proceedings on their own motion but we do not believe such a power is appropriate for the the Board we propose. The Bureau of Competition Policy will have the primary responsibility to initiate proceedings, which is a natural adjunct to its receipt of complaints and its professional capacity for research, investigation and assessment.

We have given careful consideration to the types of orders the Board should be empowered to make and have concluded that, subject to limitations set out below, it should have the power given to the Restrictive Trade Practices Commission by the 1975 amendments with respect to exclusive dealing and tied selling, namely, power to make an order prohibiting the continuation of an existing practice "and containing any other requirement

that, in its opinion, is necessary to overcome the effects thereof in the market or to restore or stimulate competition in the market".*

This is a broad power. It is important that as far as reasonably possible the Board confine itself to saying "no" to business proposals or activities, and avoid giving detailed direction as to how the persons before it ought to conduct their business affairs in the future. Market economies cannot be fine-tuned, and Board members should have a healthy scepticism about the desirability of their making detailed decisions that hamstring management options. It would, for example, be most undesirable for the Board to specify lines of business a company could and could not enter, or its prices, profits or costs either directly or by specifying any limiting formulae for calculation. These types of order would be completely antithetic to the Board's function and purpose, and would amount to its operating like a utility regulator without even at the same time protecting the enterprise against losses. It would, however, be a very different and proper thing for the Board, for example, to prohibit a firm or group of firms from quoting a delivered price without also quoting an f.o.b. price, assuming a situation where that might be effective.

It may well be that in a given situation the Board may decide that a prohibition order, or approval of a rationalization, specialization or export agreement, should be made conditionally. For example, a proposed merger might be prohibited unless a tariff were reduced or removed, or unless the parties licensed certain patents. There is a

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* Section 31.4(2). The remedial power relating to market restriction is expressed in virtually identical language.

small but nevertheless important distinction between imposing terms and conditions upon something a businessman himself proposes to do, which leaves him at least with the choice of whether or not to pursue his plans under the constraints imposed, and imposing corrective orders that inescapably require something to be done or not done.

Orders can be specific without usurping the functions of management, and it is important that the Board's orders be sufficiently precise that they leave no reasonable doubt about what they prohibit or require. We accept the provision of the 1975 amendments that Commission (or Board) orders be enforced by criminal penalties and provide a foundation for civil damage suits, but it follows that the Board ought not make any order that does not tell the businessman with reasonable certainty just what is and what is not covered by the order. It simply would not do, for example, for a person to be ordered to stop "misusing your market power" on pain of criminal sanction. Accordingly we recommend that the Board only be authorized to make orders that are sufficiently specific as to give reasonably certain notice of what acts are required or prohibited, and that the adequacy of an order in that respect be reviewable by the courts under the provisions of the Federal Court Act. In the absence of a successful review application within the time provided, the order should be deemed to be sufficiently specific for purposes of enforcement of that particular order.

Effective jurisdiction over mergers requires that the Board have power to order dissolution of a merger. We recommend below that courts not have jurisdiction to set aside a Board decision as to the appropriateness of a particular remedy, and dissolution of a merger should fall into that general category. There are two other remedial powers, however, those of divestiture for misuse of market power and interim prohibition orders, that should be subject to special limitations.

Divestiture of assets is an extreme remedy that we have recommended be available on a "last resort" basis for cases of misuse of market power. By this we envisage rare situations, normally involving repeated misuse despite Board orders relating to particular tyes of misuse by the same person, where divestiture appears to be the only effective solution. Divestiture might also be ordered in the form of compulsory licence or even annulment of industrial property rights. In view of the severity of the divestiture remedy its availability should be conditioned so that review by the Federal Court could take place on the questions of whether the Board reasonably found divestiture to be necessary, and also as to whether the details of the divestiture order were reasonably necessary and as equitable as possible in all the circumstances. If an application for review is allowed the matter should be referred back to the Board for further consideration.

Interim prohibition orders are also a necessary power for the Board so that it might act promptly in those cases where irreparable harm or serious inconvenience might otherwise result and a prima facie case for a remedy is established. For example, this power might be necessary to protect a person from immediate effects of a misuse of market power by a competitor, or to prevent consummation of a merger pending proper assessment.* On the other hand, interim prohibition orders can work serious inconvenience or harm and are granted without a full hearing of the matter. Accordingly we believe they should be reviewable by the courts.

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* In some merger cases it would be sufficient to order that the businesses continue to be operated separately, and the assets remain separately identified, until the assessment of the merger has been completed.

The Board should be able to issue interim prohibition orders on terms, but the orders should not endure for more than a limited period, such as ninety days, unless the case is exceptional. Limited duration of the order minimizes the risk of its being resorted to as a cover for administrative inefficiency in the Department.

The Board should have a general power to rescind or vary its earlier orders, except for advance clearances and orders dismissing applications, on the basis that circumstances have changed or fresh evidence has become available that could not reasonably have been presented to the Board at the earlier hearing.

The Board should not have the power to order continual returns of information from any person with respect to whom an order is made. It is not a monitoring or supervisory agency, and the Director would be responsible to police compliance with a Board order. For the same reasons we recommend that a similar authority existing in section 31(1) be repealed.

(3) Procedures. As a superior court of record the Board would have all the powers, rights and privileges as are vested in such courts with respect to the attendance, swearing and examination of witnesses, the production and inspection of documents, enforcement of its orders and all other matters necessary or proper for the due exercise of its jurisdiction.

The Board should be subject to the requirements of natural justice. Specifically, any person who would be directly affected by an order sought should be given adequate notice of the time and place of the hearing, the nature of the allegations made, and the authority and power of the Board to deal with the application so he can prepare his case properly. Documents and material filed with the Board should be furnished or made available to

him. He should have the right to attend the hearing with counsel, cross-examine witnesses, present oral and documentary evidence to support his own views, obtain any transcripts and present arguments or submissions to the Board. The members of the Board panel that hears the evidence should obviously be disinterested and free of bias arising from the circumstances or a personal relationship, and they should themselves make the decision after listening fairly to both, or all, sides. There should be no power to delegate hearing or decision-making functions.

The Board should prepare its own rules of practice and procedure, perhaps in consultation with the Chief Justice of the Federal Court of Canada, to be published after approval by the Governor-in-Council. It is envisaged that these rules would be fairly brief and would relate to such matters as setting times and places for hearings, notices, the interchange of preliminary informative and responsive documents clarifying the issues and positions to be taken with respect to the governing standards and criteria for the decision, preliminary applications, and so on. The rules should take due account of the need for expeditious resolution of most matters coming before the Board, and special provision should be made for the hearing of particularly urgent matters.

It is important that the Board be given full power to implement any pre-hearing procedures it feels are necessary to ensure proper and early definition of the precise issues involved in a matter coming before it, and that it be allowed to take all reasonable initiatives to minimize delays, surprise, uncertainty and expense of hearing. In matters as complex as are involved in this field, pre-hearing definition of the issues, and organization and exchange of evidence, can be fundamental requirements of efficient and fair hearings.

In view of the Board's expertise and responsibility, the right of panel members to ask any relevant questions should be ensured, as well as a right for the panel to request parties to furnish certain types of evidence in relation to certain issues.

We have concluded that with three exceptions the Director of Investigation and Research should have the sole and exclusive power to bring cases before the Board. There is a danger in concentrating this power in the hands of one person, partly because of a risk of overemphasizing one economic or other point of view, a risk of that person being influenced by extraneous political considerations, and partly also because of a risk that he may feel obliged to keep the Board busy. Further, private complainants would probably prefer to proceed directly to the Board as quickly as they wished. On the other hand, there is also a public interest in screening out frivolous complaints and preventing the use of public machinery for the primary purpose or with the primary effect of harassing others or obtaining information from one's competitors. The Director, further, would be able to prevent inundation of the Board with economically insignificant cases or questions, or with cases where an order is likely to have little or no effect. A rule of exclusive access, even if not absolute, places a particular public trust and responsibility on the Director, but we believe it to be the better of the alternatives.

The first exception would permit a person who is subject to or directly affected by an order to apply to have it rescinded or varied on the ground of a change in underlying circumstances or fresh evidence.

The second exception would permit a person who is seriously injured in his business by a practice over which the Board has jurisdiction, or where serious injury is threatened, to apply directly to

the Board where in the judgment of the Board the matter is too urgent to require that the complaint be processed through the Director's office. We should note in this connection that the Board's purpose, and the purpose of its remedies, is to make the system work better. It does not have power to make "reparations" orders, or other orders the primary purpose or effect of which is to benefit particular private claimants, although such a benefit might be involved incidentally.

The third exception to this rule would be applications for the approval of rationalization, specialization or export agreements having extra-territorial implications.

In each of these three exceptional cases notice of the application should go to the Director and to other persons directly affected, all of whom would be entitled to participate in the hearing.

Interested persons or groups should be entitled to intervene in hearings before the Board. As with the case of all persons who become party to proceedings before the Board as a result of their own direct application, however, the Board should have the power to order costs against them and to require security for costs. It should also have the power to order costs in their favour.

As indicated, the Board in our view would normally sit in panels of three when holding hearings, the exception being cases of particular importance where the panels are enlarged. Implicit in this recommendation is our belief that hearing officers sitting alone, whether or not they are members of the Board, should not be used. Nor should Board members or staff preside at any preliminary examinations of witnesses that may occur in the course of the Director's investigations. This we believe is important to the independence of the Board and to the principle that it should decide matters only on the basis of evidence presented to it at a regular

hearing. The Director's oral investigative inquiries upon oath can be conducted just as well before special examiners used for regular court purposes, with disputed matters going before the Federal Court or, in the case of a matter subject to the Board's jurisdiction, before a full time member of the Board with an appeal to the Federal Court.

The Board should hold its hearings in public except to the extent it deems it necessary to protect a legitimate business interest such as confidential information, or the public interest. Similarly, of course, documentation filed would be open (as indicated) to the public, subject to a Board order to the contrary.

