EFFECTIVE COMPETITION AND CORPORATE DISCLOSURE
A CRITICAL STUDY

by

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Economic activity in the United States and Canada is predominantly performed by corporations. They are by far the largest private employers of workers, the biggest investors and the predominant instrument of production. They are rapidly growing in size, are generating sufficient funds internally to carry out most of their expansion programs, and are diversifying into unrelated activities. Their affairs are increasingly managed by professional executives who have little, if any, stake in the risk capital. The shareholders, who are legally presumed to exercise control over the powers and actions of corporate executives, are normally too numerous and scattered so as not to be in a position to have a significant influence on the policies of the corporations.

The changing role of the corporations has led to considerable discussion about the legitimacy of corporate power and the accountability of corporations for their actions which affect others such as consumers, workers, suppliers and the public. As part of this general accountability, the question is raised about the type and extent of information that corporations should be required to disclose to persons
and groups who have no contractual relationship with these corporations. Many businessmen, accountants, political theorists, economists, and lawyers have put forward their views about corporate disclosure which differ widely from one another. A principle reason for the divergent views about corporate disclosure is that they use different frames of references to base their arguments for or against disclosure of more information than is at present provided by corporations.

This study is an attempt to use the normative model of 'Effective Competition' as a guide for the type and extent of disclosure to be made by corporations. An examination of current literature on competition suggested that the lines of demarcation for the normative model of 'Effective Competition' can be defined by reviewing the national objectives of the United States and Canada which form the framework for the model and by examining the main characteristics in the economy which reflect the structure of the model. The informational requirements of the main actors in the economy—namely consumers, employers, workers, creditors, investors, government-run corporations, foreign firms dealing with the countries and various government agencies whose actions have a direct effect on
other actors — form the basis of specific recommenda-
tions made about the type and extent of disclosure that should be required from corporations operating in Canada.
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CHAPTER I

INTRODUCTION

Modern large corporations in the United States and Canada show little resemblance to the owner-operator companies formed to gain the benefit of limited liability which was given by the passing of the Companies Acts around the middle of the nineteenth century. Unlike their predecessors which were essentially partnerships, almost all the present large corporations have a perpetual existence - both in law and reality - and are managed by professional executives appointed by Boards of Directors, who depend for their existence on the patronage of these executives. The executives have increasingly become independent of the shareholders who, under law, are the owners of the corporations and are presumed to exercise control over the powers of the executives. This independence has been strengthened by the ability of large corporations to keep under their control sufficient funds, by way of capital cost allowances and retained earnings, to initiate expansion of the

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existing corporations and absorption of rival corporations. As a result of these changes, there is a wide gap between the legal interpretation of the rights and responsibilities of corporations and the economic factors which determine the powers of corporations.

In consequence, nearly all study of the corporations has been concerned with its deviations from its legal or formal image. This image - that of an association of persons into an autonomous legal unit with a distinct legal personality that enables it to carry on business, own property and contract debts - is highly normative. It is what a corporation should be. When a modern corporation disenfranchises its stockholders, grows to gargantuan size, expands into wholly unrelated activities, is a monopsony where it buys and a monopoly where it sells, something is wrong.

While the all-pervasive influence of the modern corporations in the social, political and economic activities of the United States and Canada is recognized, there is no consensus of opinion as to the nature of responsible behavior expected from these corporations, and the types of controls that should be exercised to countervail the growing powers

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2 Ibid, pp. 72-85.
3 Ibid, p. 73.
of the professional executives who run these corporations.

The question of disclosure of information by corporations forms a part of the total question of corporate behavior. Many politicians and economists advocate disclosure of 'material' information by corporations. However, they often fail to define what is 'material' information, to whom is this information 'material', and why such 'material' information should be disclosed. For example, information about a particular process of production adopted by a corporation is very 'material' to a rival corporation. Should the corporation which has invested a large amount of money to develop this particular process reveal the information about the process to its rival? There is no agreement about the criteria that should be used to determine the types of information that should be disclosed, the manner in which it should be disclosed, and the parties to whom it should be directed.

Accountants and businessmen have generally taken a 'legalistic' view of disclosure, conveying a certain set of information to the persons under contractual or legal relationships, which stipulate disclosure of this set of information. Their view is partly based on the premise that disclosure of additional information to the stipulated persons, and of corporate information to the persons not at present
receiving such information under contract or law, should be based mainly on the cost-benefit relationship to the firm required to disclose such information. However, many politicians and economists view modern corporations as a medium used by private individuals to carry out productive and investment activities. These activities affect the livelihood and comfort of a large number of persons who are not contractually related to these corporations. Therefore, corporate disclosure should be geared to the needs of the society within which the corporations are allowed by law to operate.

What should be the basis for corporate disclosure is not a settled question. It cannot be settled until some agreement is reached on the role that the modern corporation should play in the social, political and economic activities of the country under review. This requires an understanding of the intricate forces in the society within which modern corporations operate, and the structure of power within these corporations.

As a starting point, there is general agreement among the citizens of the United States and Canada that 'private enterprise' is the most suitable method of economic activity to achieve the social and political objectives of the people of these countries.\(^5\)

Almost all the economists agree that the system of private enterprise can flourish only if independent market forces are allowed to principally regulate the activities of individuals and to determine the returns to each factor of production for its contribution. This faith in the competitive system of private enterprise is reflected in the United States Constitution and innumerable laws passed to preserve competitive forces in the economy.  

Purpose of the study: The purpose of the study, is to examine whether the characteristics of 'Effective Competition' can provide criteria for the type and extent of disclosure to be made by corporations. More specifically, the objectives of the thesis are:

1. To determine whether a normative model of Effective Competition can be devised.
2. To explore the informational requirements of such normative model of Effective Competition.
3. To examine the importance of corporate disclosure to the functioning of Effective Competition.
4. To make specific recommendations as to the type and extent of corporate disclosure required by the normative model of Effective Competition.

6 See the Supreme Court's opinion in Northern Pacific Railway Co. v. U. S. 356 U.S. 1, 5 (1958).

7 For a definition of 'Effective Competition', please see Chapter III.
Limitation of the study: Disclosure is a method of conveying certain information to specified groups of persons. The substance of the information is dependent on what is to be done with the information received. As regulators of the competitive system in the United States, the Justice Department and the Federal Trade Commission require certain information about corporate activities. The study does not cover in detail the present and possible future activities of these regulatory authorities.

It is recognized that disclosure of information by corporations does not necessarily lead to the effective control over the powers of the corporations. However, the type and extent of corporate disclosure recommended later in the study may enable those empowered with the regulation of economic activities in the United States and Canada to devise methods to achieve maximum benefit from the existence of large corporations, without subjecting the entire population to the whims of a few executives within large corporations.

The thesis is confined to the informational aspects of the broader question of the role the modern corporation should play in the social, political and economic development of the United States and Canada. It does not cover detailed discussion on the administrative procedure by which the recommended type and
extent of disclosure to be achieved.

Plan of thesis: The thesis is divided into six chapters, including an introductory and a concluding chapter.

Chapter II reviews the social, political and economic objectives of the United States and Canada which form the framework within which the normative model of Effective Competition has to be devised.

Chapter III examines the main characteristics of the normative model of Effective Competition.

Chapter IV explores the importance of the flow of information to the parties functioning under the normative umbrella of Effective Competition.

Chapter V discusses the role of modern corporations in the framework of Effective Competition, with special reference to the type and extent of information that corporations operating in Canada should provide to facilitate movement of the economy towards the normative model of Effective Competition.

Finally, Chapter VI summarizes the main findings of the study.
CHAPTER II

RELATIONSHIP BETWEEN NATIONAL OBJECTIVES AND THE NORMATIVE MODEL OF EFFECTIVE COMPETITION

Brief Outline: This chapter examines the theoretical models of perfect or pure competition and pure monopoly to find out whether they can be used to explain the present state of the economy in the United States and Canada, as well as predict the future. The study reveals that a different normative model is necessary. An attempt is made to build a framework describing the national objectives of the United States and Canada within which the normative model has to be devised.

Disagreement Regarding the Present State of the Economy

There is considerable disagreement among economists, lawyers and businessmen as to whether the present set-up of the economy of the United States is competitive. Many leading businessmen who are active in the market contend that competition among sellers to win the support of buyers is very active, although the form\(^1\) taken is different from, and more complex than, that of price competition emphasized

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in traditional economic theory. Noting the economic progress made by the United States, and especially advances recorded since the Second World War, many economists have argued that the American economy is more competitive than appears on the surface. They claim one is deceived by just looking at large corporations who administer prices of their goods, and at powerful trade unions who control the labour market. John Kenneth Galbraith, in his most recent book, The New Industrial State, confirms that the present economic system of the United States achieves most of the goals such as high standard of living, low unemployment, fairly stable prices, and economic growth that are traditionally ascribed to competition. However, he does not agree that the goals are achieved because the economy is competitive in the sense that independent market forces pivoting around the sovereignty of the consumer determine the type of products manufactured, and by whom they are manufactured.

I am also concerned to show how, in this larger context of change, the forces inducing human effort have changed. This assaults the most majestic of all economic

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3 Galbraith, op. cit.
assumptions, namely that man in his economic activities is subject to the authority of the market. Instead, we have an economic system which, whatever its formal ideological billing, is in substantial part a planned economy. The initiative in deciding what is to be produced comes not from the sovereign consumer who, through the market, issues the instructions that bend the productive mechanism to his ultimate will. Rather it comes from the great producing organization which reaches forward to control the markets that it is presumed to serve and, beyond, to bend the customer to its needs. And, in so doing, it deeply influences his values and beliefs ....

One reason why there is disagreement about how competitive, if at all, the American economy is, is because economists and lawyers relate the existing conditions to different norms or standards attached to competition. Between the theoretical limits of perfect or pure competition and pure monopoly, there is a broad spectrum of different conditions designated as 'hard' competition, 'soft' competition, 'fair' competition, 'unfair' competition, 'passive' competition, 'active' competition, 'monopolistic' competition, 'workable' competition, 'effective' competition and 'effective' monopoly. To add to the confusion, the legal definition of competition as enunciated in many anti-trust law cases differs considerably from the economic definition of competition.

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4 Ibid., p. 6.
5 Massel, op. cit., pp. 186-191.
6 Massel, Ibid., pp. 11-14.
The theoretical concept of perfect competition was devised by economists, primarily as an analytical tool to explain how various forces in an economy operate. It was not meant to represent the conditions prevailing in the economy at any given time.

Perfect Competition Defined

Perfect competition is a stage of "equilibrium" to which the economy reverts provided the following conditions are fulfilled.

1. The number of sellers in the market is large.
2. All sellers produce identical goods for resale.
3. The number of buyers desiring to purchase the goods is large.
4. Except for price, these buyers are indifferent, as to purchasing from one seller or another.
5. These buyers have perfect knowledge as to what is available in the market and at what price.
6. The sellers are in sufficient market proximity that there is no additional transport cost involved as between sellers.
7. As the buyers are presumed to have perfect knowledge of identical products offered in the market, advertising and other sales promotion tech-
niques are non-existent.

