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Copyright, Competition and Canadian Culture:

The Impact of Alternative Copyright Act Import Provisions on the Book Publishing and Sound Recording Industries

Ake G. Blomqvist
Chin Lim

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We take joint responsibility for the contents of this report. However, C. Lim carried out the bulk of the work in the case of the recording industry and A. Blomqvist in the case of the publishing industry.

A. Blomqvist - C. Lim

FOREWORD

This series of studies concerning aspects of copyright law was initiated to provide a better understanding of some important problems and issues involved in the revision of the Canadian Copyright Act. The present Act is now more than 50 years old. The wide breadth of legal, economic and technological developments since it was proclaimed underlie the significance of the revision process. The creation and dissemination of information is becoming an increasingly important resource of our society. In addition, the copyright community, including authors, publishers, the film and video industries, broadcasters, the recording industry, educators, librarians and users, contributes hundreds of millions of dollars to the economy. For these reasons the Research and International Affairs Branch of the Bureau of Corporate Affairs felt it necessary to undertake in-depth economic and legal research into the cultural, economic and legal implications of the most important of the copyright issues.

With respect to the appropriateness of the economic studies of this series, the following passage from the 1971 study of the Economic Council of Canada entitled Report on Intellectual and Industrial Property is perhaps the most perceptive and eloquent:

> It is sometimes implied that where cultural goals are important, economic analysis, with its base associations of the market place, should take a back seat. But this involves a serious misconception of the proper and useful role of economic analysis. It may well be true that in the final analysis, economics is much more concerned with means than with ends, and that the really fundamental "achievement goals" of a society are largely, if not wholly, non-economic in nature. It is also true, however, that, in practice, means can have an enormous influence on ends, whether for good or ill, and that as a result the systematic analysis of economic means is indispensable both in the specification of social goals and the planning of how to achieve them. In the case of cultural goals, among others, economic analysis can be of

> great help in bringing about a clearer identification of the goals in the first place, and then in planning for their attainment by the shortest, least costly and most perseverance—inducing route.
>
> It is particularly important that the relevance of cultural goals in a policy-planning situation should not be used as a smoke screen behind which material interests and conflicts between private and social interests are allowed to shelter unexamined. In an increasingly service-oriented and knowledge-based society, cultural matters in the broadest sense are to a growing extent what economic life is all about. They must not fail to be studied in their economic as well as their other aspects. (pp. 139-140)

It is within this spirit that the economic studies completed for the Branch have been commissioned and carried out.

In addition to internal studies, the Branch has contracted with research academics from the Canadian university community who have a special interest in copyright. The external funding of research provides the Branch with new insights and perceptions from some of the most highly skilled academics in Canada with respect to the many complex issues inherent in the revision of the Copyright Act. Additionally, it serves to foster an interest and involvement in these important policy issues amongst others within the academic community. Such involvement and input can only lead to a better understanding and consequent improvement in the copyright policy formation process.

This study by Professors Ake Blomqvist and Chin Lim of the Department of Economics, University of Western Ontario, evaluates the economic consequences of possible alternative revisions to the importation provisions of the Canadian Copyright Act. This study provides a striking example of the complexity of the issues involved in the revision process. The importation provisions affect the welfare of authors, publishers, book manufacturers and the book-buying public. The authors in presenting a careful study of the present Act's import provisions, a thorough analysis of the workings of the book and recording industries and the development and empirical testing of a model of the pricing behaviour of firms in these industries have produced a most valuable research paper.

Given the rigor of the economic analysis and the clear and lucid exposition of the existing law and practices in the affected industries, this paper should be both informative for and of interest to members of the legal and economic academic communities, the copyright interest groups themselves and all those interested in copyright law policy formation.

It should be noted that the results and recommendations contained in this study are those of the authors and do not necessarily imply acceptance of same by Consumer and Corporate Affairs Canada. We believe that this approach is optimal for the purpose of encouraging the researchers to employ the widest scope in both the creation and presentation of their views.

Fenton Hay

Dr. Fenton Hay
Director
Research & International
Affairs Branch

SUMMARY

This report considers the economic impact on the Canadian book and sound recording industries of alternative legislative provisions relating to the importation into Canada of works covered by copyright. More specifically, we assess the effects on these industries of a Copyright Act provision under which the owner of the Canadian copyright to a work would effectively have the right to bar any foreign edition or version of that work from being imported into Canada (referred to as the principle of territorial divisibility of copyright). This is compared to a situation under which no such right would exist, so that anybody would be permitted to import any foreign editions of the work -- except, of course, any copies that had been illegally produced.

Although section 17(4) of the present Copyright Act protects a Canadian copyright holder against so-called "indirect infringement" through imports of competing editions, its application is limited, in the case of books, by other sections in the Act which provide certain exceptions to the rule. Ambiguities in the definition of the exceptions and problems of enforcement also appear to have reduced the effectiveness of this protection.

In their recommendations for a review of the Copyright Act, Keyes and Brunet have proposed that section 17(4) be retained and that the exceptions and ambiguities limiting its applicability be eliminated. This would amount to firmly incorporating the principle of territorial divisibility into Canada's copyright law.

To assess the consequences of this alternative as opposed to that of no import restrictions, we first develop a framework to analyze whether import restrictions would be likely to involve higher prices for books and sound recordings in Canada. Based on this analysis, we then discuss the way in which various interest groups (such as readers/listeners, Canadian and foreign authors or performers, and publishers or record companies) would be affected under the alternative policies.

In the absence of import restrictions, the prices charged by publishers and record companies could not exceed the prices charged for comparable editions sold in other countries, after adjustment for transport costs, any duty payable on imports and so on. Otherwise, retailers would simply import the foreign editions. With import restrictions, there is no such constraint on pricing, since imports by retailers would then be illegal.

Even with import restrictions, however, it would not necessarily be in the publishers' or record companies' interest to charge higher Canadian prices than those which would prevail without restrictions. The individual firm must take account of the fact that a high price will entail a reduction of sales, mostly at the expense of works sold by other Canadian publishers or record companies. If competition in the Canadian market is sufficiently strong that firms believe sales would be very sensitive to price increases, prices <u>with</u> import restrictions might be no higher than they would be without them. Expressed in the terminology of economic theory, if firms perceive that the price elasticity of demand for a typical book or record in the Canadian market is relatively high (in absolute value), import restrictions need not result in higher prices.

Using data from a variety of sources, we undertake an extensive study of the evidence regarding the pricing behaviour of Canadian publishers and record companies. With respect to the latter, it quickly becomes clear that there is no support for the hypothesis that Canadian prices would be higher with import restrictions than without them. Incorporating the principle of territorial divisibility in the Copyright Act would therefore probably not result in higher prices for sound recordings in Canada or in higher earnings for Canadian record companies and performers.

Evidence on book publishing behaviour, drawn principally from Statistics Canada data, indicates that <u>the prices in Canada of those books that have a market both in Canada and in foreign countries would be substantially higher</u> (by 10 to 20 per cent) <u>with import restrictions than without them</u>. Thus, readers would have to pay more for such books. On the other hand, authors, Canadian or foreign, would earn larger royalties and the profits of publishers, Canadian-owned or foreign-owned, might be somewhat higher as well.

In assessing whether import restrictions would be in Canada's national interest, a question of obvious importance is the extent to which the benefits from higher book prices, in the form of higher royalties and publisher revenues, would accrue to Canadian (as opposed to foreign) authors and publishers. (All the <u>costs</u> of higher prices would clearly be borne by the Canadian readers.) There are two principal reasons why one must expect that <u>a large portion of the benefits would accrue to foreign nationals</u>.

First, due to Canada's obligations under the international conventions to which she belongs, import restrictions cannot be limited to foreign editions of Canadian-authored books. They must also be extended to foreign-authored books when a separate Canadian copyright exists (we assume that the essential criterion for a Canadian edition to exist, so that import restrictions on foreign editions may be involved, is simply that somebody has acquired the copyright specifically for Canada).

Second, suppose that protection against competition from imports of foreign editions of any given work can be obtained by selling the work in Canada as a Canadian edition (i.e., by acquiring the Canadian copyright of the work before selling it). Since the evidence suggests that this would enable the seller to earn a higher net return by charging a higher price for the work in Canada, one would expect that a larger number of foreign books would be sold in Canada after transfer of copyright than in the absence of effective provisions to restrict imports. To earn these additional returns, however, the Canadian publisher would have to purchase the copyright from the foreign author or publisher. Since the foreign individual or firm originally owning the copyright can shop around for the highest Canadian bidder, and since Canadian publishers will compete for the rights, most of the potential increase in net returns will be dissipated into higher payments for the Canadian copyright to foreign works.

Thus, if the principle of territorial divisibility was incorporated into the Copyright Act, book readers would pay higher prices for Canadian books (particularly those by established Canadian authors whose works are sold both in Canada and in foreign markets) and also for foreign books. Some Canadian authors would benefit from higher royalty earnings. The profitability of the Canadian publishing industry might improve, although competition between publishers for the copyright to the works of authors would make authors rather than publishers the chief beneficiaries.

Imported books constitute about 75 per cent of the value of all books in Canada. Hence, the bulk of the potential extra earnings from sales of books at higher prices in Canada would accrue to the foreign authors or firms from whom the Canadian copyrights would be purchased. Calculations from the data suggest that no more than about one-tenth of the total extra cost to consumers of higher book prices would be passed on as extra royalties or profits to the Canadian authors or publishers. As a way of stimulating creative activity, which of course would be the ultimate objective of the legislation, import restrictions under the territorial divisibility principle do not seem particularly effective.

So far, we have implicitly assumed that higher prices paid by consumers under territorial divisibility would be reflected either in higher royalty revenues to foreign and Canadian authors or, possibly, in higher profits to publishers. A further possibility is that some of the cost to readers would be swallowed up by the higher costs incurred under import restrictions. This problem is especially likely to arise in book distribution. There is evidence that the most efficient technology in book distribution requires large-scale operations involving computerized inventory management and control and computerized ordering and billing procedures. Since import restrictions with the accompanying enforcement procedures will raise the cost of all book imports, and since the Canadian market may be too small for this technology to be efficiently utilized, import restrictions would slow the adoption of this cost-reducing technology in Canada. Distribution costs represent a major proportion of the retail price of books (and sound recordings). Therefore efficiency in this sector is important not only to book buyers but also to authors, whose potential royalty earnings out of a given gross revenue will obviously be higher when distribution is less costly.

This report also considers the problem of remainders and deletes -- important concerns in the book publishing and sound recording industries. The problem typically arises when declining sales for a book in a foreign market have triggered a remaindering clause in the publisher's contract, entitling him to dispose of unsold copies in the remainders market without being obliged to pay regular royalties. From time to time, remaindered copies have found their way back to Canada where they have been sold at low prices, thereby reducing sales of higher-priced "regular" Canadian editions on which the authors would have earned royalties.

There is no doubt that this practice has, on occasion, reduced the incomes of certain Canadian authors, publishers and recording artists who have sold copyrights for separate foreign editions of their works. However, the problem can be avoided in several ways even without import restrictions. The simplest one would, of course, be to let Canadian publishers or record companies market the work in a single edition or version sold at roughly the same price (adjusted for transportation costs and so on) throughout the world. Or, the Canadian seller of foreign copyrights to a Canadian work could add a buy-back clause under which the foreign publisher or record company would be obliged to offer unsold copies to the Canadian seller of the rights (perhaps at an agreed price) before he could remainder. Since the problem can be avoided through private contractual arrangements, the case for solving it using the blunt instrument of general Copyright Act import restrictions seems to us a weak one.

The overall conclusion is that Copyright Act import restrictions represent a costly and ineffective way of attaining Canada's cultural objectives (i.e., creating additional financial incentives for Canadian authors and recording artists to engage in creative activity). A policy of directly subsidizing royalty payments by publishers and record companies to Canadian authors and performers represents a far less costly method of achieving it.

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CHAPTER I

THE MAIN ISSUES

Introduction

The purpose of this report is to evaluate the economic consequences of possible alternative revisions to the import provisions of the Canadian Copyright Act. Before undertaking such an evaluation, it may be useful to recall briefly the purpose of copyright legislation in general and, in particular, the complications that arise as a consequence of the fact that many goods covered by copyright enter into international trade. Needless to say, the international aspects are of considerable significance for Canada because of the large share of imports in the markets for both books and sound recordings.

In general, the purpose of copyright legislation in any country is to provide an incentive for potential creators of literary and artistic works to actually produce such works. This is done by making it illegal for anyone to reproduce and distribute for sale copies of the works covered by copyright, except with the consent of the holder of the copyright. In this way, the law creates a monopoly with respect to the sale of copies of the particular work, and through the exploitation of that monopoly right it becomes possible for the initial one-time costs of creating the work to be covered.[1]

The extent to which the holder of the copyright for any particular work is protected by legislation varies, of course, from country to country. In some respects, a degree of uniformity does exist, however, due to the fact that more countries are members of one or another of several international agreements with respect to copyright. A fundamental principle in those agreements relates to non-discrimination, under which each member country undertakes to apply the same

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1. In the absence of copyright legislation, the prices of copies of "literary and artistic" works would tend to be driven down, by competition, to a level at which they would cover no more than the costs of production and distribution, with nothing left over for the original creators. Under such conditions, few if any works would be created.

rules to protect the interests of copyright holders who are nationals of other member countries, or who hold copyright in a work created by a national of another member country, as they do in the case of a copyright holder who is a domestic national, or for a work created by a domestic national. This principle is of great importance to a Canadian author of books that may be sold in other countries as well as in Canada; his copyright will then be protected in the same way as that of authors and publishers in those countries. At the same time, the principle imposes a constraint on Canadian copyright legislation. If, for example, the Copyright Act were to be revised so as to strengthen the protection enjoyed by Canadian authors and publishers, this would implicitly necessitate increasing protection for foreign authors and publishers. As will be seen below, this fact is one of great importance in assessing the costs and benefits to Canada of changing the Copyright Act importation provisions.

The point of the preceding discussion is to establish that the general effect of the Canadian Copyright Act is to create a monopoly for the copyright holder, whether Canadian or foreign, on the reproduction and sale of a particular work for which he holds the rights. More precisely, it protects him from competition by prohibiting other individuals or firms <u>in Canada</u> from reproducing and selling the work, unless authorized to do so by the copyright holder. The specific question to which this report is addressed is whether it is in Canada's interest that this protection be extended to exclude competition from imported copies of the work, even when those copies have been legally produced (i.e., with the consent of the original copyright holder) in their country of origin. From the preceding discussion, it should be clear that this is a question concerning the <u>degree</u> of monopoly protection created by the Canadian Act: if the Act provides protection from competition by <u>both</u> domestic <u>and</u> foreign producers and sellers, it obviously creates a <u>more</u> complete monopoly position than if it protects against domestic competition alone. Alternatively, since foreign copyright legislation already provides monopoly protection in the foreign market, the question can be re-formulated to ask whether the Canadian Act should simply extend this protection to the Canadian market (in effect making Canada a part of the copyright holder's worldwide monopoly), or whether it should strive to create a <u>separate</u> monopoly position for the work in Canada by prohibiting unauthorized imports.

The answer cannot be a simple one. As we discuss in detail later, a restrictive policy under which imports are prohibited will tend to generate increased revenue for Canadian creators of literary and artistic works, which may stimulate the rate at which such works are created. This presumably would create a desirable effect in terms of Canada's cultural objectives. At the same time, such a policy would tend to raise the prices paid by the reading and listening public for books and sound recordings, not only for Canadian works but also for foreign works. The cost of promoting Canada's cultural objectives in this manner may be high indeed, and we will argue later in the report that there are other methods which would serve this purpose more efficiently (i.e., at lower cost).

The main body of the report is organized as follows. In the remainder of this introductory chapter, we discuss some of the legal and institutional problems which arise in a concrete specification of the two alternative sets of legal provisions corresponding to the restrictive and non-restrictive approaches described above. This includes questions such as the treatment of remainders and deletes; the position of Canadian publishers acting as exclusive agents for foreign copyright holders; and the issue of enforcement provisions if a restrictive alternative were to be chosen. We also touch briefly upon certain problems which arise in the case of sound recordings as a consequence of the fact that copyright may subsist not only in a particular recording but also in the music and lyrics upon which the recording is based. Chapter II contains some quantitative background information on the Canadian book publishing and sound recording industries. In Chapter III, we develop a simple theoretical model of the pricing decisions of book publishers and producers of sound recordings, and we analyze the way in which this pricing behaviour is likely to differ between situations with and without the type of import restrictions discussed above. It turns out that the answer to this question depends critically on the relative magnitudes of the price elasticities of demand for work in Canadian and foreign markets, as assessed by publishers or record producers in their pricing decisions.[2] It may also depend on the relative costs of book production and distribution in Canada and abroad, and on the costs of transport and duties, etc. In Chapter IV, we utilize some of the existing information on cost and prices in book

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2. We are, of course, not claiming that publishers or producers actually operate in terms of well-specified price elasticities. However, a publisher who picks a particular price (or markup) presumably does so because he estimates that he would lose some sales at a higher price. Informal estimates of price responsiveness along such lines is equivalent to a judgement of the relevant price elasticity.

publishing and sound recording to estimate the relevant elasticities and other parameters affecting the industries' likely response to differential import provisions. On the basis of these estimates and other data, we conclude that, for the sound recording sector, the behaviour of prices, and hence the output of the industry and the rate of creation of Canadian sound recordings, would be essentially unaffected by the choice of import provisions in the Copyright Act, at least as far as regularly priced records are concerned. The main effect of choosing a restrictive set of import provisions, therefore, would be to protect Canadian producers against competition from the importation of deleted records. In the case of book publishing, by contrast, the evidence indicates that such legislation would affect the prices, sales and output not only for remainders but also for regularly priced books. Specifically, we are able to forecast a substantially higher level of book prices in Canada under an effectively enforced set of import restrictions, by comparison with a hypothetical alternative under which imports were to be completely unrestricted. Chapter V contains a concluding discussion of the expected impact of alternative legislative provisions on the various interest groups who would be affected, including Canadian creators of literary and artistic works. In addition, we also investigate the effects of an alternative hypothetical policy involving unrestricted imports combined with direct subsidies to Canadian creators of literary works for the book publishing industry. We are able to show that such a policy would be far less costly (to book readers and taxpayers) than a policy of indirect support of Canada's authors and publishers through Copyright Act import restrictions.

Main Alternatives for a New Copyright Act

We cannot undertake here a full discussion of the many technical legal problems which inevitably arise in translating a general principle concerning the treatment of imported material covered by copyright into a set of actual legislative provisions. Nevertheless, we believe it is useful to note that the two main alternatives that we analyze, namely, a comprehensive set of effectively enforced import prohibitions and completely unrestricted imports, do have counterparts in the legal debate in the principles of "territorial divisibility" of copyright and "exhaustion," respectively. We will also briefly consider the question of the legal position of firms in Canada who act as exclusive agents under either alternative. Because of the quantitative importance of this type of arrangement in Canadian book publishing, much of the debate has come to focus on the effect of copyright legislation on those who are in that position.

No import restrictions: the principle of exhaustion

From a legal point of view, the non-restrictive alternative is fairly simple to envisage -- it would correspond to universal application of the principle of exhaustion with respect to books and sound recordings.[3] This would mean that importation of any edition or version of a copyrighted work would be permitted, as long as it had been produced with the consent of the copyright holder. The qualifying part of the sentence would mean that there would be protection against pirated versions (i.e., those produced illegally in a country where the work was protected by copyright, or legally in a country where no copyright protection existed), but there would be no protection against authorized foreign versions.

The consequences of adopting this approach are simple to describe. A Canadian publisher or producer of sound recordings would have to recognize the possibility that copies of foreign versions might be imported into Canada and compete with his own copies for sale in Canada. Even if it were possible to sell foreign rights subject to a provision that no foreign copies would be sold by the foreign buyer of the rights for export to Canada, this would be difficult to enforce since: (a) such a private contract provision would not be binding on the importer; and (b) imports into Canada most often take place through foreign wholesalers with neither party, exporter or importer, bound by such a contract. A Canadian buyer of the copyright to a foreign work, for purposes of producing a Canadian edition, would have to anticipate that copies of any other edition from a foreign country might be imported. A Canadian exclusive agent could take no action against other Canadian importers who were buying around the agent directly from abroad.

The principal gainer from application of the principle of exhaustion would be the Canadian reading or listening public, who would indirectly have access to any less expensive edition published or recorded abroad. We will return later to the industries' argument that not even the public would benefit in the long run because import compe-

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3. In legal terms, the doctrine of exhaustion has been described as being based on the notion that "once a party has placed goods for sale in any market, his rights with respect to such goods...should be exhausted" (Consumer and Corporate Affairs Canada, 1978, p. 6).

tition would ultimately decrease their access to original Canadian works.

Extensive import protection: the principle of territorial divisibility

To precisely specify an alternative set of Copyright Act import provisions that would involve a higher degree of protection is not as easy as describing the no-protection case. Under the heading "What We Want," the Writers' Union of Canada formulates what they would consider to be the objective of revised import provisions for the case of books:[4]

> To put it in the simplest possible terms as authors we want to make it illegal for anybody to sell foreign editions of our books in Canada in competition with Canadian editions of those books. If a bookstore flouts the law we want to see that bookstore prosecuted. (Writers' Union of Canada, 1978, pp. 7-8)

Even if this were accepted as the objective to be attained in a new Copyright Act, translation of the objective into a specific set of provisions regarding imports of copyrighted books is far from simple. There are a number of subsidiary issues which would have to be resolved before this could be done.

First, the Writers' Union refers to "our books," i.e., books written by Canadian authors, and nothing is said about import provisions regarding copyrighted works written by foreign authors.

Second, with the exception of the call for summary remedies in the second sentence quoted above, the question of how the importation provisions are to be enforced is not directly addressed in the brief. Specifically, the question of whether Revenue Canada should continue to have responsibility for barring imports of the prohibited works, as they

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4. Many briefs have been submitted by various interest groups in connection with this issue, both in favour and against restrictions. We do not propose to review these briefs here, although we will be quoting that of the Writers' Union extensively since it provides a very clear statement of its side of the arguments in favour of "non-exhaustion."

presently do for certain categories of books, would have to be resolved.

Third, the statement in the brief implies that protection should be given only in the case where a Canadian edition exists. This gives rise to the question of how a "Canadian edition" is to be defined. Should it refer to a work printed in Canada or, as in the case of sound recordings, manufactured here? or a book co-published by a Canadian and foreign publisher? It also would seem that, with this formulation, no protection would be given to Canadian agents of foreign publishers, and the issue of whether such protection should be provided would also have to be considered in the legislation.

As noted in Appendix A, in the clause-by-clause review of the current Copyright Act undertaken by A.A. Keyes and C. Brunet (1977), the recommendations made with respect to import provisions included retention of the present section 17(4) but elimination of sections 27 and 28, which contain the administrative remedies.

In legal terms, section 17(4), which provides broad protection for a Canadian copyright holder against import competition from any foreign source, corresponds to incorporation of the principle of territorial divisibility in the Copyright Act. Under this doctrine, one purpose of copyright legislation is seen as ensuring that the copyright holder is able to exploit the full commercial potential of his work in each separate market (i.e., he should be assured of separate monopoly positions in each territory). In part, this notion may be motivated by the principle that copyright in general should be divisible into constituent parts that may be separately exploited, such as film rights, paperback rights, book-club rights and so on, in the case of books. Hence, one may feel that, by analogy, copyright should also be divisible by territory. Section 17(4) thus corresponds to the idea that the holder of Canadian copyright should be able to exploit the Canadian market separately, without regard to the rights that may already exist in other territories. If this is to be ensured, it is necessary to prohibit imports of legally produced copies originating in other territories.

It is important to note that the scope of protection under this section is broader than that sought by the Writers' Union because it makes no distinction between copyrighted works created by Canadian rather than by foreign authors or artists. In fact, Keyes and Brunet do not discuss the possibility of providing discriminatory protection against imported works for Canadian and non-Canadian creators, with good reason: as noted above, Canada's obligations under international copyright conventions preclude discrimination in this form. Hence, the assumption made in the following analysis is that if increased protection against import competition is to be given through revisions to the Act, it will be non-discriminatory and will apply to works by both Canadian and foreign creators.

Concerning enforcement of the import provisions, Keyes and Brunet take a relatively "soft" line. Since they recommend elimination of sections 27 and 28, which contain the administrative remedies in the current Act, they are in fact proposing that no responsibility is to be held by Revenue Canada for enforcing the protective legislation. In addition, they also recommend elimination of the current section 25(1) which contains summary remedies which would, if strictly applied, enable the Crown to prosecute an importer of infringing copies, and the courts to impose fines or imprisonment. In effect, the recommendations would mean that the only remedies available to an injured party would be the civil ones: injunctions, rendering of accounts and payment of damages, and these would only be available following a suit by the injured party. It is worth noting that this seems counter to the demands of the Writers' Union since the Union wishes to retain the summary remedies against illegal importation and wishes the Crown to take a more active role in prosecuting offenders.

The effectiveness of Copyright Act import provisions does not, however, depend only on the kinds of remedies available. At least equally important are the provisions that affect the likelihood of obtaining a conviction. As noted in Appendix A, one of the rules that currently weakens the effectiveness of section 17(4) is that requiring proof of knowledge on the part of the importer that he was acting illegally.

For our analysis of the economic effects of a restrictive set of import provisions, we will not be concerned with the detailed means of effective enforcement. In fact, we will make the extreme assumption that enforcement is completely effective and costless. This assumption is to some extent unrealistic, of course. Even with a set of rules that removes the requirements that the injured party must prove knowledge and establishes some form of presumptive knowledge, and even with Revenue Canada becoming charged with establishing some sort of reporting system to facilitate the task of the copyright holders in checking whether infringing copies have been imported, there would still be <u>some</u> cost of investigation and litigation which would have to be borne by them. But under rules of this kind, the costs would be low and our estimates would therefore not be seriously biased. On the other hand, it is also possible that the legislators will choose to enact relatively comprehensive import provisions without at the same time creating the means to enforce them effectively. If the enforcement provisions are sufficiently ineffective, the economic consequences would be similar to those that would result from a policy of no restrictions at all (as already discussed in the context of the principle of exhaustion). If the final outcome is located somewhere in between, with comprehensive import restrictions but with enforcement provisions of intermediate effectiveness, the economic consequences will also be somewhere in between. Some of the potential benefits of restrictions will accrue to publishers, record companies and creators, and some of the possible costs will be borne by the reading or listening public. But in addition, there will be costs implied by the uncertainty of enforcement attempts and by the expanded income-earning opportunities for members of the legal profession and others who become involved in attempting to enforce the provisions either in court or at the border, or in attempting to circumvent them through legal and other means. In addition, if comprehensive restrictions are enacted but enforcement provisions are ineffective, the current intensive lobbying activity in this area will persist, entailing continuing costs in the manpower and other resources tied up because of these endeavours both in the industries and in the public sector in responding to the lobbying efforts. We must admit to a certain amount of personal bias against this type of solution and to being in favour of a "cleaner" and more easily enforced alternative.

Another question of importance in this context relates to the scope of a more restrictive set of import provisions with respect to who is to be protected: the copyright <u>owner</u> alone, or his <u>agent</u> as well. This question is of especially great concern in the book publishing industry, where the agency business accounts for a large share of the total revenues in a number of firms in Canada.

To some extent, we believe that this issue is more important from a legal point of view than from an economic one. From an economic perspective, it is reasonable to assume that if there were substantial economic advantages to protection against import competition, exclusive agents would negotiate contracts with their foreign principals which would qualify them for such protection. It has been pointed out to us, however, that the question of whether protection is given only to those who are outright <u>owners</u> of copyright is not unimportant in this regard. The argument has been made that foreign publishers are not willing to assign routinely the Canadian copyrights for titles sold by their Canadian agents, preferring to grant exclusive licenses for limited periods of time. The exception to this, it is claimed, would be the case where the agent was a subsidiary of the firm holding the copyright. Thus, granting protection against import competition only to the owners of the Canadian rights might have the effect of stimulating the establishment of Canadian subsidiaries of foreign publishers.

We believe that to some extent, this argument is overdrawn. As has been observed in the legal discussion, copyright is not, in fact, indivisible but instead denotes a bundle of separate rights with respect to a given work. Consequently, unless the legislation goes into great detail in describing the particular rights from this bundle which a Canadian right holder must have to be eligible for protection against import competition, such protection will be enjoyed even by owners of Canadian rights which are limited in scope (for example, by including paperback rights, and so on). The reluctance of foreign right holders to sell Canadian rights that are limited in this way would presumably not be as great as their reluctance to sell the complete bundle of rights. Under these circumstances, protection of copyright owners only could be expected to have consequences similar to those that would follow from protection of both owners and agents: agents would simply write contracts with their principals that would make them owners of Canadian rights to a sufficient extent to make them qualify for protection against import competition. For all of these reasons, we feel that the legal question regarding precisely who would become eligible for protection is relatively unimportant for the economic analysis. Thus, a distinction will not be drawn between owners and agents; instead, it will simply be assumed that importers will generally be protected with restrictive import provisions.

At the end of the section describing the non-restrictive types of alternative import provisions, we argued that authors, publishers, musicians and record companies would generally be expected to oppose these alternatives. The chief potential beneficiaries would be the book-reading Canadian public. With the restrictive alternatives discussed here, the situation is exactly the opposite. Take, for example, the case of a Canadian publisher of a Canadian work. If he (or the author) wished to exploit foreign markets by selling lower-priced foreign editions, he could do so without fear of these editions being imported and competing with the higher-priced Canadian edition. The so-called "remainders" problem would also be solved. An agent would have complete freedom to set his price in Canada at any level without fear of competition from imports. Musicians, singers and record companies could also be expected to favour restrictive legislation, for similar reasons. The potential losers from restrictive policies would be the Canadian buyers of books and sound recordings, who would have little protection against the possibility of rising prices. Again, the proponents of restrictive legislation would argue that, in the long run, the Canadian reading and listening public would be able to realize offsetting benefits in the form of greater availability of newly created Canadian works because book writing, book publishing and production of sound recordings would become more profitable activities. We will return later to the question of the validity of this claim and, more particularly, to the question of whether the benefits of having a greater range of Canadian-authored works could not be realized in more efficient ways than through protection against import competition through the Copyright Act.

Musical Works and the Issue of Compulsory Licensing in Sound Recordings

In the case of records and tapes (sometimes referred to collectively as "sound recordings"), copyright subsists not only in the recording itself, but also in the composition (and lyrics, if any) from which the recording is made. This is referred to as the "musical work."

Under present legislation, the exercise of copyright in a musical work is governed by a compulsory licensing system which provides to anybody the right to record any song that has been previously recorded (by, or with the consent of, the owner of the copyright in the work), subject to the composer being given notice of the intention to do so and with royalty payments to the composer being fixed by the Act at "two cents for each playing surface of each such record."[5] What is not clear from the present legislation is whether the compulsory licensing provisions become operative whenever a legal sound recording of a given work has been made anywhere in the world, for example, outside Canada (Keyes and Brunet, 1977, p. 95). In principle, this question may become important when a musical work is to be recorded for the first time in Canada, or when sound recordings are to be produced from master tapes which have been created outside Canada. We are not aware of any cases

5. In practice, the industry has been paying two cents for each song recorded when more than one song appears on a single "playing surface" on a record or tape.

testing these rules in the Canadian courts, but there has been discussion of possible changes in some of the rules under a new Copyright Act.