The matter of the burden of proof on the various issues to be decided raises basic questions of political and economic philosophy that have justifiably concerned several of the commentators over the past few years. This report has stressed the complexity of some of the factual questions that will come before the Board and has identified the types of difficult judgments that must be made. It has also stressed a general presumption against government interference in the normal operations of the economy, which extends to mergers and other aspects of competition policy. On the other hand we recommend below, as have prior proposals, that there be no appeal from decisions on matters of fact or, with the exception of divestiture and interim prohibition orders, concerning remedies, that are made by the specialized body constituted for that purpose.

The location and quantum of the burdens of proof should be clear for general purposes of the administration of justice. Also, for general reasons including those set out above the basic burden of persuasion should be placed on the person who seeks the order. This will be the Director with the three exceptions as specified above.

It is not fair, in our view, nor can it be justified from any perspective, to condemn presumptively a wide swath of practices on the basis of a general policy and some elementary proof by the Director, leaving it up to the private parties to prove that their case comes within one or more of a long list of redeeming features. This in substance reverses the basic burden of persuasion. On the other hand, the Director cannot be expected to prove a long list of negatives. Insofar as relevant matters are peculiarly within the knowledge and capacity of private parties to demonstrate, such as the nature and measure of economies likely to result from a merger, it is reasonable to rely on those parties to furnish the evidence. This, indeed, conforms to the normal common law rule with respect to such evidence. We believe the set of principles and tests proposed in this report helps strike an acceptable overall balance with respect to the burdens of proof.

As for the quantum of the proof required we are sympathetic to the views of those who feel it should be higher than the normal civil standard, which is usually described as the "balance of probabilities". On the other hand, the types of issues with which the Board will be concerned, including economic alternatives and probabilities about the future, do not lend themselves realistically to proof "beyond a reasonable doubt" or to a conclusion that is "inconsistent with any other rational conclusion", which are the criminal quantums of proof depending on the type of evidence at hand. Nor do we believe that a requirement for "cogent" evidence or a "clear probability" would solve anything. The importance of the precise formulation of the persuasive burden can be overemphasized, and it may be assumed that regardless of the way the burden is stated in the statute the Board members will take account of the degree of seriousness of the matter to the competitive process and to the parties before it, and its complexity. We have concluded that no special burden of proof

other than the normal civil burden (as applies, incidentally, in the Restrictive Practices Court in the United Kingdom) is appropriate.

The Board should be required to issue written reasons for each decision disposing of an application. The reasons should include a statement of the relevant facts, the conclusions and the reasons for those conclusions on each significant issue, together with a description of the order, if any, that was made. These reasons should be made public unless confidential information is recited in them, in which event appropriate editing should take place before publication.

(4) Finality of Decisions. The same reasons that compel us to recommend a specialized decision-maker make it undesirable to give any other body or court the power to interfere with the content of the factual or remedial decisions made by the specialized body. This does not, however, mean that the Board, qualified primarily by its capability with reference to the subject matter, should be free from the ordinary but fundamental procedural requirements of natural justice, or that it should have exclusive jurisdiction over questions of law including the legal interpretation of the statute under which it operates. Indeed it is important that the Board be left subject to the extensive supervisory jurisdiction of the Federal Court of Canada. This is what implements the rule of law. By section 28 of the Federal Court Act the Federal Court of Appeal will have the power to review and set aside a decision or order of the Board upon the ground that it

> "(a) failed to observe a principle of natural justice or otherwise acted beyond or refused to exercise its jurisdiction;

(b) erred in law in making its decision or order, whether or not the error appears on the face of the record; or

(c) based its decision or order on an erroneous finding of fact that it made in a perverse or capricious manner or without regard for the material before it."

This provides a substantially wider scope for judicial review than existed prior to establishment of the Federal Court in 1971. Previously, the grounds were largely confined to what is now subparagraph (a) above.

In addition, and on similar grounds, the Trial Division of the Federal Court will have jurisdiction under section 18 of the Federal Court Act to issue injunctions, orders of prohibition and mandamus and declaratory orders by way of relief against the Board in situations where a decision or order has not yet been made.

In other words, the courts will have the ultimate power to decide as a matter of law what the critical words in the statute mean and to resolve any disputes about the extent of the powers and authority of the Board. They will, for example, have the power to decide whether a Board order is specific enough to bind a person to whom it relates and to set aside a decision of the Board that was based on a misinterpretation of the guiding principles.

It would, on the other hand, risk defeating the entire purpose of the specialized Board to permit the courts to substitute their views as to proper judgments concerning facts, market definition or the design of the remedy, if any. We also believe the Board should not be limited by the strict exclusionary rules of evidence and, subject

to the extensive requirements of natural justice and the laws of privileged communications, should have exclusive power over its own procedures.* It should also have a slightly enlarged power of

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* This is not to say that the Board would not have to base its findings on material before it, but only that it should have broad power to decide for itself the kinds of material that were sufficiently probative for the task at hand. Lord Justice Diplock put the matter this way in commenting on the need for the Commissioner to base his decision on "evidence", in Regina v. Deputy Industrial Inquiries Commissioner, Ex parte Moore, 1965 1 Q.B. 456 at 488:

> "... 'evidence' is not restricted to evidence which would be admissible in a court of law. For historical reasons, based on the fear that juries who might be illiterate would be incapable of differentiating between the probative values of different methods of proof, the practice of the common law courts has been to admit only what the judges then regarded as the best evidence of any disputed fact, and thereby to exclude much material which, as a matter of common sense, would assist a fact-finding tribunal to reach a correct conclusion: cf. Myers v. Director of Public Prosecutions.
>
> These technical rules of evidence, however, form no part of the rules of natural justice. The requirement that a person exercising quasi-judicial functions must base his decision on evidence means no more than it must be based upon material which tends logically to show the existence or non-existence of facts relevant to the

(Footnote continued on next page.)

judicial notice to ensure the entitlement of members to rely upon the general personal expertise that qualified them as members. To this limited extent, then, the ordinary scope for "error of law" or an improper basis for a decision within the meaning of section 28 of the Federal Court Act would be reduced.

It is easy to overemphasize supposed differences between review and appeal in the courts. On the one hand, appellate courts are generally reluctant to interfere with the findings of fact of the person who heard the evidence in the first instance. On the other hand, the Federal Court is capable of remedying perverse or unsupported findings of fact as well as errors of legal interpretation by was of review. The sole thing we wish to prevent is substitution by the regular courts of their assessment of the facts and preferences as to remedies for the findings and decisions of the Board. Even that is difficult to achieve for as Lord Diplock observed recently, rather cynically, in elaborating his view that for many types of problems the common sense judgment of fairminded

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> issue to be determined, or to show the likelihood or unlikelihood of the occurrence of some future event the occurrence of which would be relevant. It means that he must not spin a coin or consult an astrologer, but he may take into account any material which, as a matter of reason, has some probative value in the sense mentioned above. If it is capable of having any probative value, the weight to be attached to it is a matter for the person to whom Parliament has entrusted the responsibility of deciding the issue. The supervisory jurisdiction of the High Court does not entitle it to usurp this responsibility and to substitute its own view for his."

laymen using informal procedures is preferable to using the regular courts, "If the material before the reviewing court discloses that the decision under review is one which the court would have reversed if it had come up on an appeal from a lower court of law, legal reasoning is never at a loss to find a way of reversing it despite its classification as administrative."*

It should also be noted that under the authority of the Federal Court Act the Board will be entitled, at any stage of its proceedings, to refer any question of law, jurisdiction, practice or procedure to the Federal Court of Appeal for a summary hearing and determination.

With respect to findings of fact and the design of any order, which should not be subject to review or appeal before the courts except as to the degree of specificity of an order and the need for or nature of a divestiture order or an interim prohibition order, we considered the possibility of an appeal on the merits to another panel within the Board either by way of a rehearing or simply on the basis of the transcript, and only by a party against whom an order was made or only where there was a dissent in the first panel. We have concluded it would not be worthwhile. Such an internal appeal might have been appropriate had we contemplated decisions being made by subordinate hearing officers. We do not contemplate this, however, and where a matter is simply one of judgment there would be a natural reluctance on the part of a second panel to differ from the conclusion of the first panel. In any event the commitment of public resources could not be justified.

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* Foreword to Schwartz and Wade, Legal Control of Government (1972), p. xiii.

There is, however, a need for some safety valve to avoid the effects of a decision or remedy which, although within the Board's jurisdiction and properly arrived at, is nevertheless undesirable. In large part this need arises from the fact that the Board will be restricted to considering only the principles and criteria set out in the statute, which would also have been the criteria according to which the Director decided to bring the application. By limiting the scope and power of the Board and the aspect of the "public interest" it implements, and thereby permitting it to be an expert body and providing better notice to persons who appear before the Board as to the nature of the issues, a need arises for an over-riding coordination of national policies. The cabinet exercises authority now over tariff reduction and foreign mergers. There may also be cases where the mechanisms to handle short-run adjustment costs are inadequate. The responsible political authorities must, further, accommodate the complete range of public policy goals and it is conceivable that a Board decision might interfere to an unacceptable degree with objectives concerning employment, regional economic welfare, resource management, general concentration of economic power or other matters with which the Board as such ought not be concerned. The Canadian economy is not as uniformly vigourous as some other economies and there is a greater need at times to compromise between public policy objectives. Balancing the priorities from time to time between broadly conflicting objectives presents raw political questions and should be the responsibility of political authorities.

Accordingly, the Governor-in-Council should be empowered to rescind or vary any order of the Board. This power should only be exerciseable within a limited time period, such as sixty days.

This type of executive power exists in many statutes creating specialized agencies and appears to have worked satisfactorily. In practice, not surprisingly, very few appeals are in fact taken to cabinets and, of the few taken, seldom does one succeed.