8. Entry into, and exit from, the market are easy and inexpensive.

9. Mobility of the factors of production in the market is unrestricted.

10. The consumers and the sellers are rational in their analysis of what is in their respective interest.

In such a condition of perfect competition, the seller is faced with a price determined by the forces of supply and demand for the product offered by all the sellers in the market. As he is one of a large number of sellers, he cannot influence the price at which his product sells in the market. If he increases his price above the market price, then all the buyers divert their purchase to other sellers offering at the market price. There is no incentive for him to lower his price below the market price as he can sell all he can produce at the going market price.

In such a situation of perfect competition, the reward to the seller is dependent on how efficiently he utilizes the factors of production under his control, as compared to the efficiency of his competitors. If he is less efficient than his com-

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petitors, then he is forced out of the market. If he is more efficient than his competitors, then he benefits by receiving profit in addition to the average return on capital established by the market. Thus competitive forces under perfect competition result in the best possible allocation of economic resources, the maximum possible aggregate production and benefit to producers according to their productivity.

**Pure Monopoly Defined**

As a polar theoretical benchmark, economists devised the concept of pure monopoly. The conditions of pure monopoly are:

1. There is only one seller of a product in the market.
2. There is no acceptable substitute for the product.
3. The seller is in a position to prevent the buyers or others from making the product or its substitute.

Under pure monopoly, the seller faces a falling demand curve. It is normally more profitable for him to stop production when marginal cost equals marginal revenue, but before his average cost stops falling. Thus the resources under the control of the seller are not utilized.

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to the full and the buyers pay a price for the product which is higher than the market price that would have prevailed under perfect competition. Pure monopoly is deplored because it leads to misallocation of resources and because the impersonal power of the market is replaced by the uncontrolled power of the monopolist.

These are extreme conditions which have not prevailed for any length of time in actual markets. But they have been used as devices to analyze the prevailing markets and to examine how close the markets are to the desired norm of perfect competition. However, in the 1930's, Joan Robinson and Edward H. Chamberlin questioned the desirability of gearing the economy towards the norm of perfect or pure competition. According to Chamberlin, the normative stage or perfect competition entailing production of identical goods was not only not attainable but not desired by the people of the United States. Once the economy

9 Massel, op. cit., p. 3.
progressed beyond the subsistence level, the tendency of the persons in the economy was to spend the discretionary income on varieties of goods which may be close or remote substitutes for one another. Chamberlin advocated incorporation of such realities in normative theories of behavior to which the economy was to be geared.

The explicit recognition that product is differentiated brings into the open the problem of variety and makes it clear that pure competition may no longer be regarded as in any sense an "ideal" for purposes of welfare economics. In many cases it would be quite impossible to establish it, even supposing it to be desirable. Retail shops, for example, could not all be located on the same spot, and personal differences between actors, singers, professional men, and business men could not be eliminated. But even where possible, it would not be desirable to standardise products beyond a certain point. Differences in tastes, desires, incomes, and locations of buyers, and differences in the uses which they wish to make of commodities all indicate the need for variety and the necessity of substituting for the concept of a "competitive ideal" and ideal involving both monopoly and competition.

Since Chamberlin put forward his theory of monopolistic competition as a norm to which the existing conditions of the market should be compared and towards which the economy should be influenced, there have been many attempts to set up other norms depicting 'optimum' competitive con-

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ditions. Perhaps the most popular one has been 'Workable Competition' which was first put forward by John Maurice Clark in 1940.\textsuperscript{15} It has been widely used by the United States Department of Justice in Anti-trust cases and became a subject of close scrutiny by the U. S. Attorney General's Committee.\textsuperscript{16}

Although 'workable' or 'effective'\textsuperscript{17} competition as a norm has received substantial support from many Judges trying anti-trust cases, there is no agreement among economists whether it is the 'optimum' that should be used as the goal of the economy of the United States. This difference of opinion is not at all surprising because all the normative concepts of competition other than perfect competition or pure monopoly, are based on value judgements about social, political and economic goals of the country. The major goals or objectives of the people of the United States have not been concisely and comprehensively defined in any legal document, manifesto or charter.


\textsuperscript{17} Effective Competition is at present widely used in place of Workable Competition. See J. M. Clark,"Competition, a dynamic process," p. IX, U. S. Attorney General's Committee, op. cit. p. 320.
These national goals are scattered in the U. S. Constitution, the various legislative Acts like the Sherman Act of 1890, the Robinson-Patman Act of 1913, and the innumerable court decisions on civil liberty, business performance, private property and other plethora of activities. Some of these national goals are inconsistent with one another. For example, one reason why competition is desired is to direct the allocation of resources to the most efficient use. Logically, this results in the eventual elimination of any firm that does not utilize the resources under its control efficiently. It appears that public policy through the Robinson-Patman Act is designed to protect small businesses from the market forces of competition in which large corporations enjoy extra benefits due to their size, finances or control over the market.\(^\text{18}\) To take another example, effective competition requires that impersonal market forces be allowed to operate freely, not only with respect to prices, but to level and conditions of employment. The present tendency in the United States is to remove the uncertainty of market forces from the labour scene by providing security of employment, guaranteed annual wages and other similar stipulations.\(^\text{19}\)

\(^{18}\) Massel, *op. cit.*, p. 35.

\(^{19}\) *Ibid*, p. 33.
National Objectives

From the myriad of pronouncements of social, political and economic goals of the United States, the important goals are discussed below. Many of these are of an economic nature. It can be argued that economic goals are not the only ones a society possesses, and may be in conflict with other goals of a social or political nature. This is not denied. However, any normative standard of competition involves mostly economic factors which can only be stipulated if the economic objectives of the society are enunciated clearly.

At present the main national objectives of the United States and Canada are:

1. Efficient Utilization of Resources: It is realized that the economic resources of the United States - or for that matter of any country - are not unlimited. Therefore, it is essential that these resources are used in the most efficient way. The traditional American faith in competition to achieve this aim is reflected in the United States Constitution which endorses private enterprise. The Sherman Act of 1890 is another reflection of the

20 Throughout this chapter, the word "competition" is used to denote the effort of two or more parties to secure the custom of a third party by the offer of the most favourable terms. See Webster's Third New International Dictionary, p. 464.

21 For a defence of using economic goals,
faith the Americans have placed in competition to achieve the aim of efficient allocation of resources.

The Sherman Act was designed to be a comprehensive charter of economic liberty aimed at preserving free and unfettered competition as a rule of trade. It rests on the premise that the unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress, while at the same time providing an environment conducive to the preservation of our democratic and social institutions.22

It has been argued by some economists that competition is not a prerequisite to the efficient allocation of resources. According to them, the Soviet-type of economic system based on central economic planning leads to better utilization of economic resources. Whether the American private enterprise system or the Soviet-type of central planning by the State leads to more efficient utilization of economic resources has not been conclusively resolved.23 However, the Soviet-type of central economic planning is rejected per se by the United


States because it conflicts with other national goals of private incentive which are discussed below.

2. Reward for Individual Initiative: The logic behind the private enterprise system in the United States is that individual initiative and hard work should be rewarded. The promise of private gain encourages individuals to undertake new, and often risky ventures. The material achievement of hard work is considered to be an important indicator of success in life. Within the confines of law, Americans are free to spend their wealth in any way they choose. This assurance of unrestricted control over private wealth serves as an important incentive for individual initiative.

3. Personal Freedom: Freedom of the individual to speak, to worship and to own private property is enshrined in the Constitution. Americans have by tradition been suspicious of government interference in regulating this freedom. However, with the rise of "big business" and "big labor", this traditional opposition has been modified, especially in the case of regulating competitive forces.

The relationship between competition and personal freedom has changed with the times. At one time personal freedom meant absence of government interference. Currently it has a much broader connotation.

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It has taken on elements of economic and political freedom. It relates to immunity from private as well as governmental interference. It is recognized that various freedoms do require some government restrictions which lay down the general rules of the game. Therefore, there is little support today for the contention that government should not interfere with the liberty of individual businessmen to enter into contracts which will restrict competition. Instead, there is a feeling that such restrictions may affect the freedom of others who want to enter a market and of consumers who would like to make their own choices.²⁵

While the intervention by government in the economic sphere has been on the increase, especially since the Second World War, the economy of the United States is still far from being government controlled. Private enterprise is still the mainstay of the American economic system.

4. Dispersion of Economic Power: By tradition, people in the United States are opposed to concentration of power, be it political or economic. When it has been found necessary to endow the Federal Legislature and the Executive with power, various devices of checks and balances are designed to ensure the proper exercise of this power. Those holding power are subjected to periodic scrutiny by the people who have delegated this power. This scrutiny may be by way of elections or public hearings.

With the rise of large business corporations having power over the livelihood of thousands of employees and suppliers, and often possessing buying powers larger than those of individual States, many Americans have opposed this concentration of economic power.

Industrial power should be decentralized. It should be scattered into many hands so that the fortunes of the people will not be dependent on the whim or caprice, the political prejudices, the emotional stability of a few self-appointed men. The fact that they are not vicious men but respectable and social minded is irrelevant. That is the philosophy and the command of the Sherman Act. It is founded on a theory of hostility to the concentration in private hands of power so great that only a government of the people should have it.

Despite this traditional opposition to concentration of economic power, the Supreme Court, under the Sherman Act, has lately been reluctant to break up large corporations solely on account of size. Under the 'Rule of Reason' doctrine, the plaintiff is required to establish that the detrimental effect of the relative size of the firm compared to the total market is such as to impede competition. The economic argument behind this line of thinking is that large firms benefit the economy by stabilizing the employment conditions, by encouraging technological innova-


tion through heavy outlays in research and development, and by undertaking risky ventures. Therefore, unless the disadvantages associated with monopoly or monopsony power are established, the large firm should not be convicted because of its sheer size. 29

5. **High and Stable Employment**: Following the high level of unemployment during the depression years of the 1930's, both the United States and the Canadian government are committed by legislation to do all in their power to promote maximum employment. Both governments have frequently utilized fiscal and monetary policies as counter-cyclical devices to maintain 'high' levels of aggregate demand and employment. There is no agreement among economists as to what level of employment is 'high'. In both countries, the rate of employment over the last twenty years has ranged from a low of around 2 per cent to a high of over 7 per cent. 30 In comparison, the employment rate in France, West Germany, Sweden, Norway and Japan has normally been less than 2 per cent. 31 Under the circumstances it is not resolved

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29 See *Brown Shoe Co. of U. S.* 370 v. 346 (1962) in which the Supreme Court approved a merger on the basis that the merged firm may strengthen competition against a larger competitor.

30 See *U. S. Statistics on employment and Dominion Bureau of Statistics publications, Canada.*

31 The definition for "unemployment" used by the Dominion Bureau of Statistics, Canada, differs from the definition used by the H. M. Statistical Office, London. However, this difference in definitions does
as to what level of unemployment should be considered satisfactory for the United States and Canada. However, based on various studies made to relate the unemployment level to price stability, the Economic Council of Canada considers 3 per cent a maximum allowable level of unemployment.

We believe that, over the medium-term future, economic policies should be actively directed towards achieving a target of a 97 per cent rate of employment (or a rate of unemployment of not more than 3 per cent). This objective has important implications for other objectives - such as the maintenance of reasonable price stability and a viable balance-of-payments position - and an effective combination of policies will be required to achieve these various objectives in a consistent fashion.

The national goal is not only for high but for stable employment. This requires the government to avoid cyclical economic disturbances and to maintain aggregate demand at fairly high level.