Keyes and Brunet advocate retention of the compulsory licensing system, although they recommend that the present statutory rights be replaced by a royalty given as a percentage of list price at a rate subject to periodic review. They also recommend clarification of the present ambiguous situation with respect to recordings made outside Canada and propose that a new Act include a rule based on the principle of territorial divisibility:

> That, as a condition of the issuance of a compulsory licence to mechanically reproduce a musical work, the musical work must have been embodied in a sound recording previously made in, or imported into, Canada for purposes of retail sale, by or with the consent of the copyright owner of the musical work. (Keyes and Brunet, 1977, p. 96)

It is important to note that the rules adopted in a new Copyright Act with respect to compulsory licensing will essentially influence the <u>division</u> of revenues from a given sound recording, based on a particular musical work, between the various participants in the creation of the recording: the composer, lyricist, performers and recording studios. We will argue, however, that they will not greatly affect the price of the recording or the total amount of money earned by sales of the recording. Since the present analysis focusses on the relative economic impact of restrictions on the consuming public on the one hand, and the various copyright holders on the other, we will essentially confine the analysis to the effects of import provisions regarding the sound recordings themselves. However, it is worth observing that if some part of the copyright interest is held by foreign nations (i.e., foreign composers, lyricists, artists and producers), then the division of total revenues from sales of the recording might, in fact, significantly affect the Canadian public interest. In the present context, it appears likely to us that the major part of the gains from the principle of territorial divisibility would accrue to foreign composers, possibly at the expense of Canadian artists and recording studios. Hence, if the principle of exhaustion is applied with respect to the imports of sound recordings themselves, it would seem logical and probably also in Canada's interest to apply it to the issue of compulsory licensing as well -- i.e., to abandon the principle of territorial divisibility.

<u>The Problem of Remainders and Deletes</u>

In evaluating the choice between a restrictive or non-restrictive set of import provisions, it is generally assumed in this report that whichever alternative is chosen, all legally produced copies of books and sound recordings will be treated the same way. A suggestion has been made in the debate that, at least if the principle of exhaustion is applied as the general rule, special legislative provisions should be made to protect Canadian industries against import competition for particular categories of books and sound recordings, namely, the remainders (in the case of books) or deletes (in the case of sound recordings).

For the Writers' Union of Canada, this may be the most important issue in the current copyright legislation. Much of the highly emotional debate in this field has dealt with this particular problem. In the recent brief on the subject to the Secretary of State and the Minister for Consumer and Corporate Affairs, the Writers' Union described the problem, and advocated remedial action, in the following terms:

> Thousands of these books, remaindered at cost in the United States and sold, at a fraction of their original price to jobbers, are now on the shelves and in the windows of three Canadian book chains in direct competition with the Canadian editions of the same works. The results have been devastating....
>
> At the moment, at least twenty-six of the country's major writers are suffering from a situation that has no parallel in the English-speaking world....
>
> If the government does not act -- and swiftly -- Canada is going to lose some of its best writers to the United States....
>
> For several years, writers in this country have been asking for government action in this matter. We don't feel that any effective action has yet been taken. We are tired of delays. As working writers we cannot afford them. We ask for immediate action... <u>now</u>...not a year from now or two years from <u>now</u> or God knows when.... (Writers' Union of Canada, 1978, pp. 1, 2, 7, 8)

What other interest group could present its plea for special protection against import competition with such ringing eloquence?

The problem arises as follows. In most (though not all) contracts between an author and his publisher, or between two publishers when one is selling territorial rights to another, there exists a remainders clause which specifies that, under certain circumstances, a given edition of a book can be disposed of by the publisher as a remainder. This essentially means that the publisher may pay a low or zero rate of royalty to the author or to the publisher from which he acquired the copyright. In the latter case, if the author is paid a percentage of net receipts from foreign editions, his income per copy sold is greatly reduced as well. Generally, the remainder provision is triggered by the publisher having experienced a sufficiently long period of sufficiently small sales. He will then have the right to dispose of unsold copies as remainders, which are typically priced much lower than the original terms on which the book was sold. There is an active market in low-priced remainder editions in the United States, with some large retailers (Barnes and Noble in New York is one) specializing in the sale of such editions.

The situation in the sound recording industry is entirely analogous, except that the term used is deletes instead of remainders. Contracts between artists and record firms, or between firms when territorial rights are bought and sold, again contain provisions describing the circumstances under which the buyer of the copyright may delete the record and dispose of unsold copies without being liable for royalty payments. In practice, deletes are also priced at a fraction of the amount for which the record was originally sold.

To a small but important minority of English-speaking Canadian writers and Canadian recording artists, the remainders issue is of vital importance: those with an international audience who can expect to enjoy significant sales of their works in foreign markets. Often, the most profitable way of exploiting the foreign market is simply to refrain from selling copies of the Canadian version of the book; instead the author or artist, or his Canadian publisher, sells the foreign rights for the particular country to a foreign publisher or record firm, who creates a separate version which he then sells in his own market.[6]

The pricing of the foreign version is normally the prerogative of the foreign buyer of the rights, and one reason why Canadian authors and publishers are pushing for import protection is the fear that such foreign editions may be priced below the Canadian ones. Another reason, however, is found in the risk that the foreign versions may be remaindered or deleted. By itself, the fact that the foreign buyer decides to invoke a remainders or deletion clause should not be particularly alarming. It simply indicates that the work is no longer selling sufficiently well to make it worth while to maintain the unsold copies as part of his inventory, so that the Canadian author or artist could not expect much revenue from the foreign version in any event. The problem arises, however, when the work is still selling well in Canada. In that situation, a Canadian book chain or wholesaler may simply buy up a substantial quantity of the remaindered foreign copies and import them into Canada, selling them at a price well below that of the regular Canadian version. Since little or no royalty is earned on remaindered or deleted copies, to the extent that sales of these copies displace sales of the Canadian ones, the author or artist (and the Canadian publisher or record company) loses revenue.

The quantitative significance of this loss of revenue is impossible to assess, since it is difficult to estimate what the sales of the regular version of a work would have been if there had been no sales of low-priced foreign remainders or deletes. The Writers' Union provides estimates for the royalty losses "on a sample of titles affected since 1970 by importation" (Appendix A in their brief) comprising six books with losses shown as ranging from about $4,000 to less than $150 (the period over which the losses are calculated is not shown). The estimates are based on declines in sales relative to an (unspecified) earlier period and hence fail to account for the fact that a decline would almost certainly have taken place even with no import competition, following the normal time pattern of sales for any book.

In our opinion, however, the main issue at hand is not whether the presumed royalty losses are quantitatively large, but rather whether there are ways of resolving the problem without having recourse to comprehensive restric-

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6. Especially in the case of sound recordings, the foreign version may be identical to the Canadian one except for the cover or the label.

tions on imports of foreign editions, such as those advocated by the Writers' Union. As is implicitly noted in their brief, there are. An author or a publisher selling foreign rights may simply specify that any remaindered copies of the foreign edition are to be sold back to the Canadian copyright holder. The brief notes that this has in fact been done by "many publishers," but it is also observed that this solution is not costless:

> Since the remainder date is totally unpredictable this can frequently mean substantial capital outlay, capital which could be directed more usefully in other areas. In addition, they must absorb increased warehouse and insurance costs. (Writers' Union of Canada, 1978, Appendix A, p. 2)

The same solution could, of course, be applied to the problem of deleted sound recordings.

The conclusion of this discussion must be that the importance of the remainders/deletes issue as an argument against free importation of copyrighted material has been greatly exaggerated. It can be resolved in a simple way through a buy-back clause (or similar contractual device), the possible costs of which sould be regarded as a relatively inexpensive insurance premium against the possible losses through imports of remainders or deletes. Naturally, Canadian authors, publishers and recording artists would prefer not to pay this implicit premium, but it is difficult to regard this as a decisive factor in favour of broadly based import restrictions.

CHAPTER II

INDUSTRY STRUCTURE AND PERFORMANCE

The Book Industry

Introduction

The writing, production and distribution of books represents a relatively large economic activity in Canada. For the year 1977, Statistics Canada indicates the following totals. The value of sales of books published in Canada in English and French, respectively, was estimated at $127.7 million and $40.5 million. In recent years, Canada has developed a significant export trade in books: for the year 1977, it is estimated that the value of export sales was $56.5 million. It is well known in the industry that the major part of this total stems from a large publisher in the mass-market paperback field, Harlequin Romances, which has had remarkable success in developing a North American market for its publications. The works of a number of the better-known Canadian authors in the regular trade book field are also sold in foreign markets on a fairly significant scale, but often in editions that have been produced outside Canada, and hence they do not appear in the export figures of Canadian publishers.

Imports of books into Canada are also large. For the year 1977, Statistics Canada gives figures of $368.2 million and $46 million for imports of books in English and French, respectively. Again, the distinction between imports and Canadian-produced books is to some extent arbitrary because of the fact that some books written by foreign authors are published and produced in a Canadian edition by a publisher in this country, and hence are not reflected in the import statistics. The share of imported books appears to have remained remarkably constant over the recent years. Data from a Bureau of Management Consulting study indicate that in the early 1970s, the import share was just under 70 per cent of the total market (1977, p. 36); the most recent (1977) Statistics Canada data yield an import share of 68.9 per cent.

Taking sales of "own titles" by Canadian publishers plus net imports of books produces a figure of roughly $27 per capita book sales in Canada. It is difficult to make exact comparisons with other countries. Nevertheless, it is interesting to note that the total sales of American publishers per head of the U.S. population gives a figure of about U.S.$21, which is substantially below the Canadian figure. Exports and imports of books play a much smaller relative role in the United States than in Canada, as might be expected given the large size of the U.S. domestic market for books.

The above figures refer to the actual sales revenue of publishers, or to what is referred to by Statistics Canada as "first point of sale." The total amounts paid by the ultimate book buyers are considerably higher, with the difference representing value added in distribution. Precise statistics on the magnitude of this value added are much more difficult to come by than are the data on the publishing industry. Statistics Canada, using an "experience figure," estimates that the sales of the publishing industry represent about 60 per cent of the total amount paid by book buyers. This figure is consistent with commonly observed discounts on books to bookstores of about 40 per cent off list price. Using this rule of thumb, the total amount paid by Canadian book buyers for domestic and imported books can be estimated at about $1000 million, or $45 per capita. Applying the same procedure to the U.S. data produces an estimate of U.S.$7676 million for total sales, or U.S.$35 per capita.

On a per capita basis, the Canadian publishing industry thus appears to have a significantly larger potential market than the U.S. industry, even after conversion to a common currency at present exchange rates. This, however, need not necessarily mean that it is more profitable. Factors such as a high cost structure and a market which is small in absolute size are often cited as severe handicaps under which Canadian publishers operate. Indeed, there seems to be a widespread popular view that Canadian publishing is an ailing industry that depends on a substantial amount of government assistance for its survival.

Available data for the publishing industry as a whole do not support this view. According to unpublished Statistics Canada estimates, the after-tax rate of return on equity in the industry as a whole was 20 per cent in 1976, and 29 per cent in 1977. Furthermore, for the industry as a whole, income from government grants constituted less than 1 per cent of net sales revenue in either year.

When the data are disaggregated by size, however, a different picture emerges. For both years, firms with sales over $1.5 million have considerably higher returns than smaller firms (24 per cent for large firms as opposed to 5 per cent for smaller firms in 1976 and 34 per cent as opposed to 3 per cent in 1977). While it is true that the majority of all Canadian-controlled publishers are small, it is obviously not true that all of them are. For 1976, Statistics Canada lists 23 foreign-controlled firms with sales over $2 million, and 13 Canadian firms.

In discussing the profitability of publishing by size class of firm, one must finally keep in mind that for many firms in this industry, publishing of new titles represents only a part of their business. Another very important part is the exclusive-agency business -- i.e., the importation and resale of foreign publications under exclusive-agent agreements with foreign publishers. There appears to be a widely held view in the business that exclusive-agency business is profitable, whereas publishing of new titles for the Canadian market is not. The pattern of profitability by size class would appear to be consistent with this view: publishing firms with large sales revenue also tend to be those with a relatively large share of agency business. Thus, one could argue that their higher return on invested capital simply reflects their higher concentration on this activity.

We will return later in this report to the significance of agency business for the Canadian publishing industry. It is worth noting at this point, however, that the evidence can also be interpreted as being consistent with another view, namely, that there are economies of scale both in the publishing of own titles and in the agency business. Efficient utilization of an editorial and production staff is easier when a fairly large number of titles are published each year. Efficient distribution and marketing also requires a relatively large volume of sales. Furthermore, book publishing and marketing clearly are highly interdependent. A publisher who does his own marketing and distributing will acquire a better feel for the tastes and preferences of the book-buying public than will a publisher who markets through another publisher. Hence the former will become better able to find saleable manuscripts. For these reasons, a large publisher with a high-volume marketing organization will be more efficient at the agency business, and hence this business will become concentrated with the large firms. At the same time, an effective marketing organization will enhance the profitability of the publishing side of the operation and the publisher will be able to realize economies of scale, further improving profitability in publishing as well.

From the viewpoint of the economic health of the book publishing industry, the numbers quoted above relating to sales revenue and profits are clearly the most significant. Much of the public interest in the book industry, however, is concerned with a different set of issues, the so-called cultural objectives. It is not obvious how the attainment of cultural objectives should be defined, although clearly they cannot be measured simply by the sales or profits of publishing firms operating in Canada. A more reasonable interpretation, one may argue, would be to define them with reference to something like "Canadian identity," which, in turn, could be taken to depend on the number and variety of books written with some focus on "Canadian content" and the extent to which they are being read by the Canadian public. From this point of view, the importance of the performance of the publishing industry does not lie in its generation of profits, in its impact on the balance of payments or even in the number of jobs it creates. Rather, an efficiently operating publishing industry is important because of its role of intermediating between the Canadian reading public and Canadian writers. Its performance, then, should not be assessed by its profitability, but rather by the extent to which it helps maintain an active group of writers engaged in creating literary works which are of interest to the Canadian public. This will require, in part, that such writers earn an adequate income through royalty revenues and the like, and perhaps also that publishers will be willing to take a chance, from time to time, in publishing the works of new writers -- i.e., those who do not yet have an established reading public, and whose work can be expected to sell only in relatively limited quantities. Thus, from the standpoint of the Canadian public interest, it seems to us that the performance of the publishing industry, or the efficacy of public policy measures, cannot be assessed validly by looking at the profitability of publishing firms. Instead, they should be evaluated by assessing the efficiency with which the industry generates income for writers, both established and aspiring, and the cost at which it makes books available to the public. These observations may seem to be trivial, but on occasion the debate regarding policy in this area tends to lose sight of these fundamental aspects of the role of the publishing industry.

One suggestion that has sometimes been made is that the degree of success in attaining cultural objectives should be measured by the number of titles published. Using this measure, it appears that the number of works by Canadian authors has been growing. For example, in 1972, 1157 new works by Canadian authors were published in the English language; this grew to 1252 in 1974 and 1279 in 1976. The corresponding figures for foreign authors were 266 in 1972, 846 in 1974 and 908 in 1976 (Bureau of Management Consulting, 1977, pp. 106-109; Statistics Canada, <u>Book Publishing: A Cultural Analysis,</u> 1976, Table 27). The largest increase in works by foreign authors would seem to indicate a growth in the extent of co-publications. The number of titles published in the French language in 1976 was about one-quarter of the number in English, but the proportion of Canadian writers is much higher (82 per cent vs. 58 per cent). Again, this reflects the extent of co-publication ventures, which are much less frequent among French-language publishers.

While these numbers appear to indicate a modest but steady growth in Canadian publishing activity, it should again be noted that they represent at best a very incomplete measure of the attainment of Canada's cultural objectives if, indeed, that concept can be given a well-defined meaning. Thus, "the number of titles published" will reflect in equal measure an adapted Canadian edition of a foreign high school text, published to take advantage of the preference given to Canadian texts through directives issued by provincial governments, a new novel by Margaret Laurence or the most recent monthly offering by Harlequin Romances. It will also reflect the publication of a Canadian edition of a foreign best seller. One's intuitive notion of cultural objectives certainly would suggest that not all of these should be given equal weight. Moreover, as argued above, the attainment of these objectives should reasonably be considered as referring not only to the number of books being written, but also to the number of people who read books (including foreign books). This, in turn, will depend in part on the prices at which books are being sold, and it seems to us that these considerations are also important in assessing Canadian performances in this respect.

The book industry: submarkets and distribution channels

The discussion up to this point has dealt with the book trade as a whole, without distinguishing between types of books by content, distribution channels and so on. Yet the trade is characterized by considerable variety in these respects, with different kinds of problems calling for different strategies on the part of the publisher.

One important distinction arises from the nature of a book's contents and ultimate use. In Table 1, the aggregate value of sales by Canadian publishers are classified according to the "commercial categories" customarily used in the industry. The importance of educational publishing should be noted. Sales to elementary-secondary institutions in 1977 accounted for almost one-third of the total sales of the publishers surveyed by Statistics Canada. In the elementary-high school market, most books are sold directly to schools, who pay for them out of public funds and in turn provide them to students. The fact that they are paid for by someone other than the user is likely to influence the responsiveness of total sales to price. As well, the fact that those selecting the titles to be bought are experts in the field is likely to call for a somewhat different promotion strategy than would be the case of post-secondary education books, where selection of texts is done by the instructor but the book is paid for by the students. For the case of el-hi texts, it should also be noted that the market has been affected to some degree by the increasingly common practice of provincial ministries of education of restricting the choice of books that can be used as texts in the elementary-high school system. In consequence, Canadian el-hi publishers are now enjoying a measure of protection from competition from foreign publishers. For these reasons, the various submarkets are analyzed separately in the empirical analysis.

Table 1

Net Book Sales by Commercial Category, 1976
(Own titles only. Millions of dollars)

	El-hi	Post-sec.	Prof.	Trade*	Mass-market**
Total sales	42.0	5.7	15.9	36.0	42.0

SOURCE: Statistics Canada. Cultural Statistics, Book Publishing: A Cultural Analysis, 1976.

* Other than mass-market paperback
** Over 95 per cent are trade books

Another important distinction which can also be expected to influence the publishers' marketing strategy is that of "format category." Statistics Canada categorizes books in three major ways: mass-market paperback, hardcover and "other paperback" (called "quality paperbacks"). Subsequent analysis will distinguish between mass-market paperbacks and other books for several reasons. A large part of the distribution of mass-market paperbacks in Canada is handled by specialized wholesalers, and a large proportion of all copies are sold in outlets other than traditional bookstores: cigar stores, variety stores, supermarkets, etc. Hence they are aimed at a customer category which can be expected to behave somewhat differently from the more deliberate buyer who selects his hardcover book or quality paperback from a traditional bookstore. Furthermore, paperback publication tends to be done on a very large scale, and the extent of co-publication ventures between Canadian and foreign firms appears to take place to a much larger extent for this format category than for the others. It should be noted in this context that mass-market paperbacks, in spite of their relatively low price, constitute a large proportion of total book sales in Canada: in 1976 they represented 30 per cent of total sales, including exports.

Book distribution and technological change

One thing that is striking to a newcomer who studies the book trade for the first time is the large share of the cost of a book that is accounted for by distribution. To begin with, as was noted above, the publisher receives on average only about 60 per cent of the price at which a book is typically sold, with the rest corresponding to the cost of distribution services performed by other agents than the publisher himself. Apart from this, however, the value added in publishing already includes a substantial amount of distribution. To illustrate this, consider, for example, a small publisher who does his marketing through a large publisher acting as his agent. Since he is likely to have had his printing done in an outside printing establishment, he may in fact never handle the final copies of the book. They will be picked up by the larger publisher and stored in his warehouse. The processing of orders from bookstores, billing and transportation from the publisher's warehouse to the bookstore may all be handled by the publisher who acts as agent. All these are distribution functions, similar to those performed by exclusive agents representing foreign publishers in Canada. The large publishers perform these distribution functions for themselves, so that their total revenue figures in fact include a large proportion of revenue derived from distribution activity. As a consequence, the apparently wide difference in size between the largest and smallest publishers is to some extent misleading: the largest look large in part because they combine publishing, marketing and distribution, while many of the smaller firms perform only publishing in the strict sense of the word.

If the cost of the distribution services performed by the publishers themselves is added to the 40 per cent distribution margin referred to above, it becomes clear that well over half of the price paid by the ultimate consumer represents the costs of distribution. Hence, the cost of books to consumers and the share of total sales revenues accruing to authors depend as much on efficiency of the distribution process as on that of the editorial and production processes.

As a consequence of the large sums of money involved in distribution, there are many opportunities for making profits by innovation in the form of various kinds of specialization and the introduction of new technology. In recent years, the large bookstore chains (e.g. Cole's, Classic Bookshops) have been obtaining an increasing share of the market. Mass-market paperback publishing houses have national distributors who handle the distribution of magazines to the various outlets they serve. In the United States, a further specialized link in the distribution chain has emerged, the "rack jobber," who intermediates between wholesalers and ultimate retail outlets. For the library market, which has somewhat specialized needs, there is also a relatively large business in wholesaling books. Sometimes the wholesalers perform not only distribution functions but also handle the cataloguing and special binding required by libraries, for example. In the United States and the United Kingdom, there has been considerable growth in the scale of specialized wholesaling, not only in the traditional mass-market paperback and library markets, but also in the trade book market, so that bookstores have begun buying to an increasing extent from wholesalers rather than directly from the publishers. This trend can be explained in part by new technological developments (involving the use of computers and micro-fiche services) which have enabled the wholesalers to greatly reduce the time required to fill a bookstore's orders, partly by giving the store access to information about the wholesaler's current inventory, and also by providing the store with information about sales of current titles in other stores.

In Canada, the growth of this type of wholesaling and the rate of technological development in wholesaling appear to have been considerably slower. Most of the book trade continues to rely to a considerable extent on the traditional channel directly from the publisher to the bookstore or the school. The functions are, in effect, performed jointly by the publisher and the bookstore. Rather than ordering from one or only a few wholesalers, a bookstore owner in Canada has to place his orders with a large number of publishers and handle a large number of incoming books from different sources. The publisher, on the other hand, instead of selling a large number of copies to only a few wholesalers has to handle orders from a large number of bookstores and bill each one. "By-passing the middleman" therefore adds to the operating costs of both bookstores and publishers, and the question that therefore arises is whether these functions could not be increasingly performed by specialized wholesalers in Canada as well. The answer will depend in large measure on various aspects of government policy. For example, re-introducing the recently abolished tariff on imported books would make the extension of the U.S. wholesaling operations to Canada more difficult, and would also make it more difficult for Canadian wholesalers to enter into cooperative arrangements with them. In addition, the decisions taken by the government with respect to the import provisions in the Copyright Act may also have a significant impact, as will be discussed later. In any event, the impact that these decisions will have on future trends in the book distribution system is a very important reason why the Canadian book-buying public should be concerned about them. These trends will have a substantial effect on the availability and cost of books in Canada in the future.

The Record Industry

Introduction

Previous studies of the Canadian record industry[1] are few in number. In Canada, descriptive studies of the industry structure can be found in studies by Anderson (1977), Klopchic (1976), Keon (1980) and the Department of Industry, Trade and Commerce (1978). These are all highly descriptive works which offer little or no analysis for the explanation of the industry structure or the important question of pricing behaviour. In the United States, partly because of the size and the longer history of the record industry, two in-depth studies can be found in the doctoral dissertations by King (1966) and Vlahakis (1975). King's study is more specialized, concentrating on the detailed description of the marketing and distribution structure of the industry. The only study that comes close to offering some explanation of the behaviour of the industry structure is that of Vlahakis. Its shortcoming, however, lies in its inadequate explanation of pricing behaviour.

Nonetheless, the above literature provides valuable information on the characteristics of the industry. It provides a useful basis for a theoretical construct in explaining the industry pricing behaviour and hence the issues of

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1. From now on, "record industry" is used as a generic term to include the production of pre-recorded tapes.

import restrictions. Although the sources from which we quote refer to conditions in the U.S. industry, we will argue below that they can essentially be applied to the Canadian situation.

The essential features of the industry can be listed as follows:

(a) demand uncertainty;

(b) high concentration ratio;

(c) high vertical integration among the major firms; and

(d) price leadership.

In what follows, each characteristic is discussed in greater detail.

Demand uncertainty and high concentration ratio

It is a well-established fact in the industry (whether domestic or foreign) that demand for each record release is highly uncertain, contributing to a high degree of fluctuation in profit. As an example, it was noted that:

> Twenty years ago, the four giants were CBS, RCA Victor, Capital and Decca; they accounted for about half the business in the U.S. Of these, only CBS, which currently has about 20 percent of the market, has maintained its dominant position. The others have seen their fortunes rise and fall with the popularity of their superstars. (Rice, 1979, p. 61)

Consumers' tastes for each type of record are difficult to predict. This is the main reason why a large part of the record business is centred around the promotion of artists. Harry Anger, a vice-president for marketing at one of Polygram's labels, maintained that "if pitching is 70 percent of baseball, promotion is 70 percent of the record industry" (Rice, 1979, p. 60). Despite massive promotional efforts, it was noted that two-thirds of all records are dismal flops (Ibid., p. 60). This testifies to the fact that although promotional activites were mainly designed to increase and sustain demand, their ability to completely eliminate uncertainty of demand is far from complete.

In 1971 the concentration ratio in the United States, calculated as a share of market sales on the top 4 and 8 music recording companies (out of 1138), was 52.6 per cent and 81.8 per cent, respectively (Vlahakis, 1975, p. 40). This is contrasted with the situation in Canada where, in 1977, the top 7 companies' share of the market (out of 74 companies) was about 66 per cent (Statistics Canada, The Recording Industry, p. 5). In both countries, therefore, the concentration ratio is high. The direct implication of this is that market power is concentrated among the major companies.

Another important statistic that bears on the Canadian market structure is that foreign subsidiaries overwhelmingly dominate the market share of records and pre-recorded tapes. Tables 2 and 3 indicate the size of the Canadian market and its breakdown between foreign subsidiaries and Canadian-owned companies for both records and pre-recorded tapes, respectively (Keon, 1980, p. 37). The percentage of sales in Canada by foreign subsidiaries of records and pre-recorded tapes (calculated from Table 2) is shown in Table 4.

Table 2

Canadian Market for Records ($000s)

	Total sales of phonograph records	Sales by foreign subsidiaries	Sales by Canadian-owned companies
1973	73,603	63,173	10,430
1974	92,736	81,836	10,900
1975	100,847	91,324	9,523
1976	112,864	101,673	11,191

SOURCE: Keon, 1980, p. 37.

Table 3

Canadian Market for Pre-Recorded Tapes ($000s)

	Total sales of pre-recorded tapes	Sales by foreign subsidiaries	Sales by Canadian-owned companies
1973	31,565	27,813	3,752
1974	39,048	35,358	3,690
1975	42,537	37,986	4,551
1976	47,232	44,212	3,020

SOURCE: Keon, 1980, p. 37.

Table 4

Foreign Subsidiaries' Percentage Share of Market

	Records	Pre-recorded tapes
1973	85.8	88.1
1974	88.3	90.6
1975	90.6	89.3
1976	90.1	93.6

SOURCE: Keon, 1980, p. 38.

For 1977, figures in Statistics Canada, The Recording Industry, 1977, show that foreign subsidiaries accounted for 83.5 per cent of the total sales of the record industry. These figures indicate that not only is the Canadian record industry concentrated per se, but it is concentrated in the hands of foreign-owned companies. The analysis of the market structure in the Canadian scene cannot, therefore, be isolated from the evolution of the market structure in a foreign country -- particularly the United States, which is the major foreign element of the foreign subsidiaries in Canada.

In his study on the market structure in the United States, Vlahakis (1975) draws the following conclusions:

(a) Entry into the industry is easy (due to the low capital requirements) and free entry has transformed the industry from a tightly controlled oligopoly in the forties and fifties to a loose oligopoly in the seventies (made up of a few large firms and a competitive fringe made up of many small firms).

(b) The small size of the entrants, coupled with the highly uncertain demand and, therefore, profit has caused a large turnover of the number of firms in the competitive fringe.

(c) The share of the competitive fringe has progressively increased in recent years and a number of successful fringe firms like Atlantic and Motown have become significant competitors of the majors.

(d) The entry of new firms has led to consumer identification of product quality by the name of the artist rather than by the name of label of the recording company. This de-emphasis of the big-name recording company has made it convenient for additional firms to move in.

(e) The increased entry of new firms in the 1960s created a problem of survival for new entrants and established firms. Survival of a music recording company depends on hit records. The attempt by every recording company to produce a hit record created a severe problem of obsolescence of catalogue records, thereby creating a secondary market for cut-out and obsolete records.

(f) The increased entry did not significantly change the oligopolistic structure of the industry -- i.e., the concentration ratio was not greatly reduced. Although oligopoly was maintained, the rank of the four or eight larger producers did change over time.

In summary, despite easy entry, large fluctuations in demand have also caused many exits, and consequently the market is still highly concentrated.

Vertical integration and price leadership

Another notable characteristic of the market structure is the increasing vertical integration practised by the majors.

> In the fifties all the companies, large and small, relied on independent distributors to wholesale their product. But as volume began to soar, the big companies, like CBS, that could afford the high, fixed costs of an in-house distribution network, set up branches all over the country. By cutting out the middle-man's profit, they can sell record stores an album that lists at $7.98 for about $4.05, while independents (distributors) charge $4.25. (Rice, 1979, p. 68)

The increasing vertical integration among the majors to exploit the economies of scale of distribution has made it difficult for independent distributors to survive. Due to the more efficient distribution services and better cash advances provided by the majors -- CBS, EMI/CAPITOL, MCA, POLYGRAM, RCA and WEA -- smaller independent labels have increasingly migrated from the independent distributors to the majors' distributing arms. In 1979, RCA took on the distribution of Twentieth Century Fox and A&M Records which, with estimated sales of $100 million, is the largest of the independent labels (Rice, 1979, p. 68). In 1978, companies like United Artists, DIM, ABC also migrated to the distribution services of the majors.

A small-label owner who opts to use the majors' distribution arms receives less money per album sold than he would from an independent distributor but, in return, he obtains a degree of financial security, almost always including a sizable cash advance against future royalties, that no independent distributor can offer. As a result, the six major companies in the United States achieved a share of the U.S. market that has probably surpassed 85 per cent. This trend is increasing since, in the meantime, other independent record companies like Arista, Motown, Fantasy, Chrysalis and Mushroom reportedly have been negotiating distributing deals with one or more of the major record companies, although each has denied that it will abandon independent distribution (Kirkeby, 1979).

The majors, of course, are increasing their distribution activities at the expense of dwindling business on the part of independent distributors. In the United States, the wholesale price of a record distributed to a retail store by a major is about $4.05, which is considerably less than the $4.25 which is roughly the wholesale price required by an independent distributor. To convince the retailer to buy his more expensive record the independent distributor must have hit records to offer, but they are becoming scarce since more independent labels are being bought out by the majors.

This discussion on market characteristics has set the stage for the analysis of price leadership in the industry. Price leadership is the phenomenon in which changes in prices of records are almost always initiated by the majors and followed by the smaller independent record companies. The best example of price leadership can be found in a statement by the president of a medium-size phonograph record company in anticipation of a price increase of records in 1970: "If RCA, CBS, and Capitol decide to raise prices, the whole industry will raise prices. Who are we to argue?" (Billboard, Sept. 1970, quoted in Vlahakis, 1975, p. 174). Similar statements are made by the smaller independent record companies in Canada.

Given the market characteristics discussed in the preceding section, it is not difficult to see why price leadership arises. The large uncertainty in demand for a product causes payments from small independent distributors to the smaller record producers to fluctuate according to sales. Mainly because of their small size and undiversified activities, the independent distributors are not able to reduce their risks sufficiently to provide adequate insurance in terms of advance payments to the small independent record producers. This is reflected in the increasing numbers of independent record producers that have their products distributed by the distribution arms of the highly vertically integrated and horizontally diversified majors who are able to provide insurance in the form of an advance payment.