The Governor-in-Council would make its decision on the basis of over-riding concerns of public policy. It is important, however, that the Governor-in-Council be required to make its decision and reasons public at the time of any decision to interfere with a Board order.

Cabinet review and judicial review take place on essentially different grounds and from different perspectives, and accordingly it should be provided that neither cabinet review nor judicial review proceedings should be prejudiced or affected by the fact that the other has or has not been sought.

Further, Board orders should take effect at the time and in the manner stated by the Board unless it is ordered otherwise in particular cases by the cabinet or the courts.

IV - 2. ENFORCEMENT

A. By the Government

The recommendations made in this report would, if implemented, result in transferring certain areas of substantive law from the criminal courts to the civil jurisdiction of the National Markets Board. Criminal remedies would, however, remain an important support for the competition laws. Types of conduct that are widely viewed as being contrary to the public interest regardless of their particular factual context, and which can be defined with reasonable specificity in advance so as to give fair warning, would be prohibited by criminal law. This would include failure to comply with Board orders which will be reviewable by the courts as to the degree of their specificity.

The subject matter on which we were asked to report did not require us to consider other criminal prohibitions that will remain in the Combines Investigation Act. Apart from section 32, of course, most of those prohibitions have been the subject of very recent attention by Parliament.

The need for a coordinated and consistent enforcement policy involving both the criminal and the civil laws should be stressed. It is important for the overall effectiveness of the substantive laws and the decisions applying them. The primary responsibility for coordination lies upon the Director of Investigation and Research. He performs that responsibility by setting priorities from time to time in consultation with his research and policy personnel and, in the future, by his decisions to pursue criminal or civil remedies in particular cases before the courts or the Board (or Commission), as the case may be.

The program of compliance, which we have urged above be used cautiously and with restraint, illustrates the nature and benefits of centralized and coordinated enforcement.

In 1946, the Minister of Justice succeeded the Minister of Labour as the minister responsible for the administration of the Combines Investigation Act. In 1966, the Minister of Justice was in turn replaced in this responsibility by the Registrar General and 1968, the new Ministry of Consumer and Corporate Affairs succeeded to the role. The Director of Investigation and Research, who is an officer under the Act in that department with special statutory law enforcement responsibilities, is not empowered to institute criminal prosecutions despite his control over the investigations and his assessments made with the assistance of his legal, economic and commercial advisors. By section 15 that power remains with the Attorney General of Canada:

> "s.15(1). The Director may, at any stage of an inquiry, and in addition to or in lieu of continuing the inquiry, remit any records, returns or evidence to the Attorney General of Canada for consideration as to whether an offence has been or is about to be committed against this Act, and for such action as the Attorney General of Canada may be pleased to take.
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> (2) The Attorney General of Canada may institute and conduct any prosecution or other proceedings under this Act, and for such purposes he may exercise all the powers and functions conferred by the Criminal Code on the attorney general of a province."

The Attorney General of Canada has the power to appoint and select any counsel required to assist him in this task, and by section 13 he also has the power to appoint and instruct such counsel as may be required to assist in inquiries.

We considered whether it would be desirable to authorize the Director to perform the critical functions of instituting criminal prosecutions and selecting and instructing counsel himself. Certainly his office has an intimate knowledge of the facts and evidence in each case, which are frequently voluminous and complex, as well as a thorough knowledge of the jurisprudence, which is necessary to perform the statutory responsibilities. The Director only submits a case to the Attorney General after concluding that an offence has been disclosed by the evidence. Further, the length of time required to investigate and consider a case properly is frequently very extensive and further delays while the Attorney General's office duplicates the consideration of the evidence might seem difficult to justify, quite apart from the potential for frustration and damage to morale if conservative judgments are made in an area of the law the Director has concluded should be tested or clarified in the courts for the general benefit of his enforcement program and the deployment of resources. In short, untimely or overly conservative decisions by the Attorney General can interfere with effective policy implementation.

It should be noted that the decision to prosecute now, after the 1975 amendments, has considerable significance to companies and individuals who have been damaged by conduct prohibited under the Act and who may wish to sue to recover their losses.

The decision whether or not to institute a prosecution is also important to potential accused persons and defendants, however, and on balance we are of the view that the Attorney-General should retain the exclusive federal authority to institute criminal prosecutions. Even if the Director were authorized to institute criminal proceedings the Attorney-General would presumably retain the authority to take over, stay or withdraw the prosecution but, unlike civil proceedings before the

National Markets Board, criminal prosecution has a unique social significance that probably alone justifies leaving the decision to prosecute where it has traditionally resided. The Attorney-General historically exercises a broad discretion in deciding whether or not a prosecution is, overall, in the public interest and, if it is, the form the prosecution should take. Although decisions as to the sufficiency of evidence face the ultimate discipline of the courts regardless of whether the Director or the Attorney-General makes the decisions to prosecute, criminal prosecution itself is so serious that an independent check on the single-minded enthusiasm of the investigators and policy makers might on rare occasion be a useful safeguard. Departure from this traditional protection cannot in our view be justified by periodic shortcomings in interdepartmental cooperation or understanding.

One of the consequences of doing away with the opportunity for a Commission (or Board) hearing between the Director's investigation and the decision by the Attorney-General is that nothing specific about the investigation is made public if the Attorney-General, for whatever reason, decides not to prosecute. However, there seems to be no legal reason why the Director could not, particularly if he felt frustrated by delay or an unwise decision on the part of the Attorney-General of Canada, remit a copy of the evidence to a provincial attorney general.

An additional possibility is that the Director, in cases where he recommends prosecution, might be required to make available for public inspection the statement of evidence he has submitted to the Attorney-General regardless of whether or not a decision is made to prosecute. Much can be said in favour of such a proposal. Private litigants would have the benefit of much of the investigation and evidence anyway under the existing legislation if the Director referred the

matter first to the Restrictive Trade Practices Commission, the report of which would normally be published. It would also be a useful assist to private claimants, who will sometimes face prohibitive burdens of investigation in order to decide whether to institute an action for damages even without the benefit of the prospective defendant having been previously convicted.

We do not recommend the above possibility, however, because in our view it would not be desirable to use documents obtained from one party in confidence or by means of compulsory search powers (which are considerably more wide ranging than civil discovery procedures) for the purposes of private civil actions. When considered with the possibility of an increased number of inquiries resulting from "six person complaints", made in conjunction with plans to sue civilly, there is some risk of improper or overly zealous use of the procedure. It may be that more detailed consideration of this question than we have been able to devote to it will produce satisfactory safeguards, and the issue may be affected by whether or not a public official or governmental body is permitted to sue for damages on behalf of one or more persons or the public generally, but on the basis of our consideration we are not prepared to recommend it.

The need to allocate ultimate enforcement authority between the Departments of Consumer and Corporate Affairs and Justice does not affect the obvious need and desirability for close cooperation between the two departments in applying the Combines Investigation Act. The public is as much entitled to interdepartmental cooperation and understanding as it is to the protection of having the Attorney-General exercise the exclusive federal authority to institute prosecution and conduct appeals. Selection of counsel, for example, frequently requires consultation. Many combines cases are very complex and require an understanding of the economic context of both the laws and the facts

for effective presentation by counsel. Background and experience with the subject matter are more necessary here than in some other areas of law and the Director is likely to be aware of persons with the best qualifications for particular assignments. Hopefully, over time, these persons will increasingly be found within one of the two departments. (Such a development might, for example, be hastened to the extent that the Director is able to utilize departmental lawyers for those cases he takes before the Board that require lawyers rather than experienced lay personnel for their presentation.)

When the Director conducts an inquiry and uses his compulsory investigative powers he may not know, although he would usually have a good idea, whether any proceedings instituted as a result would be criminal or civil. The availability of the extraordinary compulsory investigative powers is justified for both types of proceedings but the powers also create a special obligation to disclose to the accused or the parties as the case may be, in advance of the hearing, as much detail of the case against them as can reasonably be provided. This special obligation is in addition to the need for pre-hearing discovery that results from the sheer volume and complexity of the evidence in many combines cases.

It is perhaps trite to emphasize that regardless of whether proceedings are taken in the criminal courts or before the Board the public has no interest in secrecy or surprise, any more than it does in a biased selection or presentation of the evidence. The public representative in the hearings has a broader responsibility than private parties, who understandably assume an adversarial role. Comprehensive criminal discovery procedures of general application are being studied, but we believe that in any event in all combines proceedings the government should as a matter of regular practice offer to opposing parties in advance of the hearing comprehensive disclosure of

its proposed evidence, including a narrative of the relevant facts, the identity and any statements or outlines of the evidence of proposed witnesses, expert and otherwise, copies of all documents proposed to be relied upon, and a statement of positions to be taken on matters such as market definition, the nature of the public harm involved and, on a tentative basis, remedies.

Nor is pre-hearing discovery a one-sided question. Disclosure by the defendant of the nature or theory of his defence, his expert evidence and documents, as well as making all reasonable admissions of fact, is equally important to defining the issues in advance of the hearing so the hearing can proceed with dispatch and with a minimum of surprise in coming to grips with the real issues. In general the Federal Court Rules constitute an excellent model for pre-hearing disclosure, the underlying principles of which are equally applicable in criminal and civil proceedings.

B. By Private Persons

The Combines Investigation Act can be invoked in two basic ways in private litigation - it can be relied upon by a plaintiff as part of his cause of action, or it can be relied upon by a defendant as part of a defence. In other words, it can be used either as a sword or as a shield.

Prior consideration of the appropriate scope or function for private causes of action based upon breaches of the Combines Investigation Act has resulted recently in the addition of section 31.1 to the Act to supplement causes of action existing in the common law of tort and by virtue of section 7 of the Trade Marks Act to cover certain types of competitive excesses. Also, class actions are receiving separate study at the Minister's request. Accordingly, we did not give detailed consideration to causes of action based on breaches of the Act.