6. Economic Growth: A high level of economic growth has assumed an important position among the national

not invalidate the statement that the rate of employment in the U. S. and Canada was higher than in the west of Europe during the last twenty years.


objectives of both the United States and Canada. It "essentially involves a basic concern with productivity growth - that is, the growth of output in relation to the resources used to produce it." 34 Although the intricate relationship of factors contributing to productivity growth in Canada is not fully grasped by the Council, it has set a target of 5 per cent annual growth in actual physical output as a national objective. 35

The growth of the economy is desired not only to accommodate the annual increase in population but to raise the standard of living of the existing population. Economic growth requires investment in technologically advanced capital equipment, in training of skilled workers, and the creation of a climate conducive to risk-taking and innovations.

7. Reasonable Price Stability: Both the United States and the Canadian governments are particularly concerned about the continuing tendency of prices to increase. Between 1953 and 1963 the average annual increases in consumer prices and in prices of all goods and services produced in Canada were 1.4 per cent and 2.0 per cent respectively, but there have been some moderate year-to-year variations around this rate. 36 According to the Council, prices should

34 Ibid, p. 5.
not be allowed to rise faster than the 1953-1963 rate. The acceptance of this rise in prices is based on the belief that the other national objectives of a high level of employment and a high rate of growth inevitably result in some increase in domestic prices. But the government is anxious to see that the rise in consumer prices does not reach a high level of say, 4 per cent, as this may result in Canadian exports being out-priced in the overseas markets, by competitors whose prices on current and potentially exportable goods are not rising as fast as that of the Canadian exporters.

8. Equitable Distribution of Rising Incomes: It is the pronounced aim of the Canadian Government to see that the rising income of the country is equitably distributed among different factors of production. This has proved to be 'a very complex matter, defying simple formulation'. Should the return to each factor of production be left to market forces or should these forces be tampered with to assist any particular factor in receiving a bigger return? No easy answers can be given. Conceding that market forces do not always lead to a

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socially desirable level of income, the government has used progressive income tax and welfare subsidies to iron out large disparities in net income.

9. **Assistance to Special Groups or Interests**: Although assistance to special groups or interests cannot truly be called a national objective, the government of the United States has over the years assisted one group or another for particular reasons, mainly on ethical grounds of fair play and a 'just' society. Although the basic concept of the labour union is to prevent competition among its members, it has been exempted from the provisions of the Sherman Act which is designed to prevent restraints in competition. This exemption is designed to encourage the unions to have sufficient strength and power to be able to bargain effectively with powerful employers.

The agricultural industry in the United States has not been subjected to open competition since the depression days of the 1930's which ruined many farmers. On the basis that agriculture is a basic industry which should be encouraged to thrive, minimum prices for most of the staple crops and minimum income per acreage are guaranteed by the United States agriculture authorities. This special assistance has not encouraged the agriculture industry to be as
efficient as some believe it could have been if it were subjected to competitive forces. The problem now faced by the government is to provide sufficient protection to the agricultural industry without impairing the forces which encourage efficiency in the industry.

Since the late nineteenth century when many firms started becoming big and powerful, the public policy has been to protect small businessmen from the 'hard' or 'predatory' competitive practices of large firms. The Federal Trade Commission Act of 1914 was passed with an intent to protect small businessmen from discriminatory practices of suppliers who give special price and service allowances to large firms. Section 5 of the Act declares:

Unfair methods of competition in commerce, and unfair or deceptive acts or practices in commerce, are declared unlawful.

As a further encouragement to small businesses, some States have imposed special sales taxes on chain grocery stores and department stores. In Canada, the Income Tax Act imposes a considerably lower rate of tax on businesses whose annual profits do not exceed $35,000.39

However this support to small business has not been consistently applied, and has been partly neutralized by other anti-trust or anti-merger provisions. For example, a manufacturer is subjected to

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anti-trust laws if he sets resale prices for independent distributors (unless permitted by state law). But he commits no offence if he sells at a fixed price through his own chain of subsidiaries acting as distributors. This naturally encourages vertical integration which invariably hurts small independent businessmen.

The list of national objectives discussed above is by no means exhaustive. There are many other objectives like national security, surpassing the rate of growth of the Soviet-type of economics, special aid to the underprivileged both inside and outside the United States, which have preoccupied the government at one time or another. Even the objectives discussed above are not always consistent with one another. The aims of high and stable employment and rapid economic growth following technological innovation may be achieved by encouraging large progressive corporations to take over small inefficient firms. As this conflicts with the other national objectives of personal freedom from economic concentration of power and encouragement to individual initiative, public policy is opposed to such mergers.

In one area, mergers, the Supreme Court has led the way, not only ignoring efficiency but repudiating it as an anti-trust objective to be weighed with other factors in reaching decisions. The assumption, and recently the admitted assumption, has thus shifted away from an interest in the greater
efficiency of highly competitive markets to an interest in traditional competition, irrespective of efficiency. 40

Whenever one national goal or objective has been in conflict with another, the government has had to make a choice based on economic factors and political expediency. It has often been found that a particular set of policies cannot incorporate all the national objectives. A choice is often made as to which objectives should be given priority. In the case of Canada, the goal of rapid and sustained economic growth has in the last twenty years been relegated to second place in preference to full employment and price stability. 41

Given the national objectives discussed above, many economists have attempted to devise a normative system of competition which can fulfill most, if not all, these goals. The emphasis is on a competitive system in preference to a state-planned system because the predominant opinion in the United States and Canada is to preserve the competitive system at any cost. The competitive economic system with dispersion of power is considered a major foun-


dation of the political democratic system which is prevalent in both the countries. According to E. V. Rostow, competitive capitalism is a necessary element of a democratic society.

Unless the members of an opposition can make a living without the permission of the government; unless they can function as a political party, obtain newsprint and presses, hire meeting halls, publish freely; unless they can have access to television without complete dependence on the goodwill and sporting instincts of the government in power, their opposition is bound to be a feeble, meaning­less force, existing only by sufferance. Capitalism is a vital part of the price of liberty.42

Based on past experience with different types of competitive systems, the normative model of competition is not expected to fulfill all the national objectives. It is recognized that the national objective of equitable distribution of income cannot be solely accomplished through the market forces generated by competition; the tax system is designed partly to achieve this end. Special provisions made to protect labour unions, farmers, small businesses and others, run counter to the operations of market forces; these are recognized as exceptions to the competitive system. The government has set up certain minimum standards of quality of product, labelling, packaging, and marketing to ensure that unfair advantage is not taken of the lack of knowledge among buyers. Some strategic industries like water, power,

electricity, gas, city transport, railroads and social infrastructures like defence, highways, education, and medicare are frequently excluded from the private enterprise system. They are run by government departments or statutory boards and are subjected to periodic scrutiny. Within the economic and legal framework set up to serve as the rules of the game, an attempt will be made to devise a normative model of competition designed to fulfill most of the national objectives.

Summary: The main conclusions of the chapter are as follows:

1. Economists and lawyers disagree on how competitive, if at all, the American economy is, because they relate the existing conditions to different norms or standards attached to competition.

2. The theoretical concepts of perfect and pure competition and pure monopoly cannot be used to explain prevailing conditions and predict the future, mainly because they are based on conditions which have not prevailed for any length of time in the economics of the United States and Canada.

3. Any attempt to devise a normative model of Effective Competition requires an examination of the national objectives of the United States and Canada. These are discussed in the chapter.
CHAPTER III

MAIN CHARACTERISTICS OF EFFECTIVE COMPETITION

Brief Outline:

In this chapter, an attempt is made to define the normative model of Effective Competition within the framework of the national objectives discussed in the last chapter.

Choice of Suitable Nomenclature

The national objectives and specific exceptions to the free enterprise system, discussed in the last chapter, serve as the "rules of the game" within which the normative system of competition has to be devised. Various names have been suggested for this normative system of competition. Chamberlin devised 'Monopolistic Competition' as a norm for public policy. This name has been criticized on the ground that it reminds the reader of the monopolistic element in the economy. 'Workable Competition' was first put forward by John M. Clark in 1940 as a norm which is attainable within the set of objectives and conditions prevalent at any given time.¹ In his latest book on competition,²

¹ Clark, 1940, op. cit.
Clark has used 'Effective Competition' as a preferred substitute for 'Workable Competition' for the following reasons:

1. The name is 'positive' in that it is reflective of what is desirable as a matter of public policy.

2. The word 'effective' is suggestive of desired performance or results.

The use of 'Effective Competition' as a norm is also endorsed by the United States Attorney General's National Committee to study the Anti-trust Laws. In this study, 'Effective Competition' is used as a normative state desired by the United States and Canada, and towards the attainment of which public policy should be geared.

Many economists reviewing 'Workable' or 'Effective' competition as a norm have attempted to define it in a few words. Their definitions have either been incomplete or vague. For example, C. E. Ferguson has defined 'Workable Competition' as follows:

An economic system is workably competitive if there is no feasible change in industrial and union structure that would make target attainments more likely, given the probability limits imposed upon our knowledge by its origin in empirical research.

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5 Ferguson, loc. cit., p. 80.
While this definition may satisfy the psychological need of a person, it does not assist him in finding the characteristics of this normative state. John M. Clark gave up defining 'Effective Competition' in a few sentences. Any theorist attempting to define 'Effective Competition' meets with the following difficulties:

1. At a time when 'Perfect Competition' was considered as an unattainable ideal but towards which the prevailing economy should be steered, it was quite easy to define this normative concept. Based on a set of assumptions about a large number of buyers, homogeneous product, perfect information, ease of entry and exit, mobility of factors, and profit maximization, an optimum model of 'Perfect Competition' can be logically devised which essentially depicts the cost-price relationship. Similarly, a theoretical model of 'Pure Monopoly' can be devised on the basis of certain assumptions.

However, devising the model of 'Effective Competition' poses many complications and problems. The existing conditions that constitute competition, which form the basis of the model, are too complex to be compartmentalized into a set of a few observations or hypotheses which are concise and

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7 See Churchman, Prediction and Optimal
meaningful. Further, the importance given to each of the forces in the economy to fulfill the national objectives is dependent on the judgement of the theorist, which is based mainly on subjective evaluations. Thus, given the economic conditions of a country and the objectives desired by the people, it is not unusual to find two theorists devising completely different models to attain the objectives.

2. There is a wide disparity between what economists consider as competition and what lawyers define as competition. Economists normally consider the power over the market by way of control on price and entry enjoyed by any firm, as a crucial factor in determining whether an industry is competitive. The lawyers are restricted in their definition to what is defined as 'competition' or 'restrictions to competition' in the legal statutes. Sections 1 and 2 of the Sherman Act of 1890 define what is considered as anti-competitive and therefore illegal.

Section 1

Every contract, combination in the form of trust or otherwise, or conspiracy,
in restraint of trade or commerce among the several states, or with foreign nations, is declared to be illegal.

Section 2

Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several states, or with foreign nations, shall be guilty of a misdemeanor.

These clauses are too sweeping in their wordings and, if taken literally, can outlaw all interstate commerce - for every contract is in restraint of trade. The important point in the legal attempt to regulate anti-competitive forces is to attack the actions of the firms irrespective of whether the ultimate result enhances or restricts competition.

It is important to reconcile the economic and legal approaches to Effective Competition as law is an instrument to regulate the practices of firms and individuals towards the goal of Effective Competition. This reconciliation requires the formulation of a concise definition of Effective Competition by the theorist which task, with the available method of analysis, it is not easy for the theorist to do.