The implicit insurance risk premium is, of course, reflected by the lower price an independent label receives from the major. For example, a major offers a price of $3.47 in contrast to $3.55 or $3.60 per album offered by an independent distributor to a record producer (Kirkeby, 1979) in return for financial security in the form of an advance payment. The larger major firms are able to act as insurers because of their ability to better minimize risks from their usually diversified activities.

The increasing dependence of the smaller independent labels on the distribution services of the majors, who among themselves own a large market share, suggests that the majors possess a high degree of market power over the smaller independent labels. Since a distribution service is a package of items like selling, storage, transportation, extension of credit and provision of market information, it is inevitable that a small independent label who purchases a major's distribution service for its competing market also seeks the major's cooperation in this vital marketing link.

We conclude, therefore, that the smaller independent labels and the majors both compete and cooperate owing to the formers' dependence on the latters' distribution services. Competition in quality and quantity of sales (hit records) still remains the single most important rivalry among record producers, large or small. This competition, the sole determinant of which is the consumers' tastes for an artist's act, can hardly be eliminated by the majors. The other integral part of competition, prices, however, is more easily influenced by the majors owing to the dependence on the majors' distribution services. Thus, cooperation between the small independent labels and the majors lies in the implicit coercion by the latter to eliminate price competition. This is consistent with the observation of price leadership by the majors in the industry.

CHAPTER III

EFFECTS OF ALTERNATIVE COPYRIGHT ACT IMPORT PROVISIONS: THEORY

Introduction

In this chapter, we turn to an analysis of the specific policy issue with which this report is concerned, namely, the likely consequences for the publishing and sound recording industries of alternative changes in the import provisions of the Canadian Copyright Act. Whereas the foregoing discussion has been mainly descriptive, the task of predicting the effects of alternative policy changes of this kind requires a more analytical framework. The effects of policy changes will depend on the reactions of the various participants in the book and record trades to the new set of constraints imposed on their behaviour under a different set of policies, and on the way the decisions of these agents interact in the marketplace. Hence, a systematic evaluation of alternative policies requires some sort of model describing their behaviour and the way in which their decisions interact. The purpose of this chapter is to construct a model of this kind to isolate the parameters that will determine the magnitudes of the effects on the industries of alternative changes in copyright legislation. An attempt to estimate the actual values of those parameters, and hence to empirically measure these magnitudes, is made in Chapter IV.

The Publisher's/Record Company's Decision Problem

The fundamental problem that we are seeking to analyze in this report involves the financial return to creative activity in the form of writing and publishing of books and in creating sound recordings of musical works. We begin, therefore, by considering a situation when a work has been "created," in the sense that an author has produced a manuscript, or a musician or group of musicians have created an arrangement of a musical work and prepared themselves for performing a recording of it. If a book or a sound recording is actually produced and sold, the author or musicians can expect a financial return on their efforts. A model can be formulated to describe how this return is determined and how the expected return may change in response to various changes in the conditions affecting the markets for books and sound recordings.

The process of transforming manuscripts or musical performances into books or sound recordings to be distributed to the public is almost always done by intermediaries -- i.e., book publishers, recording studios and record companies. The decision on whether or not to undertake the process therefore depends on their assessment of costs and returns. The returns to the original creator of the work will depend partly on the skill with which the work is produced and marketed, partly on the terms of the prior agreement under which the publisher or record company undertakes these activities.

To bring the analysis to bear directly on the issue of import restrictions, we will assume that, in assessing the financial potential of a work, the publisher or record company may sell copies of the work both domestically and abroad. To simplify the formal argument, we will lump all markets in other countries together into a single foreign market, indexed by superscript "a"; the domestic market is indexed by "c" for Canada. Thus, the publisher or record company may have to consider not only domestic costs of production and distribution, but also the corresponding costs in the foreign market. Similarly, the critical decisions regarding the price at which the work is to be marketed have to be made not only for the domestic but also for the foreign market.

With the assumption that the publisher or record company plans to market a particular work both at home and abroad, his expected costs, C_i, associated with the production and distribution of the i^{th} work, may be written as:

$$C_i = f_i^a + f_i^c + q_i^a m_i^a + q_i^c m_i^c \qquad \text{Equation (1)}$$

Here, f_i^j are the fixed, or "one-time," costs of creating and marketing the works in the respective markets, m_i are the marginal costs per copy, and q_i are the quantities (number of copies) that the firm expects to sell in the respective markets.

Total expected revenues to the firm from the i^{th} work, R_i, may be written as:

$$R_i = p_i^c q_i^c + p_i^a q_i^a \qquad \text{Equation (2)}$$

where p_i^j represents the net revenue per copy (i.e., after discounts to retailers) accruing to the firm. Combining equations (1) and (2), the expected contribution to the firm's overhead costs and profits from the work may be written as:

Equation (3)

$$W_i = R_i - C_i = (p_i^c - m_i^c)\, q_i^c + (p_i^a - m_i^a)\, q_i^a - f_i^c - f_i^a.$$

Given the cost parameters m_i^j and f_i^j, the value of W_i will depend on the number of copies sold and the net prices p_i^j that the firm decides to charge. Obviously, the expected sales depend on the prices, and we will take this into account in analyzing the pricing decision below. It is important to realize, however, that the cost parameters may also be influenced by the firm through its decision with respect to the technology by which the work is to be produced and marketed.[1] For example, suppose that a book written in the United States is printed in only one edition to be sold both in the United States and Canada, with production of all copies taking place in the United States. In that case, almost all of the fixed costs will obviously accrue in the United States: the cost of editing, design and layout, of creating the photographic plates used in printing the book, etc. The value of f_i^c, the fixed costs of marketing the book in Canada, will then be relatively small. It will reflect only the publisher's cost of adding another title to the range of books he is already promoting and selling. Since all copies are printed in the United States, m_i^c will be higher than m_i^a by the cost of transporting and clearing through customs copies of the work destined for Canada's market.[2]

Suppose, on the other hand, that the publisher decides to market the work in Canada as a separate edition, created and produced in Canada. In that case the f_i^c may be substantial; in some cases there may be some modification of the content and there may be separate design costs. Even if no new photographic plates are produced (i.e., the book is printed from imported plates), there are some fixed, or "one-time," costs of preparing a new print run and, while there will be no international transport costs, the marginal

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1. They will, of course, also be affected by various characteristics of the work, such as (in the case of books) the length of the manuscript, degree of technical content, illustrations and the quality of paper and binding. These characteristics may be taken as given at this stage, however.

2. This cost, of course, includes any duty payable on imported books or sound recordings. For books, the duty is currently zero, but not for records.

cost of printing and binding may differ from that in the United States because of different costs of material, labour, etc. The marginal cost of marketing may also differ between the two countries.

We now consider the determination of the net revenue, p_i^j. The normal practice in the book industry is to fix a list price for a book, which is also the price appearing in the publishers' catalogues. The net revenue of the publisher will be substantially less than the list price, however, because of the discounts given by the publishers to the booksellers. These discounts typically range between 40 to 45 per cent of list price, depending on the size of the bookseller's order, and in some cases may be different if the book is sold to a wholesaler. As well, where the author's royalty is fixed as a percentage of the list price, the royalty payments should be taken as a reduction of the net revenue of the publisher rather than as an addition to the marginal cost per copy of the book. We shall treat royalty payments in this way in some of the empirical discussion below, although at this point we will implicitly treat the author's royalty as a fixed sum, i.e., a part of f_i^j. We will also disregard variations in the discounts to retailers and simply assume that there is a simple factor of proportionality between list price and net revenue, so that when the publisher determines the list prices at which the book will be sold, he is also implicitly determining his net revenue levels, p_i^j.

Pricing practices in the sound recording industry are quite similar to those in book publishing, with discounts to distributors ranging between 40 to 50 per cent of list price, depending on the volume of the order. A somewhat surprising aspect of the pricing practices is the uniformity of prices between different works in a given market; the significance of this phenomenon will be discussed later.

In terms of analyzing the impact of alternative Copyright Act import provisions, the most important question probably concerns the effects which the different rules would have on the level of Canadian book prices in general and/or the prices of internationally marketed books in particular. To evaluate these effects, we have to formulate a hypothesis regarding the way in which prices of different works are set by the copyright holder. Following the traditional approach in microeconomic analysis, we will assume that the objective of the publisher or record company can be very simply represented as being to maximize profits, given by equation (3).

We will consider the choices of where to produce copies of the work, whether to produce separate editions and so on, as having already been made so that the values of f_i^j and m_i^j are known. In general, of course, we expect copies will be produced where it is cheapest to do so, given transport costs and tariffs, and that separate editions will be produced only if this increases total profits.

Given the cost parameters, the choice problem then consists of selecting the list prices to be charged in the U.S. and Canadian markets which will maximize W_i. Since we are taking the net revenues as proportional to list prices, we will henceforth consider the p_i^j themselves as the relevant choice variables.

Analogous choices have to be made in the case of sound recordings. The major fixed item in this case is the cost of the recording process itself, i.e., the production of a so-called master-tape. Once a master-tape has been produced, the problem of international marketing reduces to the question of whether to supply the foreign market through exports of domestically manufactured copies (i.e., phonograph records or pre-recorded tapes), or to create a separate release in the foreign market and supply it with copies manufactured in the foreign country. The choice will depend on the relative marginal costs of production and distribution, the cost of transport (including duty), the fixed costs of manufacturing and promoting a new foreign release (i.e., the f_i^c for the case of an American recording to be released in Canada) and on the expected sales volume in the foreign market. In practice, the marginal costs of production and distribution do not seem to be higher in Canada than in the United States. Transport costs include a relatively sizable duty rate, and the fixed costs of setting up production and promotion for a Canadian release (made from an imported master-tape) are not very high. Hence, most sound recordings sold in Canada are in fact manufactured here, and imports of records and tapes mostly involve specialized works with relatively small expected sales (or deletes).[3]

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3. While the examples above have dealt with the case of marketing decisions regarding a foreign-produced work in the Canadian market, it should be obvious that the analysis would be analogous for the case of a Canadian-produced work to be marketed in other countries.

Distribution Through Agents or Sale of Rights

The preceding discussion implicitly refers to those cases where the publisher himself (or the record company) markets copies of the book (recording) on both sides of the border (possibly through a subsidiary in Canada). At first glance, it would appear that in the situation where marketing in Canada takes place through an agent, or through the sale of rights to a Canadian publisher, or through a co-publication agreement, the analysis should be different. If, for example, the rights are sold to a Canadian publisher who markets a separate Canadian edition on his own account, one might argue that equation (3) is inappropriate since, from the viewpoint of the American publisher, there would be no fixed or variable costs and no sales revenue, but instead a lump-sum payment for the Canadian rights. Similar considerations would apply to marketing through an agency agreement. The position of a Canadian publisher or record company who is about to market a work in a foreign country through an agent, or via a separate edition or release, is exactly symmetrical.

The model of the marketing and pricing process formulated above may still be applicable, however, if the profit variable W_i is interpreted as the joint gross profits of both the principal and agent, or the buyer and seller of the foreign rights, and if the marketing and pricing decisions for a given work tend to be made such that the joint profits are as large as possible.

For a wide class of works which are internationally marketed in these ways, this interpretation is clearly realistic; namely, the case where the works are marketed in the foreign market through the original rights holder's subsidiary. A large proportion of all records and tapes sold in Canada are released in this way by a Canadian subsidiary and, in the case of books, many Canadian editions of foreign books are also distributed by subsidiaries who have acquired the rights from their foreign parents.

But it is reasonable to argue that for the case when the work is marketed in foreign countries through an independent firm acting as an agent, or by purchase of separate copyright, joint profits will be maximized. Consider the case of a Canadian publisher acquiring the Canadian rights to an American book. The American rights holder will sell the rights only if his total profits (including the amount paid for the rights) are at least as high as they would be under any alternative marketing and pricing strategy (for example, sales through an agent, or direct marketing by himself). Moreover, the American publisher would obviously have an interest in selling the rights to the highest bidder or, more precisely, to that Canadian firm which could generate the most profits for him. On the other hand, the Canadian publisher ultimately acquiring the rights would still be expecting to make some net profits for himself, after paying for the right. If the bidding for rights is competitive, it follows that there would be no other Canadian firm that could pay as much for the rights (or generate as much profit for the original rights holder) without himself taking a loss on the work. Hence, the joint profits would indeed be maximized.[4]

Entirely analogous arguments can be applied to the marketing of books or sound recordings through exclusive-agency agreements or co-publication.

Based on these considerations, we may conclude that a representation of the publisher's or record company's decision problem as that of finding the maximum value for W_i is generally applicable, and we now turn to a more detailed characterization of the solution to the problem of finding those prices p_i^j for the domestic and foreign market which maximize W_i.

The Demand for a Work

The main constraints faced by the copyright holder stem from the fact that the list prices of books or sound recordings will influence the number of copies sold. We therefore turn to a discussion of the demand schedules facing a publisher (or record company) who wishes to market a new work.

The nature and purpose of the institution of copyright is such as to confer upon the original holder a monopoly on the production and sale of his work. A moment's reflection will make it evident that the value of this monopoly right originates from the fact that a given work is, to some extent, a unique product in that different books and sound recordings are only imperfectly substitutable for one another.

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4. It also follows that if there were several publishers in Canada who were about equally efficient, competition between them would tend to drive their net profits on such arrangements to zero. In other words, their revenues from co-publishing or from publications in Canada of foreign books (or an agency business) would just cover their costs, including a competitive return on their invested capital. We make use of this result in Chapter V.

Hence, it would not make much sense, in the present context, to formulate a demand function for books or sound recordings in general, or to speak of a single price for such works in the market. Instead, the relevant constraint facing the copyright holder is a notional demand schedule for the particular work with which he is concerned. This schedule involves the projected volume of sales as a function of the list price that the publisher or record company decides to charge.

The expected sales volume of a given book obviously will not depend only on its own price, however. A given book in a given season will compete for the consumers' money with all other books, published domestically or imported, offered for sale in that season. Thus, expected sales will partly depend on the prices being charged for other books. More generally, since money spent on books could be spent on other goods and services, the demand for a given title will also depend on its price relative to those of other goods and services.

Finally, the inherent characteristics of the book itself, such as the degree to which the author is well known, or whether the topic happens to be of particular interest at the time the book is being offered, will obviously also play a role.

Similarly, in the case of records and tapes, the demand for a given title[5] will depend not only on its own price, but also on the prices of other records and tapes, as well as on prices of other goods and services. In addition, the influence of other less predictable factors, such as the popularity of the particular group or orchestra recording the work at a given time, will probably be even greater in this case than in the case of books.

To reflect these considerations, we will write the demand function for the i^{th} title in the j^{th} market as:

$$q_i^j = f^j(A_i^j, p_i^j, \eta^j, P^j), \; j=a,c \qquad \text{Equation (4)}$$

where q_i^j and p_i^j are the number of copies and the publisher's net revenue per copy for the i^{th} title in the j^{th} market; η^j is a vector of the prices of other books in the j^{th} market; P^j is a price index for "other goods" (i.e., a general cost-of-living index); and A_i is a constant reflecting the in-

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5. Henceforth, both particular literary works and particular sound recordings will be referred to as "titles."

fluence of inherent characteristics of a book or sound recording, such as the reputation of the author or music group, and the nature of the content on the demand for the i^{th} title in the j^{th} market.

The Optimum Solution

Given the preceding specification of the decision-making problem we may now proceed to a characterization of profit-maximizing behaviour and to an investigation of the reactions that would be expected to occur in response to changing constraints. Before doing so, however, it should be emphasized that the discussion so far has been concerned with the pricing and marketing decisions for a single title. In the real world, of course, each publisher or record company deals with more than one title. As will become clear in the following discussion, the characterization of the optimization decision will be somewhat different when it is recognized that this is the case, so that the appropriate objective of each firm is taken not as the maximization of profits for each title independently, but rather as that of maximizing the joint profits from all titles over which it has control. The extent of this difference depends on the extent to which one or more individual firms each has control over a relatively large share of the total market. In addition, as we will also discuss, an extremely important determinant of the nature of the optimum solution is the presence or absence of various forms of implicit or explicit collusion between firms.[6] To take an extreme example, if there is very extensive collusion in this sense, the appropriate specification would involve the joint maximization of the total profits earned by all publishers or record companies together -- over all titles simultaneously.

The question of interdependence in pricing and publication decisions among Canadian publishers will be dealt with in the empirical section. In the present context, this question will be left open and the optimum solution will be discussed with regard to alternative assumptions. Under the first assumption, each firm controls only one title and, under the second, varying degrees of interdependence between the pricing and publication decisions among many titles are recognized.

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6. The term "collusion" is to be understood here in its technical economic sense and taken simply to mean any form of common action serving the industry's common interest, such as an implicit agreement to refrain from predatory price cutting.

Independent Pricing: The Firm's Equilibrium

Consider now the case of the publisher or record company who faces the problem of maximizing the profits given by equation (3) from a single title which may be sold in both the home and foreign markets, while taking the prices of all other titles as given. The choice variables, therefore, are p_i^c and p_i^a. The problem is constrained by equation (4), i.e., the demand schedules for the two markets. It is argued below that if the copyright holder in a given market is protected by legislation (such as that proposed for the Copyright Act) against competition in a given market from copies independently imported for resale from the other "market," the demand schedules (4) are the only relevant constraints.

Without such protection, however, pricing in a given market will have to take into account the possibility of such competition. Suppose, for example, that the publisher of a U.S. book decides to market it in Canada through an exclusive agent to whom he sells the Canadian rights. If the agent sets a price in Canada which is sufficiently high, Canadian booksellers will find it profitable to buy around the agent -- that is, to independently import copies from the American publishers at the U.S. price. The American publisher may try to avoid selling directly to Canadian booksellers in order to honour his contract to the Canadian exclusive agent (or to protect his own interests if he is marketing in Canada through his own subsidiary). If buying around is legal, however, there is nothing to prevent Canadian booksellers from buying copies from American wholesalers or entering into arrangements with American bookstores to divert orders to Canada, and so on. Bookstore chains with outlets on both sides of the border cannot be prevented from diverting American copies to Canada. Entirely similar considerations would apply to the case of a Canadian book marketed in both countries if the price in Canada is set too high relative to the price at which the book is marketed in the United States. They also apply, of course, to the case of a record company selling in both markets.

While we recognize that buying around probably will not be sufficiently effective to entirely erode the ability of, say, an American publisher to protect his Canadian agent, in order to highlight the difference between restricted and unrestricted imports, we will nevertheless assume that when imports are legal and there are no restrictions on imports (i.e., when the exhaustion principle applies), the choice of prices in the two markets will be constrained by

$$p_i^c \leq p_i^a + t \qquad \text{Equation (6)}$$

where t is the cost (to an independent importer) of importing copies of the title from the United States into Canada.[7] A similar inequality constraint would be added to represent the requirement that the U.S. price must be low enough to prevent buying around in the other direction because book prices in the United States are generally lower than in Canada. However, this constraint will generally not be binding in the case of books,[8] and is neglected here.

The publisher's or record company's problem may now be written in full as:

maximize

$$W_i = (p_i^c - m_i^c)q_i^c + (p_i^a - m_i^a)q_i^a - f_i^a - f_i^c \qquad \text{Equation (3)}$$

subject to

$$q_i^j = f^j\,(A_i^j,\ p_i^j,\ \eta^j,\ p^j)\quad j = a,c \qquad \text{Equation (4)}$$

and

$$p_i^c \leq p_i^a + t \qquad \text{Equation (6)}$$

If total profits are differentiated with respect to the p_i^j, taking the constraints into account, the following necessary conditions for a maximum are reached:[9]

$$q_i^c\ (1 + \varepsilon_c X_i^c) - \lambda = 0 \qquad \text{Equation (7)}$$

$$q_i^a\ (1 + \varepsilon_a X_i^a) + \lambda = 0 \qquad \text{Equation (8)}$$

$$\lambda \geq 0,\ \lambda(p_i^c - p_i^a - t) = 0 \qquad \text{Equation (9)}$$

where

$$\varepsilon_j = \frac{\partial q_i^j}{\partial p_i}\,\frac{p_i^j}{q_i},\quad j = a,c$$

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7. As previously discussed, t includes costs such as freight, brokerage charges and duty.

8. In the case of records, however, it might be.

9. Further details regarding this and other mathematical derivations in this report are available from the authors on request.

denotes the elasticity of demand for the i^{th} title with respect to its own price, in the j^{th} market, λ is a Lagrange multiplier, and

$$x_i^j = \frac{p_i^j - m_i^j}{p_i^j}, \; j=a,c \qquad \text{Equation (10)}$$

Given the profit-maximizing prices determined from equations (7) to (10), the corresponding quantities can be found from equation (4) and hence total profits from equation (3).

From equations (7) to (10), it can be seen that the probability that the price in Canada will be set at a level high enough to make buying around profitable (i.e., $p_i^c \geq p_i^a + t$) depends on the difference between ε_c and ε_a, the Canadian and U.S. demand elasticities, and also on t, the cost of transport, which should be understood to include any customs duties and cost of customs clearance as well as regular transport costs. It also depends on the m_i^j which, in turn, are also influenced by transport costs for the case of a book or record which is manufactured in the United States, or on relative production costs in the United States and Canada.

We will return later to the details of the empirical evidence on these variables. Anticipating the discussion there, however, it appears to justify the following tentative conclusions:

a) The difference between the levels of prices for typical books in the United States and Canada appears to be, if anything, more than proportional to the estimated differentials in marginal cost. Hence the implied elasticity ε_c would be no higher in absolute value than ε_a.

b) For books produced outside of Canada and imported, the marginal cost of supplying the book to the Canadian market will include transport costs, etc. If the elasticities are the same, or if ε_c is lower in absolute value than ε_a, it is easy to show that the foreign publisher would want to set the Canadian price p_i^c at least as high as p_i^a + t. According to the theory, this would mean that we would have

to have $p_i^c = p_i^a + t$. In fact, the data seem to indicate that for many books sold in both markets, we have $p_i^c > p_i^a + t$, in violation of the inequality (6). This would tend to indicate that, under present legal and institutional arrangements, buying around acts with only partial effectiveness in setting an upper limit on prices in the Canadian market.

c) For sound recordings, the evidence indicates fairly unambiguously that, when converted into Canadian dollars, list prices for comparable recordings in the United States are higher than the comparable Canadian prices. This indicates either that perceived price elasticities in Canada are higher (in absolute value) than in the United States, or that marginal costs of production are lower in Canada than in the United States, or some combination of these factors. In any case, any threat of buying around will then be irrelevant, at least for regular-priced records: Canadian tape and record prices would be the same whether or not such a threat were present.[10]

Pricing and Copyright Act Import Restrictions

As is clear from the preceding discussion, the question of whether or not the pricing decisions of the publishing firms or record companies will be constrained by an expression such as (6) will depend on the degree to which a threat of buying around is present. But the question of the presence or absence of such a threat is, of course, closely related to the form of import provisions in the Copyright Act. As has already been discussed, the maximum threat of buying around would exist if legislation were to incorporate the principle of exhaustion -- i.e., if the importation of any legally produced editions or releases were permitted without restrictions. The upshot of the preliminary discussion of the evidence was that, for most books (but not sound recordings), sold both in Canada and in foreign markets, the publishers would, in fact, be effectively constrained by the buying-around threat; they would find it profitable to set relatively high prices in Canada if they could, but the threat of losing sales from buying around prevents them from doing so. Formally, a situation where constraint (6) is effective in this way corresponds to a positive value of λ in equations (7) to (9) above.

Suppose now that the legislation were instead to incorporate the principle of territorial divisibility, so that imports of any foreign version would be illegal if it would infringe on the rights of the holder of the Canadian rights to a work. If the legislation were effectively enforced,

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10. Formally, this means that at the optimum, (6) is a strict inequality. It is not a "binding" constraint.

this would mean that a Canadian edition of any work (Canadian or foreign authored) could be priced independently of the price at which it was sold in foreign markets because there would be no buying around. The implications of our evidence is that for most such books, this would entail a higher price than would be possible under exhaustion. Formally, introducing territorial divisibility into the problem is equivalent to eliminating constraint (6) from the problem, or to setting $\lambda = 0$ in equations (7) to (9). These conditions would then be replaced by:

$$(1 + \varepsilon_c X_i^c) = 0; \qquad \text{Equation (11)}$$

$$(1 + \varepsilon_a X_i^a) = 0 \qquad \text{Equation (12)}$$

A comparison of the two sets of conditions indicates that since λ in equation (7) is positive, the Canadian markup over marginal cost X_i^c in equation (11), corresponding to territorial divisibility, would be higher than the markup under exhaustion from equation (7). Since the evidence indicates that marginal costs for book production in Canada are at least as high as in the United States, this also means a higher price.

This, in itself, is not very surprising. All it says is that when the publisher of a Canadian edition of a book sold in the United States is protected against competing imports, he would tend to set the price in the Canadian market at a higher level than if he were not so protected. Of more interest is the way in which the restrictions would have differential effects on different categories of books. This can be seen by first combining equations (7) and (8) into:

$$w_c\ (1 + \varepsilon_c X_i^c) + w_a(1 + \varepsilon_a X_i^a) = 0 \qquad \text{Equation (13)}$$

where

$$w_c = \frac{q_i^c}{q_i^c + q_i^a}, \quad w_a = \frac{q_i^a}{q_i^c + q_i^a}$$

Consider a book written primarily for and sold in the foreign market. For such a book $w_a \rightarrow 1$, and hence

$$X_i^a \approx \frac{1}{/\varepsilon^a/}$$

The Canadian price will be $p_i^a + t$, with p_i^a being very close to the price that the American publisher would set in the United States even when he could set separate prices in the two markets. It follows that the price in Canada would be relatively low, a good deal lower than it would be if the Canadian copyright holder could set his price independently. Import restrictions would thus tend to raise the prices of such books by a relatively large amount.

Consider, on the other hand, a book written primarily for and sold in the Canadian market, i.e., $w_c \rightarrow 1$, and hence

$$x_i^c \approx \frac{1}{/\varepsilon^c/}$$

For such a book, the imposition of import restrictions would make little difference to the price at which the book would be sold in Canada. The price in the United States, however, would likely be substantially lower when the Canadian copyright holder could price a U.S. edition without having to fear competition in the Canadian market from imports of this edition. It also follows from this type of argument that the profit-maximizing price of a Canadian book not marketed in the United States (i.e., with $w_c = 1$) would not be affected directly by copyright import restrictions. For a book with a substantial share of its sales in both markets, however, both price levels would change: the Canadian price would tend to rise, the U.S. price to fall.

It should finally be noted that the extent to which book prices in Canada would be raised, if publishers were given the opportunity to do so under protection of Copyright Act import restrictions, would depend on the precise legal definition of the circumstances under which a particular work would qualify for such protection. The proposal most frequently heard involves protection under the Act when a Canadian edition exists or when a book covered by Canadian copyright is published under the imprint of a Canadian publisher. If, for example, the latter condition were accepted as the criterion for qualification, only works which in fact existed in Canada under such an imprint could be priced without regard for the threat of buying around. Under current practices, many foreign books sold under exclusive-agency agreements would <u>not</u> qualify, since they do not bear the Canadian publisher's imprint.

As noted in Chapter I, we believe that the importance of this limitation to the applicability of the analysis may be exaggerated. The costs of ensuring that a particular work would qualify for protection are not high. All it requires is that a Canadian firm acquire the Canadian copyright and that the words "published in Canada by X" are added to the title page for the expected number of copies to be sold in Canada. Thus, as long as there are profits to be made by utilizing the protection of import restrictions to raise prices, one could expect that titles now sold by exclusive agents would then be sold under the imprint of a Canadian publisher who had acquired the Canadian rights (or under a co-publication arrangement). Nevertheless, it has to be recognized that a precise estimate of the fraction of Canadian publishers' sales that would benefit from protection, is impossible. To be on the safe side, we have assumed in the aggregated estimates below that over half of all foreign books sold in Canada (by value) would not benefit in this sense.

The above analysis has concerned book publishing only. While the principles of the analysis are also applicable to sound recordings, the evidence from the pricing of records and tapes indicates that constraint (6) would not be binding under unrestricted trade.[11] Put differently, the evidence can be interpreted as implying that Canadian costs are sufficiently low and the perceived elasticity of demand sufficiently high (in absolute value), that Canadian record companies would not raise their prices even in a situation where the threat of import competition was eliminated through legislation. In view of this, the analysis in the rest of the report will focus on the impact of Copyright Act import restrictions on the book trade, with only occasional references to the sound recording industry.

Each Title Priced Independently: Market Equilibrium

In the preceding section, we dealt with the decision problem facing a publisher with respect to the publication of a single title. In this section, we turn to an analysis of the interaction between the individual decisions made in this way by publishers and the characteristics of the market as a whole when it has reached an equilibrium state. The characteristics that are of main interest are the earnings of authors, the profits of publishers, the number of titles that will in fact be published and the expected sales volume of different titles.

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11. Random sampling from record company catalogues quickly reveals that the vast majority of records are sold for wholesale prices of Can$4.20 and U.S.$4.20 in Canada and the United States, respectively, with the corresponding list prices being Can$7.98 and U.S.$7.98. Given the present exchange rate of roughly U.S.$0.85 for the Canadian dollar, independent imports of regular records for which a domestic release exists would not be profitable even if there was no tariff. The fact that there is a tariff further reduces the threat from import competition.

We first need a definition of equilibrium. By "equilibrium," we mean, first, a situation where publishing firms earn only normal profits (i.e., a rate of return on invested capital which is just enough to induce them to maintain their investment in the industry), so that there is no tendency for new firms to enter the industry, or for existing firms to leave. Second, in equilibrium there must be no net tendency for the number of writers in the market, or the number of new titles being published, to change. All titles that are commercially viable will be published. The works that are not being written will be those for which the projected revenues, with a profit-maximizing price, will not yield their authors a sufficiently large royalty income (after allowing for the fixed and variable costs of production) to make it worth their while to create them.

Consider now the two-market model described in the previous section, and suppose initially that the industry is in equilibrium under a regime with no import restrictions. We will discuss qualitatively the nature of the changes in the equilibrium configuration that would be expected to take place in response to a change in some of the parameter values that determine the equilibrium. We first consider the predicted response of the system to changes in one of the cost parameters for books published in Canada -- namely, the fixed cost parameter. This may be envisioned as representing a hypothetical policy designed to support the Canadian publishing industry, such as a lump-sum subsidy paid for the publication of a given title. Second, we consider the system's response to a change in import restrictions: what will happen if protection is given against import competition from foreign editions to the holder of the Canadian copyright for a given work? This, of course, corresponds to the type of policy change that is being proposed under the Copyright Act, as discussed above.

Suppose that there is a reduction in the fixed costs, f_i^c, of producing a title in Canada; this may occur as a result of a government subsidy of a fixed sum for new titles produced. Because the variable costs of producing books have not changed, and since the demand functions for books are not affected, there will be no effect on book prices; these are determined by conditions (7) to (10), which do not involve the fixed-cost parameter f_i^c. For a given number of titles being published, however, the profits, W_i, will increase by the amount of the subsidy. <u>If there is sufficient competition between publishers for new manuscripts, however, these extra revenues will be passed on to the authors.</u> Hence, the initial effect will simply be an increase in authors' incomes by an amount equal to the subsidy for each title written and published.

But the number of titles being created is not likely to remain unchanged. In the initial situation, some titles were not being published that had almost had enough estimated sales potential to justify publication, given their estimated costs of production. With the decrease in fixed costs through the subsidy, some of those titles would now become commercially viable. Hence, the rate of creation of new titles could be expected to increase.