Private actions are an integral part of the total law enforcement apparatus, however, and for that reason we do have some comments on the subject as a whole. We make only one specific recommendation for legislative change, relating to the use of the Act by way of defence to a civil action.

Use of the Act as a Sword

Private actions based on injury resulting from anti-competitive conduct have been encouraged from time to time in order to provide for compensation to injured persons and to prevent the unjust enrichment of persons who breach the law. They are also advocated as a method of inducing compliance with the law by strengthening the deterrence element and by providing a check against deficiencies in the government enforcement program.

Many believe, further, that these various objectives will not be adequately achieved, and a perceived imbalance between the power of big business and that of the rest of society will not be rectified, unless private actions are specifically encouraged and facilitated by one or more special techniques established by legislation. The special techniques that have been most widely considered in the context of competition law have been to provide for multiple damages, new class action procedures and incentives to use them, and litigation assistance in one form or another from statutory agencies, public officials and public enforcement activities. Several such techniques have indeed been adopted in the United States and to a lesser extent in other countries and by some provinces in Canada. Many of the techniques are still in experimental stages and few clear lessons or results have yet emerged from the experience with them.

Persons injured or threatened by anticompetitive conduct should have available to them the usual legal means to obtain redress or protection,

and special techniques for encouraging or facilitating private suits might well be appropriate for some situations. Indeed, they might have an important role to play in making the competition laws fully effective. It is vital, however, that any assessment of the desirability of these techniques take into account the larger social and economic perspective.

Assessing the desirability of various methods of facilitating or encouraging private enforcement is a complex task. Comparisons with other jurisdictions are less rewarding than appear on the surface, due in part to the fact that private enforcement is only part of the total law enforcement package. For example, as in the case of section 31.1 of the Combines Investigation Act private actions based on breach of competition laws are usually related to criminal offences having occurred. This requires that account be taken of certain aspects of criminal law enforcement. What is the scope and effect of criminal law enforcement and alternative remedies in the other jurisdictions? To what extent might criminal law have been relied upon in Canada primarily for constitutional law reasons rather than because criminal remedies were ideal? What is the nature of the combines offence, including the degree of specificity with which it is defined and the type of intent required for the offence? How do changing vigour of the criminal enforcement effort, changes in sentencing criteria and in the severity of penalties, and current developments towards new mechanisms for restitution and compensation within the criminal law generally, affect the question? No single enforcement mechanism can be assessed in complete isolation from the others.

The procedures and functions of private civil actions in this field obviously reflect many of the general complexities of competition policy and law. Care must be taken that they not be structured on

the basis of oversimplified notions of pricing processes, the working of markets and the application of business revenues, lest some enormously difficult questions calling for quite arbitrary judgments be imposed upon the courts.

Class actions or other forms of collective proceedings to remedy private claims illustrate some of the policy difficulties involved in considering special rules or techniques for this field of civil litigation. As a procedure for permitting virtually identical claims to be litigated together class actions streamline litigation and are desirable for the efficiency they provide. By spreading litigation costs over a large number of claimants, class actions make it economically feasible to assert smaller claims. Acute questions of public policy arise, however, where collective proceedings for individually de minimis claims are involved because of the special temptation to introduce unique rules of procedure that create special incentives to settle litigation for reasons other than the merits and thereby have the practical effect of rules of substance. Matters of notice, proving and quantifying damages, and costs, are especially vexing. Difficult judgments will have to be made, if any new class action rules are to be adopted, in order to be fair and realistic so far as claimants are concerned without at the same time being oppressive from the defendant's point of view. It will also be important to be absolutely clear about the supporting policy objective and to decide how far notions of unjust enrichment or deterrence are worthwhile as the primary bases for private actions. Deterrence, of course, is one of the basic purposes of criminal law enforcement and not only is the criminal law process probably the most efficient means of achieving deterrence, but the possibility of increased civil liability could have an unsettling effect upon criminal sentencing, let alone upon the basic principles of criminal liability.

The potential burdens of some of the litigation-assisting techniques referred to above create in themselves added incentives to settle claims regardless of the merits, and therefore an increased potential for misuse. Some of this is inherent in any litigation, but it is an inevitable evil that should be minimized. Care should be taken that it not become a tool of public policy.

One general concern we have, which we believe is shared at least by the business community, relates to the intimidating rate at which complicated new laws are being enacted. Obviously this by itself should not stand in the way of new requirements being imposed on industry where the matter has been thoroughly considered and new rules are clearly desirable, but there is a point beyond which costly and cumbersome procedures specially designed to protect purchasers, sometimes as much from themselves as from others, are not on balance worth the price. After all, the system assumes and, more importantly, relies upon purchasers being basically intelligent and discriminating in their decisions. The government should be cautious about acting, out of understandable sympathy for the few who are not, to play the nursemaid to consumers generally by providing more than the usual criminal and civil means of redress. We should be very clear about the justification before we impose additional burdens on the business community, especially at a time when it is being urged to become more enterprising and more productive in order to make Canadian industry more competitive in international markets. Also, as a more general matter, we should be careful that by a series of small steps over time we do not de-emphasize the need for consumer self-reliance.

We repeat that we make no specific recommendations on this subject. Class actions, indeed, appear to have little potential in the areas of substantive law with which we are primarily concerned in this report. We do, however, emphasize

that policy decisions in this area, as with all other aspects of competition policy, must be made in the light of comprehensive and long-run criteria, and that short-run immediate interests should not blind policy makers to the ultimate objective of making markets work more effectively.

Use of the Act as a Shield

The applicability of the Combines Investigation Act in actions to enforce restraint of trade covenants, or in connection with industrial property rights where issues of competition policy are raised, has been unclear. Section 39, enacted in 1952 within Part V of the Act which defines the substantive offences, provided that: "Nothing in this Part shall be construed to deprive any person of any civil right of action." The section was amended in 1975 by adding to the beginning of the section the words: "Except as otherwise provided in this Part". Neither the original section nor the amendment is clear in its meaning and effect. Section 31.1, also added by the 1975 amendments, ensures a limited right to sue for damages and to that extent overcomes past judicial decisions that were to the effect that commission of an offence under Part V does not, without more, give rise to a civil cause of action even where private damage resulted from the conduct. Section 31.1, however, is not situated in Part V and its limitations cannot therefore be exceptions to which the amended section 39 refers.

The parliamentary debates at the time of the enactment and amendment of section 39 shed no light on what Parliament intended the effect of the section to be. Many believe it was intended to ensure against the courts adopting the view that by providing criminal remedies Parliament meant to preclude any civil remedies that might have existed on the basis of the same facts as constituted an offence, such as for the tort of conspiracy. It is also possible to argue however, that the section

precludes a defence of illegality or public policy, that otherwise might be raised in an action brought to enforce an agreement or other claim forming an essential part or arising out of a situation constituting an offence, particularly where other remedies are available elsewhere under the Act.

This latter effect would be undesirable in our view, regardless of the existence of other remedies under the Combines Investigation Act or any other statute. We recommend that section 39 be amended, not only to clarify that nothing in the Act should be construed to deprive a person of any civil cause of action or defence based on an allegation that certain acts contravened the requirements of the Act, but also to provide that no action shall be based on a contractual provision or be brought in furtherance of a plan or scheme that contravenes a requirement of Part V of the Act or an order of the Board.

The further question arises as to whether the courts, in determining whether or not contractual provisions are enforceable and in particular whether they are unreasonable with reference to the interests of the public, should be required to go beyond matters of criminal prohibition and in effect to exercise the jurisdiction of the National Markets Board. Should defendants be permitted to counterclaim for the types of orders the Board can make, including the grant of a licence of industrial property rights? Utilization of private litigation in this manner to enforce the purposes and principles of the Combines Investigation Act is tempting, but we have decided not to recommend it. The Board has been proposed in this report on the basis of its special capability to assess complex market phenomena against standards that cannot realistically be formulated in very specific terms. Access to the Board has been largely restricted to the Director of Investigation and Research. We are

also concerned about bogging down private litigation by permitting general probes or fishing expeditions into a plaintiff's general commercial activities, quite apart from the effect this might have if the plaintiff were a small enterprise suing a large competitor as might be the case in an industrial property infringement action. Broad matters of competition policy and the operation of the market are not of primary relevance as between the parties, and the general situation might have changed after the time a defendant committed himself by contract.

We also note that courts are not dependent upon the parties to raise a matter of public policy before they can consider it in reaching a decision.*

Another possibility, that we have also decided not to recommend, is that the National Markets Board have jurisdiction, on application by the Director, to declare particular covenants in restraint of trade to be unenforceable where they

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* See Trudel v. Clairol Inc. of Canada (1974), 54 D.L.R. (3d) 399 (S.C.C.). The rule applied by the courts to determine the question of enforceability of covenants in restraint of trade exists quite independently of the Combines Investigation Act. It is that covenants restraining a person's right to trade are prima facie void as being contrary to public policy. They will only be enforced if they can be shown to be reasonable with reference to the interests of the parties and also reasonable, or not injurious, with reference to the interests of the public. See Stephens v. Gulf Oil Canada Ltd. et al. (1974), 3 O.R. (2d) 241 (Ontario High Court), reversed by the Ontario Court of Appeal on December 4, 1975.

limit entry or expansion unreasonably with reference to the interest of the public. The effects of these covenants can be of more than merely local interest, and such a proposal has the attraction of subjecting the question to more or less consistent evaluation much in the way that the 1975 amendments provided for the review of exclusive dealing, tying and market restriction arrangements. The courts currently exercise jurisdiction over the matter, however, and there is insufficient justification for substituting a new and more complicated system of rules and decision making. We also note that an undue lessening of competition by such a means probably falls within the scope of section 32.