Aim of Definition

The absence of a short and concise definition of Effective Competition does not mean that

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8 Low, op. cit., p. 13.
it is not a meaningful concept. The aim of definition is to draw a line of demarcation between what is pertinent and what is not.

A definition is brought about by creating a class of objects with common properties, thereby these objects are made distinct from those lacking the characteristic attributes. In extremely simple and concrete situations it may be easy to specify these attributes, but in cases of even moderate complexity a perfect definition is difficult to attain. It should contain neither too few nor too many properties, only those of constitutive nature; it ought to be without ambiguity and it must avoid circular reasoning. Yet, the chief criterion of a good definition is its power of demarcation - that is the ability to separate clearly objects belonging to the defined category from other or similar objects that do not belong to it.

Following the procedure adopted by such notable economists as Corwin D. Edwards, Mark S. Massel, Stephen H. Sosnick, and John M. Clark, the lines of demarcation for Effective Competition are drawn by emphasizing the main characteristics of the normative model. These are derived by observations and abstractions from real conditions. They are the ones

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which have been frequently seen to have existed when many of the national objectives were being fulfilled. Their presence or introduction has improved the competitive conditions of the market.\textsuperscript{14} For sake of clarity and convenience, the main characteristics are divided into the following three categories:

A. \textbf{Standards of Structure}: These are mostly characteristics external to the firm. They include such indicators as the numbers of buyers and sellers in the market, the geographical distribution of supply and demand, the difficulties of entry into the market, the independence of firms in the market, and the type and degree of vertical integration which exist. In essence, they constitute the environment within which the firm operates. This area is most susceptible to alterations by public policy.

It has often been argued\textsuperscript{15} that the performance of the firm is the only criterion by which the competitiveness of the economy should be judged. Conversely, an environment conducive to Effective Competition does not guarantee that the firm will behave in a competitive manner. This argument has

\textsuperscript{14} Massel, \textit{op. cit.}, p. 193.

\textsuperscript{15} See Ferguson, \textit{op. cit.}, pp. xvii - vix.

\textsuperscript{16} The word "competitive" is defined in \textit{Webster's Third New International Dictionary} as under (P. 464) Of, or relating to competition. Produced by, based on, resulting from, or capable
been convincingly repudiated by notable economists like Corwin Edwards, Stephen Sosnick, and John M. Clark who have drawn from practical experience to demonstrate that the performance of the firm is quite sensitive to the external environment within which it operates.

The concepts of workability which have proposed criteria for structure, or conduct or performance, or combination thereof, therefore, are not compatible. Performance is what is of utmost importance here, and whether performance is satisfactory can be judged only with performance criteria. But improvable, fortuitous, or passing performance can be adequately judged only by adding structure and conduct criteria. The conditions adopted as sufficient for workability will promise satisfactory performance only if they include dimension norms of structure, conduct, and performance.¹⁷

B. Standards of Conduct: This category relates to the conduct or behavior of the firms in the market. It includes such attributes as collusion among the competitors regarding price or volume of output, the method of determining prices in the industry, discrimination in prices and services to different size of firms, method of pooling patents among competitors, and the response of firms to profitable opportunities. These attributes are by no means exhaustive. As they can be proved by evidence, they have been used widely

of existing in rivalry of economic endeavour and without the presence of monopoly or collusion.

¹⁷ Sosnick, op. cit., p. 399.
in determining cases under the Sherman Act and the Robinson-Patman Act.

C. Standards of Performance: Performance of a firm, an industry or a market is the most crucial criterion in judging whether the benefits attributed to Effective Competition are being achieved.

Conceptually, the ultimate judgement about the effectiveness of competition in a market should be its performance. How competitive are the prices, the production, the innovations, and the consumer choices? The principal significance of indicators of structure and behavior is the light they throw on expectations of performance.18

The three categories of structure, conduct, and performance, are not mutually exclusive. As they are closely interrelated, an evaluation of the competitiveness of any firm should require a study of all the characteristics discussed below.

Main Characteristics

A. Structure:

1. Concentration: One of the most important characteristics determining the environment for Effective Competition is the relative concentration of sellers, buyers, and suppliers within a market. It has been observed that, other things being equal, a market with a large number of firms and of relatively even strength

18 Massel, op. cit., p. 221.
tends to be more competitive than a market dominated by one or a few very large firms with the rest of the small firms depending on the goodwill of these large firms. However, there is no a priori formula to indicate the minimum number of firms that should be in the market before it becomes effectively competitive. This depends very much on the type of industry, the stage of growth of the industry, the importance of economies of scale in the industry, the importance of technological innovation to the industry, and the relative size of the market held by say the 'Big Five' in the industry. A rough guidance is provided by some anti-trust cases in which relative size was used to determine monopolistic power.\textsuperscript{19}

Any discussion of the relative size of the firm requires defining the total size of the market for the product which the firm is producing. What products are substitutes for one another so as to be included in the same market? What is the cross-elasticity of demand between the products? Should Cadillacs be included in the same market as Volkwagens? Should the copper and say plastic industry be included in one market because many of their pro-

ducts are increasingly serving as substitutes for one another? The answer to these and many other similar questions will determine the total size of the market and the relative share of each of the firms in the market. The United States Supreme Court dealing with Anti-trust cases has not come up with consistent answers. In the famous Cellophane Case the Supreme Court interpreted the market for wrapping material broadly to include flexible wrapping materials which might be construed as substitutes for cellophane. On the other hand, in the General Motors Case, the Court applied a particularly narrow concept of the market, declaring that paints used by automobile manufacturers are of a special type and should not be included in the broad category of paints for all purposes. Despite these apparently conflicting views of what constitutes a market, economic analysis can be used to determine cross elasticities of demand between products and, by setting up certain demarcation lines which are broadly agreed by policy makers, a fair assessment of the size of the market can be made.

Even if the total market for the product is defined, and the relative size of the market held by

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the larger firms known, the characteristic of concentration cannot by itself give a complete answer to the question whether the market is effectively competitive. It has to be related to other characteristics.

2. **Opportunity for Entry:** Even if the firms in a market are few enough to be able to charge prices higher than those possible under perfect competition, an important point taken into account by the existing firms while considering to charge higher prices is whether such high prices will attract other large firms producing different products to enter into the market for the product in the hope of earning 'monopoly' profits. This will in turn depend on whether it is relatively easy to enter the market.

If there are no substantial barriers to entering a market, strong monopoly elements will probably not endure. High profits or opportunities to enter the market with lower costs will attract newcomers. Similarly, if the members of an industry felt that it was easy for others to enter the market, they would be less inclined to fix prices since more profitable prices would make the market more inviting to outsiders.22

Whether entry into a particular industry is relatively easy or difficult is dependent on a number of factors like long-run cost curves in the industry, product differentiation within the industry, and special restrictions imposed by patents, special group discounts and other similar devices.

22 Massel, op. cit., p. 199.
The long-run cost curves which the new entrants have to face after the initial period, are considered of vital importance in determining the opportunity for entry by new firms. If there is no long-run cost advantage to an existing firm, then new firms may decide to risk the initial losses, or loss of profits involved in entering a new market, in the hope of being able to compete effectively in the long run.

Besides the long-run cost relationship, an important factor in determining entry in a market is the extent of fixed costs in capital equipment and technological know-how required to enter a new market. If the fixed costs of entering a new market are high - like in an automobile industry - the opportunity for entry is very much restricted. However, this high initial cost has not proved an insurmountable problem in the case of many industries because potential or new entrants are mostly big corporations or conglomerates with access to sufficient funds to enter large scale industries.

Product differentiation is not only a determinant of the total effective market for the product but influences the opportunities for entry into a market. If the product differentiation has been carried too far so that each segment of the total mar-

ket constitutes a market in itself, then there is a
greater opportunity for a relatively small but
specialized firm to enter a particular segment of the
market, although a substantial part of the larger
market may be dominated by a few very large firms.

In another respect, product differentiation
in consumer goods may restrict entry into the market.
When the consumers have been persuaded through heavy
advertising that a particular brand of product is
different from, and superior to, the rest of the
products which can be considered as substitutes, it
is difficult for a new firm to enter the market with
a substitute product. But this difficulty should not
be exaggerated as buyers are quite susceptible to
offerings of superior quality products at competitive
prices.

The monopoly powers given for a fixed period
of seventeen years by patents have served as restric-
tions to entry into some industries. 24 The attitude
to granting of patents is one of ambivalence. The
advantages of granting patents to encourage inven-
tions and innovations are recognized. However, some
firms have used this right to further monopolistic

interests. There have been many instances of firms not using the processes or products patented but at the same time preventing competitors from using them. Patents which are not intended to be used by the patentee have been exchanged between colluding competitors to discourage potential entrants from taking advantage of these patented processes on the expiry of the patent. Partly for these reasons, the Supreme Court has recently taken an unsympathetic attitude to such firms filing suits against those who have infringed such patents.25

There are many other types of restrictive practices adopted by the existing firms to prevent, or make extremely difficult, entry by new firms. Distributors are tempted by higher discounts to handle only the products of the firm in the industry.26

It is submitted that public policy should be geared to increase opportunities of entry by discouraging firms from using restrictive tactics to prevent new entrants into the market. This requires not only examining the relative strength of the existing firms but observing how this strength is utilized in preventing entry by new firms.

25 See Sigmun Tinberg, "Equitable Relief Under the Sherman Act" (University of Illinois Law Forum Vol. 1950 Winter), pp. 629, 645. From 1941 to 1945 patents were not upheld in 80 per cent of cases in the Circuit Court of Appeals and the Supreme Court.

3. **Independence of Rivals:** Not only should there be sufficient number of firms to create effective competitive conditions, but these firms should be independent of one another. If they are independent of one another, then each of them is free to take full advantage of any opportunity open to it, irrespective of the consequences of its action on the competitors. Whether the firm will initiate changes will depend on its belief about the speed and extent of reaction of its competitors. If there are many firms, each controlling a small part of the market, the action of one firm is unlikely by itself to induce others to follow the move because the effect of the move by the initiating firm will be diffused in the market. In such a case, the firm is more likely to initiate changes in the market, making it more competitive.

Some of the formal requirements to ensure independence of competitors are covered by Sections 7 and 8 of the Clayton Act, which regulate intercorporate stock acquisitions and interlocking directorships. These formal requirements are not by themselves sufficient to guarantee independence of actions by competitors. Many of the collusive practices result from informal agreements negotiated at cocktail parties and on golf courses. These are hard to detect and legislate against. It is submitted that the most effective way to prevent the independent firms
from colluding on prices or market is to make it attractive enough, through structural changes, for any of them to reap higher benefits by not colluding with others. According to John M. Clark\textsuperscript{27} it is not essential for all the firms in the market to be acting in their own individual interest. If a few reasonably strong firms have the perspectives and the market situations that lead them to initiate aggressive action, then it sets the pace for the others to follow.