This would, of course, tend to increase the size of the total income transfer from the government to authors. But it is also worth noting that it would tend to cause a certain degree of earnings redistribution among authors. With unchanged prices of books, the total amount of money spent on books among the reading public would not change much. Hence, most of the revenue earned by the publishers and authors of the new titles created as a result of the subsidy would come at the expense of losses in sales of the titles that would be produced without the subsidy. Ultimately, therefore, the royalty incomes of the more established authors would tend to decrease relative to what they would have been without the subsidy, but with the smaller original number of titles.[12]

Consider now the alternative policy of imposing import restrictions. In the preceding section, we saw that such a measure was likely to change the prices of some, but not all, books sold in Canada. Specifically, we showed that profit-maximizing prices would be likely to rise more the larger the share of the expected sales volume of a title in the foreign market.[13]

Of all books sold by publishers in Canada, those with the largest proportion of foreign sales are obviously those written by foreign authors and sold here either on an exclusive-agency basis, or as co-publications in which the Canadian firm publishes the book jointly with a foreign firm. Hence, provided again that publishers compete to a suffi-

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12. A plausible argument can be made to show that for some authors, those with a high initial share of the market, the net effect of the subsidy might be a decrease in income. Suppose sales of each old title shrink by a given percentage when new titles are introduced. The absolute net income loss on a large title may then be greater than the amount of the subsidy, hence reducing net income.

13. Note again that this discussion would not apply to sound recordings.

<u>cient extent for authors' manuscripts, one group of beneficiaries from the higher prices and expected higher sales revenues from the Canadian market would be those foreign authors whose books are sold on a significant scale in Canada.</u>

Some Canadian authors would also benefit from higher Canadian prices and sales revenues. They are typically well-established authors whose books sell on a significant scale in the United States, usually as foreign editions stemming from co-publication ventures between a Canadian and foreign publisher.

Some benefits would also accrue to Canadian writers whose books are sold primarily in the domestic market. Because the prices of books by foreign authors, and by Canadian authors selling in both markets, would now be higher, the Canadian reading public would to some extent tend to substitute purely "domestic" books, whose profit-maximizing prices would not change, for those whose prices had risen. In technical terms, the extent to which this would happen would depend on the cross-price elasticity between the former and the latter types of books. An attempt will be made in Chapter V to speculate on the magnitude of this elasticity.

Finally, as a consequence of the predicted increase in demand for books written primarily for the Canadian market, some titles that would have appeared prior to the imposition of import restrictions as almost but not quite commercially viable would now have a higher expected sales volume. As in the case of a decrease in the fixed costs of publishing a book, the imposition of import restrictions would, to some extent, tend to stimulate the rate of creation of Canadian literary works and would thereby contribute in some measure to the attainment of Canada's cultural objectives as previously defined.

In attempting to quantify the differential effects of exhaustion and territorial divisibility, we compare the relative magnitudes of benefits to Canadian authors with the costs to the book-reading public in the form of higher prices (taking account of the leakage of benefits to foreign copyright holders). We do not, however, attempt to estimate the differential effects of the two alternatives on <u>publishers</u>, as distinct from authors; nor do any such effects appear in the theoretical discussion above. In view of the fact that the publishing industry would certainly be affected by the choice of alternatives with respect to Copyright Act import provisions, this requires some explanation. The reason why we proceed in this way lies in our assumption that publishers compete with each other for the copyright to literary works. The initial effect of the institution of copyright is to confer a monopoly for the exploitation of a work on its authors. If there is competition between Canadian publishers in the buying of copyright (from Canadian authors or foreign publishers), the purchase price for the rights will reflect the full value of this monopoly right. The actual revenues of the publishers, under this assumption, will just cover their total costs of manufacturing and distribution (including overhead costs) and will also include the normal rate of return necessary to induce the publishers to stay in business. Since this will be true, under the assumption of competition, both with and without import restrictions, it is meaningless to ask what the differential impact on publishers' profits will be: the answer ought to be that the rate of return on capital invested in the publishing industry will be the same in either case. It is another matter that the gross activity (as measured, for example, by total employment in the industry) might be negatively affected by exhaustion. To the extent that this would happen, labour and other resources would have to be transferred out of the book publishing industry into other employment and, as is well known, such transfers are not costless. As in other cases when an industry must contract because of increased foreign competition, a strong case can be made for some form of adjustment assistance to facilitate such a transfer.

Interdependent Pricing: The Publisher's Equilibrium

The discussion, up to this point, has dealt with the special case in which the publisher makes his pricing and publication decisions independently for each title. Specifically, the prices of all other titles and the range of titles offered for sale, have been taken as given. To some degree these assumptions are unrealistic, for several reasons.

First, each publisher will of course be offering more than one title at a given time and, since his demand for a given title will depend to some extent on the prices of his other publications, a publisher who wishes to maximize the profits of his operation as a whole must recognize this interdependence. To give a simple example, suppose there exist two similar books on jogging, A and B, and that both are sold by the same publisher. The incentive to increase sales of book A by lowering its price is not likely to be very great because by doing so the publisher will simply be losing some of the potential sales of book B. If book B is sold by another publisher, however, the incentive to reduce the price of A would be much greater.

Second, there is also the possibility that in publication and especially in pricing decisions, each publisher takes into account the possibility that his decisions will induce his competitors to change their pricing strategies. For example, a large publisher who is responsible for 10 to 15 per cent of all domestically published and exclusive-agent sales in the Canadian market may contemplate a major price reduction across the whole range of his titles to increase his sales. A priori, it seems likely that before doing so he would weigh the possibility that his competitors would try to defend their market share by lowering their prices as well. If he believes that they would, it is of course much less likely that he would in fact reduce his prices.

These points may be formally demonstrated, along lines very similar to those in the preceding section.

Consider the case of a publisher who attempts to maximize his profits not just from one publication, but from a whole set of publications (indexed, as before, by the subscript i, i=1, m). From a formal point of view, the only change in the situation, as previously stated, is that the objective function now becomes the sum of the profits from each title, and that (with no import restrictions) there now are m constraints, stating that the price in a given market has to be low enough to prevent buying around, one for each title. In other words, the problem becomes:

$$\text{Max} \sum_{i=1}^{m} W_i \qquad \text{Equation (14)}$$

subject to:

$$q_i^j = f^j(A_i^j,\ p_i^j,\ \eta^j,\ p^j),\ j=a,c,\ i=1,m \qquad \text{Equation (15)}$$

and

$$p_i^c \leq p_i^a + t,\ i = 1,\ m \qquad \text{Equation (16)}$$

Solving this problem along the same lines as before it can be shown, after considerable manipulation, to yield a set of necessary conditions for a maximum which may be written, by analogy with equation (13) above, as

$$w_c(1+\varepsilon_c x_i^c + \sum_{k\neq i} x_k^c \eta_{ik}^c) + w_a(1+\varepsilon_a x_i^a + \sum_{k\neq i} x_k^a \eta_{ik}^a) = 0 \qquad \text{Equation (17)}$$

i=1,m

and

$$p_i^c = p_i^a + t,\ \ i=1,\ m \qquad \text{Equation (18)}$$

where η^c_{ik} is the cross-elasticity of demand for the i^{th} title with respect to the price of the k^{th} title, i.e.,

$$\eta^c_{ik} = \frac{\partial q^c_i}{\partial p^c_k} \frac{p^c_k}{q^c_i}$$

for the Canadian market, and similarly for the foreign market; remaining symbols have been previously explained.

The cross-price elasticities can be taken to be positive since different book titles are to some extent substitutes for one another. From this, it follows that for given own-price elasticities of demand, the profit-maximizing prices in both markets will tend to be higher since X^c_i and X^a_i, which represent the markup over marginal costs, have to be larger in order to satisfy equation (17) than they would with no pricing interdependence.

As before, if import restrictions are introduced, constraint (16) will no longer be binding. Hence, after rewriting, for the Canadian market, the condition for profit maximization becomes:

$$X^c_i = \frac{1 + \sum_{k \neq i} \eta_{ik} X^c_k}{/\varepsilon_c/}, \qquad \text{Equation (19)}$$

and similarly for the foreign market. These markups, and hence prices, are obviously higher than they would be under independent pricing when the markup is given by $/\varepsilon_c/^{-1}$. A question of considerable interest in the present context is whether the price increases predicted when import restrictions are introduced would be larger in absolute value, or relative to their original level, in this case than in the case where there is independent pricing. This will depend on the relative magnitude of the terms involving the cross-price elasticities in the Canadian and foreign markets.

These terms can be thought of intuitively as reflecting the extent to which a publisher (or a group of publishers who are reluctant to encroach on each other's market shares) takes into account the effect that a sales expansion for a given title will have on sales of the other titles that he controls. An a priori argument can be made that many Canadian publishers do so to a significant extent. Many of them not only sell their own titles but also act as agents for other, principally foreign, publishers. Hence, reducing prices on their Canadian titles may cut into their sales of agency books and vice versa. This type of concern is less likely to be relevant to foreign publishers. In addition, one might speculate that the relatively few large publishers operating in Canada, with their head offices all located in Toronto, may be somewhat more likely to operate with a mutual understanding of the undesirability of any one of them provoking a price war by attempting to increase his share of the market.

On the basis of these considerations, it is reasonable to predict a larger price increase, both relatively and absolutely, in response to the introduction of import restrictions, than would be predicted with independent pricing of each title.

At this point, however, these conclusions are only hypotheses suggested by theory. In Chapter IV, we will discuss the question of whether the available empirical evidence on the Canadian book trade supports the notion that these types of non-competitive behaviour would constitute a problem of practical significance under a regime of more strongly enforced import restrictions.

Interdependent Pricing: Market Equilibrium

The preceding discussion dealt with the decision-making problem faced by an existing publisher who is deciding on his pricing strategy for a given set of titles that he is about to offer for sale. As before, we must now turn to a discussion of the problem of market equilibrium.

As we argued above, for a given set of own-price and cross-price elasticities of demand for books, the price structure that would emerge under interdependent pricing would likely imply higher book prices than would prevail under independent pricing. Suppose now that the elasticity of demand for books in general, with respect to some index of the prices relative to other goods and services, is less than unity in absolute value. With higher book prices, the reading public would spend more money on books than they would at lower prices. For a given number of titles, the sales revenue per title would then tend to be higher than under independent pricing.

One argument in the preceding section was that a consequence of an increase in the expected revenue per title would be an increased rate of creation in Canada of some marginal titles that did not appear commercially viable at lower prices. This argument rested, however, on the assumption that publishers were competing with sufficient aggressiveness for authors' manuscripts so that, in equilibrium, any excess profits from a given title would accrue to the author. The earnings of the publisher would be just enough to pay for the fixed and variable costs of producing and selling the book and to provide a return on his capital sufficient to induce him to remain in business. Under this assumption, there would be equilibrium with respect to the number of firms: existing firms would not want to leave, but neither would there be any tendency for new firms to enter the industry.

On the other hand, if it is argued that publishing firms do not necessarily behave in accordance with the model of competitive independence on the pricing side, it is also reasonable to ask why they should be expected to behave competitively on the buying side (i.e., in the market for manuscripts). Once the possibility of non-competitive behaviour on the buying side is introduced, however, it will no longer necessarily be true that higher prices and larger revenues per title will be reflected in higher royalty incomes to authors. Instead, they may simply be reflected in increased profits to publishers. <u>If this were the case, higher book prices need no longer necessarily lead to an increased rate of creation of Canadian literary works</u>. This possibility, it seems to us, considerably weakens the arguments in favour of territorial divisibility.

The question of whether, in equilibrium, there is enough competition between publishers for manuscripts to ensure that the zero-excess-profit condition for publishers is approximately satisfied, is a two-pronged one. First, the answer will depend on the degree of competition between the publishers who are present in the industry at any given time. Second, it will also depend on the potential competition that existing firms face from possible new entrants into the industry.

With respect to competition between existing firms, little can be said at the theoretical level. As in the case of pricing, one would expect the degree of competition to vary inversely with the extent to which the market is dominated by a small number of large firms. For example, if there are only a few large firms and each already has a book on jogging, it is not very likely that any of them would bid aggressively for the rights to publish another book on the subject, even if it was good enough to compete effectively against existing titles. The author might try to solicit bids from smaller firms but, as we will argue below, smaller firms may not be able to do as good a job of marketing a given title for him, so that he might end up with lower royalty revenues. Furthermore, the fewer and larger the firms in the industry, the more likely they are to recognize their independence. A given firm may be less likely, for example, to try to lure an existing writer away from a rival by offering him better royalty terms if it takes into account that the rival firm may retaliate in the same manner. Thus, with an absence of competition in this sense, one would likely observe a situation where each firm would offer a more or less standardized set of terms in their royalty contracts, with no firm showing much willingness to depart from those terms even for a potentially profitable work, or to improve their royalty terms in response to a general increase in the profitability of publishing new titles.

The above discussion relates only to competition between a given set of existing firms. In order for an absence of competition between small firms to result in "excess" profits on a continuing basis, however, one further condition must be fulfilled: there must be factors that prevent new firms from entering the industry in response to a high degree of profitability. If there are no such factors, new firms will enter, the dominance of the large firms will be reduced, competition will increase (both on the buying and selling side) and, ultimately, excess profits will tend to disappear.

It is generally argued that, in the book publishing industry, there are few barriers to entry, at least for domestic firms (foreign firms wanting to establish subsidiaries in Canada are, of course, subject to the general restrictions on foreign investment). As is well known, in many concentrated industries dominated by a few large firms the most significant barrier to entry results from a combination of substantial economies of scale and an imperfect capital market: to operate efficiently, a large-scale operation is necessary, which would require a large-scale investment to get started. Because of a risk-averse capital market, most potential entrepreneurs will find it difficult to raise the necessary capital. In book publishing, it is claimed, economies of scale are not very important. All that is required to establish a small-scale firm is an office with a telephone, a small editorial staff and enough working capital to finance the production of a few titles. Services such as design of books, composition, printing and binding and the services necessary for efficient distribution can be bought from other firms until the sales volume of the new operation becomes large enough to warrant a larger investment in the facilities necessary to provide those services internally. By that time, with a proven record, the firm will find it less difficult to raise the necessary financing.

This argument appears to have considerable merit and serves to explain why the publishing industry in Canada consists of not only a relatively few very large firms with an annual sales volume in excess of $8 million, but also substantially more than 100 firms with annual sales below $1 million. At the same time, the argument may be considered somewhat misleading because it neglects the possibility of economies of scale and barriers to entry in the production of some of the auxiliary services which many small publishers buy from the outside. The most important of these probably are the marketing and distribution functions. Large-scale operations are necessary to effectively utilize a network of salesmen or to carry out warehousing and order fulfillment at low cost. The recent rapid growth of independent wholesalers, who operate on the basis of very large volume and with computerized inventory management and order processing, provides some indirect evidence of the importance of such scale economies. Hence, while barriers to entry may be unimportant for publishing per se, they may be more significant, and hence competition may be less active, in marketing and distribution. Ultimately, a lack of effective competition in this sense may give rise to monopoly rents, or may simply create a situation where a less efficient technology will not be replaced by a more efficient one when the industry is in equilibrium in the sense above. <u>For a given gross revenue, the royalty incomes of authors would then be lower, and the rate of creation of literary works would tend to be lower, than would be the case with more active competition, lower monopoly rents and more efficient marketing and distribution technologies</u>.

From the viewpoint of policy analysis, however, the question of primary interest is not just a characterization of the nature of industry equilibrium, but also an analysis of the industry's response to policy-induced changes in the environment in which it operates. We will discuss the predictions of the analysis for hypothetical changes in the degree of protection against import competition from foreign-produced editions of given titles. However, the analysis of the industry's likely reaction to a change in the fixed costs of publishing a new title would be quite similar to that in the previous section and will not be repeated here.

<u>Industry Response to Changing Constraints</u>

In this section, we first consider the question of how an imperfectly competitive publishing industry might respond to the increased foreign competition that would result, for example, if the principle of exhaustion were to be explicitly incorporated in the Copyright Act, and tariffs and other impediments to international trade in books were reduced.

Suppose that competition in the Canadian book industry is relatively weak because there are substantial economies of scale at some stage in the production and distribution process, so that only relatively few firms are able to produce these services efficiently. Reduction in the barriers to international trade might then serve to increase competition in the industry, if those services could be imported.

In principle, distribution services can in fact be imported: foreign or Canadian books can be bought by Canadian retailers, libraries or education institutions, via foreign publishers or wholesalers, if the latter were allowed to extend their distribution networks into Canada. Smaller Canadian publishers, such as those specializing in titles of specific interest to a Canadian audience, might benefit from being able to import distribution services in this way. The price would probably be lower than the cost of the alternative of selling through larger publishers who operate only in the Canadian market and who have little competition. Ultimately, the resulting lower distribution margins would tend to benefit authors and, as a result, more Canadian titles might be published.

It is sometimes argued that sales of Canadian publishers would suffer if they were to undertake their distribution through international publishers or wholesalers because those distributors would not provide effective marketing services in the Canadian market. By contrast, it is argued that when Canadian publishers do their own distribution, they can also market their books more effectively. Moreover, when they distribute their books through a larger publisher who serves the Canadian market, that publisher provides a package of services including both distribution and marketing.

It is probably true that a greater reliance on international distribution channels, under a regime of unrestricted imports, would tend to reduce marketing efforts specifically directed at the Canadian market, compared to a situation in which books in Canada are marketed and distributed with little or no competition from international publishers or distributors.[14] But, in such a situation, most of the marketing efforts of the distributors/publishers operating in Canada will be directed towards the promotion of <u>foreign</u>

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14. By "international," we mean publishers or wholesalers operating across borders; we do <u>not</u> mean Canadian subsidiaries of foreign publishers.

books which they distribute as exclusive agents, or co-published editions. This is especially likely for those firms that are Canadian subsidiaries of foreign publishers. Increased competition from international distribution channels could, therefore, also result in less intensive marketing of foreign books.

If that were to happen, the ability of Canadian publishers to undertake effective marketing on their own, or through contracts with larger publishers to market,[15] but not distribute, their books, could be substantially enhanced. This might not necessarily reduce marketing costs. But if it makes the marketing of Canadian titles more effective, the net results are the same, namely, an increased revenue potential for firms specializing in Canadian titles and hence, indirectly, for Canadian authors.

The major conclusion from these arguments is that, on balance, increased competition in the Canadian market from international (in practice, North-American wide) distribution systems would tend to have some beneficial effects on Canadian authors and on Canadian publishers specializing in the production and marketing of works directed specifically at a Canadian audience. It would tend to reduce distribution margins and to reduce the marketing activities of those firms (especially subsidiaries of foreign firms) who would otherwise specialize in the distribution and marketing of foreign books. Thus, it would enhance marketing opportunities for specialized Canadian publishers; the latter might also gain some opportunities to undertake marketing for foreign publishers as it becomes less profitable to establish or to maintain Canadian subsidiaries.

Now, consider the converse case where the Canadian market becomes potentially insulated from international competition through import restrictions. The effects would essentially be the opposite of those described above. Distribution margins would tend to be higher (or the distribution services would be carried out less efficiently) and, with higher Canadian prices for foreign books, such books would tend to be more intensively marketed, especially by Canadian subsidiaries of foreign firms. Some Canadian authors would still derive some benefits from their ability to price discriminate between the Canadian and foreign markets, as discussed above, and from the tendency for the demand for Canadian books to rise when the prices of foreign books rise. It is, however, quite conceivable that these effects could

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15. "Marketing" implies promotional activities as distinct from physical distribution of copies.

be more than offset by the higher distribution costs and the heavier promotion of foreign books that would also result from import restrictions.

CHAPTER IV

PRICING AND COSTS: THE EVIDENCE

Introduction

From the discussion in the preceding chapter, three factors have emerged as the most important determinants of book prices in Canada. First, book prices depend on the marginal cost -- i.e., the variable costs per unit -- of producing and distributing copies of the books sold in Canada. Second, they are influenced by the publishers' estimates of the responsiveness of sales of a given book to a hypothetical change in its price or, more formally, by the perceived price elasticities of demand. Third, they are affected by the degree of interdependence in pricing between different titles of a given publisher, or between different publishers when prices are decided on.

The purpose of this chapter is to evaluate the empirical evidence on the performance of the Canadian publishing industry in recent years against the background of these factors. In the first section, we consider the evidence on book prices themselves and, in particular, whether it supports the widely held view that the structure of book prices in Canada is high relative to that in other countries. The next section contains an analysis of some of the evidence on the composition of total costs in Canadian book publishing. We use this information in the following section to provide an estimate of the average value of the perceived price elasticity of demand for a book in Canada and in the United States, respectively. Our finding is that the markups over marginal cost generally tend to be higher in Canadian publishing. The method used for the comparison does not, however, permit an answer to the question of whether this results from a lower (in absolute value) price elasticity of demand in Canada or from a higher degree of pricing interdependence. In the next section, we therefore analyze the markup behaviour of Canadian publishers using an alternative method based on data disaggregated by individual titles. In the course of this analysis, we attempt to determine the extent to which the higher Canadian markups depend on elasticity differentials rather than on a difference in the degree of pricing interdependence.

Evidence on Book Prices

Any attempt at systematic comparisons of the level of book prices between Canada and other English-speaking or French-speaking countries is obviously made difficult by the heterogeneity of the commodity in question. Book prices will differ greatly because of content (a specialized book on a technical subject vs. a novel designed to reach a general audience) or because of the format (hardcover vs. quality paperback vs. mass-market paperback) even for the same title. The problem of devising a theoretically satisfying index of book prices that can be used for such a comparison, therefore, would be exceedingly difficult and we will not attempt it here. Partial comparisons can, however, be made on the basis of the data available from various sources.

The data come from a variety of sources. The first set of price comparisons here was based on the information in various country-specific publications giving more or less complete lists of books in print. Such sources were available for the United Kingdom, the United States, France and Canada. Price comparisons made on this basis suffer from the weakness that the prices cannot be weighted by sales and, in the Canadian case, they refer only to domestically published (i.e., not imported) books. Nevertheless, the information derived from this type of source is informative in a number of ways.

A second form of price comparison can be carried out from data available on the unit value of publishers' sales in various categories. This comparison has the advantage that these values represent averages weighted by sales. Because of data limitations, the method could only be applied to a United States-Canada comparison.

As noted several times above, in the Canadian market a very large proportion of all books sold are imported titles. Although no published surveys of prices of imported books in Canada could be found, unpublished evidence is available from the catalogues of publishers who are exclusive agents since they include the imported titles, with Canadian list prices, in their seasonal catalogues. For a number of cases, we were able to locate titles included in the Canadian catalogues in the relevant edition of Books in Print for the country from which the book was imported.

Table 5

Books in Print: List Price Comparison (Can$)

	Canada	United States	United Kingdom	France
1. Mean price, all books	7.39	15.45	11.88	10.77
2. Paperbacks as percentage of all titles	43.5	27.5	40.5	17
3. Mean price, paperback titles	4.2	5.6	4.4	13.02
4. Mean price, all titles costing less than $14	5.46	6.56	4.96	5.80
5. Mean price, all paperback titles costing less than $14	4.07	4.87	3.83	7.47
6. Paperbacks as percentage of all titles costing less than $14	50	41	53	13

SOURCES: Books in Print 1978-1979, British Books in Print 1978, Canadian Books in Print 1978 and Les livres disponibles 1978.

Books in Print

The sources for the prices used in the comparisons based on national listing of books in print were the U.S. Books in Print 1978-79, British Books in Print 1978, Canadian Books in Print 1978 and the French Les livres disponibles 1978. The coverage of available titles varies substantially from one publication to another. Thus, the U.S. volume includes all titles published by U.S. publishers and all foreign books carried by them on an exclusive basis. However, it does not include publications available only to schools. The Canadian volume, on the other hand, includes only those titles "bearing the imprint of Canadian publishers or Canadian subsidiaries of international publishing firms." In other words, it excludes imported books even if they are carried on an exclusive basis. Further, it is "basically a listing of books in the English language." As an illustration of the importance of the difference in coverage, it is worth noting that while the other listings contain between 200 and 500 thousand titles or editions, Canadian Books in Print has slightly less than 20 thousand entries.

The price comparison was accomplished by simply drawing a random sample of 200 entries from each source. The results are summarized in Figures 1 and 2.

At first glance, the results appear somewhat surprising. A simple average of the 200 prices indicates that the mean price in the Canadian volume is substantially lower than in any of the others (see Table 5). There are also relatively more paperbacks in Canada: 43.5 per cent of the titles in Canadian Books in Print are paperbacks, with the corresponding figures for the United States, United Kingdom and France being 27.5 per cent, 40.5 per cent and 17.0 per cent, respectively. The mean price of the Canadian paperbacks is $4.20; for the other countries, in the same order as above, the means are \$5.60, \$4.40 and \$13.02. (The figures have all been converted into Canadian dollars using mid-1978 exchange rates.[1])

On reflection, however, it may be argued that a simple comparison of means is considerably misleading. The high averages for the United States and the United Kingdom reflect in large measure the relatively high frequencies of books costing in excess of \$15. These titles are likely to be books that are very expensive to produce and books on specialized subjects that will be bought by only a relatively limited set of readers. Since the Canadian market is relatively small, it is unlikely that a separate Canadian edition of such a book will be produced; instead the book will be imported, either directly or on an exclusive-agent basis. But imported books do not appear in the Canadian listing. For this reason, we also carried out a comparison on a truncated portion of the sample by excluding all titles priced at the equivalent of Can\$14 or higher. The results are shown in lines 4-6 in Table 5. The mean prices of all books and the mean paperback prices are now much closer together, and the Canadian prices are shown to be considerably higher than those in the United Kingdom, for both hardbacks and paperbacks. Canadian prices are still a good deal lower than U.S. prices but, as noted in footnote 1, this is probably a reflection of the under-representation of low-priced paperbacks in the U.S. Books in Print.

The evidence indicates that the average title published in Canada is priced below those in the countries that are major foreign competitors of Canada's publishers. But, as was implied by the argument above regarding the specialized high-priced titles, this is not the same as saying that the typical book sold in Canada has a lower price

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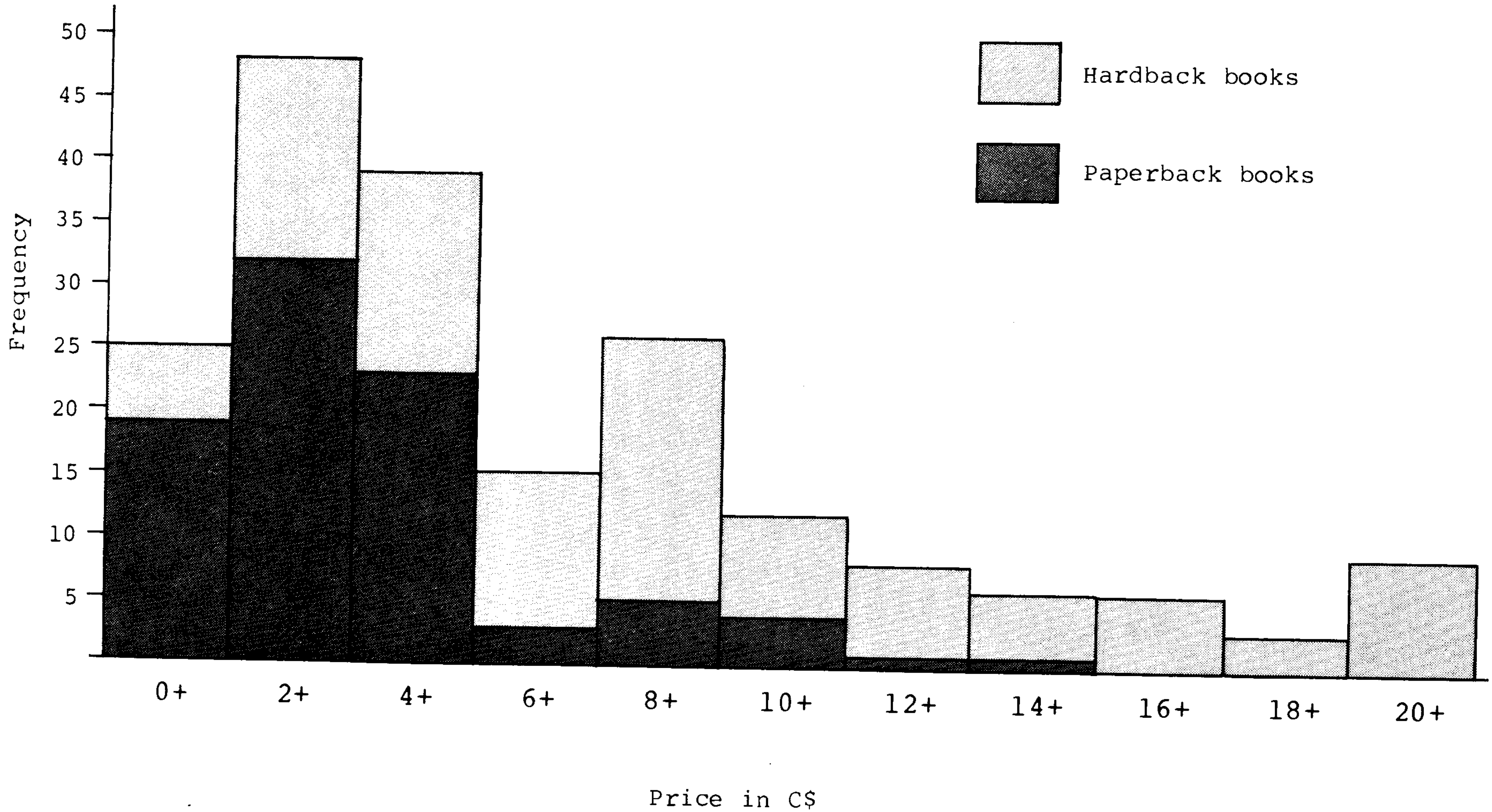
1. In commenting on a first draft of this report, the Association of Canadian Publishers (ACP) pointed out that there exists a separate Paperback Books in Print for the United States. This probably means that some paperback editions of titles published or sold by U.S. publishers do not exist in the comprehensive Books in Print that we used. While time has not permitted us to check this conjecture, we have assumed it to be true and have modified our conclusions regarding the level of book prices in the United States in this section accordingly. These modifications strengthen our overall conclusion in this chapter that Canadian book prices generally tend to be significantly higher than U.S. prices. We are grateful to the ACP for drawing this problem to our attention.