The other primary area of concern with respect to defences to private actions relates to actions alleging infringement of industrial property rights. Restraints of trade in licence agreements or assignments frequently take one or more of the forms referred to above in this report and we say nothing further about them. Two other matters we have considered are threats to a person that an infringement action will be instituted against him, and the doctrine of licensee estoppel.

An infringement action is recognized as an almost uniquely serious form of commercial litigation. In addition to the complexity, length and cost of the legal proceedings, a defendant frequently faces a risk of substantial damages and sometimes a risk of losing his very right to continue in his business. Also, his customers may be placed in positions of uncertainty, leading them in turn to make changes or adjustments to their trading relationships. As Lord Justice Bowen observed, a threat of a patent infringement action "is about as disagreeable a thing as can happen to a man in business, and is the thing most calculated to paralyze a man in his business, even if he be

innocent of any infringement of patent law".* Clearly threats of this nature can have a predatory or monopolistic purpose or effect. However, the owners of industrial property rights must remain entitled to assert their rights as they understand them to be. This is why the concern has focussed on unjustified threats. Causes of action exist both by common law and under section 7 of the Trade Marks Act against a person who causes damage by publicizing threats based on an invalid or non-existent right. The common law action also requires malice, although for the statutory cause of action malice is only relevant to the assessment of damages.

In view of the jurisdiction exercised by the courts over unjustified threats of infringement actions we do not believe further safeguards are required.**

The doctrine of licensee estoppel is a principle of contract law that prevents a licensee from contesting the validity of an industrial property right which is a subject of the licence. If a "no-contest" clause is not an express term of the

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* Skinner & Co. v. Shew & Co., [1893] 1 Ch. 413 at 424 (Court of Appeal).

** The existence of the common law tort of abuse of legal process should also be noted. This cause of action is quite limited but it applies where actions or other legal proceedings are instituted for an improper purpose. It does not require published threats as an element of the cause of action.

Any decision to adopt a criminal prohibition of predatory conduct in the Combines Investigation Act, which would also give rise to civil consequences, would further affect this matter.

licence contract, a covenant not to contest the validity of the right during the life of the licence will be implied unless it is excluded expressly or by implication. The scope and effect of express covenants not to contest validity depend on the precise language used. Sometimes the "no-contest" provision extends to other rights, not subject to the licence, that are claimed by the licensor and sometimes it also extends beyond the duration of the right that is licensed.

Questions of licensee estoppel seem to arise primarily in connection with patent licences. We have not made a thorough study of the doctrine of licensee estoppel or of the implications or mechanics of changing or doing away with it, and we recommend that the matter be left to the patent law revision programme currently underway in the Department. Serious questions of public policy are raised by the doctrine, however. Why should any person affected not be entitled to challenge at any time on any ground the validity of a claim of an exclusionary commercial right? How can the restraint on competition be justified if the right that is claimed is not valid? Why should a licensee be in a worse position than his "infringing" competitors? In the words of the United States Supreme Court a few years ago when it very severely curtailed the doctrine of licensee estoppel in that country:

> "Surely the equities of the licensor do not weigh very heavily when they are balanced against the important public interest in permitting full and free competition in the use of ideas which are in reality a part of the public domain."*

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* Lear, Incorporated v. Adkins, 89 S. Ct. 1902 at 1911 (1969).

It may be that a public interest in facilitating licensing and in guarding against persons profiting from related know-how, and indeed from a continuing licence, at the same time as they attack the very basis of their receiving them, means that any prohibition of the doctrine should be qualified, but these are matters of general application to all industrial property rights that should be resolved in the context of the revision of the industrial property laws. The question may be affected by the adequacy of other avenues that are made available for challenging industrial property rights or limiting their effect.

IV - 3. ADVANCE CLEARANCE

We have outlined the reasons why a considerable degree of uncertainty must be tolerated in the general statutory standards and criteria. It is nevertheless possible to reduce the inconvenience of this uncertainty by enabling businessmen to obtain early and authoritative evaluation of their plans if they wish it, and we recommend that an advance clearance procedure be established for proposed mergers and rationalization arrangements. Clearance of a merger would insulate the firms involved from any further proceedings before the Board challenging the merger. In the case of a rationalization arrangement, clearance would be available to clarify the status of the arrangement.

We considered the desirability of making such an advance clearance procedure available for all practices subject to the Board's jurisdiction but concluded this would not be desirable from the point of view either of the public or of the business community. It is fundamentally important that businessmen not be encouraged or induced, in effect, to negotiate their plans with the Director's office or with the Board, nor should they fear suffering any adverse consequences later for not having done so. No one really knows how some plans will work out in practice or what competitive effect they may or may not have until they are put into operation and adjusted to fit the circumstances. Policies that are acceptable today may not be acceptable in the changed conditions of tomorrow.

Similar considerations apply with respect to the criminal prohibitions. The Director's statutory law enforcement powers are extensive, commensurate with his responsibilities, and he inevitably becomes involved, with respect to the more nebulous areas of the law, in advising the interested public of his general views as to the

requirements of the law from time to time as they affect his enforcement policy, and also in considering particular business plans submitted to him in advance for his comments. After considering such plans as submitted, the Director advises the person or persons who submitted the plans whether or not, on the basis of the information submitted to him, he would feel obliged by the statute to commence an inquiry if the proposals were implemented. This open door policy, informally known as the "program of compliance", is of course purely optional and in concept draws a reasonable balance between the interest in assisting those who are not familiar with the complexities of the law to understand it, and thereby to avoid needless ambush and also needless inhibition, on the one hand, and on the other hand in avoiding bureaucratic negotiation of plans with the businessman.

For these reasons it would not be desirable to formalize the program of compliance by giving the Director powers to grant legally effective clearance. If businessmen wish to discuss their plans with the Director they should of course be free to do so but, not only should they not be induced to do so, they should not expect to be relieved of the responsibility of conducting their affairs at all times in a manner consistent with the stated objectives and requirements of the law. Apart from these fundamentally undesirable effects of formalizing the program of compliance it would not be desirable to have practices insulated from remedy for any period of time, let alone permanently, as a result of private bureaucratic consultation based on refinements of policy not examined or sanctioned by the public, on sometimes sketchy information, or on tentative preliminary views.

Further, of course, advice by the Director given as part of the program of compliance should not insulate persons from a civil action in which it is alleged that the proposal, when implemented, constituted a criminal offence.

The giving of advice in this area, and particularly with respect to various schemes to sail close to the winds of illegality, was commented upon perceptively by Louis D. Brandeis (later a Justice of the United States Supreme Court). Brandeis had been asked by the president of a large company to advise on how closely the company could cooperate with its competitors without running afoul of the Sherman Act, and he replied as follows: "If you ask me how near you can walk to the edge of a precipice without going over, I can't tell you, for you may walk on the edge, and all of a sudden you may step on a smooth stone, or strike against a little bit of root sticking out, and you may go over that precipice. But if you ask me, how near you can go to the precipice and still be safe, I can tell you, and I can guarantee that whatever mishap comes to you, you will not fall over that precipice." The advice, of course, was to stay as far away from the precipice as possible. As Brandeis said, "You must not expect from the Sherman law any more than you do from any other law you are dealing with. You must not expect that you can go to the verge of that law without running any risks." (This is precisely why the Director must be careful to avoid establishing rigid, detailed enforcement guidelines. Apart from the absence of public approval, they would destroy the flexibility sought by statute. It is also why the Director's views expressed in the program of compliance must be so carefully hedged that they sometimes provide no real guidance.)

In general, we view the program of compliance as a necessary evil rather than a virtue, and we hope and expect that a shift of jurisdiction to the Board from the criminal courts will decrease the need for the program. It should not be a pillar of enforcement policy. From the Director's point of view we would hope he would bring strategic cases at an early opportunity before the Board or the courts, as the case may be, to resolve recurring ambiguities, where amendment of the

statute is not called for, and thus to assist businessmen and their advisors to draw their own conclusions as to what is and is not permissible.

Mergers and rationalization arrangements, however, are different with respect to the question of an authoritative advance clearance. Each one is a non-recurring transaction or set of transactions that frequently involves substantial reorganization of assets, contractual relations and methods so that undoing it, to the extent it can be undone at all, involves waste and detriment. Also, if a merger is approved the entity remains subject to the laws relating to the misuse of market power and remedies can be applied with respect to misuses that may occur. Controls on misuse of market power are not an adequate alternative to a merger that looks bad from the start, but they do provide some protection.

We envisage the normal evaluation process taking place with the same burdens of proof, but a process that is triggered by the firm or firms involved and that takes place within time limits set by law. Time limits are needed for those cases where the parties prefer to delay full implementation of their plans pending a decision. The time limits suggested below appear to us to be reasonable and workable.

A written application for advance clearance would be made to the Director by the firm or firms involved. The Director would have 30 days from receipt of the application to decide whether or not to hold an inquiry. During that period he might, subject to requirements of confidentiality, wish to consult other government agencies such as the Departments of Finance or Industry, Trade and Commerce or personnel in more specialized functions such as regulatory boards. He might also request additional information in writing for the purpose of making his decision. The proposal would be deemed to be approved at the expiry of the 30 day

period unless within that time the Director communicated to the applicant his intention to hold an inquiry, or else referred the matter directly to the Board for disapproval or for terms and conditions to qualify an approval.

If the Director proceeded with a formal inquiry he would have a further period of 60 days, which could be extended by order of the Board on application by the Director in extraordinary cases or in situations where there was an undue or unavoidable delay in supplying information reasonably requested and required by the Director. At the end of the 60 days, or any further period as within that time was authorized by the Board, the proposal would be deemed to be approved unless the Director had referred the matter to the Board for disapproval or for terms and conditions to be imposed.

The Board would be required to hear and decide advance clearance matters on an expedited basis, although in setting a hearing date it would presumably take into account any additional time required by the parties to prepare evidence and submissions.