4. Integration: In order to view the structure in its proper perspective, it is not only necessary to examine the relative size and strength of the firms producing the product in question, but it is essential to look at the relationship of these firms with their suppliers of materials, distributors and customers. If one large firm in the market controls the total source of raw material required by the firms to produce the product for the market, then this particular firm is in a strategic position to decide to whom to supply the raw material - thus controlling entry to the industry; at what price to supply the raw material - thus influencing the minimum price that the competitors will charge for the final product; and on what terms to supply the raw material. In 1945, Alcoa was prosecuted by the Anti-trust Division

\textsuperscript{27} Clark, 1961, \textit{op. cit.}, p. 470.
for using its power as the sole producer of virgin ingot to squeeze the competitors out of the market.\textsuperscript{28}

In order to promote effective competition it is essential to ensure that the firms in the market have alternatives both in the case of suppliers of the raw materials and as buyers for their finished products. This may require opening up the local market to foreign sellers of raw materials who may act as alternatives to the monopolist local supplier.

5. \textbf{Profit Incentive}: It is often ignored that the basic tenet of competition is to encourage an individual or a firm to take certain actions to achieve private gain which at the same time benefits the entire community - through investment, rise in income or economic growth - and is in conformity with public policies. This requires that the taxation system should be such as to leave sufficient funds in the hands of the individuals who take the initiative of earning more through competitive forces.

6. \textbf{Consumer Sovereignty}: In order to foster effective competition it is necessary for the consumer to receive offers of alternative products which are substitutes one for another for his requirements. The total decision of all the present and potential buyers

\begin{footnotesize}\begin{itemize}
\item[\textsuperscript{28}] \textit{U. S. v. Aluminium Co. of America} 148 F 2d 416 (C.C.A. - 2d 1945).
\end{itemize}\end{footnotesize}
determines which of the products will be produced and what are the maximum prices which the consumers are prepared to pay for them. Undoubtedly, these decisions are not made in the abstract and are influenced by a host of information received by the buyers through descriptive literature, the press reviews and advertisements. These media often attempt to influence the decision of the buyers, but the final decision rests with the consumer. This is known as Consumer Sovereignty.

7. Market Information: In order to ensure that the consumer exercises his judgment properly, it is essential that the information that he receives is not misleading or incorrect. This entails setting up laws regarding misrepresentation, bribery of the press, labelling and packaging the product.

The informational requirements of Effective Competition are discussed in the next chapter.

B. Conduct:

This category covers characteristics which relate to the firms' actions, dealings, or tactics. These include the relationships on price, quality, distributorships, market areas which the firms establish with one another as buyers, sellers or competitors. Some of the main characteristics are:

1. Pricing Policy: The pricing policy of a firm is dependent on a complex set of factors, including the
uniqueness of the product and the extent to which it can be substituted by other products in the market, the size of the firm compared to the size of competitors in the market, the share of the market which the firm is controlling, the anticipated response of competitors as to changes in prices initiated by the firm and the relative ease with which new firms can enter the market and unprofitable firms can leave the market. 29

In the limiting case of perfect competition, the firm has no control over the price at which it can sell the product. At the other extreme, the monopolist has substantial control over the price for its product. Most of the firms in the real market are in between these two extremes. There are many variations of pricing policy adopted by firms in different industries. If the market is dominated by one or a few very large firms, there is a tendency for one large firm to act as a leader in price, with the rest of the firms following this leadership. This understanding to follow the leadership of one firm does not require any formal contract or agreement. For fear of reprisals, the smaller firms tend not to disturb the established price. 30

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This price administration which normally leads to price rigidity is not conducive to effective competition. It usually prevents the benefits of competition from being passed on to the consumers. If such a situation is prevalent, competitive forces should be injected into the market.

A climate more stimulating to effective competition might be introduced in such a market in several possible ways, including; new entry, if large profits were being made; price discrimination; variations in the product or in other terms of the bargain; a change in the structure of the market, by an increase in the number of sellers; or utilization of other competitive devices such as product, service and customer relations improvement and more effective selling.31

According to John M. Clark,32 the spur to effective price and other forms of competition is created by a situation in which the demand functions of a single firm are more elastic than those of groups or industries - that is, those that include the products of competitors. If the price elasticity of demand for the product of the firm is greater than one, the lowering of the price will result in a net increase in total revenue. As long as the firm does not expect immediate price reductions by competitors, the advantage to the firm is to lower its price, to the level where marginal revenue equals marginal cost.


32 Clark, 1961, op. cit.
In these terms the requirement of effective competition is that some one of these variant opportunities for a profitable increase in a firm's market share, viewed in some one of these perspectives, should appear favourable enough to one or more firms to induce them to improve their offerings to their customers. That this should lead to defensive reactions by the industry or trade in general; and that this should go on until profits for the bulk of the firms - not including the very strongest or the weakest - approximate the minimum necessary supply price of capital and enterprise.33

2. Market: The extent of the market being covered by the important producers of the product is an important indicator of the effectiveness of competition. In the extreme case, two or a few firms carve out the total market into sub-markets which are the exclusive territories of each of the firms. This is usually accompanied by an understanding as to the price to be charged in each of the markets. A more usual case is the establishment of predominancy by each of the large firms in these sub-markets, with the tendency by all the firms not to disturb the pattern of the division of the market.

Public policy should guard against such divisions of the markets.

3. Marketing: Marketing is another potent instrument used by some firms to prevent effective competition. There are so many forms of restrictive marketing methods

33 Ibid, p. 480.
practiced that it is not possible to cover them all in this study. Some of the common methods are:

a) The establishment of exclusive dealers in a sub-market which prevents price competition of the product between wholesalers.

b) The franchise system which prevents dealing in competitive products in return for special services provided by the firm providing the franchise.

c) The tying contracts which force the distributors to sell all the products of the firm, even if the selling of some of the products is relatively unprofitable to the firm. Such contracts prevent the distributors from maximizing their returns.

While many of these restrictive marketing practices tend to lessen effective competition, some of them are practised to provide satisfactory service to customers or to prevent cut-throat competition. They should be examined in the light of all the surrounding circumstances and can serve as indicators of the attitude of the firms towards effective competition.

C. Performance:

The entire discussion on public policy influencing the environment within which the firm
operates and the conduct of the firm is based on the assumption that these forces are likely to bring about the desired performance in the firm, which reflects the working of effective competitive forces in the market. In the end, performance of the firm is the most important criterion to judge whether competitive forces are active in the market. The main indicators of performance are:

1. **Profit Levels:** In economic analysis, it is demonstrated that there is a tendency for the average profit of all the firms in the market to equal the price of capital and management, as the market is made more competitive. On the other hand, a monopolist earns 'high' profit because he is in a position to exploit the market. Although some economists making empirical studies have disputed this analysis, it is generally true that profit levels tend to be lower the more effective the competition is in the market. It not only forces the firms to reduce their costs but induces them to pass the benefits of these cost savings to the consumers whose goodwill and patronage are essential for the progress of the firms.

Extreme Concentration is consistent with strong competitive pressure for efficient production, but it is not favourable to the

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kind of competition that makes for rapid and adequate diffusion of the benefits.35

2. Innovation and Progressiveness: Continuous innovation leading to higher productivity is an important requirement of economic growth, especially in an economy which has attained 'full employment'. Once the economy has reached a high stage of sophistication, technological innovation requires a large outlay of capital and manpower which can only be undertaken by comparatively large firms.

The application of modern science to industrial technology, he (Galbraith) asserts has brought it about; (i) that a much longer time span is required between the initiation of a manufacturing project and the actual flow of the product on to the market, since the necessary research and development, the designing of complicated specialized machinery and raw materials, the construction of the specialized plant and machinery, the bringing together of a balanced team of specialized workers, etc. all take time; (ii) that a much larger scale of investment in complicated plant and machinery is often required for a single modern industrial project; (iii) that capital equipment and raw materials have to be increasingly specialized for their particular uses; and (iv) that similarly manpower has to be increasingly specialized in its skills and professional training, with the consequence that the industrial structure is increasingly inflexible. The result is a system which commits very large amounts of resources for a very long time ahead to an inflexible and complicated pattern of production.36

There appears to be an apparent conflict between

35 Clark, 1961, op. cit., p. 481

the requirement of a large number of firms to generate competition and the large outlay of capital and manpower required for technological innovation, which cannot normally be undertaken by small firms relying mainly on meagre profits earned in a competitive market. The traditional analysis of perfect competition does not incorporate in the model changes in technology which are deliberately undertaken at great expense in the hope of earning higher profits. Galbraith is of the opinion that large firms in the United States are innovative and progressive because they have a firm grip over the market, and therefore can plan ahead.

First and foremost, these developments make it inevitable that planning should replace the market. The large corporation producing motor cars no longer simply follows the market; it plans far ahead what type of car it will produce, in what quantities it will produce it and at what price it will sell it.

... Third, the techno-structure has devised means of controlling, or at least greatly influencing, the wants of consumers. To be successful in its planning it is necessary not only to design its future products but also to plan ahead the quantities to be produced and the prices at which they will be sold. This is possible only if the consumers' wants are moulded by advertisement and other selling techniques so that the planned quantities are in fact sold at the planned prices. Professor Galbraith maintains that, within limits, the modern industrial corporation has managed to control demand in this way. This he terms the "revised sequence". In the orthodox market economy consumers come in the market with given preferences, and their demands guide

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producers what to produce. In the "revised sequence" producers decide what shall be produced and then mould consumers' tastes to take up these products.38

This claim of Galbraith that the conditions conducive to modern technological innovation are inconsistent with the conditions for competition, is disputed by many leading economists like John M. Clark,39 J. E. Meade,40 and A. D. H. Kaplan.41 They contend that continuous innovation is not the exclusive province of large firms. Competitive forces induce relatively more innovation because the innovative firm, by producing a superior product or a similar product at a lower price, has a chance in the competitive market to benefit from such innovations.

The dynamic industries and trades are those in which techniques and products are changing rapidly, also those in which youthful expansion is going on, the two conditions being likely to occur together. Here it is natural that there should be marked difference between firms, advantages being gained by those most successful in taking the lead, and the responses of the others are not likely to be fully successful in equalizing their market position.42

So far, no conclusive evidence has been made available to establish the first hypothesis that only

39 Clark, 1961, op. cit.
40 Meade, op. cit., p. 382.
41 Kaplan, op. cit.
that only large firms are relatively more innovative and the second hypothesis that relatively more innovation is possible only if the market is controlled by large corporations.\textsuperscript{43}

The use of innovation and progressiveness of a firm as an indicator of competitiveness has met with great difficulties.

The speed with which an industry is growing is not a direct economic indicator of the state of competition within it. An industry may be actually in decline and yet be actively effectively competitive. For example, an industry may decline because the demand for its products is declining and yet there may still be competitive rivalry for shares of the remaining market. Rate of growth, however, is often important in determining the significance to be attached to other factors, and particularly to numbers and reasonable opportunity for entry.\textsuperscript{44}

3. Capacity-Output Relations: One indicator of pure monopoly in abstract theory is the excess capacity of a firm. In practice, however, there are many other reasons for excess capacity in an industry. There may be a temporary depression in the industry; the product of the industry may be going out of style; excess capacity may be due to past investment errors in the industry or to anticipated increases in demand. Therefore, excess capacity is not a very reliable indicator of the competitiveness of an industry.

\textsuperscript{43} For interesting studies, see Mason, \textit{op. cit.}, pp. 141-165.

\textsuperscript{44} \textit{Report of the Attorney General's Committee, op. cit.}, p. 328.
4. Freedom of Consumer Choice: Unlike the theoretical benchmark of perfect competition which revolves around the concept of producing homogeneous product, Effective Competition requires product differentiation to enable the consumer to choose from a variety of products offered by competitors in the market. This freedom of consumer choice is often taken for granted in any discussion of competition, but it is important to recognize it.