Figure 1

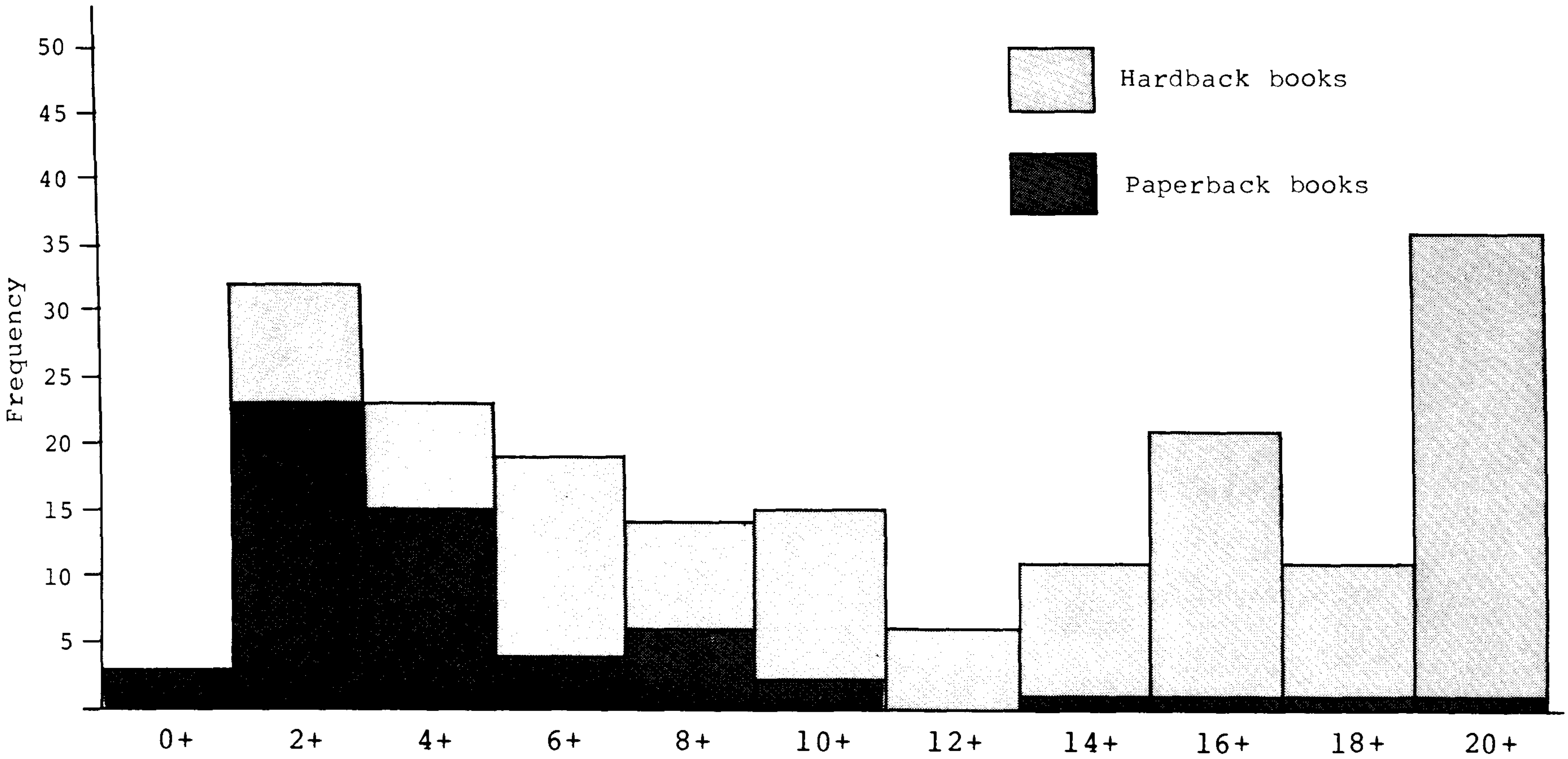
Frequency Distribution of List Prices of Books:
Canada (random sample of 200 titles)



SOURCE: Pluscauskas, M., ed., Canadian Books in Print 1978, University of Toronto Press.

Figure 2

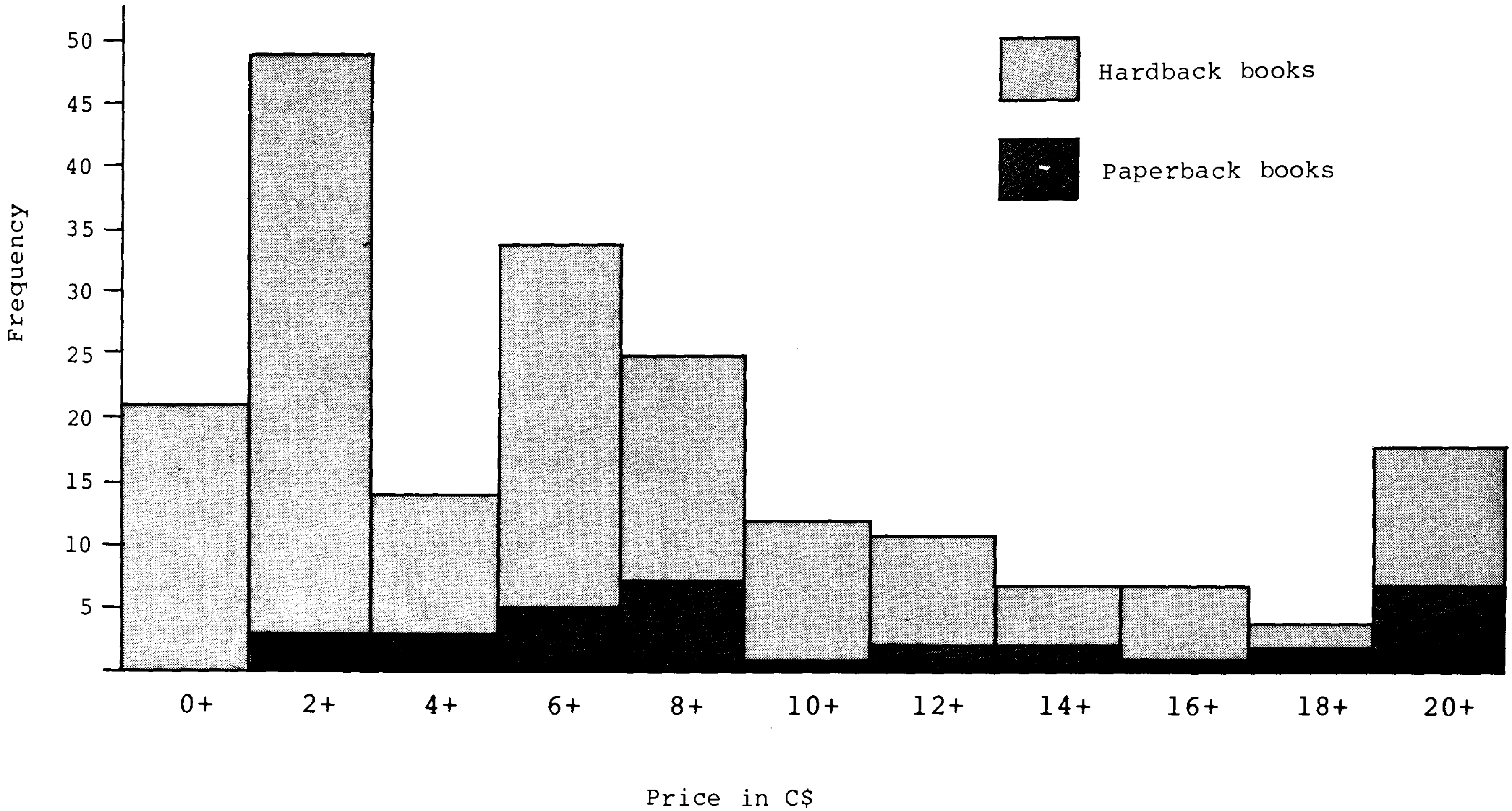
Frequency Distribution of List Prices of Books:
United States (random sample of 200 titles)



SOURCE: Books in Print 1978 - 1979, R.R. Bowker Company, New York.

Figure 3

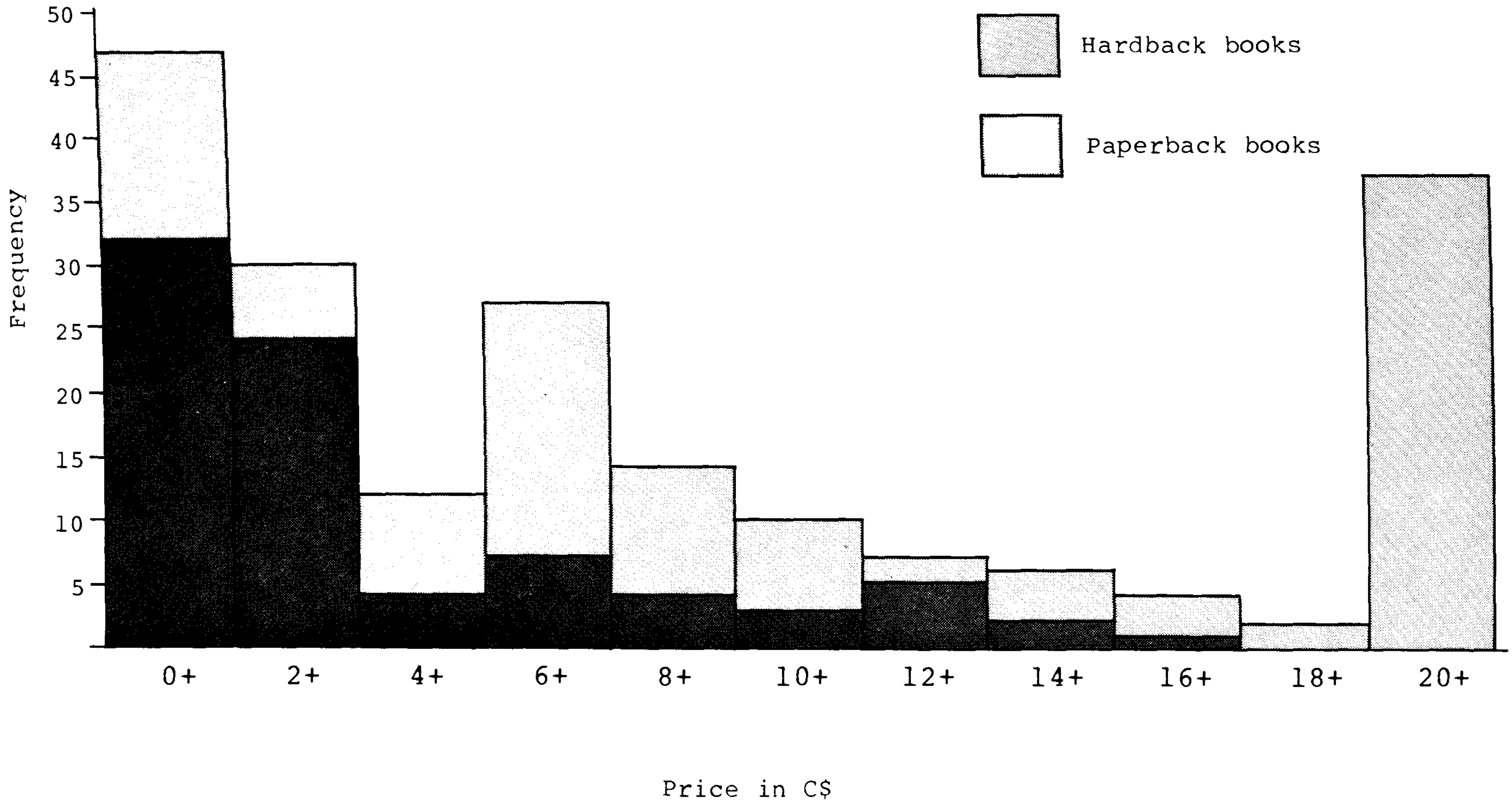
Frequency Distribution of List Prices of Books:
France (random sample of 200 titles)



SOURCE: Les livres disponibles 1978, Cercle de la Librairie, Paris, 1978.

Figure 4

Frequency Distribution of List Prices of Books:
United Kingdom (random sample of 200 titles)



SOURCE: British Books in Print 1978, J. Whitaker & Son Ltd., London.

than it does in those countries: relatively few copies of the high-priced titles may be sold and hence they may have little significance for the average book reader. Similar considerations may, of course, be applied to titles in the low-priced paperback range. If many of these are titles with a small market, which for one reason or another are offered for sale at subsidized prices (as might be the case for some volumes of poetry, or educational pamphlets), they may not represent a very significant phenomenon to most readers.

To estimate the average price of books sold, rather than the average price of titles published, one would need information on the sales volumes, as well as the prices, of the individual titles. Put differently, one would need a weighted average price. In the next section, we will consider the possiblity of getting closer to an estimate of such a weighted average from information on the unit revenues of Canadian and U.S. publishers.

Unit values of publishers' sales

For reasons of data availability, the comparison in this section will refer only to the United States and Canada. The data for the United States refer to 1976 and 1977, whereas the Canadian data are available for 1975 and 1976 only. The unit values for the respective years are presented in Table 6 by commercial category. Before discussing the numbers, it is worth noting that the comparison does not fully explain how the price of an average book bought by a Canadian reader or institution compares with the corresponding price in the United States because the data do not include information on the prices of books that are independently imported. As will become evident, this appears to be an especially important factor for post-secondary educational texts and the professional/scholarly category. Nevertheless, because the data are weighted averages of books sold by publishers, they are considerably more representative in this sense than the average title prices discussed in the previous section.

Table 6

Unit Values of Publishers' Sales
(by commercial category, Canada and United States)

			1975	1976	1977
Elementary texts	unit values:	United States	-	2.43	2.64
		Canada	2.88	3.21	-
	sales:	United States	-	408	449
		Canada	32.0	27.8	-
High school texts	unit values:	United States	-	3.59	3.93
		Canada	3.96	4.78	-
	sales:	United States	-	233	256
		Canada	13.8	14.2	-
Post-secondary texts	unit values:	United States	-	6.94	7.72
		Canada	5.76	7.14	-
	sales:	United States	-	564	592
		Canada	5.4	5.7	-
Professional, scholarly, general	unit values:	United States	-	11.51	12.22
		Canada	7.06	6.09	-
	Sales:	United States	-	559	627
		Canada	13.7	16.0	-
Trade books, all formats	unit values:	United States	-	(1.60)*	(1.68)*
		Canada	.74	1.07	-
	sales:	United States	-	(1160)*	(1326)*
		Canada	50.6	78.4	-
Trade books, other than MMP	unit values:	United States	-	2.90	3.14
		Canada	(2.88)**	(4.90)**	-
	sales:	United States	-	744	810
		Canada	17.0	36.6	-
Mass-market paperback	unit values:	United States	-	.886	.972
		Canada	.53	.637	-
	sales:	United States	-	415	516
		Canada	34.2	42.0	-

SOURCES: Association of American Publishers, <u>1977 Industry Statistics</u>, and Statistics Canada, <u>Culture Statistics, Book Publishing: A Cultural Analysis, 1975, 1976.</u>

* Assuming that all mass-market paperbacks are trade books
** Assuming that mass-market paperback trade books have the same unit value as all mass-market paperbacks

The figures have not been converted into Canadian dollars. For the first two educational categories, it appears fairly clear that the net prices charged by Canadian publishers for their books tend to be considerably above those charged in the United States. In 1975, when the exchange rate between the Canadian and U.S. dollars was close to par, the unit values in Canada were already close to the 1977 U.S. values and, in 1976 they were substantially higher in Canada than in the United States. It is difficult to speculate what the 1977 Canadian figures will show when they become available, especially if they are compared with the U.S. figures converted into Canadian dollars (which would add some 15 per cent to the U.S. figures). From preliminary data on Canadian book prices in 1977, it appears that substantial increases have occurred, so that it is likely that a considerable margin continues to exist.

For post-secondary texts, Canadian unit values appear to be no higher or even somewhat below those shown for the United States (and, unless Canadian prices increased dramatically in 1977, they will almost certainly be lower in that year if the U.S. figures are converted into Canadian dollars). It is worth noting that the college market continues to be dominated by imported titles to a much greater extent than the market for elementary and high school texts.

The proportion of college text sales in the United States to total educational text sales is 47 per cent. In Canada, the corresponding figure is just over 12 per cent. Looking at the matter differently, the ratio of sales by Canadian publishers to those of U.S. publishers was 6.8 per cent for the elementary market, 6.1 per cent for high school texts and only 0.5 per cent for post secondary.

Similar comments apply to the case of "professional, scholarly, and general reference" books, where Canadian unit values again are considerably below the U.S. ones. As was observed above, sales in Canada relative to the United States are quite low (about 2.8 per cent), and many of the titles underlying the U.S. statistics represent highly specialized low-volume works for which a separate Canadian edition would not be profitable. These titles would therefore tend to be supplied to the Canadian market as direct imports, and it is likely that Canadian buyers pay a considerably higher unit price for them than for the less specialized books sold by domestic publishers in this commercial category.

The most difficult comparison is that involving trade books because the data are not given in a comparable form. In the original U.S. statistics, the mass-market publishers are separated from other trade book publishers whereas the Canadian statistics data on trade book sales include mass-market paperbacks. In addition, because Canada now has a very substantial export business in mass-market paperbacks, the share of this format category in total Canadian sales is very high relative to the United States.

As seen from Table 6, the unit value for all Canadian trade books taken together is only $.74 in 1975 and $1.07 in 1976. The corresponding U.S. figures, which have been computed on the assumption that all mass-market paperbacks are trade books, would be U.S.$1.60 and $1.68 in 1976 and 1977, respectively.

For the reasons just noted, we think these numbers are misleading, and we therefore carried out comparisons for mass-market paperback and other trade books separately. We did this by computing a separation of Canadian trade books by format category, as follows. The Canadian source shows that approximately 98 to 99 per cent of the <u>value</u> of mass-market paperbacks fall into the trade book commercial category; from this, an estimate of dollar sales of Canadian trade books other than mass-market paperbacks can be obtained. Assuming that the same percentage of all <u>copies sold</u> as mass-market paperbacks are in fact trade books, the number of copies sold in the form of hardcover and quality paperbacks can also be estimated. Dividing one by the other gives estimated unit values comparable to those for the U.S. category of trade books other than mass-market paperback. These values appear to be substantially higher in Canada than in the United States, especially in 1976 when sales of trade books in Canada rose rapidly.

Unit values for Canadian mass-market paperbacks, finally, appear to be a good deal lower than the corresponding figures for the United States. There is some question about the comparability of the data in this category, stemming from the question of returns. In the U.S. data, both the sales revenue and the number of copies sold have been adjusted for returns, which tend to be a very high proportion of gross sales in this market. It is not clear whether returns have been similarly treated in the Canadian data, and thus the unit values shown here should be treated with some caution. Nevertheless, the result that unit values in the mass-market paperback category are comparable to, or even lower than, those in the United States is consistent with the observation in the previous section that there is a high frequency of low-priced paperbacks among all titles published in Canada.

What conclusions can be drawn from these comparisons? First, the hypothesis advanced in the previous section, concerning the reason why the average title in Canada is priced lower than in the United States (and in the United Kingdom) receives some confirmation. The highest-priced titles in the United States, according to the unit-value comparisons, are the post-secondary texts and the professional/technical/scholarly books, and the sales of such titles by Canadian publishers are relatively small. On the other hand, for several commercial categories of books, Canadian unit values, and hence probably also retail prices, tend to be considerably higher than in the United States: el-hi texts and trade books other than mass-market paperbacks. Finally, the high frequency of low-priced mass-market paperbacks in the distribution of title prices is reflected in the present comparison as well. By the total sales measure, the Canadian publishing industry is heavily specialized in low-priced mass-market paperbacks, which are sold at low unit values, and many of which are exported.

Pricing of books imported into Canada

As noted above, the price comparisons based on the national Books in Print sources and on unit value statistics suffered from the fact that the Canadian publication did not include imported books. In this section, we address the problem of pricing imported titles directly by discussing the results of a survey of a sample of specific titles where pricing information was available on a title-by-title basis for both the Canadian market and the market in the country of origin.

Such a comparison is useful in part because the sample is matched title-by-title, so that the comparison is not influenced by differences in the mix of titles (by commercial or format category) between the respective countries. Furthermore, since the sample consists of titles for which identical copies, produced in the same production process abroad, are sold in the Canadian and foreign markets, no biases are introduced in terms of differences in the physical quality of copies sold in the two markets. The marginal costs of producing copies for the Canadian market are the same as for the foreign market after adjustment for the costs of transportation and border clearance. Hence, according to the theoretical model, any observed price differentials can be interpreted with some confidence as being evidence for differences in perceived demand elasticities between the Canadian and foreign markets. At the same time, because the possibility of buying around exists for precisely this set of titles, one would not expect to find very large price differentials, even if the elasticities were significantly different. For this reason, the comparison can be taken to provide estimates that constitute lower limits on any existing elasticity differentials of this kind.

Since published data on prices of books imported on an exclusive-agency basis are not available, we obtained the sample information by writing to a large number of English- and French-language publishers. To obtain evidence on changes in pricing practices over time, we asked the publishers to send us not only their current catalogues but also any available issues of catalogues going back to 1975.

While we received a large number of replies, the response rate from the French-language publishers was considerably below that for English-language ones, and we got relatively few back issues of catalogues. Consequently, the comparisons are based primarily on information from 1978, though we have a somewhat smaller sample of data from earlier years.

The comparison was based on matching the prices given in the catalogues with those shown in the Books in Print in the country of origin. For a very large number of titles, such a matching was not possible, presumably because they were new titles which had not yet appeared in the relevant Books in Print. In spite of this difficulty, we were able to get over 200 observations on price differentials referring to books imported from the United States, and 28 observations for the United Kingdom; no systematic comparison was possible in the case of books imported from France. It may be worth noting that the large number of catalogues assembled for this paper could be used for a more comprehensive survey in the future, as the respective Books in Print sources are brought up to date.[2]

The main results of the price comparisons are summarized in Tables 7 to 9. The numbers appearing were computed as follows. For each publisher, we computed the average

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2. A more up-to-date comparison between Canadian and U.S. prices could also have been made by comparing prices in the Canadian catalogues with the information in Forthcoming Books (New York, R.R. Bowker Co., bimonthly), where more recent information on U.S. book prices is available than in the regular Books in Print. We are grateful to the Association of Canadian Publishers for drawing this source to our attention.

price for the titles chosen from the Canadian catalogue. The average price for the same titles in the country of origin was computed from the relevant Books in Print source. This average was then converted to Canadian dollars. The numbers shown were next computed as the ratio of the Canadian average to the average in the country of origin. Hence, the numbers represent the average markup of the Canadian list price over the equivalent of the foreign list price in Canadian dollars, multiplied by 100.

Table 7

Average Ratios of Canadian List Prices to U.S. List Prices for Books Imported from United States, 1978
Selected Publishers and Titles

Publisher	Price ratios (per cent)	Number of observations
1)	103.4	34
2)	102.1	21
3)	117.9	26
4)	112.2	5
5)	99.9	12
6)	122.7	19
7)	107.8	20
8)	114.0	15
9)	95.6	19
10)	112.2	29
11)	101.7	10
12)	97.3	9
13)*	87.5	26
Weighted average	105.8	245
Weighted average excluding publisher 13	108.0	219

SOURCES: Publishers' catalogues, Books in Print 1978.

NOTE: U.S. list prices were converted to Can$ using the 1978 "mid-period" exchange rate from International Monetary Fund, International Financial Statistics.

*Paperback publisher only

Table 8

Average Ratios of Canadian List Prices to U.K.
List Prices for Books Imported from United Kingdom,
1978 Selected Publishers and Titles

Publisher number	Price ratios (per cent)	Number of observations
1)	132.0	8
2)*	114.2	20
Weighted Average	119.3	28

SOURCE: Publishers' catalogues, British Books in Print 1978.

* Paperbacks only

Based on the evidence presented here, the markup on books imported from the United States appears to vary a great deal from one publisher to another: the lowest markup observed in 1978 (publisher number 9) implies a price 4 per cent lower than the Canadian-dollar equivalent of the U.S. price, with the highest being 28 per cent higher. In part, this variation can be explained by differences in the composition of publishers' imports since, during the period to which these observations refer, there was a 10 per cent duty on the value of book imports on trade books, but not on education books. Publishers specializing in the latter could be expected to show a lower markup. But, in general, the variation is too large to be accounted for by this factor alone, so that it appears that publishers simply differ in their markup policies.

Table 9

Average Ratios of Canadian List Prices to U.S. List Prices for Books Imported from the United States, 1975 Selected Publishers and Titles

Publisher number	Price ratios (per cent)	Number of observations
1)	115	27
2)	112	10
3)	114	11
4)	108	20
Weighted average	112.3	68

SOURCES: Publishers' catalogues, Books in Print, 1975.

NOTE: U.S. and U.K. list prices were converted to Can$ using "mid-period" exchange rates for 1978 and 1975, respectively, from International Monetary Fund, International Financial Statistics.

The average markup in 1978, between 6 per cent and 8 per cent, appears too high to be accounted for by duty, transport costs from the United States and customs brokerage expenses. Since the duty is applied to the actual price paid by the importer, which for exclusive agents is almost certainly less than 50 per cent of the list price, this factor should account for no more than a 5 per cent markup. It does not apply to educational books and, therefore, on average, it should account for no more than 3 or 4 per cent. From information gathered from a customs broker, it appears unlikely that transport and brokerage costs would add as much as 2 per cent to list price, especially for higher priced titles.[3] Furthermore, even though the 1978 exchange rate would indicate that the U.S. dollar was worth 14 per cent more than the Canadian, it seems unlikely that the costs of inputs used in distribution (labour, equipment, working capital) were 14 per cent higher in Canada than in the United States. It would appear from this evidence that markups are sufficiently high to generate <u>some</u> excess profits (in the economist's sense) on imported titles, or (which seems at least as likely) to pay for the cost of a distribution process that operates less efficiently than in the United States.

Even though the evidence is based on a smaller sample, there is even stronger support for the hypothesis of excess profits (or a less efficient Canadian distribution system) in the case of books imported from the United Kingdom. While transport costs from the United Kingdom obviously are higher than those from the United States, the observed markups are much too high to be explained by this factor.

Finally, it is interesting to note that the markups in 1975 seem to have been noticeably higher than in 1978. We interpret this decline as being due principally to the rapid increase in the price of the U.S. dollar between those dates. To maintain a markup factor of 12 per cent, say, the Canadian importer would have had to increase Canadian list price levels not only to reflect price increases in the United States, but also by an additional 14 per cent to compensate for the exchange-rate charge. It is hypothesized that they were reluctant to display such a high rate of price increase over a relatively short time. If this reluctance is temporary, however, some increase in markup levels could be expected as the exchange rate stabilizes.

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3. We were quoted a surface transportation rate from New York or Chicago to Toronto of between 3 cents and 4 cents/lb., depending on the size of the shipment; an average book weighs about 1.3 lb. including packing material. A freight rate of 4 cents/lb. on a shipment of 500 copies, each of 10 titles each of which constitutes a "line of classification" with a fixed charge of $1.00, and each book listing for $5.00 with a "value for duty" of one-half the list price, will result in a transport plus brokerage cost of $320 or 6.4 cents per book, i.e., about 1.3 per cent of the list price.

Costs of Book Production and Distribution

In this section we describe the information we were able to find with respect to the components of the total cost of production and distribution of books in Canada and, to the extent possible, we compare the cost pattern with that in countries whose publishers compete with those in Canada. Again, because of data limitations, the quantitative analysis is confined to a Canada-U.S. comparison.

Such a cost analysis may be of interest in its own right. For example, it facilitates an evaluation of the frequent claims regarding low profitability in Canadian publishing and provides some evidence regarding the relative importance of the cost components that may influence this profitability. The main reason for analyzing the composition of total costs, however, is that it yields the data necessary for undertaking a separation of the variable (or marginal) costs from those that do not vary with the number of copies sold. This estimate of marginal cost is then used to provide information on the perceived elasticity differentials between Canadian and foreign markets. As was shown in the preceding chapter, such elasticity differentials are of crucial importance in evaluating the likely effects of Copyright Act import restrictions.

The data for Canadian costs have been taken directly from a forthcoming Statistics Canada publication which is based on responses obtained in a special survey of book publishers. We have aggregated some of the items to make them conform with the items available from U.S. sources.

U.S. data for various categories of publishers came directly from the Association of American Publishers' 1977 Industry Statistics. The only modification undertaken was to convert the original figures from the mass-market paperback category into percentages of net sales to make them comparable with those remaining and with the Canadian data.

The figures in column (1), Table 10, were computed as follows. To get a set of average figures across all categories of U.S. publishers which would be as comparable as possible to the Canadian figures (which are not available disaggregated by commercial or format category), we computed a weighted average of various types of costs in the different industry subgroups, with the weights being the shares of the respective commercial and format categories in the Canadian industry in 1976. Hence, column (1) represents that hypothetical set of cost shares which would have prevailed in the United States if the U.S. industry had had the same composition of sales of own titles between the various commercial and format categories as the Canadian industry.

Table 10

Composition of Total Costs and Revenues of Canadian and U.S. Publishers (per cent of net sales)

	(1) United States	(2) Canada
Gross sales	124.8	112.69
Net sales	100	100
Returns	24.8	12.69
Manufacturing costs	34.5	41.9
Royalties	15.3	5.08
Cost of books sold	49.8	46.98
Margin on sales	50.2	53.02
Other income	3.0	2.05
Editorial costs	3.8	2.44
Production costs	1.7	.87
Marketing costs	16.9	14.80
Fulfillment	7.7	9.23
General administration costs	10.1	14.01
Operating costs	40.20	41.35
Net operating income	13.0	13.73

SOURCES: Compiled, as described in the text, from data in the Association of American Publishers' 1977 Industry Statistics and in an unpublished survey of Canadian publishers by Statistics Canada.

Comparison of columns (1) and (2) raises a number of interesting questions. First, the problem of books returned to the publisher for credit appears to be less significant in Canada than in the United States. The relatively high U.S. figure results primarily from the large returns in mass-market paperback publishing. We do not know whether Canadian publishers in this field have somehow been more successful than their U.S. counterparts in resolving the problem, but that is what the data suggest.[4] Second, the composition of the "cost of books sold" item differs a great deal between the two industries, with Canadian costs of "manufacturing" being much higher, and royalties much lower, than in the United States. To a considerable extent, this is likely to be a statistical illusion because the Canadian manufacturing figure includes the cost of imported exclusive-agency titles. Since the exporter and not the importer pays the royalty on those books, the royalty figure shown by the latter will be artificially reduced. The total costs of books sold as percentages of net sales come out relatively close: 49 per cent in the United States, 47 per cent in Canada.

Editorial and production costs in Canada appear relatively low. This again reflects the fact that a portion of Canadian sales are agency imports or co-publications on which such costs are not generally incurred. On the other hand, it appears that marketing and fulfillment[5] costs together account for a somewhat smaller share of net sales in Canada than in the United States: 24 per cent vs. 25.4 per cent. The general and administrative costs, which correspond to various overhead costs of the publishing operation in general, are substantially higher in Canada. If this is taken together with net operating income as a measure of the contribution of book sales to overhead and profit, the difference is even greater: for Canada, the total is nearly 28 per cent whereas, for the United States, it is just over 23 per cent.

In light of this information, it is possible to make a few comments on the proposition that the high cost level in the Canadian publishing industry puts Canada at a competitive disadvantage relative to other countries and that stronger protective measures than those currently in place

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4. A large proportion of Canadian paperbacks are exported. If those books are sold on a "net price" basis with no return privileges, the problem of returns would tend to be understated for Canada.

5. "Fulfillment" is the term used in the industry to refer to the costs of order processing, assembly of the books included in a given order, billing, etc.

are required to ensure the survival of a viable Canadian publishing industry.[6]

The first comment to be made is that if the profitability in Canada is indeed low, it does not seem to have resulted from a relatively high cost of books sold. If it is true that Canadian manufacturing costs are relatively high, this is offset by relatively lower royalty payments and relatively low prices paid for books imported by exclusive agents. Neither does it appear that editorial and production costs are substantially higher relative to sales. Even if one adjusts these costs for the estimated share of sales corresponding to imports, they appear to be no higher relative to sales than in the United States (neither do royalty costs, if similarly converted). Although fulfillment costs appeared high relative to sales, this was more than offset by an apparently lower share for marketing costs in Canada.

Indeed, if profitability in some parts of the industry is low, the reason should be sought in the higher share of general and administrative overhead costs, or in the relatively large use of capital. As a fraction of <u>sales</u>, net income in Canada was in fact somewhat <u>higher</u> than in the United States. As a rate of return on <u>capital invested</u>, however, Canadian profits may still have been considered low, namely, if the amount of capital invested (including working capital) was larger, relative to sales, in Canada than in the United States.

The possible problems of relatively high overhead costs and relatively large amounts of capital invested are likely to be related to economies of scale. Administrative overhead could be expected to fall and the efficiency of capital utilization (in particular, through more efficient inventory management) to improve with volume of sales. Hence, it is reasonable to hypothesize that if there is a profitability problem in Canadian publishing, it should affect small firms more severely than large firms.