The interest in confidentiality (and there could be a very important need for it in some merger applications) need not interfere with the need for a verifiable record arising from this process. Clearance would be a binding safeguard against future proceedings before the Board with respect to a merger only if there were no significant omissions of information from the original application or in meeting requests by the Director for further information. We recommend that where a merger is deemed to be approved by virtue of the Director neither deciding to hold an inquiry nor referring the proposal to the Board, the Director would then file in confidence with the Board a copy of all information supplied to him by the applicant in connection with the proposal. If, on the other hand, the Director proceeded with the matter

nothing would be made public until a brief period after it had been referred to the Board, such as would permit the applicant an opportunity to withdraw, in which event the only publication would be an anonymous account of the proposal such as the Director might find desirable for the purpose of his annual report. The applicant should also have the opportunity to apply to the Board for an *in camera* hearing which should be permitted if sound reasons for confidentiality exist.

The advance clearance procedure proposed above also lends itself well to the proper evaluation of mergers proposed under the Foreign Investment Review Act, section 2(2) (a), (c), (d) and (e) of which raise issues of concern to competition policy. Currently the Director's power of investigation may be limited both by an arrangement with the Foreign Investment Review Agency that prevents him from using FIRA information by itself to initiate an inquiry, and also because by statute he cannot hold a formal inquiry unless he has reason to believe that an offence against the merger law is about to be committed. This latter requires him to assume that Cabinet will approve the proposed merger as one which is or is likely to be of significant benefit to Canada, because otherwise the merger would not take place at all. A good measure of cooperation exists between the Foreign Investment Review Agency and the Bureau of Competition Policy but the respective statutory constraints, which are largely time constraints so far as the Agency is concerned, tend to frustrate meaningful evaluation of competitive issues. A further difficulty is the uncertain effect of cabinet approval under the Foreign Investment Review Act upon a prosecution under section 33 of the Combines Investigation Act, despite section 5(3) of the Foreign Investment Review Act.

It makes sense that the special machinery, processes and expertise used in administering the Combines Investigation Act should also be utilized

in assessing foreign merger applications to the extent that the issues are those that also arise under the Combines Investigation Act. It would also ensure that comparable standards of evaluation are applied to foreign and domestic mergers.

The basic difficulty in harmonizing the procedures under the two statutes stems from the fact that for all intents and purposes under the Foreign Investment Review Act a merger cannot take place unless and until specific approval is given. This results in special time pressures. The time limits we have proposed for the advance clearance procedure under the Combines Investigation Act are, however, the minimums that we believe are necessary to ensure responsible assessment of the issues. Obviously in both cases it is important that the persons making the assessment move as promptly as they can, but something more than that type of exhortation is required.

There appear to be four alternatives. First, the Director could do the best he can within the existing FIRA deadlines. Second, applications under the Foreign Investment Review Act could be withheld from cabinet until such time as the normal advance clearance evaluation under the Combines Investigation Act was completed. Third, the existing time limits under the Foreign Investment Review Act could apply but cabinet approval could be subject to being reversed in view of the results of the assessment under the Combines Investigation Act. Or, fourth, the existing FIRA time limits could apply subject to a right of the cabinet to defer its decision in a particular case until the normal advance clearance evaluation under the Combines Investigation Act were completed and a report to cabinet filed.

It is reasonable to anticipate that most mergers would be unobjectionable from the point of view of the combines authorities and that only the more difficult cases will give rise to time pressures.

We recommend that the second of the above alternatives be adopted, namely, that the matter not proceed to cabinet until the evaluation under the Combines Investigation Act is completed. In part this choice follows from our view that as a matter of law a cabinet decision approving a merger application under the Foreign Investment Review Act should insulate the persons involved from further merger proceedings under the Combines Investigation Act. Unless the cabinet decision were delayed some foreign mergers would not be evaluated with the degree of thoroughness with which domestic mergers were evaluated, and disparate treatment would not be desirable.

Our second preference would be for the fourth alternative set out above.

We further recommend that the evaluation under the Combines Investigation Act be limited to the question of whether a proposed merger should be prohibited according to the tests for mergers set out in the Combines Investigation Act. Even if the Director's or the Board's recommendation is that the merger not be prohibited, the assessment of "significant benefit" by the economic criteria set out in the Foreign Investment Review Act should be left to the Foreign Investment Review Agency.

Appropriate amendments to the Foreign Investment Review Act would be required if the above recommendations are accepted. We suggest, however, that the principle of confidentiality existing under the Foreign Investment Review Act be preserved and that hearings and reports of the Board on FIRA applications be kept confidential. We do not believe the same special rule can be justified as a general matter in the case of advance clearances voluntarily sought by the parties for mergers not subject to the Foreign Investment Review Act.

"Phase II" of the implementation of the Foreign Investment Review Act, relating to the establishment of new businesses in Canada by non-eligible persons or the expansion of established businesses into "unrelated" fields, occurred on October 15, 1975. Unlike the case of mergers, these types of new investment will almost invariably constitute a form of entry to be encouraged from the perspective of the policies recommended in this report. It is difficult to conceive of any such investment having an adverse effect so far as those policies are concerned, although the question posed by the Foreign Investment Review Act goes beyond probable adverse effects to ask whether "significant benefit" is or is likely to result. The combines authorities, as we perceive their function, would have no interest in prohibiting or in any way directing this type of investment, or in seeking undertakings with respect to it. In fact the entire economic aspect of Phase II of the Foreign Investment Review Act seems alien to the policies and concepts advanced in this report, and we recommend that the combines authorities have no function or responsibility in the application of Phase II.

IV - 4. THE RESEARCH FUNCTION

The combines administration - in the sense of the Director of Investigation and Research and the Restrictive Trade Practices Commission - has had since the 1952 revision of the legislation the responsibility to develop a program of research into monopolistic conditions in the Canadian economy. In the words of the legislation:

> 47.(1) The Director
>
> (a) upon his own initiative may, and upon direction from the Minister or at the instance of the Commission shall, carry out an inquiry concerning the existence and effect of conditions or practices relating to any product that may be the subject of trade or commerce and which conditions or practices are related to monopolistic situations or restraint of trade, and
>
> (b) upon direction from the Minister shall carry out a general inquiry into any matter that the Minister certifies in the direction to be related to the policy and objectives of this Act,
>
> and for the purposes of this Act, any such inquiry shall be deemed to be an inquiry under section 8.
>
> (2) It is the duty of the Commission to consider any evidence or material brought before it under subsection (1) together with such further evidence or material as the Commission considers advisable and to report thereon in writing to the Minister....

The recommendations of the MacQuarrie Committee on which this section was based envisaged a very ambitious program of research ranging from industry studies through the entire range of topics involved in the area of industrial organization and public policy.* In the quarter-century since the program was initiated its accomplishments have, not surprisingly, fallen somewhat short of these splendid objectives.

In part, this limited success can be attributed to the inherent complexity of research in this area: the theoretical concepts are in a state of flux; operational criteria provide a poor fit for the theoretical issues; data, even when they may be considered to be relevant, are often very difficult, or very costly, to obtain; long-run, dynamic issues which are basic to policy considerations present particularly intractable problems for research inquiries, and so on. Nevertheless, in view of the resources devoted to research by the combines administration, particularly in the latter half of the period under consideration, something more might have been expected than has been achieved.

Apart from the complexity of the issues in the field of restrictive practices and industrial organization as a restraint on effective performance, the record of policy research in government agencies and other large organizations suggests that there may be other factors that have an inhibiting effect. The very attempt to "organize" such research may contribute to the pursuit of predetermined goals. A former head of the National Research Council has observed that the ideal research team is a professor and two or three

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* See Report of the Committee to Study Combines Legislation and Interim Report on Resale Price Maintenance (Ottawa, 1952), pp. 43-4.

graduate students. Such a unit will possess flexibility and freedom from the need to specify its objectives in precise and detailed terms; it will also be able to avoid the time-consuming process of writing progress reports and reports explaining why it decided to drop unpromising lines of investigation and to take up others.* Much of so-called research by organized groups turns out to be little more than the compilation and routine processing of more or less useful economic (and other) data.

Penetrating and original work is also made more difficult by an almost inevitable tendency for government research groups, especially in rather controversial policy areas, to adopt accepted and safe topics for exploration rather than probing more sensitive and fruitful issues. For example, the failure of a government agency to investigate the contribution that higher taxes - federal, provincial and municipal - have made to higher prices is difficult to understand except in terms of some such aversion. Research programs relating to the effectiveness with which the parent department is carrying out its purposes are also generally likely to receive little encouragement.

Such considerations raise serious questions about the nature and extent of the research program which the combines administration should undertake.

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* Dr. E.W.R. Steacie, in further emphasizing the role of the individual, remarked, "There is a popular view that team-work is the modern way to do research, and that the day of individual accomplishment is past. I don't believe a word of it. A team has never had an idea, and never will. What it will do is to drive relentlessly on towards the obvious conclusion." "The Process of Technological Change", Management Conference, Queen's University, June 16, 1959.

The indispensable attribute which should characterize the staff and the program is that of superior quality. Only research of superior quality is worth doing at all; routine performance tends to be cumulative in its effect, both on the calibre of the staff that can be recruited and retained, and on its morale. A small staff marked by intellectual excellence and ability to produce respected studies should be the aim rather than a larger group with general "service" responsibilities in the Bureau.

This raises a question to which the Director should, we believe, give serious consideration, that is, whether it would not be useful to draw a distinction between the role of the research group and that of an economic analysis section which would serve to assist the work of the Bureau in its enforcement activities and other continuing responsibilities.

A small research group which would undertake independent studies, as well as joint studies with university staff members, with experts in the private sector and officials in other federal departments, provincial governments and international agencies, would have much to recommend it. Advantages of flexibility, access to a wider range of experience and competence, hopefully lower costs, and higher morale resulting from interaction with productive outsiders, would appear to be achieveable. There would also be an important gain in promoting wider understanding of the functioning of the legislation, and a greater awareness of the complexity of the government-private sector interrelationships through such joint undertakings.