Customer competence is generally either taken for granted or dismissed as outside the sphere of economic analysis. But we have seen that it is a prerequisite to healthy competition and does not take care of itself in an age of new products and applied science, but affords many problems of policy and implementation. The recognition of these problems and of the inevitable differences in success in different parts of the economic field form part of the assumption necessary to realistic thinking about competition.45

5. Wasted Resources in Selling Activities: Some economists have argued that, with price competition no longer of great importance among oligopolists, these firms 'waste' economic resources in heavy, and often unnecessary, advertising.

This indicator requires agreement on what is 'informative' advertising and thus 'useful' and what is 'persuasive' advertising and thus 'unnecessary'. It also requires some agreement on whether advertising increases total aggregate demand for all the products in the economy.

45 Clark, 1961, op. cit., p. 466.
Other Indicators of Performance

There are many other indicators of performance like labour conditions in the firm, and the firm's contribution to national defence which have been put forward from time to time. But they are not precise enough to be used to gauge the performance of the firm.

The review of the major characteristics of Effective Competition as a normative model does not give a firm indication of the causal relationship between these characteristics. It is recognized that the performance of the firms in the market is the final indicator of whether the market is competitive. The performance of a firm at a particular time may be the result of a number of cross currents which are difficult to identify and almost impossible to fit into meaningful causal relationships.

Shortcomings in Defining Effective Competition

Admittedly, the normative concept of Effective Competition is not simple and precise to be used as a reference indicator to judge whether a particular industry or market is competitive. This is mainly because the economy to which it relates is a whirlwind of complex sets of forces moving in all directions. Any attempt to simplify the model will result in the tools of analysis being clear but not effective to carry out any meaningful examination of
"Workable" or "effective" competition supplies no formula which can substitute for judgment. It suggests leads to data of significance, and a means of organizing the data bearing on the question whether a given market of itself is sufficiently competitive in its structure and behavior to be classified as workably competitive. And it provides some benchmarks or criteria, representing somewhat different points of vantage for the process of making that judgment.

Even if the desirable characteristics in the standards of structure and conduct are introduced through public policy, there is no guarantee that the performance of the firm will be such as to enable the country to achieve most of its national objectives. The belief of many economists - based on the statistical law of probability - is that, given the environment which is conducive to effective competition, the emerging relationship between the firms and the average performance of the firm will enhance the national objectives which logically emanate from Effective Competition. Some recent studies have confirmed a positive correlation between structure conducive to effective competition and desired performance of the firm; between concentration plus barriers to entry and the earning of abnormal profits.

Summary:

The principal points in the chapter are as


47 Collins and Preston, op. cit.

48 Mann, op. cit.
follows:

1. Considering the complex sets of forces that affect the economy, it is not possible to give a short and meaningful definition of the normative model of Effective Competition.

2. The lines of demarcation for the definition of Effective Competition are drawn by discussing the characteristics in the economy which constitute the normative model of Effective Competition. These characteristics are divided into the categories of 'structure', 'conduct', and 'performance'.
CHAPTER IV
INFORMATIONAL REQUIREMENTS OF
EFFECTIVE COMPETITION

Brief Outline

The main characteristics of the normative model of Effective Competition, discussed in the last chapter, are not all self-generating and self-regulating. The desired environment and forces have to be created to generate and preserve those characteristics which are conducive to the normative model. This necessitates conveyance of information about the state of affairs to the various actors in the economy - namely consumers, employers, workers, creditors, investors, government-run corporations, government agencies and foreigners having commercial dealings with the United States and Canada, who form an integral part of the model, and whose actions have a bearing on the competitiveness of the economy. An attempt is made in this chapter to outline the kinds of decisions these actors normally make, and the types of information necessary to make these decisions. The major weaknesses of economic analysis in the handling of the informational requirements of each of the actors in the economy are also discussed.
Major Weaknesses of Economic Analysis

The traditional tools of economic analysis normally used to analyze the competitiveness of an economy are static in nature in that they do not give proper recognition to the processes by which the competitive forces in the economy are brought about.

The dynamic forces resulting in Effective Competition are not all self-generating and self-regulating. The desired environment and forces have to be created and preserved. The standards of conduct have to be regulated to achieve the desired objectives. If the performance of the majority of the firms is not conducive to the fulfillment of the national objectives, then the forces of the environment and the conduct have to be re-examined to find inconsistencies or weaknesses. This search for deficiencies is a continuous process. It is also necessary to examine and incorporate into the model new forces generated by changing business policies and practices, which are likely to enhance competition. All this presupposes that the various actors within the economy - be they consumers, employers, workers, creditors, investors, government-controlled business organizations, or those responsible to generate and maintain the forces assisting competition - are endowed with sufficient information to initiate the desired moves.

A major weakness of the economic tools used
to analyze competition is that they do not explain clearly the processes by which the informational requirements of each of the actors in the economy are met. The entire model of competition is based on actions/taken by various actors in the economy which lead to the desired results. It is recognized that the initiation of the action is based on receipt by an actor of certain information which enables him to form certain expectations about the future. Based on his estimate of the future and the steps that may be taken by other actors, he initiates certain moves which he believes to be in his own interest. Thus any move is a result of certain information received by the actor and his assessment of the situation based on the information currently received, and on the past experience of the actor.

This informational aspect of competition is virtually ignored in traditional economic analysis. In explaining the forces leading to 'Perfect Competition', economists assume that the actors possess 'perfect knowledge' of the conditions in the market. A consumer buys from the cheapest source because he knows the type of products being offered by all the sellers and the prices at which they are being offered. As all the consumers buy from the cheapest source, there can be only one price for the product. The worker is assumed to know about the wages being offered by all the employers. He works for a firm which offers
the highest return for his services. The buyer of raw materials knows what is being offered in the market and at what price. He naturally buys from the cheapest source. A potential investor is assumed to have perfect knowledge of the various opportunities for investment. Being a rational man, he invests in a project whose present value is the highest.

Who provides the required sets of information? How are they transmitted? What criteria should be used to judge the adequacy of information? What is the effect on the model if 'perfect information' is not received? What is 'perfect information'? These questions are not tackled in most of the economic textbooks dealing with competition.¹

Any adequate theory of economic adjustment, whether it be in terms of the maintenance or the attainment of an equilibrium position, must represent entrepreneurs as taking investment decisions on the basis of expectations about the relevant future circumstances. This indeed would probably be admitted; what commonly fails to be recognized, however, is that the possibility of forming reliable expectations is not independent of the particular market conditions which define the model employed. In saying that expectations or beliefs are reliable I imply that they are grounded on adequate information or evidence. It is the availability to entrepreneurs of this information which I now wish to demonstrate, is a function of the nature of the particular form of economic organization or system within which they are presumed to operate. If the defining conditions of our model are such as to preclude this availability, as I

¹ See Samuelson, op. cit., which makes no mention of the informational requirements.
believe to be the case with perfect competition, then we cannot hope to obtain a proper understanding of the process of economic adjustment or of the factors which will influence its success or failure.

This lack of emphasis on the informational requirements of competition has been an important factor in the inability of many economists to explain clearly the process of competitive forces which leads to the desired results. Economists are quick to point out the main characteristics of Effective Competition but fail to provide effective remedies if some or all the characteristics are absent from the economy. This failure to explain the process and suggest effective remedies has made it more difficult for those responsible for generating and preserving competitive forces, to take timely decisions.

A Proposal

The author is of the opinion that providing 'timely' information of 'material significance' to the actors in the economy will improve the competitive process leading the economy towards the desired objectives. In order to enable the authorities concerned with the regulatory activities of competitive environment to act decisively without loss of time, a certain set of information should be made available. What information is 'of material significance'? To

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whom is it of material significance? What is the effect of such public disclosure of information on various actors in the economy? What is the benefit of such information and by whom is the benefit received? What is the cost of providing such information?

All these questions are quite legitimate and can only be answered if the frame of reference is made clear. It is asserted that Effective Competition as a normative model is the most effective means to achieve most of the national objectives discussed in Chapter II. The model is a dynamic one and requires continuous adjustments to deal with changing conditions in the market. The main characteristics of Effective Competition discussed in Chapter III provide a guide as to which information is 'material' to attain and preserve Effective Competition. It is assumed that the disclosure of a set of information which assists in the attainment of Effective Competition, results in net benefit to the society, although such a disclosure may be detrimental to a particular person or group in the economy. This assumption is based on a premise, frequently used in welfare economics, that a move is desirable if its benefits to the majority of persons in the society far outweigh the losses suffered by a minority in the society. The desirability of the move is not changed even if the benefited
majority does not compensate the injured minority.\(^3\)

The characteristics discussed in Chapter III reflect the actions of various actors in the economy, namely; consumers, employers, workers, creditors, investors, government-run corporations, foreign firms dealing with the home country and the various government agencies whose actions have a direct affect on the other actors. The actions taken by these actors are dependent on the information they receive about the state of the economy in general and about the actions of other actors in the economy in particular. It is generally assumed that an actor will make a more rational decision if he is furnished with reliable information about the factors on which his decision is based.\(^4\)

**Informational Requirements of Various Actors in the Economy**

To create an environment conducive to Effective Competition, each of the actors needs to be furnished with certain types of information. The informational requirements of each of the actors are discussed below:

A. **Consumer**: A consumer is a person (or a firm) that utilizes economic goods.\(^5\) These goods are normally

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\(^3\) See Ferguson, 1964, *op. cit.*, Chapter I.


\(^5\) See Webster's *Third New International Dictionary*, p. 490.
purchased from others. As a rational man, he attempts to purchase his requirements from a seller who gives him the best offerings in price, quality of product, terms of payment, and after-sales services. In order to make an objective comparison he seeks to obtain the following information from all the sellers:

1. **Price:** Price of a product is probably the oldest and most common type of information available in the market economy. As this information forms the basis of any transaction in the market, it is made available to a potential buyer. Price plays an important part in determining the sources of supply and the use of substitute products.

2. **Product:** Information about the product is important for the conclusion of a transaction. If the product is of a non-technical nature, then it is often purchased on the basis of appearance, taste or smell. For chemical or technical products, further information is provided and, if found necessary, tests are carried out. Information on product is important to the buyer to compare prices of substitutes and to determine which of the similar products is available at the lowest price. Information on the product usually indicates the time of delivery of the product.

3. **Payment:** Sometimes during the negotiation of the
contract for sale, terms of payment are either discussed or made clear. By terms of payment is meant the method and timing of payment. Most of the purchases of goods and services in the market are in return for payment of money. Payments are often made at the time of the transfer of goods. However, sale on credit basis is quite common in almost all the industrially advanced countries. Information about terms of payment is important to the buyer to determine the quantity of goods he can purchase at any particular time. It is quite common to find a comparatively higher priced product purchased because the terms of payment are more attractive. It is common knowledge that the purchase of a house in Canada is determined more by the attractiveness of monthly payments than by the sale price.

4. Cost of Service: For many technical products, the cost of after-sales service is of great importance. The potential buyer wishes to know what warranty period is covered for the product and what are the charges for replacement parts and specialized services provided by the seller. This information is normally provided in advance of the purchase. As the seller cannot anticipate the type of repair required, he normally gives information about the prevailing rates for services - either on hourly or job basis.