Evidence from the same unpublished Statistics Canada survey used to construct Table 10 strongly confirms this. Taking their estimated net-of-tax return to publishers' equity as a measure of profitability, one can derive Table 11.

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6. We accept this proposition only for the sake of argument. As discussed in Chapter II, available data do not support the notion that the publishing industry as a whole in Canada is especially unprofitable.

Table 11

Rate of Return to Equity, Net of Tax (per cent)*

Type of publisher	1976	1977
Sales under $1.5 million:		
Canadian	7 (3.5)**	5 (2.6)
foreign	-4 (-1.1)	-3 (-.8)
total	5 (2.5)	3 (1.7)
Sales over $1.5 million:		
Canadian	53 (14.2)	118 (26.5
foreign	18 (10.6)	19 (11.6
total	24 (11.8)	34 (16.5
Total, all groups	20 (9.5)	29(13.2)

SOURCE: Statistics Canada, unpublished survey data.

* Computed as total net profits in group/total equity in group

** Numbers in parentheses are net-of-tax profits plus net interest paid/total assets

As noted above, the data do not appear to support the notion that the Canadian publishing business is exceptionally unprofitable: after-tax rates of return on equity of 20 per cent and 29 per cent in 1976 and 1977, respectively, appear reasonable. But for publishers with sales of less than $1.5 million, the claim certainly does appear to be justified, with after-tax profit rates as low as 3 per cent and 5 per cent, respectively.

The very high profit figures for the larger Canadian firms primarily reflect the fact that those firms are heavily indebted. That is, the equity base on which the rate of return is computed, is fairly small. To allow for this, we have also shown the total returns to capital (i.e., after-tax profits plus net interest costs) as a percentage of total assets. This measure shows much less variation between Canadian and foreign firms, but the low returns of the smaller-scale publishers is again confirmed. In interpreting these numbers, it should be kept in mind that the returns shown for foreign firms are, to some extent, arbitrary since loans and interest payments to and from affiliated firms (i.e., foreign parent organizations in this case) are included in the computations.

The major conclusion from the analysis of the relative cost structure of the U.S. and Canadian publishing industries is that a good part of the problem of low profitability in Canadian publishing appears to be high overhead costs and inefficient utilization of capital. These problems, in turn, are closely related to economies of scale. Profitability is not a major problem for large publishers with sales in excess of $1.5 million (still quite small by U.S. standards). It should also be noted that this group of large publishers accounts for most of the activity, however measured, in the publishing industry. Thus, 1977 Statistics Canada data indicate that of 108 reporting publishers, 41 of them, each with net sales over $1 million, accounted for over 90 per cent of total sales. Hence, the problem of profitability in Canadian publishing is one that primarily affects a relatively large number of small firms which together account for less than one-tenth of total industry sales.

Costs of Production and Book Pricing in Canada: Evidence from Relative Cost Data

In the theoretical discussion, three factors were isolated as determinants of the effects that restrictive import provisions would have on book prices in Canada. The first one was any perceived differential in the price elasticities of demand for given book titles between the markets in Canada and in those countries that are the most important sources of Canadian book imports. The second was the degree of interdependence in the pricing of different titles or between different publishers when they set their prices. The third was the level of marginal costs of book production and distribution in Canada relative to that in foreign countries.

The question of relative costs is briefly discussed in Appendix B. Our main conclusion there is that, while there is some evidence of higher costs in Canadian than in

U.S. publishing,[7] we would expect that in the long run, domestic and international competition in book manufacturing and distribution should tend to make the levels of costs in the two countries vary together. Moreover, we argued that Copyright Act import restrictions would essentially protect Canadian copyright owners only, not book manufacturers or distributors. Hence, the degree of international competition, and therefore the level of efficiency and cost, in book manufacturing and distribution should be largely unaffected by copyright legislation. This is the assumption we will make in the quantitative illustrations in Chapter V.

In this section, we attempt to obtain evidence on the other factors, i.e., the perceived elasticity differentials and the degree of interdependence in pricing. At this point, we will simply try to draw inferences from the cost and price data described above but, in the next section, we will also discuss a series of statistical estimates of the pricing behaviour of Canadian publishers which we have derived directly from unpublished data supplied by Statistics Canada.

According to the theoretical analysis above, for the case where each title is priced independently and a book is to be sold in a single market only,[8] the profit-maximizing price set by the publisher would be determined by the projected own-price elasticity of demand for the title and the <u>marginal</u> cost of producing and selling an additional copy of the book, according to the formula given by:

$$x_i^j = \frac{1}{/\varepsilon_i^j/} \qquad \text{Equation (20)}$$

where

$$x_i^j = \frac{p_i^j - m_i^j}{p_i^j}$$

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7. For reasons of data availability, the United States was the only country for which such a comparison could be undertaken.

8. Or, equivalently, when the given market is isolated from import competition via import restrictions.

Equation (20) can be rewritten after manipulation as

$$\frac{m_i^j}{p_i^j} = \left(1 - \frac{1}{\varepsilon_i^j}\right) \qquad \text{Equation (21)}$$

Now ε_i^j is the perceived own-price elasticity of demand for the i^{th} title in the j^{th} market. Since each book is, to some extent, a unique product, there is no reason to expect that these elasticities should be the same for different titles. Even for a given market, one would expect considerable variation in the ratio of marginal cost to price. Suppose, however, that on the average there is a tendency for perceived elasticities to be different between markets. In that case, the average rates of m/p (across many titles) should differ as well. The approach in this section is based on using available data to estimate average ratios of this kind for the United States and Canada in order to answer the question of whether the relevant demand elasticities are indeed different.

The preceding discussion is based on the assumption that there is no interdependence in pricing. For the case where there <u>is</u> such interdependence, it is implied by the analysis in Chapter III that (20) has to be replaced by

$$X_i^j = \frac{1 + \sum_{k \neq i} \eta_{ik}^j X_k^j}{/\ \varepsilon_i^j\ /} \qquad \text{Equation (22)}$$

where the η_{ik}^j represent the cross-price elasticity of demand for the i^{th} title with respect to the price of the k^{th} title in the j^{th} market, and where the range of summation is given by those titles for which the publisher jointly maximizes his profits. Suppose now that in equation (22), we replace the individual markups X_i^j by this average value for a given market. The formula then becomes:

$$\overline{X}^j = \frac{1}{/\ \varepsilon_i^j\ / - \sum_{k \neq i} \eta_{ik}^j} \qquad \text{Equation (23)}$$

where $\overline{X}^j$ is the average value of the markup for the j^{th} market.

Note that $\bar{X}^j$ can also be written

$$\bar{X}^j = 1 - \left(\frac{m}{p}\right)^j \qquad \text{Equation (24)}$$

where $(m/p)^j$ again is the average ratio of marginal cost to price in the j^{th} market. If data can be found to estimate this ratio, they can be used to estimate the average value of the right-hand side of equation (23).

A conclusion to be drawn from this discussion is that, on the basis of markup information alone, it is not possible to infer whether differences in average markups (or, equivalently, ratios of marginal cost to prices) are due to differences between markets in the perceived own-price elasticities of demand or to different degrees of pricing interdependence, as represented by the cross-price elasticity terms. Fortunately, however, it is possible to show that this difficulty does not affect the conclusions with respect to the consequences of import restrictions: the effects of such restrictions will be the same whichever explanation is valid.

Before turning to the empirical evidence, it should again be noted that the data presented here on markup behaviour in Canada to some extent reflect the influence of present import restrictions. But we know that those restrictions are neither unambiguous, nor very strictly enforced. One would thus expect that, with more rigid enforcement, we would have observed Canadian markups which would have been somewhat higher than those we have in fact found. This would have reinforced our conclusion in Chapter V, namely, that import restrictions based on the principle of territorial divisibility would cause book prices in Canada to be significantly higher than they would be without such restrictions (i.e., with the exhaustion alternative). Hence, the quantitative illustrations in Chapter V of the effects of territorial divisibility contain a downward bias of the cost of import restrictions in this respect.

Turning now to the empirical evidence concerning ratios of marginal cost to prices on which the analysis is based, a difficult conceptual problem must be resolved prior to estimating such ratios. That is, the problem of devising an appropriate measure of marginal cost, defined as the addition to the publisher's total cost when an additional copy is produced and sold.

The most significant feature characterizing the production and distribution process for a given book is that it is subject to strongly decreasing average costs. Put differently, the fixed costs of producing a book are quite high relative to the variable costs (i.e., those varying with the number of copies sold). To start with, the time and effort involved in writing a book corresponds to a fixed cost, as does the process of editing a manuscript and transforming it into a form in which it is ready for the printer. This process involves layout, special artwork, jacket design, etc. The printing cost process also involves a large element of fixed costs: typesetting, paste-up, assembly, film and plates are various phases of the manufacturing process which have to be undertaken before the first copy can be produced. It is worth noting that a large part of the costs in this category are labour costs, so that they are sensitive to wage differentials in an international cost comparison. The truly variable costs in the manufacturing process are mainly the cost of paper, material for the cover and binding.

The cost of editing, preparing and manufacturing books is typically shown in Canadian studies as corresponding to no more than about 45 per cent of publishers' net sales (e.g., Table 12). Apart from the retailer's or wholesaler's discount, the other major cost component is the publisher's share of the marketing and distribution costs. The distribution costs per title (warehousing, order fulfillment and transportation) obviously depend, to some extent, on the number of copies sold, but they are certainly not proportional to the number of copies. The cost of order fulfillment, for example, depends much more on the number of orders received from different booksellers, and on the number of titles for each order, than on the number of copies per title. While we have been unable to find hard statistical evidence on the degree to which these costs should be considered variable, it is significant that in the costing analysis formats which we have seen, warehousing, order fulfillment and billing are characterized as semi-variable or are included in overhead. Marketing and promotion costs are also partly fixed, partly variable. To the extent that the intensity of the promotion effort depends on the expected number of copies sold, or salesmen are paid a bonus per book sold, it can be argued that they have a variable cost element. On the other hand, to the extent that promotion takes place through inclusion in the publisher's catalogues or in advertising campaigns common to several titles which are directed to the publisher's regular clientele, promotion costs do not vary with the number of copies sold for a particular title. Similarly, the marketing activities may primarily take the form of maintaining a regular sales force who make rounds to a given set of buyers and who are paid salaries and travel expenses. If that is the case, the cost of marketing will not depend on the number of copies sold of a given title and will have to be regarded as a fixed cost.

In addition to these costs, publishing firms (like firms in any industry) also have certain overhead costs that depend neither on the number of copies sold per title nor on the number of titles published or marketed by the firm: salaries of the executive and administrative staff, costs of maintaining a head office and so on. These costs are clearly fixed in the sense that they do not vary with the number of copies sold; they may also be considered fixed in the sense that they do not vary with the number of <u>titles</u> the publisher produces.

As argued above, royalty costs present a somewhat different type of problem. Once a book has been written, the efforts of the author, for which royalty costs are supposed to represent a payment, are in the nature of a fixed cost. On the other hand, given the way in which contracts between authors and publishers are written, royalties will in fact represent a variable cost and, in traditional analysis, are treated as such. From the viewpoint of the pricing decision, however, it is important to note that royalties are typically specified as a percentage of list price. Hence, they will play a role quite analogous to the discount awarded to a bookseller, and therefore can also be taken as a reduction in the net revenue to the publisher. We will interpret the role of royalties in this way and use a modified concept of net sales revenue, defined as the publisher's revenue per copy after the retailer's discount <u>minus</u> royalty payments to authors, as the relevant price variable in our study of markup behaviour.

The above discussion applies to the case of a publisher who sells books that he himself has produced. For a publisher who sells books as an agent for somebody else, the situation is somewhat different. His marginal cost is simply the net price he pays for the book, plus freight and duty where applicable. If the selling (foreign) publisher prices the book above <u>his</u> marginal cost, as he must in order to make such an arrangement worthwhile, it is easy to show that a conflict of interest will arise between the foreign publisher and his agent: the profit-maximizing price set by the agent will tend to be higher than the price that the original publisher would like to see the agent charge. When there is competition between agents for the business of foreign publishers, however, the price actually set by the agents will ultimately tend to reflect the foreign publisher's interest; i.e., the price actually set will be one that maximizes profits when the publisher's marginal cost of production (plus transport and duty) is used in equation (20) or (21).[9] But this would mean a lower list price than would be predicted using the agent's marginal cost (i.e., the net price he pays) to determine the list price.

In light of this discussion, we now turn to an attempt to utilize the revenue, cost and price data analyzed above to derive rough estimates of comparative perceived demand elasticities in Canada and the United States. The approach will be to estimate the marginal cost in relation to the relevant net sales revenue; this ratio will correspond to the left-hand side of equation (21). The implied elasticity estimate may then be solved from (21).[10] Two sets of estimates will be provided, the first based on simple definitions of marginal cost and net sales price, the second on more sophisticated ones incorporating some of the modifications discussed in the preceding paragraphs.

Table 12 presents a re-arrangement of the data on the relative cost structure in U.S. and Canadian publishing from Table 10, and the estimates are based on those data. As noted, we will start with a simple definition of marginal cost: we define it as the "cost of books sold plus royalties" (i.e., all manufacturing costs plus royalty payments, plus the actual cost of importing books sold on an agency basis), line 4, Table 12. For Canada, this represents 47.0 per cent of net sales vs. 49.8 per cent for the United States. As argued above, distribution and fulfillment costs are, to some extent, variable and, from discussions with people in the industry, we believe one-half is a reasonable

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9. This argument was implicitly relied on in the discussion in Chapter III, to effectively eliminate the agent's decision-making problem from the analysis.

10. The distinction between elasticity differentials and pricing interdependence will be disregarded in this section; as argued in the introduction, this does not affect the conclusion.

Table 12

Estimates of Adjusted Net Sales Revenue, Marginal Costs and Own-Price Elasticities, U.S. and Canadian Publishers

		Canada	United States
A.	Revenues		
1.	net sales revenue	100	100
2.	less royalties	5.08	15.3
3.	adjusted net sales revenue	94.92	84.7
B.	Costs		
4.	cost of books sold plus royalties	46.98	49.8
5.	less royalties	5.08	15.3
6.	subtotal	41.90	34.5
	for Canada only:		
7.	less cost of agency titles	28.35	
8.	plus marginal cost of agency titles	17.25	
9.	subtotal	30.81	34.5
10.	less weighted average of plant costs	1.97	4.1
11.	adjusted cost of books sold	28.84	30.4
12.	plus ½ marketing/fulfillment	12.02	12.3
13.	estimated marginal cost	40.86	42.7
C.	Elasticities		
14.	estimated elasticities	1.76	2.02

SOURCE: derived from the data in Table 10.

NOTE: The elasticities in line 14 are interpreted as averages for the Canadian and U.S. markets and were obtained from equation (21) after substituting

m_i^j = estimated marginal cost (line 13)

p_i^j = adjusted net sales revenue (line 3)

and solving for ε_i^j.

estimate for the variable proportion. Hence, we add one-half of these cost shares to the cost of books sold,[11] which results in figures of 59.0 and 62.1 for Canada and the United States respectively. With these definitions, these figures correspond to the ratio on the left-hand side of equation (21). From this, we can compute the implied estimates of the elasticities ε^j; they are -2.44 for Canada and -2.63 for the United States. Hence, using this method, the estimated elasticity for Canada does appear to be somewhat smaller in absolute value than in the United States, but not by much.

As noted, however, this computation is based on a very simplistic definition of marginal cost. For purposes of getting a more accurate comparison, we will modify the definition in several ways.

First, as noted above, from the viewpoint of the pricing decision, royalties might be most appropriately treated not as a part of the publisher's marginal cost but, rather, as a reduction in his net revenue. For the revised estimate of the elasticities, we thus define both marginal cost and the publisher's net revenue as net of royalties (lines 3 and 6, Table 12). Because royalties are a higher fraction of net revenue in the United States than in Canada, this modification alone would produce an estimated elasticity that is lower in absolute value in the United States than in Canada.

Second, however, a substantial proportion of the cost of sales in Canada represents the cost of books imported on an exclusive-agency basis and, as we have argued, the recorded value of such purchases represents an overestimate of the relevant marginal cost. We will attempt to correct for this, as follows.

The proportion of agency imports in total net sales of Canadian publishers was estimated at 37.1 per cent of total sales in 1976 (Statistics Canada, 1976). We now wish to estimate the actual cost to the publishers of importing those books. We assume first that the discount to retailers is 40 per cent in both Canada and the United States. Let ℓ_c denote the value <u>at list prices</u> of agency books sold by publishers in Canada; thus, $\ell_c\,(1-.4)=37.1$, which produces $\ell_c = 61.83$. From the evidence given in Tables 7 to 9 above, list prices of agency books sold in Canada are taken to be 8 per cent higher than in the United States. Hence, denoting

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11. From Table 10, marketing and fulfillment costs were 24.6 per cent of U.S. net sales, 24.03 per cent in Canada.

by ℓ_a the value of agency books sold in Canada at U.S. list prices produces ℓ_a x 1.08 = 61.83, or ℓ_a = 57.25. The discount granted exclusive agents may be estimated at 50 per cent to 60 per cent; i.e., the price paid by the Canadian agent to the U.S. publisher corresponds to 40 per cent to 50 per cent of the U.S. list price. Taking the midpoint of those estimates, 45 per cent of the U.S. list price is adopted as the agent's net cost. To this should be added the cost of freight, duty and brokerage, which would correspond to about another 10 per cent.[12] Hence, as a percentage of net Canadian sales, the cost of agency imports is estimated at 57.25 x .45 x 1.10 = 28.35 (line 7, Table 12). To get the relevant marginal cost of Canadian agency sales which, as argued above, is identical with the marginal cost to the U.S. publisher, the estimated value of Canadian agency sales at U.S. list prices (57.25) was multiplied by .256, which was our estimate of U.S. marginal cost as a percentage of U.S. list price, and 2.58 was added for transport and duty.[13] The result, 17.25, was added back to the Canadian cost-of-sales figure (line 8) to get 30.81 (line 9).

We have argued above that not all of what is traditionally included in manufacturing costs corresponds to variable costs: plant costs, such as "composition, assembly, films and plates," in Statistics Canada's terminology are, in fact, fixed costs and should not be included in the estimate of marginal costs. Evidence from both U.S. and Canadian data on manufacturing costs indicate that a correction for this factor may be of considerable significance.

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12. The duty on books prior to 1979 was ten per cent on the invoiced value; no duty was charged on educational books, however. Based on conversations with a customs broker who arranges both transport and brokerage, we believe that the cost of these items is unlikely to constitute more than one to two per cent of the list price of a book imported from the United States, and only slightly more on imports from Europe. For these reasons, the ten per cent allowance for freight, duty and brokerage is, if anything, probably on the high side.

13. The number .256 is the product of .427, the estimated ratio of marginal cost to net sales revenue for U.S. publishers (line 13, Table 12), and .6, the publishers' net sales revenue as a fraction of list price. The value 2.58 for transport and duty is 10 per cent of 57.25 multiplied by .45, i.e., 10 per cent of the estimated net price paid by the Canadian agent.

The Association of American Publishers' Industry Statistics provides data that makes it possible to separate plant costs from other manufacturing costs.[14] Applying this correction to the U.S. data in Table 12 and re-calculating the weighted average cost of books sold, 34.5 (line 9), produces a revised figure of 30.4 per cent (line 11).

For the Canadian case, separating plant costs from other manufacturing is not as easy. From unpublished raw data collected by Statistics Canada via questionnaires regarding costs and revenues of individual book titles (the data used are prepared in their reports entitled Book Publishing: A Cultural Analysis), a sample of publishers' estimates of plant costs (defined as "composition, assembly, films and plates," following the questionnaire definitions) was obtained for a limited number of titles in various commercial categories.

Since estimates of paper, printing and binding costs were available, the proportion of plant costs in total manufacturing costs could be estimated. By weighting those proportions by the share of the various commercial categories in total sales, we calculated an average ratio of plant costs to total manufacturing; this ratio was as high as 40 per cent. We find this implausibly high and, to be on the conservative side, we arbitrarily adjusted the figure down to 30 per cent.[15] We then took into account that plant

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14. Except for mass-market paperbacks, where it probably is not very large.

15. It can be shown that the main conclusion of this report would be even stronger if we had accepted the 40 per cent figure.

costs will be relevant only to newly published titles,[16] and we finally estimated that plant costs accounted for just under 2 per cent of total net sales of Canadian publishers (line 10). This produces an adjusted cost of books sold in Canada of 28.84 per cent of net sales (line 11).

As before, we finally add back that portion of marketing and fulfillment costs which was estimated at half of the total costs under those headings in the data from Table 10. The resulting estimates of marginal cost as a proportion of net sales revenue are 42.7 per cent for the United States and 40.86 per cent for Canada (line 13). Adjustment of the net sales figures for royalty payments (line 2), following the argument made earlier, produces elasticity estimates of -2.02 for the U.S. market and -1.76 for Canada as shown in line 14, Table 12.[17] With this approach, the perceived elasticity in the Canadian market thus appears to be substantially lower than that in the United States.

We recognize that the values of the elasticity figures must be viewed with a great deal of caution, since they depend on a number of fairly crude assumptions and are de-

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16. There are no plant costs for sales of titles which are reprints or backlist sales, or which are imported. The adjustment to account for this fact was as follows. Letting m_d represent marginal manufacturing cost on domestically produced titles, as a percentage of net sales, and m_a be the actual net cost paid for imported titles, we have

$$m_d s_1 + m_d(1 + c)s_2 + m_a s_3 = 41.9$$

where s_1, s_2, s_3 are, respectively, the shares of reprint plus backlist sales, sales of newly produced domestic titles and sales of imported titles; c is the proportion of plant costs in total manufacturing costs, set at .3. We have already estimated $m_a s_3$=28.35 per cent. Statistics Canada data for 1976 gives s_1=.272, s_2=.357. Solving for m_d yields m_d=18.4 per cent. The estimate of plant costs is then given by $m_d c s_2$=1.97 per cent, as listed in line 10, Table 12.

17. It is interesting to note that an implied estimate of the elasticity for own titles can also be computed. Addition of the 12.02 per cent representing marginal marketing and distribution costs to the 18.4 per cent marginal manufacturing cost computed in the previous footnote yields a marginal cost of 30.42 per cent. Assuming a royalty rate of 8 per cent on own titles can be shown to imply an estimated elasticity of -1.49.

rived from aggregative data which, in some respects, may not be completely accurate. However, they are based on the best evidence available and on the best judgement we could find with respect to the assumptions to be made. While other researchers might use slightly different assumptions, or different bodies of data, we doubt that the basic conclusion would be reversed.

Book Pricing Behaviour in Canadian Publishing: Direct Evidence

The data discussed in the preceding section can be interpreted as yielding a certain amount of indirect evidence on the pricing behaviour of Canadian publishers. By analyzing the relationship between net revenues to publishers and marginal costs, inferences were drawn regarding the average demand elasticity perceived by the publishers when they set their prices. Certain assumptions were necessary, however, to utilize the evidence in this way: e.g., that net sales revenues of publishers were representative of the list prices charged to the public. In addition, because the data were aggregated across commercial and format categories, it was not possible to allow for the possibility that there are differences in perceived elasticities between these categories. Finally, further hypotheses regarding pricing behaviour were suggested in the theoretical discussion but could not be considered using the aggregated data in the preceding section. The first hypothesis was that pricing behaviour would differ between co-published and other titles because of fear of competition in Canada from independent imports of the foreign edition; the second was that publishers are interdependent in their pricing decisions.

In this section, we report on an attempt to use disaggregated data to study pricing behaviour for the various commercial and format categories separately and to provide evidence relevant to the two hypotheses just discussed. The data were provided by Statistics Canada and came from their questionnaires on individual titles published by Canadian publishers; copies of the questionnaires can be found in Statistics Canada, Book Publishing: A Cultural Analysis, 1975, Appendix B. For reasons of confidentiality, we could not be given access to the raw data, so that the calculations had to be performed at Statistics Canada using their data processing equipment and working from the data stored on their tapes.

Information provided through the questionnaires includes the list price of the title and the publisher's estimates of various costs incurred by him in publishing the title in question. The commercial and format categories of the work are also given, together with information on co-publication arrangements.

The basic hypothesis of this report is that a profit-maximizing publisher will set his price with reference to the marginal cost of producing and selling extra copies of the work. In the preceding section, we identified marginal cost for own titles with part of the manufacturing cost (paper, printing, binding, excluding plant costs), and some portion of the marketing and distribution costs. On the questionnaire, no information is available on the latter. Since most publishers include those costs as part of their overhead allowance in their own costing analysis for a given title, it is unlikely that any useful information could have been derived by including a question asking for such information. Because of this, we have to make the assumption that paper, printing and binding costs represents a reasonable proxy for marginal cost. In other words, we assume that if a more comprehensive measure of marginal cost had been available, it would have been proportional to paper, printing and binding (henceforth denoted PPB).

According to Statistics Canada, the response rate to the question on PPB costs is considerably higher than that pertaining to other cost items such as: composition; assembly, film and plates; and others. Since PPB is the variable of main interest here, the low response rate for the plant cost components is not in itself a problem. We do, however, suspect that in most cases where plant costs have not been given, they may have been included in PPB. Therefore, the estimate of marginal manufacturing cost as PPB divided by the number of copies printed will be biased in those cases. As will be described below, we did attempt to correct for this possible bias in the statistical analysis.

To proceed with the statistical analysis, we assume that for a given commercial and format category, the perceived own-price elasticity of demand, which is relevant to price setting in that category, is the same across various titles. If this is true, the ratio of price to marginal cost (or equivalently, the ratio of marginal cost to price) should be constant across such titles. This is the basic proposition underlying the analysis below.

As our measures of price and marginal cost, we have used the list price of the publication and PPB divided by the number of copies printed, respectively. With respect to the price variable, the theoretical analysis has been carried out using the publisher's net revenue, not list price, as the relevant variable. If discounts to booksellers and royalty rates are assumed to be relatively constant percentages of list price within given commercial and format categories, then list price will serve as an accurate proxy for the relevant price variable.

Within the framework of this model, it is relatively simple, from a conceptual point of view, to test the hypothesis that the pricing behaviour of Canadian publishers tends to be different between works which are co-published and those which are not. Since we did have information pertaining to the co-publication arrangements for each title, we were able to construct a dummy variable (which took on the value 1 for works not co-published and 0 otherwise). We could then statistically test, for the various categories, whether the relationship between price and marginal cost appeared to be significantly influenced by co-publication status. The prediction from the theory would be that co-published works would tend to be priced lower, relative to marginal cost, than works which were not co-published.[18]

The hypothesis regarding interdependence in pricing behaviour is considerably more difficult to test statistically. One implication of interdependent pricing would be that over time the pricing of books, relative to marginal cost, would tend to change simultaneously for all titles, if it changed at all. For example, if there is interdependence in pricing in the sense that one or more publishers exercise price leadership (so that the pricing policy in the industry as a whole tends to follow the behaviour of that group of price leaders), prices should change in relation to marginal cost for all publishers together rather than independently from one publisher to another. Or, there may be interdependence in the sense that publishers who sell both their own and imported agency titles tend to determine prices of both types of books interdependently. Then, if there were a change in the costs of imported agency titles, one would expect to see a simultaneous change in the prices of their own titles as well, even if there is no change in the cost conditions affecting Canadian titles. Put differently, there should be a change in the price of their own titles in relation to marginal cost.

As an imperfect test of the interdependence hypothesis, we have therefore tried to test statistically whether there is a tendency for the prices of publishers' own titles

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18. This is because of possible competition from imported copies of foreign editions.

to change simultaneously relative to marginal cost. We were able to do so by taking advantage of the fact that the data were drawn from responses to questionnaires from two years, 1976 and 1977. By including in the analysis a dummy variable for the year in which the title was released, we were able to test the hypothesis that prices had changed systematically in relation to marginal cost between those years. We will interpret a statistically significant effect from this variable as evidence that some form of interdependence does exist or, more technically, as a rejection of the converse hypothesis of independent pricing behaviour.

Finally, as discussed above, we suspected some bias in the measure of marginal cost used in the analysis because some publishers may have included certain fixed plant costs in PPB. To correct for this, we included the number of copies printed of the title in question as one possible determinant of the price in relation to the (biased) measure of marginal cost. If some fixed costs had indeed been included, the degree of over-estimation of true marginal cost would tend to vary inversely with the number of copies printed and, by allowing for this effect, some of the possible bias can be removed.

The statistical analysis took the form of estimating the coefficients of two sets of multiple regressions in the following form:

$$RAT = a_0 + a_1 \times IND + a_2 \times COPDUM + a_3 NCOP + \varepsilon$$

$$RAT^{-1} = \alpha_0 + \alpha_1 \times IND + \alpha_2 \times COPDUM + \alpha_3\ NCOP + \varepsilon'$$

where RAT is the ratio of list price to marginal cost; IND is a dummy variable taking on the value 1 in 1976 and 0 otherwise; COPDUM is a dummy variable taking on the value 1 if the title is not co-published and 0 otherwise; NCOP is the number of copies printed; and ε and ε' are random errors.

As noted above, marginal cost is measured as PPB/NCOP. The second set of regressions were run with the ratio of marginal cost to price as the dependent variable because we believed that there were errors of observation in the marginal cost data in some cases, so that the marginal cost variable took on values near zero. For that type of measurement error, the variable RAT would take on very large values which might seriously bias the estimated coefficients. When the dependent variable was defined as RAT^{-1}, those measurement errors would result in these observations taking on values close to zero, which would tend to have a much less significant effect on the estimated coefficients.[19]

The results of the regression equations are shown in Tables 13 and 14 for the various commercial and format categories.

We first consider Table 13, where the dependent variable is RAT. The first thing to note about these regression equations is that the R^2s (i.e., the proportion of the variance explained by the regressions) are extremely low. This should not come as a surprise: if both null hypotheses (i.e., that there is no interdependence in pricing, and that the pricing decision for a co-publication is made in the same way as for a non-co-published work) are true, and the PPB variable is a good proxy for the "true" marginal cost, then the dependent variable would be constant and the R^2 would be zero. Hence, the signs of the coefficients and their level of statistical significance are of primary interest. Because the dependent variable is the ratio of list price to marginal cost and since the co-publication dummy is positive for works that are not co-published, a positive sign for its coefficient would indicate that co-published works are priced lower, relative to their marginal cost, than non-co-published works, as hypothesized above. Using conventional tests, the coefficient is statistically significant in only two of nine cases, but it has the expected positive sign in seven.[20] Thus, the evidence provides some support for the hypothesis that the risk of being bought around tends to cause publishers to price co-published works lower than they otherwise would; we take this to indicate that the profit-maximizing price in Canada would be higher in the absence of buying around.

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19. For the technically inclined reader, we note that if the dependent variable is a ratio and there are normally distributed errors of observation in one of the variables making up the ratio, putting that variable in the denominator will generate a component of the error term that is not normally distributed, invalidating the significance tests.