A word should be added about the importance of extending research into the legal field. Policy in the area of industrial organization and economic change inevitably involves, as Professor John R. Commons has so brilliantly demonstrated, complex

economic-legal considerations. These "two solitudes", often characterized by a rather deep mutual misunderstanding, have been the source of a significant degree of confusion in appraising the more complex areas of combines policy. For example, the application of criteria which are relevant for the appraisal of conspiracy cases to the basically different issues of a merger case, and statements by the court that it will not consider "conflicting theories of political economy" at the same time that it is applying a highly idiosyncratic theory to the facts of the case - such developments, and others equally disconcerting, could not survive a closer understanding and working relationship between experienced industrial organization economists and a sophisticated combines bar. A broadly based joint research program could make a useful contribution to the clarification of basic concepts and to the development of operational tests of those concepts.

Certainly, the important role of the legal profession in the preparation of cases and in the proceedings before the board and the courts requires that the substance of the economic issues involved should be clearly understood. Without such initial understanding, the danger of proceeding at cross purposes and at excessive length is greatly increased. As an American Commission member rather tartly observed about a particularly protracted case, "An expert can practise his expertness and yet act decisively and with dispatch. An expert can also be a reasonable man." But only, it should be added, if the issues are clear and the analysis relevant.

Although it would not be difficult to do so, it is not our intention to provide a list of important research areas; in part, because the areas that we regard as having special significance are referred to throughout this report, and, in part, because senior qualified personnel are available within the Bureau to work out with the research

staff the selection of topics that assume special importance from time to time. Furthermore, we do not envisage that a large number of projects will be in process at any one time; perhaps something of the order of three or four projects, with the publication of an important study, say, every two years, would be realistic. If a comprehensive list of research projects came to be regarded as a prescribed program, it would seriously constrain the necessary freedom of the Bureau to shift its priorities with the passage of time.

Although we do not perceive much merit in a large, continuing, advisory committee on research, we think it would be worthwhile if the Director were to appoint an ad hoc committee of, say, three members (one from his staff, one from another department of government, and one from outside the government service) to review and report, every three years, on the performance and the program of the research section. Many research institutes find such periodic reviews of considerable value. They can provide a medium of contact to avoid wasteful overlaps in research, to direct attention to areas of research pertinent to industrial organization in the broader sense, and to discourage undue concentration on a particular topic or type of inquiry.

Proposals have been made that the research group should undertake the regular, long-term gathering of data by compulsory powers in order to monitor what are considered to be strategic developments for policy making. Such proposals have an obvious attraction; they also have obvious difficulties. It is, for example, difficult to specify the sort of statistical data that would cast unambiguous light on the complex concepts that would be relevant for policy. In fact, a case can be made for the view that on such matters as dynamic change, long-run transformation of the economy, and the like, qualitative, innovative analysis will be required to provide worthwhile assistance to policy makers. It is also a basic human failing to be

unable to turn off any automatic process. Once the continuous collection of data is initiated, like one of those coveted spinning wheels in fairy stories that turns out something highly desirable but unless stopped by the magic word goes on doing so, effectively devaluing its own product, so the accumulation of data tends to continue long after the original purpose for its collection is forgotten. In view of the cost of providing additional data over and above that already being submitted to various governmental agencies, a strong case for its value in policy analysis should be established before further requests are made. In any event, only short-term projects should be given consideration.

One of the newer compilations of data - line-of-business reporting - which is being pioneered by the Federal Trade Commission in the United States, has aroused much interest and some controversy. Although we did not undertake an exhaustive examination of this proposal, it appears on a brief review that there are still many problems of a technical nature to be resolved;* in addition, even if these are overcome, the value of the measure in evaluating various dimensions of economic performance remains to be demonstrated. In the circumstances, we feel that Canada should not attempt to institute such a system at this time.

Matters of Procedure and Publication

Up to the present, the Restrictive Trade Practices Commission has participated in varying degree in the preparation of different research

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* For a discerning analysis of the technical difficulties involved, see Betty Bock, "Line-of-Business Reporting: A Quest for a Snark?", The Conference Board Record, Vol. XII, No. 11 (Nov. 1975), pp. 10-19.

inquiries: in some cases it has held hearings (public or private) based on a "green book" prepared by the Director, and has subsequently written its own report; in others, it has circulated the Director's study to a limited group of interested persons and then issued the study with brief introductory comments; in some cases the Director has used (with the approval of the RTPC) the powers of the legislation to require the provision of information, in other cases the information has been obtained on a voluntary basis.

In view of the changes we have proposed in the role of the specialized adjudicating body, it would not be appropriate for the Board to participate in the preparation or evaluation of research studies since they may have an impact on new directions in policy.

We therefore propose that the research function should become the sole responsibility of the Bureau of Competition Policy. The research studies should be published directly by the Bureau without any hearing before the Board. However, in order to facilitate effective response to the study, it should be available publicly for a period of sixty days to interested parties who could submit their comments to the Director within that time period. The Director would then prepare a brief summary of such comments for inclusion as an appendix to the research study. In cases where there is a controversial or voluminious response or where some of the commments are repetitive or of doubtful relevance, the Director may wish to refer the material received to a competent, independent authority who will prepare a summary of manageable size to be published over his own signature as an appendix to the study. We also suggest that the legislation provide that the research study <u>shall</u> be published on the recommendation of the Director.

With respect to the use of formal powers under the legislation to require returns of information to the Director, we suggest it be employed with

restraint. The effective research work already completed in these areas has relied less on access to information obtained by formal returns than on perceptive analysis of material that was readily available or was supplied voluntarily. Where compulsory powers are used to obtain material, the conceptual framewwork within which the material is to be examined, and the potential contribution that the inquiry is expected to make to understanding theoretical or policy issues, should be fully explained to those who will suffer the inconvenience and often the substantial expense of complying with the order. Our experience in the supervision of graduate theses suggests that when a serious effort is made to explain the purpose of the request for information, a surprisingly generous level of co-operation is usually assured. Furthermore, discussion with staff members of the firms involved not infrequently resulted in improvements in the formulation of the research project.

There will undoubtedly be studies which require special types of information, and so the use of the power to require its provision should be retained*, but a great many important research projects can be undertaken with material already available. A record of successful use of such material will make more persuasive the rare request for special or confidential material that may require costly preparation. It is perhaps unnecessary to add that it is important to respect the confidentiality of all sensitive information provided. In some cases, the parties may agree to full publication after a lag of, say, three years, but that should be a matter for discussion and negotiation at the time the information is requested.

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* We can, however, see little need for the use of the power of search or the examination of witnesses under oath in the preparation of research studies.

The reticence of some private organizations - business and other - to provide information relating to their operations, which still lingers on even when no serious question of confidentiality is involved, requires re-evaluation by such groups, as does the government's sturdy refusal to open its own files to public scrutiny. Light is still the sovereign remedy.

The penetrating and informed studies of individual industries in the United States by Dean E.S. Mason and his disciples, based on the most detailed information about individual firms, have contributed in a fundamental way to the enrichment of our understanding of the dynamics of economic change in a modern enterprise economy. Although much of the factual material was derived from court proceedings the economic analyses based on it established the need for significant re-interpretations of accepted policy.

No such studies are available in Canada. Court proceedings have not explored economic issues in any depth. Furthermore, the tendency in Canada for business firms to oppose the provision to the combines authorities of information routinely provided to other branches of government, even when no question of confidentiality is involved, is not conducive to the creation of an environment of objective analysis. The creation of such an environment may require the assistance of outside agencies, but however achieved, it is important that it be accomplished, particularly at a time when the role of a private market economy is under review.

SEPARATE STATEMENT OF REUBEN M. BROMSTEIN

A group report inevitably involves individual compromises to achieve common objectives particularly in relation to complex problems such as Combines Law proposals.

While in sympathy with many of the arguments raised in the pricing policy section, I must offer some comparative reflections, particularly in relation to price discrimination. The proposed civil remedy for price discrimination is innovative. I suggest, however, that we consider the National Market Board's jurisdiction as supplementary to the existing criminal jurisdiction and retain section 34. Although there is no record of judicial enforcement of the criminal sanction, which was enacted many years ago, it appears to act as a demonstrative deterrent and has, I understand, been effective in preventing extreme abuses. In addition, the recently-created right of private action would allow aggrieved parties to sue for damages. If the Board's civil jurisdiction proves ineffective, there would be a serious gap in the legislation until alternative remedies are enacted. The Board's civil jurisdiction should prove useful where the criminal onus of proof and sanctions are too severe.

Section 35, dealing with advertising and promotional allowances, should remain as a criminal sanction. The deterrent effect is of value. A civil jurisdiction would permit the reintroduction of discriminatory allowances unless and until the Board orders a specific firm to behave otherwise.

Fair trade laws and price discrimination legislation as seen in the Robinson-Patman Act were, and are, often primary concerns of many U.S. small business groupings. At the present time, there are few organizations which advocate identical legislation in Canada. The existing Canadian

price discrimination legislation is, I believe, for all its weaknesses, less rigid than section 2 of the Robinson-Patman Act, and this approach may have contributed to the growth of buying groups which appear to have flourished more rapidly in Canada in areas such as groceries, drugs, auto parts and hardware.

I could find little recent useful documentation concerning the size and health of the small business community in Canada. Although the high profile and effervescent character of entrepreneurs indicate that they are still a relatively vibrant sector, any complete and definitive analysis may reveal a declining share of GNP.

The impact of price discrimination when combined with market power is always difficult to determine. The only measurable results may be long-run changes in market structure. Connections are difficult to prove. The decline of small business in food retailing since the 1950's, for example, is evident. The structure of the market is now more concentrated. Complaints over the years were not infrequent. Is it not possible that many efficient small businesses, not just inefficient ones, disappeared as a result of their inability to compete with greater financial and market power? If so, how does one unscramble the omelette? Any resulting long-run structural rigidities may impose costs on society that outweigh any short-run benefits. Losses in human resources to society as represented by small firms and their entrepreneurs who became wage earners may be irreplaceable. Small businessmen are often the most vocal proponents of, and the yeast which can be so essential to, the market system.