Although the above-mentioned types of informa-
tion are intended primarily for the potential buyer, they become common knowledge in the market. They are used by competitors and others to adjust their own positions in the market. All of them are taken into account in judging the competitiveness of the firm.

B. Employer: An employer is "an owner of a firm, or a firm, that employs personnel for wages or salaries." He normally employs these personnel to produce goods and services for sale in the market. His informational requirements are:

1. Information about his own enterprise: He has, or should have, full access to all the information about his own business enterprise. The types of information in which he should be particularly interested include his cost of production for the product, the allocation of this cost between the various factors of production, the selling price for the product, the trend in sales of the product, and the net worth position of the business enterprise.

2. Information about other firms in the market: In order to judge the competitiveness of his own product, he is interested to know about the price, the quality, the terms of payment and the after-sales services which his competitors are offering for their products which have a high degree of substitutability for the

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6 Webster's Third New International Dictionary, op. cit., p. 743.
product of the employer. These kinds of information can be obtained from the market with comparatively little effort or expense.

To enable him to judge his efficiency compared to his competitors who may be using different processes of production, he requires information about the competitors' cost of production for the product, and their division between the different factors of production. At present, most of the firms do not give these types of information by product. In the next chapter, specific recommendations are made for the disclosure of these types of information by corporations.

Besides producing the product for the market, he normally plans for the future. He has to decide whether he will produce more or less of the product in future. He also has to decide whether there will be any changes in the line and mix of products at present produced by his enterprise. To facilitate his decision on these matters, he requires information about the trend of the market for the products under review. It helps him considerably if he manages to get information about the plans of his existing and potential competitors, but this information is not normally available until after the plans have been put into effect.

C. Worker: A worker is a person who is employed by
another person or a firm for a wage. In most cases his main, if not the only, source of livelihood is the pay packet he gets at the end of the day, or the week, or the month. As his economic progress and promotion prospects are closely tied with the progress of the firm, he is naturally interested to know the rate of progress of his employing firm as compared with the rate of progress of competing firms in the market, and in industries producing other types of goods and services. Some important indicators of the rate of progress of a firm are:

1. **Trend in Sales:** He is interested to know whether the sales of his firm - both in physical volume and in monetary terms - are on the increase, and whether the rate of increase is greater than the average for the product in the market.

2. **Trend in Profit Margins:** He is very much interested to know how the profitability of his firm compares with the profitability of competitors in the market. If his firm is not making as much profit as the competitors, then he should be concerned to look at the reasons for this comparative inefficiency. However, if his firm is making a higher profit than the competitors, then he is in a better position to ask for a raise in wages.

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3. Productivity and Capital Investments: Productivity is defined as "the physical output per unit of productive effort." The term is often used to demonstrate "the degree of effectiveness of industrial management in utilizing the facilities for production."

Attempts to measure and compare productivity between firms or factors have met with great difficulty, mainly because there is no consensus on the items that should be included.

Different systems of weighing the items entering into indexes of productivity will often produce different results. Like any index number, such measures need to be interpreted with caution and with reference to a restricted context. Particular care should be used when it is desired to isolate and measure the productivity of separate factors of production that contribute jointly to the same end product.

It is recognized that there is generally a positive correlation between the productivity of the factors of production in a firm and the profitability of the firm. It is also asserted that, in many industries, the productivity of all the factors can be increased by increased automation, which often requires heavy outlay in capital equipment.

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8 Ibid., p. 1810.
9 Ibid., p. 1810.
11 For a definition, see Webster's Dictionary, op. cit., p. 148.
4. Innovation: Innovation means "the introduction of something new as the driving force in practical economic advance."\textsuperscript{12} Under the present industrial structure, it has been noticed that those firms that have been innovative have normally earned higher rates of profits compared to those firms that have not been innovative. Innovation, which normally requires large capital investments, is one indicator of the progressiveness of the firm.

In short, the worker is interested to know the progress made by his firm in comparison with the competitors. Under the present regulation, he is not entitled as a worker to receive the types of information that may affect his livelihood.

D. Creditor: A creditor is a person or a firm to whom a debt is owed.\textsuperscript{13} He is classified as a short-term creditor if the debt is repayable during the current year. If the debt is not repayable during the current year, then he is classified as a long-term creditor.

One of the most important items of information required by the short-term creditor is the liquidity of the debtor firm. Several measures like Current Ratio,\textsuperscript{14} and Acid Test Ratio,\textsuperscript{15} are used to determine

\begin{itemize}
\item \textsuperscript{12} Ibid, p. 1166.
\item \textsuperscript{13} Kohler, \textit{op. cit.}, p. 152.
\item \textsuperscript{14} Ibid, p. 155.
\item \textsuperscript{15} Ibid, p. 21.
\end{itemize}
the liquidity of a firm. In addition, he is interested to know about the profitability and the capital structure of the debtor firm.

The long-term creditor is in many ways in a similar position to the shareholder of the debtor firm. He is primarily concerned with the profitability of the debtor firm.

The shareholders, long-term creditors, general public, and employees are concerned with the projected profitability of the firm as a measure of its ability to distribute dividends, pay interest and repay capital on long-term debt, set fair price with a fair profit, pay fair wages, and continue to be financially viable. A projection of profit is based upon the record of the past profitability of the company as presented in the Income Statement, the Statement of Sources and Applications of Funds, and condensed in the extended historical analysis of ratios. This base must be adjusted for the anticipated change in the future environment, in which the firm will operate. It must be recognized that no final method has been devised to predict the future, but, on the other hand, it is accepted that all well-managed firms will prepare a comprehensive and detailed operating, capital and financial budget for the coming year, and many firms will present an estimate of the firm's financial needs and profitability for a five or ten-year period in the future. These plans, if available, would materially assist groups of outsiders in decisions about the company, so long as they were made aware of their inherent limitations.16

Besides the projected profitability of the firm, the long-term creditor is interested to know about the capital structure of the firm and the activities of the firm.

E. Investor: An investor is a person (or a firm) "that seeks to commit funds for long-term profit with a minimum of risk." The two main types of investors - those investing in the shares of a corporation, and those investing in the creation of a new enterprise or the expansion of an existing one - should be treated separately because their informational requirements are different.

1. Investment in the shares of a corporation: A person considering purchase of shares of a corporation should examine a host of factors including the projected profitability of the corporation, the probability distribution of expected return in the future, the capital structure of the corporation, the trend of the market for the product which the corporation produces, the quality of management, and generally the performance of the corporation compared to other corporations producing similar products. Most of the information about past performances is available from financial statements published by these corpora-

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17 Webster's Dictionary, op. cit., p. 1190. In this study, an 'investor' is not synonymous to a 'speculator'.


tions offering shares to the public. Some corporations make forecasts for a future period of normally one year. The unavailability of information about future plans of a corporation makes it difficult for financial analysts to make predictions about the future profitability of the corporation. In many cases, these tentative predictions form the basis of judgment for the purchase of shares of the corporation.

On many occasions, financial analysts have expressed their dissatisfaction at the type and extent of information supplied by corporations, which form the basis of their recommendations to their clients about the purchase or sale of shares.\(^\text{19}\) It is submitted that the recommendation in the next chapter about the type and extent of corporate disclosure will obviate many of the difficulties at present faced by financial analysts in their evaluation of corporations.

2. **Investment in a new undertaking, or the expansion of an existing undertaking:**

Any person considering investment in an undertaking to produce a product for the first time requires information about many factors including the probable size of the market for the product, the trend of the market, the shares of the market held by large firms, product differentiation practiced in


the market, brand loyalty, prices charged by producers, their cost of production, the break-even sales figure, and the ease of getting raw materials for the manufacture of the product. Some types of information like product differentiation, brand loyalty, prices charged by producers and the ease of getting raw materials for the manufacture of the product, can be obtained by carrying out investigations in the market. However, most of the remaining information required to inject competitive conditions in the market is not available to the potential entrant in the market. The specific recommendations in the next chapter attempt to ease the difficulties faced by a new entrant in the market.

A person (or a firm) considering expansion of an existing undertaking has considerable information about the trend of the market, unit cost of his own product and the profitability of the industry. Being in business for a long time, he gets a fairly good idea of the cost of production of his competitors and the brand loyalty for the product. It is submitted that he will allocate his capital resources more rationally and efficiently if he has accurate information about all the factors on which a new entrant seeks information.

F. Government-run Corporation: A government-run corporation producing goods and services for sale to
the public is, in many ways, in a similar position to a private corporation. However, in the area of price and profits, it might be subjected to greater scrutiny and control. In some cases, a major aim of a corporation is to cover its costs. This aim frequently forms the basis of its pricing policy.

G. **Foreigner**: In any consideration of the effective competitiveness of the economy, the possibility of a person buying from, or selling to, a foreign person plays an important part. In the case of the United States, purchases from countries other than 'communist countries' are practically unrestricted, provided the buyer pays import duty. Canada allows importation of consumer goods from practically all countries of the world. In the case of machineries, importation is allowed provided similar machines are not readily available from a Canadian manufacturer.

Information about buyers and sellers of products in any country can be normally obtained by approaching the chamber of commerce or government trade agencies of the foreign country.

Foreigners are increasingly interested in investing in the United States and Canada. They are interested in receiving information on all the factors considered in case of the local investors.

H. **Government Agencies**: Among the many Canadian government agencies dealing with trade and commerce, the important ones for the purpose of this study re-
quiring information are:

1. The Department of Internal Revenue requires information about 'taxable income' of all the persons and firms carrying out productive activities. This information is supplied by all the persons who are subject to tax and all the firms, whether they make profits or not.

2. "Canadian corporations, private and public, whose gross revenues exceed $500,000 or whose assets exceed $250,000 (excluding certain financial institutions, utilities and some other firms) are required, since 1962, to file returns under the Corporations and Labour Unions Returns Act." The information received under the Act is used mostly for statistical purposes and is disclosed to the public in aggregate form. The information, as presented to the public is of very limited use.

   The usefulness of CALURA is now mostly for economic analysis, and even in this respect there is room for improvement.

3. Other Agencies: Under the Companies Investigation Act, 1960, a government department has been set up to maintain the competitive structure in the economic system by taking actions against combinations that prevent or lessen unduly competition and mergers or monopolies that may operate to the detri-

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21 Ibid., p. 180.
ment of the public.

The department normally acts as a result of information about restraints of competition received from various sources. It does not receive regular information about all the firms operating in Canada. CALURA was meant to provide sufficient information on a regular basis on which the department may act, but a subsequent amendment to the Act largely nullified this intention. 22

It is submitted that the department carrying out the surveillance function requires the following types of information, in addition to the types of information discussed above.

A. **Assets owned by a firm:** In order to examine the characteristics and relative strengths of the firms in the market, it is essential to have information about the assets owned by each of the firms in the market. This information, along with other information pertaining to sales and profit levels, can be used to determine whether any change in the structure or conduct is necessary to inject competitive forces.

B. **Sales or turnover:** The sales figure for a product of a firm is an important indicator of the concentration of the market. If the sale made by one firm constitutes say 90 per cent of the total market

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for a product, then the market cannot be called effectively competitive. Conversely, if there are many firms in the market, each of which produces a small share of the market, then there is a greater likelihood for the market to be effectively competitive.