20. In one case, that of French el-hi texts, there were no co-published works.

Table 13

Regression Results,
Dependent Variable: Price/Marginal Cost

Language and commercial category	IND. (1)	COPDUM. (2)	NCOP. (3)	CONST (o)	Standard error	R^2	Number of observations
English elementary-high school	.63*	-1.1	$.49 \times 10^{-4}$**	5.14	2.6	.045	549
English post-secondary	1.38*	.2	$.14 \times 10^{-4}$	5.5	3.14	.04	139
English professional, technical & scholarly	.86*	.39	$.14 \times 10^{-3}$	4.2	3.5	.03	295
English trade	-.27	.62*	$.37 \times 10^{-4}$**	5.4	3.3	.03	963
English mass-market paperback	-.78**	42.7**	$.2 \times 10^{-3}$**	-21.8	23.6	.19	1266
French elementary-high school	.62	1.16	$.26 \times 10^{-3}$**	3.26	5.6	.39	221
French post-secondary	19.6	-	$.29 \times 10^{-2}$*	-10.3	37.4	.08	64
French professional, technical & scholarly	1.77*	1.25	$.89 \times 10^{-3}$**	1.7	2.4	.29	77
French trade	.81	-.25	$.5 \times 10^{-4}$	6.1	8.4	.007	317
French mass-market paperback	.35	1.5	$.6 \times 10^{-4}$	3.3	2.1	.09	19

* indicates an F statistic at 4 or over
** indicates an F statistic at 10 or over

Table 14

Regression Results,
Dependent Variable: MC/Price

Language and commercial category	IND. (1)	DUM. (2)	NCOP. (3)	CONST (o)	Standard error	R^2	Number of obser-vations
English elementary-high school	-.26**	.023	$-.19\times10^{-4}$ **	.66	.75	.07	549
English post-secondary	-.16*	.037	$-.12\times10^{-4}$	.36	.37	.07	139
English professional, technical & scholarly	.01	-.002	$.14\times10^{-4}$ *	.28	.21	.03	295
English trade	-.01	-.004	$-.2\times10^{-5}$ **	.24	.18	.02	963
English mass-market paperback	.03**	-.034**	$.33\times10^{-6}$ **	.13	.03	.38	1266
French elementary-high school	.03	.034	$-.28\times10^{-5}$	.26	.43	.013	221
French post-secondary	-.076	-	$-.47\times10^{-4}$ **	.53	.15	.53	64
French professional, technical & scholarly	-.2	-.45*	$-.12\times10^{-3}$ *	1.0	.45	.25	77
French trade	.007	.05	$-.27\times10^{-5}$ **	.23	.16	.05	317
French mass-market paperback	-.02	-.04	$.2\times10^{-5}$	.28	.06	.1	19

* indicates an F statistic at 4 or over
** indicates an F statistic at 10 or over

The coefficient for the IND dummy variable is positive in eight out of ten cases, and is positive and statistically significant in four cases. Given the definition of the dummy variable, this indicates that list prices in relation to marginal cost tended to fall between 1976 and 1977. Thus, there is some evidence of interdependent pricing which, in this case, took the form of not passing on fully the increases in marginal cost that took place between those years. It is interesting to note that all four significant coefficients occur in the textbook or professional/technical categories, which may in part reflect the worsening prospects in the educational market due to declining enrollment.

In the equation for English-language mass-market paperbacks, the regression coefficients are implausibly large, possibly due to errors of observations in the measure of marginal cost, which constitutes the denominator of the dependent variable. As discussed above, we attempted to reduce the effects of this problem by re-estimating the markup equations using the ratio of marginal cost of list price (RAT^{-1}) as the dependent variable. The regression coefficients estimated by this procedure are shown in Table 13.

After allowing for the changes in signs and magnitudes of the coefficients caused by the change of the dependent variable, the results shown in Table 13 are similar to those in Table 12 and will not be discussed in detail. For mass-market paperbacks, however, a more reasonable set of coefficients was obtained, although the sign pattern is opposite that of most other categories: co-published works tend to have a higher price relative to marginal cost and, in 1977, the price of mass-market paperbacks rose relative to marginal cost. We shall not attempt to speculate on the reasons for this, except to note that the highly significant coefficients in this equation are consistent with the notion that this part of the publishing industry is dominated by a few large firms who tend to follow a uniform pricing policy. Hence, it is not surprising that the hypothesis of independent competitive behaviour can be rejected in this case.

Finally, the hypothesis that some fixed costs are included in the reported PPB received some support from the evidence. The variable NCOP has the expected sign in all cases and is statistically significant in six out of ten cases.

We finally used the results listed in Table 13 together with data from the Association of American Publishers' 1977 Industry Statistics to compare price/marginal cost ratios between the United States and Canada for the various commercial and format categories shown here. We first computed U.S. manufacturing costs net of plant costs for the various categories. It was then assumed that U.S. net sales were 60 per cent of list prices. That is, we converted net sales to equivalent sales at list price and then computed the ratio of this value to manufacturing costs. This provides a crude estimate of the ratio of the average list price to marginal cost per copy used in the regressions. For the Canadian case, the ratio was computed from the regressions for non-co-published works, and at the mean number of copies printed in the respective category in 1977.

The results of this comparison indicate that the markup over marginal manufacturing cost on trade books in Canada is substantially higher than in the United States: ratios were 6.32 and 6.15 for English and French trade books in Canada, and 4.63 for U.S. trade books. For the educational and professional/technical categories, U.S. markups appear to be considerably lower than those in Canada. However, there is reason to believe that the U.S. figures are overestimates. First, the figures have not been corrected for returns and unsold copies. Second, the average discount of 40 per cent, assumed in converting to equivalent sales at list prices, may be too high for these categories. Furthermore, according to the results here, the markups in Canada for these categories were substantially lower in 1977 than in 1976. Correction of the U.S. figures by assuming 15 per cent unsold or returned copies and a 30 per cent discount, produces estimated markups very close to the Canadian figures for 1977 and considerably lower than those for 1976.

Conclusions from the Evidence

From the theoretical discussion in earlier chapters, it appears that the critical parameter in assessing the differential effects of alternative approaches to import provisions in the Copyright Act is the perceived demand elasticity for an individual book title.[21] As was shown in the theory, this elasticity is directly related to book pricing: a profit-maximizing publisher will determine his markup over marginal (or variable) cost with reference to this elasticity. The prediction of higher book prices under restrictive import provisions rests on the presumption of a lower

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21. Or equivalently, differences in the degree of pricing interdependence.

elasticity (lower in absolute value) and hence a higher profit-maximizing markup in Canada. The evidence on pricing behaviour and markup policies, discussed in the preceding sections, is of considerable importance in this context and we will rely on it in Chapter V in providing a quantitative estimate of the costs of import restrictions.

The aggregate data on the relative cost structures in the Canadian and U.S. publishing industries provide fairly strong evidence that Canadian markups tend to be higher than U.S. markups.

Aggregate data for the Canadian industry include revenues and costs associated with exclusive-agency activity as well as with the production and distribution of the publishers' own titles. With respect to the pricing and markup of agency books, decisions are, to a large extent, made by the foreign publisher. He determines the agency discount, and the Canadian agent cannot afford to set his prices on those books too high since he will run the risk of having only a small sales volume and might lose the agency. In addition, for agency books (and also for co-published titles), a high price in Canada may induce buying around. It is therefore of considerable interest to study the pricing policies of Canadian publishers separately for their <u>own</u> titles, as is done here using the Statistics Canada survey data on individual titles.

With respect to the markups on trade books (other than mass-market paperbacks), it again appears that the perceived elasticity in Canada is lower than in the United States. Although the data on mass-market paperbacks appear less reliable (and may be unrepresentative in Canada because of the large export component), if anything, Canadian markups again appeared considerably higher. For textbooks and professional/technical titles the evidence is less clear. Based on the above discussion of possible sources of bias due to the fact that the form of U.S. data was not strictly comparable to that for Canada, and because of the apparently erratic markup behaviour in this segment of the Canadian market between 1976 and 1977, it seems reasonable to conclude that, with comparable data, U.S. markups would at least be no higher than Canadian markups for these categories.

There is some weak evidence that the buying around threat that exists under current legislation does indeed tend to cause somewhat lower markups for co-published books. If that is true, the elasticity estimate based on aggregate data would tend to be biased upward (in absolute value) since the pricing behaviour observed from those data is based, in part, on co-published and agency books, both of which are subject to buying around.

The attempts to derive evidence on interdependence in pricing must be characterized as inconclusive. One might argue that the apparently higher level of markups in Canada themselves constitute evidence of a lack of effective price competition, and that the dominance of a relatively small number of firms in the market makes it likely that publishers would be strongly aware of their common interest in avoiding an excessively intensive degree of price competition. These are merely conjectures, however, and there is no strong evidence of non-competitive behaviour in the data.

On balance, however, we think the evidence in favour of a lower perceived demand elasticity in Canada is fairly strong. Hence, we conclude that, in the absence of import competition for a given title, publishers would tend to take advantage of the opportunities for increasing revenues through price discrimination, and book prices in Canada would tend to rise, as suggested in the theoretical discussion.[22]

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22. It is interesting to ask whether there are any good intuitive reasons to expect the relevant elasticity in Canada to be lower in absolute value, as the evidence indicates. We can think of two plausible reasons. First, because of the larger size of the U.S. market, a much larger number of titles are published on a given subject. Hence, there may be five biographies of a particular U.S. president in the market at the same time, and they may all be making money. In Canada, two biographies of a prime minister may be too many for either one to make money. This means that in the United States there will be a stronger tendency for close substitutes for a given title to exist than there is in Canada. It is a standard conclusion in microeconomics that the existence of close substitutes for a good will raise the elasticity of demand.

The other plausible explanation relates to interdependence in pricing. Even though there was no explicit evidence of such interdependence, we nevertheless believe that the relatively high concentration in the Canadian publishing industry, the geographical proximity of publishers' head offices and the fairly high degree of trade association activity characterizing the industry create a tendency to avoid overly-aggressive price competition. If this is the case, the evidence on markups discussed here will contain some cross-price effects, as shown in equation (20). From the viewpoint of analyzing the impact of import restrictions, however, this will have exactly the same effect as a lower true elasticity.

CHAPTER V

COPYRIGHT IMPORT PROVISIONS AND CULTURAL OBJECTIVES

The Qualitative Conclusions

In light of the preceding analysis, we will, in this section, very briefly describe the major consequences that would follow from the sort of modifications to the Copyright Act import provisions discussed in the introduction. We begin by considering the effects of a restrictive set of provisions involving an effectively enforced prohibition of importing infringing copies, with this category broadly defined so that the holder of the Canadian right to a literary work (or some subset of the bundle of rights inherent in copyright) would in effect be completely protected against imports of competing editions of the work, or against imports of the work by anybody but himself. As a consequence, we will take it for granted that, in the majority of cases in which import of foreign books presently takes place through exclusive-agency arrangements, revised import provisions would mean that these imports would be undertaken by a publisher or agent who had first acquired the Canadian rights to the work.

In evaluating the effects of such legislation, we will take as our basis of comparison, not the present situation, but a hypothetical one in which the principle of exhaustion has been clearly incorporated into the Copyright Act so that there is no protection against competing imports of foreign editions. This avoids the difficult question of the degree to which the present, relatively unclear provisions have in fact acted as a deterrent to imports of this kind. As discussed above, the evidence presently available is not firm enough to answer that question with any great precision.

We now turn to an evaluation of the impact that a set of effectively enforced import restrictions would have on the various parties who have an interest in the book trade. We begin by an informal qualitative description, suggested by the theoretical discussion, and then turn to a numerical illustration based on the quantitative evidence discussed in the preceding chapter.

Among those who would be affected by well-enforced import restrictions are Canadian authors. As previously discussed, the direct benefits of import restrictions would tend to accrue primarily to established authors and, in particular, to Canadian authors whose books have, or are expected to have, an international audience. If the restrictions were effectively enforced, they would resolve the remainders problem once and for all. As discussed above, however, we do not believe that this should be a major consideration for public policy; protection against imported remainders can be obtained directly by the author or his Canadian publisher when the foreign rights are sold by incorporating a buy-back clause into the sales agreement stating that any copies remaindered by the foreign publisher will be bought by the Canadian rights holder. This protection is not without cost. A foreign publisher would not want to pay as much for the rights if there is a buy-back clause and a Canadian publisher may be reluctant to sell separate foreign rights if he runs the risk of having to buy a large number of remaindered copies in the future. Hence, the benefits accruing to Canadian authors from import restrictions on this score consist in not having to incur these costs.

Canadian authors writing for an international audience would also derive other potential benefits from import restrictions which would create the opportunity for international price discrimination. This point has been formally discussed earlier in this paper. In less formal terms, these benefits would correspond to higher revenues to the author in a situation where the price charged for his work in Canada can be maintained at a higher level than that charged for the same work (possibly in a different edition) in foreign markets. It might mean that a low-priced paperback edition may be made available in the United States or the United Kingdom but not in Canada, where only a higher-priced hardcover edition would be sold. As was demonstrated previously, the author's revenues are likely to be higher as a result.

Finally, Canadian authors may derive some indirect benefits from import restrictions. If, as is likely, the restrictions lead to higher prices for foreign books, there would be some substitution by the reading public in favour of Canadian books. Indirect benefits of this kind would accrue not just to those authors with an international audience but to all Canadian writers, and the potentially higher income expected from Canadian titles might encourage the creation of literary works which would otherwise not have been written. We will return later to the question of the likely quantitative significance of this effect and to the question of whether there are other less costly ways than import restrictions to stimulate the rate of creation of Canadian literary works.

The other main group of potential beneficiaries from import restrictions are publishers operating in Canada. An important point to be made at the outset is that any benefits to publishers would accrue to all publishers, Canadian-owned or Canadian subsidiaries of foreign firms. In fact, it is quite likely that the lion's share of any potential benefits would accrue to the latter group. As has been previously argued, import restrictions would probably lead to a greater tendency for imports of foreign books to be undertaken by a publisher who has first acquired the Canadian rights for the books. If it is indeed true that foreign publishers prefer to sell rights to their subsidiaries rather than to independent Canadian firms, one would hence expect a large share of book imports should go through such subsidiaries operating in Canada. There is also the possibility that new subsidiaries would be set up, unless this were prevented by an additional set of restrictive measures to complement the original import restrictions.

The theoretical analysis shows the possible benefits to publishers arising, on the one hand, from the higher prices that would likely prevail for two types of books: those written for a Canadian audience which would also have significant sales in foreign markets; and, much more importantly, foreign books with significant sales in Canada. On the other hand, benefits might also arise because import restrictions would protect the position of publishers in Canada with respect to their distribution and marketing functions since it would diminish competition from more efficient large-scale distribution networks operating on an international basis.[1]

In discussing these effects, it is important to carefully define what is meant by "benefits." In the present context, we will argue that benefits should be measured by enhanced profitability, i.e., a higher return on capital invested in a particular activity. Increased sales revenue or a larger gross income from performance of distribution services are not, in our opinion, "benefits" if they are offset by corresponding increases in cost, with no increase in profits.

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1. As discussed in Appendix B, this effect would follow from the fact that Copyright Act import restrictions tend to act as a non-tariff barrier, increasing the transaction costs associated with book imports.

Under this definition, however, it is far from clear that publishers operating in Canada would derive any significant benefits from import restrictions in the long run. Consider first the effects of higher book prices. The essential effect of import restrictions under the Copyright Act is to create a separate monopoly position in the Canadian market for the holder of the Canadian copyright to a given foreign or Canadian work, and the returns to this monopoly constitute the benefits of the restrictions.[2] But the rights do not originally belong to the publisher or agent. Instead, they are purchased, or leased, by him from somebody else: the author, or in the case of some foreign works, the foreign publishers. If Canadian publishers or agents have to compete for these rights, their prices will tend to rise to reflect the monopoly rent. In practice some residual benefits may remain but, if prices rise sufficiently to eliminate them completely, the Canadian publishers or agents would not be better off than before.

With respect to the publishers' distribution services, it is true that, in the absence of import restrictions of any kind, publishers might be losing business to alternative distribution channels, such as wholesalers. But they will then also not incur the costs associated with the distribution services they presently perform and, in the long run, they could be expected to earn a competitive return on their other activities, such as marketing and publishing proper.

Following this line of reasoning, therefore, the ultimate beneficiaries, other than Canadian writers, would be foreign publishers and writers.

For the sake of completeness, it should finally be noted that, as briefly discussed above, Canadian publishers or agents might in fact be able to appropriate some of the monopoly rents created by import restrictions if competition between them for Canadian rights was not very strong. It seems very unlikely, however, that this would be an important factor in the case of foreign books, partly because many foreign publishers have subsidiaries in Canada. If Canadian publishers were reluctant to compete among themselves

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2. Of course, copyright in a work always creates a monopoly position for its owner. The point about import restrictions is that they create a separate market in Canada, and it is the market separation that creates the additional return.

for the right to foreign books, the foreign publishers would simply market the books through their subsidiaries. On the other hand, restricted competition among Canadian publishers might result in lower royalty rates for Canadian authors unless they were able to market their books through foreign publishers.

Another group sometimes viewed as a potential beneficiary of Copyright Act import restrictions are booksellers. But the likelihood that this group would realize increased profits from import restrictions is even weaker. If higher book prices initially led to increased distribution margins and greater profits, existing booksellers would want to expand their operations and new ones would enter the market. Entry into the field of book retailing is exceptionally easy. As a result, competition between booksellers would increase, leading to increased frequencies of sales and markdowns off list prices or to a shrinking business volume for each retailer. In the end, no retailer would be better off than before. At best, each would earn enough profit to stay in business.

We finally come to the consequences for the people in whose interest the publishing industry is supposed to operate, namely, the readers of books. They are, of course, the ultimate losers. With import restrictions, they would have to pay higher prices for many, possibly most, imported books and for the books by Canadian writers sold both in Canada and in foreign markets. In effect, import restrictions and higher book prices can be considered as constituting a form of taxation levied on book readers, for the purpose of achieving any benefits to the other interest groups listed above.

The reason why the issues surrounding this type of income transfer have attracted so much attention in Canada, we believe, is that questions of book pricing, authors' royalty revenues and the profitability of Canada's publishing industry are all seen as being intimately connected with the cultural objectives which Canada is striving to attain.

Perhaps not surprisingly, the notion of cultural objectives has never been given a very precise meaning, if indeed this is possible. At the same time, the concept has been widely used as part of the continuing efforts of various interest groups to obtain legislative protection for their economic position or for other forms of public support. The interest groups representing Canada's writers and the Canadian publishing industry are, of course, prime examples. Presumably, the implicit reason why the Writers' Union and the publishing industry can expect a sympathetic hearing when advocating protection against import competition to improve their income or profitability status is that adequate writers' incomes and publishers' profits are seen as necessary to attain these objectives.

Suppose that the relevant cultural objective is deemed to be stimulation of the rate of creation of literary works written specifically for a Canadian audience (and mostly, one would suspect, by Canadian authors). With this definition, it is clear that the income of writers does indeed play an important role. Unless the potential rewards are adequate, many works (especially by younger and unknown authors, or those being written for a relatively specialized audience) will never be created.

Because the Canadian market is small, the projected sales volume will not be substantial enough to cover the cost of producing and distributing these books while giving an adequate return to their authors. From this viewpoint, it may indeed be in the public interest to transfer some income from readers to authors. In return, readers will have access to a wider choice of titles with Canadian content.

With respect to the profitability of the publishing industry, the situation is much less clear. It has frequently been argued that policy measures designed to enhance the profits of the publishing industry will increase the rate of publication of new Canadian titles by enabling publishers to engage in cross-subsidization. This means that publishers will use the revenues from more profitable activities (such as exclusive-agency business and sales of the more popular Canadian titles) to absorb the losses from less profitable ones (such as publication of a first novel by an unknown author).

As it stands, this argument is incompatible with the assumption of profit-maximizing behaviour. This does not necessarily mean that the argument is false: some owners of publishing firms may accept less than maximum profits because they are public spirited or because they are interested in promoting literary talent. The problem, however, is that this is unlikely to be characteristic of <u>all</u> publishers operating in Canada, or even of all Canadian-owned firms. Hence, general policy measures designed to enhance the profits of the publishing industry may, in part, have the desired effect, but the increased revenues may, in part, simply be retained by profit-seeking publishers as extra profits. They may also attract new firms whose only motivation is to take advantage of the profit opportunities created by these policies.

Furthermore, as argued above, it does not seem likely that any increase in publishers' profits which might initially appear with the imposition of import restrictions would persist over the long run. Most of these profits would be dissipated into higher revenues to foreign authors or copyright holders; higher costs associated with an inefficient distribution technology, operating on a small scale in a protected market; or higher royalty revenues to some Canadian authors. Hence, it is not clear that profitability in the publishing industry is a very good measure of the degree to which Canadian cultural objectives have been attained, or that measures specifically designed to increase profitability are likely to be an effective method for attaining them.

The discussion up to this point has dealt with the consequences of implementing the restrictive alternative: revising the Copyright Act so that it contains a comprehensive set of import restrictions with provisions to ensure their effective enforcement. We will not discuss in detail the likely consequences of the other alternative: allowing unrestricted imports of legal editions of any copyrighted book under the principle of exhaustion. The predictions of the effects of this alternative are implicit in the preceding discussion.

It must be clear by now that, in a choice between these two extremes, this paper leans towards the non-restrictive alternative. However, if one does indeed wish to stimulate the creation of literary works in Canada some form of public support will be called for. In our view, such support may most appropriately be provided in the form of direct lump-sum grants for the publication of Canadian literary works -- for example, a lump-sum grant to the publishers to offset a specific amount of royalty payments to the author. This would, in effect, be equivalent to a reduction in the fixed costs of publishing a title and we have discussed in general terms the consequences of such a policy. The ultimate result of such a policy should be higher incomes for authors and a stimulus towards a higher rate of creation of Canadian literary works.

A combination of unrestricted imports and direct lump-sum support of this kind, compared to the import restriction policy previously discussed, would have the advantage of working <u>directly</u> towards attainment of Canada's cultural objectives, as defined here, without the unintended extra costs of higher earnings of foreign authors and right holders or a costly and inefficient distribution system in Canada. The concluding section to this chapter gives a rough quantitative illustration of some of these extra costs and, even without allowing for the effect on distribution costs, they appear to be very substantial.

A Quantitative Illustration of the Effects of Import Restrictions

Introduction

This section briefly describes the results of a series of calculations designed to illustrate the orders of magnitude of the changes in the book trade that can be predicted for a hypothetical change from a situation of completely unrestricted imports to one in which import restrictions of the type discussed throughout this report were imposed. The numbers should not be taken as realistic estimates of the actual effects to be expected from types of policy changes since neither the present nor any conceivable set of legislative provisions would make the real world correspond to either extreme alternative. In spite of this, the results are interesting insofar as they give very clear indications of the relative importance of the various effects that could be expected from real policy changes.

To make the computations manageable, only some of the possible effects of import restrictions are incorporated. In particular, the important effects that the legislative decisions are likely to have on the efficiency of the Canadian distribution system have not been taken into account. Instead, the focus has been on the gains and losses that could be expected to result from changes in the prices of the various kinds of books and in the composition of demand between imported and domestically published books.

A relatively simple method is used to estimate gains and losses from policies of this nature, that of consumers' surplus. The main advantage of this approach is that it offers a way of quantifying, in monetary terms, the implicit gains and losses that society experiences when policies are introduced which affect prices and quantities in a particular market.

The specific purpose of the computations is to answer the following questions. First, if the purpose of a policy of import restrictions is to transfer income to publishers and authors in order to stimulate Canadian writing, what is the order of magnitude of the transfers that would result from a switch from unrestricted to restricted imports? Second, if the real net gains or losses to society implied by the resulting reallocation of resources can be measured, how large would they be relative to the income transfers?

The importance of answering the second question, in our view, lies in the fact that it enables one to compare the costs of this indirect method of effecting such an income transfer with those of direct transfers through lump-sum subsidies of the nature discussed above. The costs of such subsidies are quite clear cut: every dollar that is transferred to authors and publishers costs the taxpayer a dollar. If indirect transfers through import restrictions have additional costs in terms of losses of economic efficiency as mentioned above, the case in favour of direct transfers would be a strong one.

Methodology and assumptions

Computations were directly based on the methodology in the theoretical discussion above. Some of the quantitative evidence discussed in Chapter IV was used to assign values to the critical parameters. The following paragraphs discuss the assumptions underlying the calculations and present the results. The detailed methods of calculation are briefly set out in Appendix C.

The main parameters and assumptions used in the calculations were as follows. The own-price elasticity of demand for an average book in Canada and foreign markets was assumed to be -1.76 and -2.02, respectively. The transport cost (including brokerage fees, etc.) was assumed to be 6 per cent of the net price charged a typical Canadian importer of foreign books; the importer was assumed to be given a discount of 55 per cent off the foreign list price, or 25 per cent off the American publishers' net price to booksellers.

No distinction was made between books in various commercial or format categories; the analysis was carried out in terms of an average book. A distinction was drawn, however, between foreign and Canadian books. Among Canadian books, those having significant sales abroad were distinguished from those sold only in the Canadian market. Based on aggregate statistics of total sales in Canada, it was assumed that foreign books (independently imported, imported on an exclusive-agency basis and co-published) accounted for 82 per cent of the sales volume in Canada. Domestic books were set at 18 per cent of the total quantity and two-thirds of those, i.e., 12 per cent of the total, were assumed to be of purely domestic interest. For books enjoying significant sales abroad, it was assumed that equal quantities were sold in the domestic and foreign markets.[3] The marginal costs of book production in Canada were assumed to be 20 per cent higher than in the foreign market. For those Canadian books sold in both markets, it was assumed that the actual copies were manufactured in the foreign market, with half the volume being imported for sale in Canada.

On the basis of these assumptions, the predicted price changes that would result if import restrictions were imposed could be computed. The results are summarized in Table 15.

Table 15

Effect of Import Restrictions on Book Prices and Quantities Sold (percentage changes)

Price/quantity changes (per cent)		
Books with:	Canadian price/quantity	foreign price/ quantity
w_a=1	+21.9/-25.8	±0/±0
w_c=1	±0/+5.1	- / -
w_a=w_c=.5	+11.7/-13.4	-8.7/+20.2

To compute the changes in quantities sold of a typical book in the various categories, information is needed not only about the change in its own price, but, because of the cross-elasticity of demand between books, also about the change in the prices of other books. To take these cross-effects into account, an assumed change in a weighted average price of all books was computed as follows.

It was first assumed that only 43 per cent of all foreign books (i.e., those with w_a=0) would have their prices raised. This was intended to represent all co-published books and one-third of all imports; those remaining were assumed to be imported independently with no protection

3. In the terminology of the theoretical section, it was assumed that w_a=1 for foreign books, w_c=1 for the purely domestic ones and w_a=w_c=.5 for the "mixed" ones.

against import competition under the Copyright Act so that their prices would be unaffected. The increase in the price index of all books was thus computed by weighting the price increase for books with $w_a=1$ from Table 15 by the share of the affected books in the total, plus the projected price increase for those books with $w_a=w_c=.5$ multiplied by their share in the total.

The cross-elasticity of demand for any given book with respect to this price index was assumed to be +.66.[4] The net changes in quantities sold of the various categories of books are also shown in Table 15. It should be noted that the relative change in books with $w_a=1$ refers only to those imported books which did, in fact, have price increases; the total volume of imported books would have decreased by only 11 per cent. Note also that books with a purely domestic market ($w_c=1$) experience a quantity increase even though their prices are unchanged. This results purely from the cross-price effect.

Results

Based on the information in Table 15, together with the computed relative prices and the assumed marginal cost parameters, estimates of the gains and losses of consumers' surplus were computed. There are four types of effects: the loss to society from the higher prices of foreign books; the net loss (after allowing for the transfer of income to authors and publishers) resulting from the higher prices of some Canadian books; a gain to society at large accruing to Canadian authors/publishers from the expansion of sales of domestic books; and a similar gain resulting from the large

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4. This was based on the following considerations. It is known from microeconomic theory that the algebraic sum of all price elasticities of demand for a given commodity, plus its income elasticity, equals zero. The income elasticity of demand for books was assumed to be equal to unity and the cross-price elasticity with respect to the prices of all other goods and services to +0.1. Together with the estimated own-price elasticity of -1.76, this implies a cross-price elasticity with respect to the price index of other books of +.66.

revenues from the sale of Canadian books in foreign markets.[5]

Table 16

Social Gains, Losses and Transfers
Resulting from Import Restrictions
(millions of dollars)

	Gains and losses to Canadian society at large	Transfers to authors/ publishers in Canada
1. Imported books (w_a=1)	-40.10	-
2. "Mixed Canadian" (w_a=w_c=.5) domestic market	-2.79	+1.14
3. Domestic Canadian w_c=1	+2.11	+2.11
4. "Mixed Canadian" (w_a=w_c=.5) foreign sales	+.15	+.15
Total	-40.64	+3.39

In addition to the net gains to society in this sense, the gross transfers to authors/publishers implied by the various price and quantity changes were computed. The results of these calculations are summarized in Table 16, with successive lines corresponding to changes attributable to the book categories indicated. A diagrammatic exposition of the logic of the computations is given in Appendix C.

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5. To avoid misunderstanding, it should be noted that a gain to society may refer to a benefit accruing either to authors/publishers, who are part of society, or to consumers/book readers. A pure transfer from consumers to authors/publishers represents no gain or loss in this framework.

These results are rather startling. The transfer column indicates that authors and publishers would be experiencing a substantial increase in revenue under import restriction, compared with completely unhampered trade, equivalent to an annual amount of $3.39 million, or about 0.56 per cent of total domestic book sales in 1976. But the net loss to society would be nearly $41 million. Thus, the estimated loss to the rest of society, i.e., the book-reading public, would be over $44 million, or 7.4 per cent of domestic book sales. Most of the difference (over $40 million) results from the gains of foreign authors and publishers via higher prices on imported foreign books. There are also some general efficiency losses due to misallocation of resources, in the terminology of microeconomics.

The actual magnitude of these results may be extreme given that the real world is unlikely ever to have free trade or a completely enforceable set of restrictions. But there is no reason to expect that the relative magnitude of the transfers to authors/publishers on the one hand, and the losses to the reading public on the other, would be any more favourable even with more conservative estimates of the absolute amounts.

Hence, while a program of direct subsidies would cost taxpayers/book readers a dollar for every dollar transferred to the book industry, our best estimate is that each dollar transferred indirectly, through import restrictions, would cost consumers ten dollars. It is difficult to imagine a less efficient method of attaining Canada's cultural objectives.

APPENDIX A

COPYRIGHT ACT IMPORT PROVISIONS: THE CURRENT SITUATION

Importation of Books

A complete review of the current legal situation with respect to interpreting the import provisions of the current Copyright Act falls outside the scope of this report, not to speak of the competence of its authors. Nevertheless, we will briefly review what appear to an economist to be the most important consequences of those interpretations. This will serve as a background to the way in which we will interpret the proposals for revision.

As discussed earlier, the extreme positions with respect to copyright import provisions are that of exhaustion and the position that possession of copyright in a particular country confers absolute monopoly control over the sale of the copyrighted work in that country. The doctrine of exhaustion involves the notion that "once a party has placed goods for sale in any market, his rights with respect to such goods...should be exhausted" (Consumer and Corporate Affairs Canada, 1978, p. 6). Complete incorporation of this principle in a revised Copyright Act would mean that anyone could import from outside Canada any edition of a copyrighted work, provided it had not been produced in violation of copyright in its country of origin. The opposite extreme would be a situation where, provided the Canadian copyright in any work had been duly obtained under the Act, the holder of the Canadian rights would be able to effectively bar from importation into Canada any edition of that work that he would wish to keep out.

As has been discussed at length in the legal and technical literature, the current Canadian Copyright Act contains a curious and not easily interpreted mixture of both basic principles. One of the relevant sections, 17(4), the retention of which has been recommended by Keyes and Brunet, deals with indirect infringement:

> 17(4) Copyright in a work shall also be deemed to be infringed by any person who ...(d) imports for sale or hire into Canada; any work that to his knowledge infringes copyright or would infringe copyright if it had been made within Canada.