Large firms will continue to attempt to achieve objectives by means such as take-overs and private brands, as well as the development of vertical integration facilities, with or without effective price discrimination legislation. These

activities, often desirable, should be subject to review where dominance and the misuse of high levels of market power is involved. The proposals concerning the misuse of a dominant position concept, whether it be individual or shared dominance, may be useful in this connection and may prove to be one of the most important proposals arising from our report once its ramifications are more fully developed.

Problems associated with vertical integration and conglomerates such as cross-subsidization, reciprocal buying practices, dual distribution techniques and the ability of firms to give or obtain differentially favoured treatment for affiliated firms or divisions based on the flexibility resulting from finance and market power are particularly vexing to advocates of effective competition. Small and single product firms may often be at a severe disadvantage in relation to larger multi-line companies who may be no more efficient but who have preferred access to resources, markets and capital. Concerns by small businessmen often relate to such problems. They are not amenable to simple solutions. The dominance concept may again prove to be a useful frame of reference in this area.

There is no essential conflict between my concerns and those reflected in the main report. The differences recited are ones of emphasis.

Our report, of necessity, relies on economic and legal terminology. In conclusion, therefore, I suggest that wide dissemination of a less technical version of the report should be given high priority. The public debate on these matters is too fundamental and too important for Canada's future to be carried on only within the governmental, economic and legal communities.

COMMENT ON SEPARATE STATEMENT

1. The statement raises in a very general way three issues: it suggests that price discrimination has adversely affected the position of small business in some sectors of distribution, notably in food retailing; that the size and health of the small business community has somehow -- but just how is not clear -- been adversely affected recently in Canada; and that criminal jurisdiction should (therefore?) be retained in the area of price discrimination in addition to the civil remedy proposed in the report, and the criminal sanction should remain as the sole basis for dealing with advertising and promotional allowances. No supporting evidence, based on statistical sources or on authoritative opinion, is adduced in support of the expressed views.

2. On the matter of the role of the independent in retail distribution, it should be anticipated and accepted as a basic element in a dynamic market economy that the distribution system has been and will be subject "to a continual functional shuffle" which has altered and will continue to alter the allocation of marketing functions within the system.* As Moyer and Snyder have pointed out, the technology of modern communications media has tended to shift some of the selling function from the retailer to the manufacturer and his agents, and there has been a shift in the buying function from the smaller retailer and manufacturer towards the large retailer.

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* See M.S. Moyer and G. Snyder, Trends in Canadian Marketing (Ottawa, Dominion Bureau of Statistics, 1967), p. 52.

The Moyer and Snyder study continues:

> "There is in retailing a pervasive propensity to adopt the methods, and therefore the forms of big 'business'. Applied to retailing, the formula is coming to require at least four ingredients: large outlets, large families of outlets, professional managers, and the application of scientific management to the distribution process."*

It has been estimated recently that economies of scale require a minimum optimum scale of store in food distribution of approximately $500,000** in capital investment, which although not a high entry barrier in terms of barriers in other major industries, represents a substantial increase in terms of the resources of an independent retailer.

On the matter of price discrimination, the exhaustive investigation of discriminatory pricing practices in the grocery trade carried out by the combines authorities concluded that "it seems fair to say that the information on net invoice prices discloses no evidence of significant differentials as between chain stores and wholesalers or as between larger and smaller firms in each of these

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* Moyer and Snyder, op. cit., p. 89; see also pp. 144 ff., and p. 148.

** Mary Gardiner Jones, "Food retailing: a case study of United States anti-trust policy toward the distribution trades", International Conference on Monopolies, Mergers, and Restrictive Practices (London, H.M.S.O., 1969), p. 262. Miss Jones is a Commissioner in the U.S. Federal Trade Commission.

categories of distributor."* Statements to the contrary, based on a less exhaustive investigation or on no investigation at all, must be regarded as largely self-serving in character and without probative content.

Hence, the factors accounting for the decline of the independent in certain sectors of distribution over the past 40 years are largely in the nature of technical and organizational advantages enjoyed by larger-scale operations, reinforced by merger activity - of doubtful social and economic merit in some cases. Nevertheless, the smaller operator is not without his sources of strength in localities of less than 10,000 population** and in core areas and in larger localities where his ability to cater to "selective preferences" is of importance. In addition, some kinds of retail transactions cannot be mass-produced, and in them the small retailer has more than held his own. As Moyer and Snyder point out, the independent outlet is generally most effective in the retailing of such commodities as gasoline, automobiles, farm implements, meat, drugs, and apparel, where the purchase involves considerable consultation and personal service.

To sum up the changes that have occurred since 1930, these authors conclude about the experience of the independent:

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* Restrictive Trade Practices Commission, Report on Discriminatory Pricing Practices in the Grocery Trade (Ottawa, The Queen's Printer, 1958), p. 159.

** See Moyer and Snyder, op. cit., p. 150.

> "Their loss of market share among such outlets as grocery and combination stores, general merchandise stores, shoe stores, women's apparel stores, family clothing stores, and fuel dealers, has been offset by their gain in market share among other outlets such as restaurants, meat markets, lumber and building material dealers, furniture stores, household appliance stores, and drug stores.... The official record indicates that, as an institution, the independent store has held its ground quite well since 1930."*

The statistical record is summarized in Table 1; a quick review of the latest available data discloses no significant qualification of the Moyer and Snyder data.

Table 1

Number of Independent Stores, Total and as a Proportion of All Retail Stores, Canada, 1930, 1941, 1951 and 1961**

	Number	As a Proportion of all Retail Stores
1930	116,379	93.1
1941	128,816	93.8
1951	142,883	94.2
1961	163,628	93.1

* From Table 7.1, M.S. Moyer and G. Snyder, Trends in Canadian Marketing (Ottawa, Dominion Bureau of Statistics, 1967), p. 151.

** Ibid, p. 155

Sales of Independent Stores, Total and as a Proportion of Total Retail Trade, Canada, 1930, 1941, 1951, 1961 and 1964*

	Sales ($000)	As a Proportion of Total Retail Sales
1930	1,896,627.5	68.8
1941	2,420,096.1	70.3
1951	7,966,906.8	74.8
1961	12,835,737.6	70.9
1964	15,057,571.0	69.5

When the increased opportunities for small business in the services sector, and in support roles in the new generation of enterprises in space technology, oceanography and environmental monitoring, are taken into account, there seems to be little basis for pessimism about the future role of a vigorous, innovative small business sector.

3. Finally, it can be stated categorically that there is no basis for the claim that section 2 of the Robinson-Patman Act is more rigid than section 34 of our combines legislation.** Few things are more "flexible" than a piece of legislation that has not been enforced - as has been the case with our section 34. To advocate a policy of piling Pelion upon Ossa, in the form of a civil sanction upon a criminal sanction -- that is intended to be

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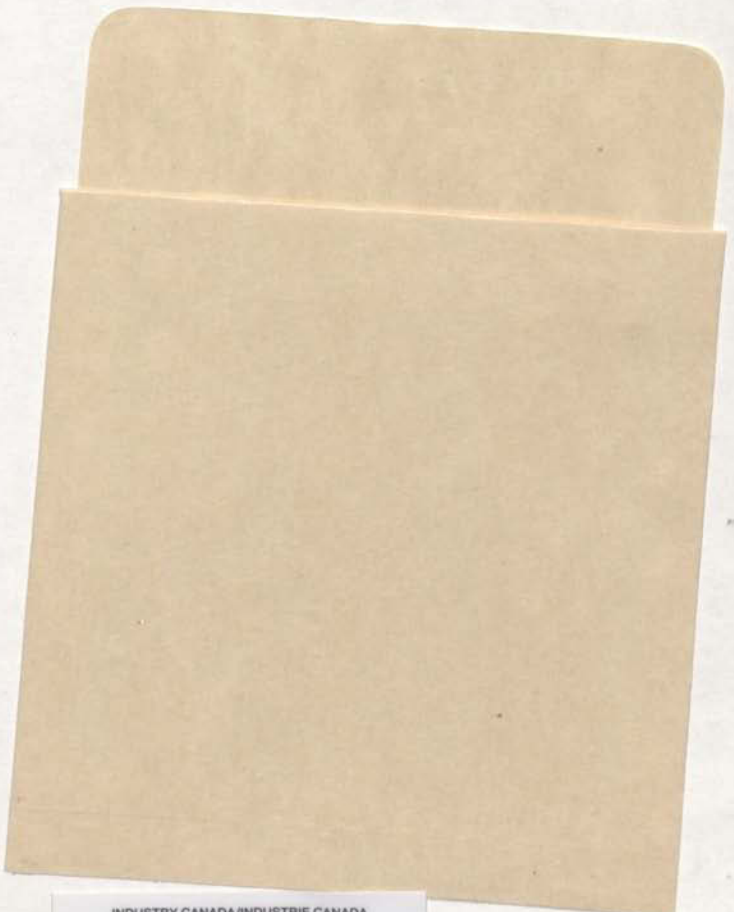
* From Table 7.2, M.S. Moyer and G. Snyder, op. cit., p. 152.

** For a discussion of this point, see, Report on Discriminatory Pricing Practices in the Grocery Trade, Appendix II, "Discussion of section 3, Robinson-Patman Act", pp. 211-220.

enforced -- is to advocate a degree of rigidity beyond reasonable comprehension. Price differentials have an important role to play in maintaining a flexible, adaptable economy, especially where oligopoly is important. The proposals put forward in the report on sections 34 and 35 strike a reasonable balance between adjustment and protection.

L.A. Skeoch



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