Apart from the technical problem of establishing knowledge on the part of the importer and enforcing compliance with the prohibition against indirect infringement of this sort, this clause, when taken in isolation, protects a Canadian copyright holder against competition for the version of the work he himself has authorized for sale in Canada, from any other authorized version. Both civil remedies (i.e., "injunctions, damages and accounts") and summary remedies (fines or imprisonment) are available under the Act. The seemingly simple rules governing the importation of copyrighted works established in section 17(4), however, become somewhat complicated through the "administrative procedures" introduced in sections 27 and 28. Section 27 in essence establishes the right of the owner of the Canadian copyright to enlist the assistance of the customs officials of the government of Canada in preventing the importation of copies, of any work, which would infringe his copyright if made in Canada:

> Copies made out of Canada of any work in which copyright subsists that if made in Canada would infringe copyright and as to which the owner of the copyright gives notice in writing to the Department of National Revenue that he is desirous that such copies should not be so imported into Canada, shall not be so imported, and shall be deemed to be included in Schedule C to the Customs Tariffs, and that Schedule applies accordingly.

Thus, section 27 appears to be relatively innocuous: it merely provides an additional mechanism through which the holder of Canadian copyright can deter anybody who might contemplate the importation of infringing copies in spite of the provisions of section 17(4). Section 28(3), however, changes the situation fairly dramatically:[1]

> 28(3) Notwithstanding anything in this Act it shall be lawful for any person...(d) to

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1. Note that the exception in this subsection refers only to books. Subsections 28(3)(a)-(c), which make it legal to import not more than two copies for personal use, to import copies for use by federal or provincial government departments and to import copies for use in libraries and educational institutions before a work has been printed or made in Canada refer to "works," i.e., to copyrightable works including books.

> import any book lawfully printed in Great Britain or in a foreign country that has adhered to the Convention and the Additional Protocol thereto set out in Schedule II and published for circulation among, and sale to the public within either; but any officer of customs, may in his discretion, require any person seeking to import any work under this section to produce satisfactory evidence of the facts necessary to establish his right so to import.

In other words, this subsection, if taken literally, in fact eliminates the Canadian copyright holder's protection against competition from some editions of the copyrighted book, namely, those editions printed in Great Britain or in a country belonging to the Berne Convention. Since the initial wording of the subsection refers to the whole Copyright Act, it must be taken to override not only the rules established in section 27 but also those in section 17(4).

A further complication is introduced in subsection 28(4):

> This section does not apply to any work the author of which is a British subject, other than a Canadian citizen, or the subject or citizen of a country that has adhered to the Convention and the Additional Protocol thereto set out in Schedule II.

From a literal reading of this section, it appears that works authored by British subjects (except for Canadian citizens) or by subjects or citizens of a country belonging to the Berne Convention are protected against import competition since the exemptions to protection established by subsection 28(3) do not apply to such works. The rules of section 27 and 17(4) remain in force. On the other hand, the exceptions in subsection 28(3) -- most importantly, subsection 28(3)(d) -- do apply when the author is Canadian. Copies of any edition of his book may be lawfully imported by third parties and will not be considered infringing copies provided they have been lawfully printed in Great Britain or in a Berne Convention country.

With respect to copyrighted books, therefore, the holder of the Canadian copyright enjoys protection from imported copies of foreign editions of the relevant work in all cases <u>except</u> when the book (a) has been written by a Canadian (or by a citizen or subject of a non-Berne country);

and (b) has been lawfully printed in Great Britain or another Berne Country.

Needless to say, there has been some controversy regarding the interpretation of these rules and their relationship to each other. Referring to the case where the author is a Canadian, Keyes and Brunet put it as follows:

> The validity of such an interpretation, however, depends on the premise that, despite its general wording, s. 28(3) only applies if by virtue of s. 28(4), the whole of s. 28 is applicable. It further depends on the assumption that, where the requirements of s. 28(4) are met, s. 28(3) is applicable to the situation envisaged by s. 27. (Keyes and Brunet, 1977, p. 197)

They add, laconically, "These difficulties exemplify the problem faced by Revenue Canada in attempting to administer these abstrusely worded provisions" (Ibid., p. 197).

Certain additional issues have also figured from time to time in the debate (whether in the courts or in policy discussion) regarding the degree of protection which the current Act affords. They will be briefly discussed here, not because they are inherently important for the Copyright Act revision process, but because they give indications of issues that should be considered if a new Act is to be effectively enforced.

One such issue concerns the practical question of enforceability of import restrictions by Revenue Canada. At the present time, the "D-memorandum," which lists the books which Revenue Canada is supposed to deny entry under the administrative provisions of section 28(2), contains a relatively small number of titles of works by Canadian authors which should be denied entry if they have been printed in a non-Berne country, such as the United States. Book shipments are cleared by customs brokers who negotiate with the customs officials on the basis of manifests, etc., describing the contents of the shipments. These documents generally contain very long lists of book titles of various sorts. In the past, most of the negotiations between brokers and customs officials have reportedly centred on duty questions; prior to the zero-rating of all tariffs on books in 1979, only books in the educational category were generally exempt from duty and much of the negotiations dealt with classification questions in this regard. In addition, customs officials are responsible for denying entry to books for a variety of other reasons: obscene or seditious content, etc. Under these circumstances, with large numbers of titles, and with a large number of prohibited categories to check for or to classify in the appropriate duty categories, the possibility that a title which should be prohibited entry under section 28(2) might inadvertently slip through the net, must have been very high. In addition, Revenue Canada at one time explicitly indicated that it was not prepared to intervene and seize copies of books under this provision once the copies had cleared customs. Thus, the protection afforded under the administrative provisions has been only partially effective at best, and the procedures would have to be simplified if such provisions were to be effective in a revised Act.

A second issue deals with the treatment of firms acting as agents in Canada for foreign copyright holders. Agency agreements may take the form of a private contract between the copyright holder and the agent that the latter is to act as an exclusive agent for the former, without any reference to copyright. Or it may include a provision under which the agent is licensed for some specific period to distribute works for which the principal holds the copyright. The question of whether the provisions of the present Copyright Act apply equally to Canadian owners of copyright in a given book as to Canadian licensees or to exclusive agents has not been fully answered by the courts. At one time, the administrative provisions in section 27 were used by agents to protect themselves, through the Department of National Revenue, against imports by anyone but themselves of books for which they acted as agents of foreign publishers. The Varcoe ruling in 1953 ended this practice. It stated that if National Revenue was instructed by the copyright owners to prevent the importation of certain books, they would bar all imports, i.e., including imports by the agent himself. A licensee or an agent may still be protected from import competition under section 17(4), but this protection requires commencement of civil proceedings for infringement and, as noted earlier, requires proof of the importer's knowledge of the violation. The distinction between copyright owner and exclusive agent has thus been of considerable importance in the application of the current Act, and a revised Act should be as clear as possible in stating precisely to whom protection is to be given if a restrictive alternative is chosen. On the other hand, as argued in this paper, the distinction may be more important from the viewpoint of clarifying the legal situation than from an economic perspective since there is nothing to prevent foreign publishers from transferring the copyright to foreign books to their Canadian agents, should it be profitable to do so.

Sound Recordings

As in the case of books, the fundamental rule in the Act with respect to importation of records and tapes is found in section 17(4) dealing with indirect infringement. As previously discussed, this section makes it illegal to import "for sale or hire" into Canada "any work that to (the importer's) knowledge infringes copyright or would infringe copyright if it had been made in Canada." Again, as in the case of books, both civil and summary remedies are available. With respect to administrative remedies, the legal situation is more favourable to the Canadian copyright holders for the cases of records and tapes: section 27, under which the Department of National Revenue is made responsible for barring the importation of copies where the owner of the Canadian copyright to the work in question has given "notice in writing...that he is desirous that such copies should not be so imported into Canada," applies to "work," and hence includes records and tapes. The exception to the Act's protection against import competition which has given rise to so much confusion in the case of books, i.e., those contained in subsection 28(3)(d), refers only to "books," however. Therefore, apart from the relatively minor exceptions established in subsections 28(3)(a)-(c), the general prohibition of imports of infringing copies in 17(4) and the administrative remedies available in section 27, are not limited by the rules described in section 28.

For the case of books, it has been argued that the administrative remedies of section 27 had, in practice, been relatively ineffective because of the difficulties faced by customs officials in checking the individual items on the long lists of titles with which they are typically confronted when clearing a particular shipment. This is likely to be at least equally true in the case of records and, in practice, holders of the Canadian rights to particular records and tapes have not attempted to avail themselves of these remedies. However, the import restrictions inherent in section 17(4) have been invoked in the courts and, in the most recent decision, the plaintiff's case was upheld without ambiguity. The Canadian copyright holders for a particular recording were, in the judge's opinion, "entitled to the declaratory and injunctive relief sought in their statement of claim" in their action against an importer of copies of an identical record album manufactured for sale in the United States by the American copyright holder.[2]

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2. Fly by Nite Music Co. Ltd. et al. v. Record Wherehouse Ltd., Federal Court, Trial Division, Mahoney J., March 14, 1975.

APPENDIX B

ABSOLUTE COST LEVELS: A CASE STUDY

Introduction

One of the conclusions of this paper is that, for the same marginal costs of book production and marketing, publishers would be expected to set their list prices and discounts to retailers such that the net price charged in Canada would tend to be higher by about 15 per cent than the U.S. price. But costs of production and marketing for a book of a given quality need not be the same in both countries. A claim frequently heard in the industry is that book prices in Canada have to be high because costs here are high relative to those in other countries.

The purpose of this appendix is to discuss the validity of these claims both in general terms and in light of the available evidence on comparative U.S. and Canadian book manufacturing costs. The next section contains an analysis of this evidence and a short discussion of its implications. In the last section, we discuss the related question of the costs of book distribution and book retailing, with particular attention to the role of distribution through wholesalers in Canada and the United States, respectively.

On average, the total manufacturing and distribution costs per copy are probably somewhat higher for the Canadian book industry than the U.S., although this is less certain after the recent devaluation of the Canadian dollar and the rapid rate of inflation in the United States than it was in, for example, 1976/77. In the long run, however, there are several reasons to expect that manufacturing and distribution costs in the Canadian market are unlikely to deviate substantially from the corresponding U.S. costs. First, because the economies are closely interlinked the prices of inputs (labour and capital equipment) will tend to be similar in the two markets, and the same technologies in manufacturing and distribution can be used on both sides of the border. Second, book manufacturing services and even, to some extent, distribution services, can be imported if they can be done at lower cost outside Canada. A Canadian edition of any book can be printed outside the country and distribution can be handled by wholesalers or retailers operating on both sides of the border. International competition will, therefore, force Canadian manufacturers and distributors to become competitive and to produce at comparable levels of cost. This may come about only through an accelerated rate of adoption of efficient technology and elimination of the least efficient, high-cost manufacturing and distribution operations, perhaps through consolidation of some of the smaller operations.

It is important to observe that, at least in principle, the necessity for Canadian book manufacturing and distribution to be efficient enough to compete internationally, has nothing to do with the question of Copyright Act import restrictions. The principle of territorial divisibility simply implies that certain books or editions of books cannot be sold in Canada. For those books that can be sold, however, there is nothing to prevent them from being printed abroad or distributed through international wholesalers. Legislation entailing territorial divisibility protects the owner of the Canadian copyright of a given work; it does not protect either those firms providing manufacturing services or the profitability of book distribution.

Should it (for some reason) be considered to be in Canada's national interest to protect the economic interests of book manufacturers and distributors (as distinct from authors or those in "publishing proper," i.e., editorial work, market assessment, etc.), this would require measures to make it more expensive to import books, such as a tariff on book imports. It is not clear to us, however, why this would be in Canada's interest. Where a book has been printed or by whom it is distributed cannot reasonably be said to have anything to do with its cultural significance.

Thus, in principle, the Copyright Act import restrictions should not be an important factor affecting competition in book manufacturing or distribution. In practice, however, it should be recognized that such restrictions may effectively act, with considerable significance, as a non-tariff barrier which may substantially raise the transactions costs of international trade in books, especially in the process of book distribution. In particular, we argue below that the operation of distribution networks serving both the United States and Canada would be considerably more difficult if only certain editions of various books could be imported into Canada, or if book imports into Canada were subject to elaborate customs clearance procedures for the purpose of enforcing such restrictions.

A Case Study

Little systematic evidence appears to be available on the absolute levels of cost of book production and distribution for either the U.S. or Canadian publishing industries. This may be partly because of the heterogeneity of books and partly because of the wide variety of services that go into the production of a given title. Some information can be gleaned, however, from a case study undertaken in 1976 by the Association of American University Presses in which five companies were asked to describe how they would produce an imaginary title (given the name No Time for Houseplants, and supposedly written by one Mr. Purvis Mulch). The book was to be printed in a run of 7500 copies and their description was to include, among other things, a costing and financial analysis. The result of the experiment has been published under the title One Book/Five Ways. The University of Toronto Press was one of those providing cost estimates.

As is generally the case in publishers' financial analyses of a projected title, the cost estimates provided the most detail for the manufacturing process (i.e., printers' plant costs; cost of paper, printing and binding; and cost estimates for special artwork, etc.). These costs, together with the editorial, production and design costs incurred before the manuscript is ready for the manufacturing process, and royalty costs, are those that can most readily be identified with a given title. Other costs, such as marketing, order fulfillment and general administrative costs are, to some extent, shared between many titles, and publishers often make no attempt to separate out the incremental cost attributable to a particular book. Instead, they typically add a large margin to cover overhead costs, i.e., shared costs of the type just listed. These overhead cost allowances are generally based on rules of thumb derived from experience and may be changed from time to time as costs change.

The information given in the study supports the notion that the costs of book production are substantially higher in Canada than in the United States. The plant costs estimated by the four U.S. publishers range between just under \$2000 to \$4400; the University of Toronto Press estimate is \$5244. Paper, printing and binding is also by far the highest for the University of Toronto Press: \$11,837 for 7500 copies vs. from between \$4500 to just under \$9000 for the U.S. firms. The most expensive element in Canada appears to be paper costs, which are shown as at least 40 per cent higher than the comparable U.S. estimates. But binding costs are also estimated to be much higher for the University of Toronto Press and account for almost half of the total manufacturing costs. As seen in Table B-1, total manufacturing costs were almost 30 per cent higher than the highest comparable U.S. figure.

Table B-1

Hypothetical Cost Comparisons for Book Production, Five University Presses

	University of Toronto Press	U.S. 1	U.S. 2	U.S. 3	U.S. 4
Plant costs Paper, printing, binding	5244 11837	4400 8875	2027 7506	1997 8633	3486 4471**
Total manufacturing	17081	13275	9533	10630	7959
Royalty costs	4922	2275	5645	3827	3262
Editorial Production, design	920 1050	-* -*	1332 350	600 1210	-* -*
List price Sales revenue	10.95 49220	6.95 31275	7.95 32731	6.95 32332	5.95 25882
Contribution to overhead	25247	15705	15871	16065	14661

SOURCE: Association of American University Presses, One Book/Five Ways, 1978.

NOTE: For comparability, some items have been rearranged, and the format of the cost analysis has been changed.

* Included in overhead

** Spiral-bound paperback; all others assumed hardback

The University of Toronto Press overhead estimate also appears relatively high. Three of the U.S. publishers expected to make a small accounting profit on the title after allowing for overhead. In spite of the higher sales price, and hence sales revenues, assumed by University of Toronto, the title does not generate enough of a contribution to cover the 40 per cent overhead allowance on projected sales revenue.

Before turning to the conclusions to be drawn from this comparison, it should be noted that the figures are given in Canadian dollars for the University of Toronto and in U.S. dollars for the other publishers. At the time (1976) the Canadian dollar was roughly at par, justifying the procedure. In late 1977, the Canadian dollar fell rapidly, and a cost comparison at that time presumably would have been more favourable to the University of Toronto Press if costs were converted to a common currency. At most, however, this would add only about 15 per cent to U.S. costs, still leaving them well below Canadian costs.

On the basis of this evidence, it is clear that manufacturing costs in Canada tend to be substantially above those in the United States and they are probably also above those in the United Kingdom and France.

As argued above, however, it need not be concluded from this that Canadian book prices must be higher than elsewhere. If printing and book manufacturing services can be produced more efficiently in the United States, for example, it would be in the Canadian public interest for publishers to have their books manufactured in the United States for import into Canada. This might entail a gradual elimination of a number of firms in the book printing and manufacturing industry in Canada. More likely, however, it would tend to force the introduction of more efficient technology with ensuring cost reductions.

Distribution Costs

The discussion in Chapter IV refers to the cost structure of publishers. The total cost of bringing books to the consumer, however, also includes the costs of the distribution system. We have not collected independent evidence on these costs, but it is likely that they are higher in Canada than in the United States. Suppose that list prices for various book categories are higher in Canada. Since the discounts off the list price at which books are sold to retailers are similar in Canada and the United States, this means that the distributive margins, in terms of dollars and cents per copy, are higher in Canada. This must mean either that average distribution costs per copy are higher in Canada or that bookstores are very profitable operations. The latter explanation seems unlikely, primarily because entry into book retailing is very easy. If profits were high, new firms would enter, competition would increase and profits would fall. If this argument is correct, the only explanation for the higher margins is higher costs.

There are several plausible explanations for the higher costs. First, a large share of the operating costs of bookstores are labour costs and, at least prior to the devaluation of the dollar, Canadian labour costs were high relative to those in the United States. Another large component is the explicit or implicit interest on the bookseller's inventory. This cost would tend to be higher in Canada because it depends partly on the price that the bookseller pays for the books; in addition, Canadian interest rates have historically tended to be somewhat higher than U.S. rates.

As in the case of publishers, it can be argued that the factors affecting Canadian distribution costs relative to foreign costs are temporary. If wage costs and interest costs become too high in Canada relative to its major trading partners, the Canadian dollar will depreciate, which will mean an improvement in the relative cost position of the Canadian distribution system. In the long run, the only factors that would systematically tend to maintain Canadian costs at a higher level would be real (as opposed to monetary) ones, such as a less efficient technology, or higher transport costs due to Canada's geography.

We doubt that the oft-quoted geography factors (Canada's low population density and the long distances from Toronto to Halifax or Vancouver) would place Canada in a very unfavourable position relative to, say, the United States. The United States is in a similar positon: it is at least as far from New York to Miami or San Francisco as from Toronto to Vancouver. In some cases, the larger size of the U.S. market may make it possible to save on transport costs by printing and binding copies of a given book in several places (for example, in both New York and San Francisco), but the fixed costs of preparing a print run would probably make this uneconomical except for titles expected to sell in very large quantities both in the east and west. Canada's low population density is a consequence of large uninhabited northern areas. If one were to define some measure of the relevant market areas (for example, by excluding territories below some minimum population density), Canadian density would probably appear to be no lower than that in the United States. Another indication of the seriousness of this fact might be an urbanization index. Using this criterion, Canada is not very different from the United States: data from the World Bank's <u>World Tables</u> indicate an urbanization percentage of 76 for Canada and 74 for the United States in 1970.[1]

Hence, we conclude that higher distribution costs due to an unfavourable geography will, at most, explain only a very minor part of the higher total costs of book production and distribution in Canada. To the extent that transportation costs are, in fact, higher in Canada, this should probably be ascribed to factors such as higher labour costs in the transportation sector or to the rate-setting policies of the Canadian Post Office, rather than to factors such as distances and density.

Technology is an important factor in book distribution. We have already referred to the increasing importance in both the United States and the United Kingdom of intermediation by book wholesalers between publisher and retailer and to the resulting improvements in marketing and inventory management. This growth has, in part, been due to the increasingly sophisticated computer-based technology introduced by the wholesalers. These developments have not yet taken place in Canada to any major extent. Most bookstores continue to buy directly from publishers, which entails higher costs of ordering for bookstores and higher costs of order fulfillment and billing for the publishers. It also entails less efficient inventory management and, consequently, a reduced availability of titles. This means a lower quality of the distribution services provided to the public at higher costs than could be achieved with a better developed wholesaling network.

To evaluate precisely the extent to which this factor is responsible for the apparent cost differential between U.S. and Canadian book distribution, a much more detailed study would be necessary than is possible in this report. In order not to exaggerate its significance, it is worth observing that the advanced technology referred to is not yet in use throughout the U.S. or U.K. book distribution system, even though it is spreading rapidly. Conversely, in some subsectors of the Canadian distribution system, the technology being used is quite similar to that used in the United States: in the mass-market paperback sector and perhaps also, to an increasing extent, in the library market. Similarly, the large book chains such as Coles and Classic Bookshops have apparently been able to make use of advanced dis-

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1. The implicit argument here is that it is the density, and not the absolute size of the market that is the critical factor for transportation costs.

tribution cost-saving technology, partly by having a sufficiently large volume of sales so that they can in essence perform their own wholesaling. In spite of this, however, it appears clear that one of the strongest influences on cost and ease of availability of books to the Canadian public in the medium term will be the speed with which this type of technology is introduced into the traditional distribution system.

An interesting question to ask in this context is why there has been an apparent lag in the development of the Canadian distribution system. The simplest answer would be that, in order to operate efficiently, a wholesaling firm using computerized technology must operate on a large scale and the Canadian market has been too small to support firms of this kind. This answer does not, however, take into account the possibility that the distribution services could be performed by existing U.S. wholesaling firms which already operate on a large scale close to the Canadian border. The question therefore becomes why have those firms not extended their operations into the Canadian market?

To some extent they have, especially in the library market. In the trade book sector, however, their access to the Canadian market has been impeded by various factors which have made it complicated to operate across the border. Until the beginning of 1979, trade books entering Canada were subject to a 10 per cent rate of duty. In addition, various customs formalities have made it a fairly costly and complicated procedure for shipments of books to be brought across the border. As we argued above, the import restrictions contained in the present Copyright Act have certainly contributed to this; under current rules, customs officials are supposed to check book shipments for books whose importation would constitute infringement of the right of holders of the Canadian copyright. Furthermore, since unhampered operations by U.S. wholesalers in the Canadian market would seriously undermine the agency system, Canadian publishers dependent on this business have resisted this trend by trying in various ways to dissuade booksellers from buying directly from foreign publishers or wholesalers. Buying around has come to be regarded as reprehensible by people in the industry. Finally, some pressure may be exerted against the extension of foreign wholesaling operations into Canada by foreign publishers anxious to protect their Canadian exclusive agent, especially when the latter is a subsidiary of theirs.

In spite of these pressures against the extension of foreign wholesaling into Canada, there appears to be a strong awareness in the Canadian book trade that, in the long run, the efficiency advantages inherent in the developing technology in that field are likely to force considerable change in the Canadian distribution systems as well. There is talk of a trend towards the increasing "continentalization" of the book distribution industry. The question of how this trend will affect the reading public, the booksellers and the publishers operating in Canada, and also to the issue of the extent to which it will affect the interests of Canadian authors and the attainment of Canadian cultural objectives has been discussed already. It is worth observing again, however, that the position taken on the issue of Copyright Act import restrictions is likely to be one of the major factors influencing the speed with which this development will take place.

APPENDIX C

COMPUTATION METHODS

Price and Quantity Changes

The calculations discussed in the text were based on the formulae for optimal pricing, with and without import restrictions, presented in Chapter III, i.e., equations (7) to (12). A distinction was drawn between three categories of titles: those with $w_a=1$, $w_a=w_c=.5$ and $w_c=1$. The respective title categories are denoted by i=1, i=2, i=3. Without import restrictions, the general formula was:

$$w_a\ (1 + X_i^a\ \varepsilon^a) + w_c\ (1 + X_i^c\ \varepsilon^c) = 0 \qquad \text{Equation (A1)}$$

$$p_i^c = p_i^a + t \qquad \text{Equation (A2)}$$

where $\varepsilon^a = -2.02$, $\varepsilon^c = -1.76$, and where

$$X_i^j = \frac{p_i^j - m_i^j}{p_i^j} \qquad \text{Equation (A3)}$$

We first set $m_1^a=m_2^a=1$ arbitrarily. To find t, we solved for p_1^a from (A1) with $w_a=1$, $w_c=0$, and then found t from $t=p_1^a \times .75 \times .06$, as discussed in the text; p_1^c is then given by (A2). To find p_2^a, one substitutes from (A3) into (A1), and sets $m_2^c=1+t$, $p_2^c=p_2^a+t$. (A1) can then be solved for p_2^a, which gives p_2^c. The value of p_3^c is found from (A1) with $w_c=1$, $w_a=0$ and with $m_3^c=1.2$, as assumed in the text.

With import restrictions, the equation is:

$$(1 + X_i^j\ \varepsilon^j) = 0,\ j = a,c \qquad \text{Equation (A4)}$$

and (A3). Using the same assumptions as before for w_i and the same value for t, p_i^j can be found directly.

To compare changes in quantities, we first assumed, based on existing data, that without import restrictions, we would have:

$q_1^c = 82; \quad q_2^c = q_2^a = 6; \quad q_3^c = 18.$

As noted in the text, it was assumed that price changes on foreign books would affect only a fraction of those sold in Canada and, in the computations, $q_1^c=35$ has been used to account for this. The remaining 47 units of imported books were assumed to be sold at $p_1^c=p_1^a+t$, whether or not there were import restrictions.

The quantity changes shown in Table 15 were then computed according to:

$$\Delta \ln q_i^j = \varepsilon^j \Delta \ \ln p_i^j + .66 \ \Delta \ln \hat{p}^j$$

where ln denotes the natural logarithm and .66 was the assumed cross-elasticity of demand for a title in the i^{th} category with respect to the index $\hat{p}^j$ of all book prices. It was assumed that $\hat{p}^a$ was constant and that $\hat{p}^c$ was given by:

$$\hat{p}^c = .47 \ (p_1^a + t) + .35p_1^c + .06p_2^c + .18 \ p_3^c.$$

From this, the price index values with and without import restrictions could be computed by substituting the corresponding values of the p_i^c on the right-hand side.

Computations of Consumer Surplus Changes

Given the computed price and quantities with and without import restrictions, the logic of the computations underlying Table 16 may conveniently be illustrated in four diagrams corresponding to the four sub-markets in which the relevant price of quantity changes occur. The relevant demand curves have been drawn for expositional purposes. In Canadian markets, the demand curve for a title in a given category will shift to the position indicated by the slashed line because the prices of other books have changed and there is a cross-price effect.

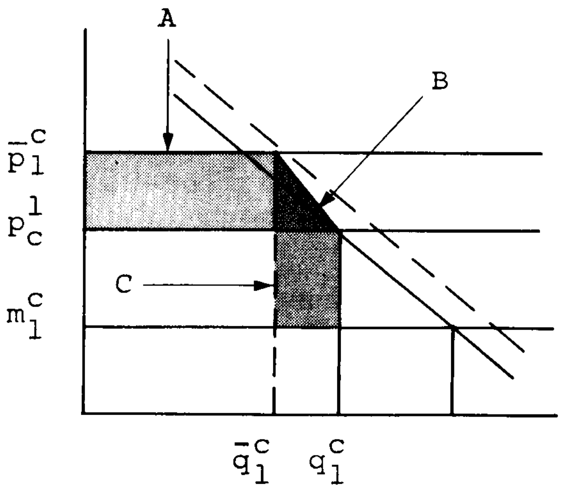
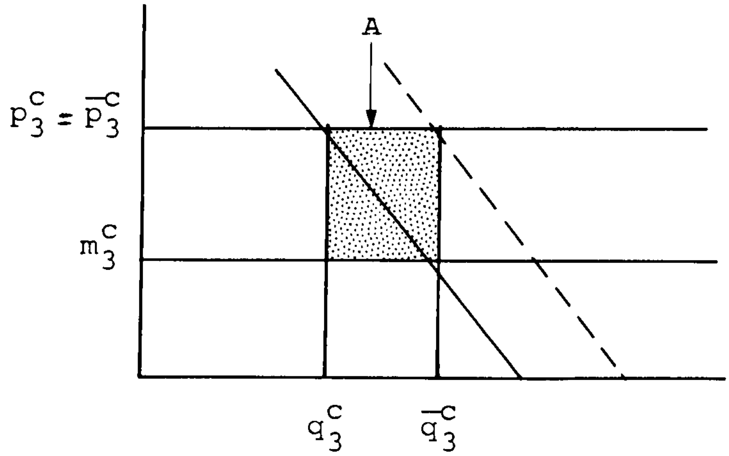
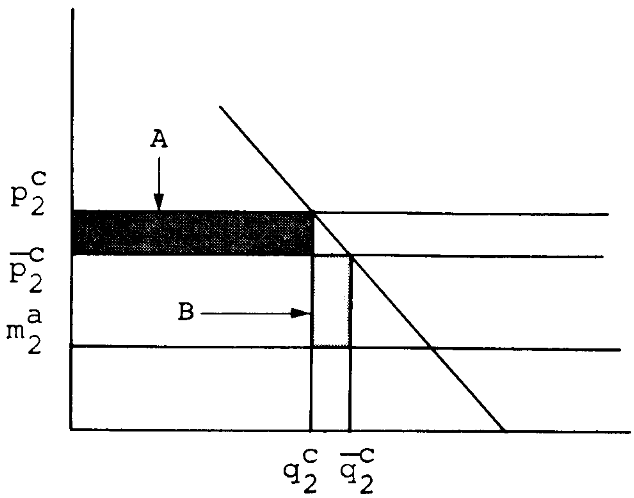


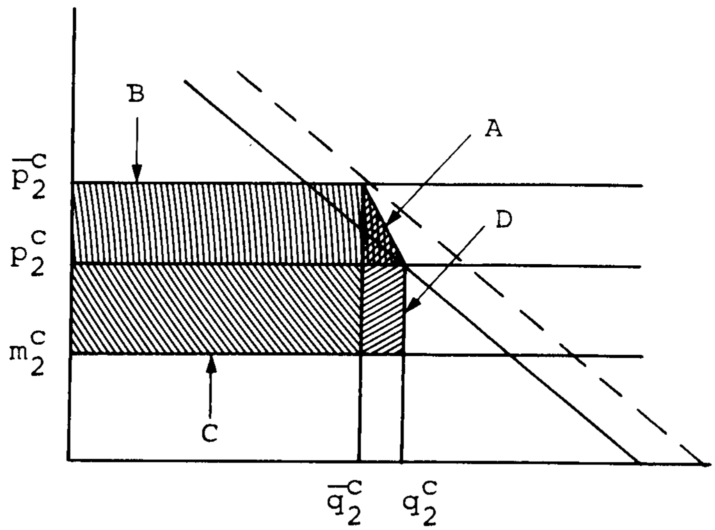
Fig. 1a



1b



1c



1d

(Note: variables with bars denote the situation with import restrictions.) To interpret these diagrams, consider first Figure 1a, representing the case of foreign books (w_a=1) imported into Canada. The net gain to foreign copyright holders corresponds to the increase in total revenue (net of the change in cost of production) given by the area (A-C). The loss to Canadian readers is the price increase on the smaller volume $\bar{q}_1^c$, plus the loss of consumer surplus associated with the import reduction, i.e., area (A+B), which corresponds to \$40.1 million in Table 16.

Figure 1b represents the market for books of domestic interest only. Here, the price does not change but the quantity does through the cross-price effect. Area A, corresponding to \$2.11 million, thus represents a gain both to Canadian copyright holders and to society (here the marginal cost of increased production is less than the consumers' willingness to pay for the books).

Figure 1c illustrates the changes in the foreign market for Canadian books. Here, the price with import restrictions is lower than without such restrictions, but there is a small net gain to Canadian copyright holders given by the area B-A which is positive. This is also a gain to Canadian society at large, corresponding to the \$.15 million shown in Table 16.

Figure 1d describes the changes in the domestic prices and quantities of Canadian books sold both at home and abroad. Their prices will rise in Canada. The gain to the Canadian copyright holders is given by area (B-D), equivalent to \$1.14 million. Area B represents a transfer from Canadian readers to authors and is thus not a net social loss. Area (D+A), however, represents a loss to consumers as book prices rise, net of the savings in production costs; this loss is given by \$2.79 million, as shown in Table 16.

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