To make the information on sales meaningful, it is important that a separate sales figure by product be given by a firm engaged in the manufacture of many types of products. This obviously requires a broadly agreed definition of what is a 'product'. No attempt is made in this study to provide such a definition. 23

The turnover of a firm reflects the speed at which the current assets - especially inventories - of the firm are being sold. If the profit margin per sale is known, then the total profit is dependent on how fast the current assets are turned over in a year. This information is often used as an indicator of the efficiency of the firm, compared to other firms in the market handling similar products. Under the 1967 Companies Act of the United Kingdom, all companies are required to state their turnover, analyzed according to "classes of business". The approximate contribution of each class to the

23 For a discussion on product see Clark, 1961, op. cit., pp. 98-102.
over-all profit must be stated. The Act does not give a definition of 'class of business'.

Kohler gives a second definition of turnover as the "ratio of sales to net worth (equity turnover), it being understood that the comparison is actually between the asset equivalent of net worth and sales." This is often used as an indicator of how efficient the management of a firm is in utilizing loan and credit facilities available at a predetermined rate of interest, to give a better return to its equity holders.

C. Cost of Production: In order to determine whether the firms are earning abnormally high profits, it is essential to know the cost of production for the product. This cost may not be the same for all the firms. Due to economies of scale or technological innovation, some firms may have a lower cost of production than others and therefore may be earning higher profits. This is not precluded by the effectively competitive process. What cannot be tolerated is the charging of a price much higher than the average cost of production, solely on the basis of control over the market gained by a few firms behaving in a monopolistic manner.

For a meaningful comparison, the amount allotted to cost of production should be segregated

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25 Kohler, op. cit., p. 503.
26 For a definition see Kohler, Ibid, p. 148.
into materials, labour, overhead. The method of allocating overhead costs to periods and to classes of output should be clearly specified.

D. Profit levels: The term 'profit' is used in Accountancy as "a general term for the excess of revenue, proceeds, or selling price over related costs." It is a residual item after 'revenue' is matched with 'costs'. It is usually preceded by a qualifying word or phrase signifying the inclusiveness of the offsetting expense or cost, as 'gross' or 'net' of these expenses. The phrase 'Net Income' is at present preferred to 'Net Profit'.

The profit margin per unit of product is a good indicator of how competitive is the firm in the industry. This information about all the firms in the market throws light on whether the market is effectively competitive.

For a meaningful comparison, it is essential to know on what basis the firm has allotted its costs and what expenses are deducted at different stages before arriving at the final figure of 'Net Income'. This requires some uniformity in accounting practices.

E. Control of rivals: To fulfill the requirement of independence of competitors offering similar products in the market, it is important to have informa-

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tion about the relationship of these firms. Independence requires that the actions of these firms are not directed or influenced by a common source. This necessitates information about the shareholders of these firms. Information about interlocking Directorships is also required. Any collusive contracts made either directly or through a common supplier of raw material should also be disclosed. Specific recommendations about what a corporation should disclose are made in the next chapter.

F. Vertical Integration: An important argument behind Effective Competition is that the firm will be induced by self interest to utilize the resources under its control most efficiently and pass on a part of the benefits of this efficiency to the consumers by way of lower prices or better services. This assumes that all the firms in the market have an even chance of purchasing the factors of production at competitive prices.

Some firms attempt to neutralize the forces of Effective Competition by controlling their sources of supply or their channels of distribution. While there is nothing inherently objectionable in dealing with a sole supplier or a distributor, this method is

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often used to push the competitors out of the market.\textsuperscript{29} Thus it is the market power and not economic efficiency which determines which firms will remain in the market. Therefore, information about vertical integration should be disclosed to enable the authorities concerned to institute any structural changes in the market.

G. Marketing Methods: Marketing methods adopted by the firms often serve as good indicators of the competitive tendencies of the industry. Large markets are carved out into small markets by exclusive dealerships or franchises. The methods used by particular firms to sell their products are common knowledge in the market. What is not disclosed are the collusive arrangements made between the competitors to restrict the effects of competition. Any such special arrangement should be disclosed to the public.

An Informed Public

Besides the information given to the potential buyers which become public knowledge, some types of information relating to assets, sales, cost of sales, and net income are disclosed by firms to their shareholders. This disclosure is based on a contrac-

\textsuperscript{29} \textit{U. S. v. Aluminum Co. of America}, 148 F 2d 416 (CCA - 2d, 1945).
tual relationship between the corporation as a legal entity and its shareholders. If the corporation offers shares to the public, then it is required by law\textsuperscript{30} to disclose certain sets of information to the public by way of Prospectus and Annual Reports. In addition, many government agencies require a corporation to provide them with certain information about the activities of the corporation.\textsuperscript{31}

It is submitted that Effective Competition as a normative model requires the disclosure of considerably greater information discussed under the major categories above. This disclosure should be made not only to the parties under existing or potential contractual relationships but also to the general public including competitors, potential entrants to the market, investors in other corporations, potential investors, employees and consumers. It is submitted that an essential requirement of Effective Competition is an informed public. The public should be made aware of the opportunities available to them to utilize the factors under their control in the most efficient manner. An informed public is also essential to carry out effectively the program of public policy designed to attain and preserve Effective Competition.\textsuperscript{32}

\textsuperscript{31} Eg. Corporation and Labour Unions Return Act.
\textsuperscript{32} Galbraith, 1961, \textit{op. cit.}, pp. 215-218, argues that mature corporations have succeeded in con-
Competition can be influenced by the mechanisms for disseminating information regarding prices, costs, and qualities, as well as data concerning supply and demand. With such information customers have full freedom of choice among the offerings of various sellers. The same data permit sellers to size up the competitive situation more effectively. Without such information pockets of monopoly or monopsony can develop.

It is recognized that the availability of extensive information about all the firms in the market can encourage the firms to enter into collusive arrangements, fixing prices at a level which does not encourage any firm to initiate a competitive move. There have been many cases of such arrangements made following information about prices and turnover supplied to trade associations. However, such a potential danger of misuse of information is not a sufficient ground for nondisclosure of additional information discussed above. Other means should be devised to minimize this danger of misuse of information.

33 Massel, op. cit., pp. 204.

34 See Carpet Manufacturers - CCH Trade Cases Par 56, 079 (1941), Battery Separator - CCH Trade Cases, Par 56, 154 (1941).
Summary

The principal points in the chapter are as follows:

1. The characteristics of the normative model of Effective Competition are not all self-generating and self-regulating. The desired environment and forces have to be created to generate and preserve these characteristics.

2. A major weakness of the traditional economic tools used to analyse competition is that they do not explain clearly the processes by which the informational requirements of each of the actors in the economy are met.

3. The informational requirements of each of the actors in the economy, namely: Consumer, Employer, Worker, Creditor, Investor, Government-run corporations, Foreigner and various Government Agencies is reviewed. The importance of having an 'informed public' is emphasized.
CHAPTER V

CORPORATE DISCLOSURE

Brief Outline

In the last chapter, the major informational requirements of the normative model of Effective Competition were discussed. Apart from the generally known information about price, product, delivery time, terms of payment, and interest rates which is divulged to attract sales, and the information about assets, profits, and dividends given to a limited group of persons under contractual relationships, there seems to be no built-in system in the economy to provide the other types of information required for Effective Competition. The tendency of the firms in the economy is not to divulge more information than is absolutely necessary to attract customers and effect sales and gain the necessary general commercial support. This is based on an apparent conviction of businessmen that secrecy is an important asset of the firm which should be utilized to further its own interests. Therefore, public policy should be aimed at forcing the actors in the economy to provide the additional
information required for Effective Competition.

After reviewing the importance of modern corporations, specific recommendations about the type and extent of corporate disclosures are made in the present chapter.

**Importance of Modern Corporation**

By far the most important influence in the economy of the United States and Canada is exercised by the modern corporation. It is the largest private employer of workers, the biggest investor and the predominant instrument of production. The role of the corporation has changed drastically since corporate status with limited liability was legally sanctioned around the middle of the nineteenth century.

Seventy years ago, the corporation was still confined to those industries - railroading, steamboating, steel-making, petroleum recovery and refining, some mining - where, it seemed, production had to be on a large scale. Now it also sells groceries, mills grain, publishes newspapers and provides public entertainment, all activities that were once the province of the individual proprietor or the insignificant firm. The largest firms deploy billions of dollars worth of equipment and produce hundreds of products. The five hundred largest corporations produce close to half of all the goods and services that are available annually in the United States.¹

This change in the role of the corporation

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has led to considerable discussion about the place of the corporation in the social, political, economic and legal framework of the United States and Canada. More specifically, the argument centres around the legitimacy of corporate power and the accountability of corporations for their actions which affect others such as consumers, employees, suppliers and the public. As part of this general accountability is the question of disclosure of information by corporations. What type of information should corporations disclose? To whom should corporations disclose? What purpose is served by such disclosure? What criteria should be used to judge the adequacy of disclosure?

**Accountants' Views About Corporate Disclosure**

The answers to these and other questions raised regarding corporate disclosure depend mainly on the interpretation given to the role of the corporation in society. The Accounting Associations and many of the business organizations have attempted to restrict their interpretation to the legal framework within which the corporation takes its roots and operates. In Canada, various Provincial Corporations

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Acts require a corporation to file an Annual Return in the Companies Registry giving information about the paid-up capital, the shareholders and the Directors of the Corporations. Corporations offering their shares to the public are required to issue a prospectus and to submit Financial Statements annually which should include the Income Statement, the Balance Sheet, the Statement of Retained Earnings, the Auditor's Report and the Director's Report. The Accounting Associations have devised certain 'Generally Accepted Rules' which should be followed by all the accredited accountants and auditors while preparing accounts and financial statements, but these rules are not backed by any legal sanctions. Under the Income Tax Act and the Corporations and Labour Union Representation Act (CALURA), corporations in Canada are required to submit certain information for tax and statistical purposes, respectively.

Apart from the type and extent of disclosure required by law, there is hardly any agreement among accountants as to what additional information should be disclosed and to whom it should be disclosed.

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3 Ziegel, op. cit., pp. 476-506.
4 Ziegel, Ibid.
The accountants have generally confined their discussion of disclosure to the effect on the actions of present and prospective investors, of providing more or less information of a financial nature. Following the legal relationship, they have assumed that the primary responsibility of the corporation is to its stockholders and that the criteria for disclosure should be based on this relationship.

However, many progressive accountants have warned the Accounting Associations of the detrimental effect of this restrictive, and often unrealistic attitude to disclosures by corporations. Rappaport has suggested the following four basic objectives for external corporate reporting:

1. The managements of large business corporations have a reporting obligation to those segments of society affected by their decisions i.e. investors, employees, consumers, suppliers, local communities and the public at large.

2. Those groups with a legitimate interest in the corporation should be provided with information essential to arriving at rational judgments concerning the equitable sharing of corporate benefit.

3. In the interest of economic progress, those groups which are responsible for allocating resources in our economy should be provided

6 See Bulletin No. 20 of the Canadian Institute of Chartered Accountants, July 1964.
with information which will promote efficient allocation.

4. In the interest of sustaining our basic values, information which is likely to influence socially desirable behavior and discourage undesirable behavior should be reported. e.g. calling attention to monopoly profits to preserve pluralism in the industrial sector of our economy.  

A standard argument put forward by the accountants is that they cannot legally force their client firms to disclose more than what is required under law. Additional disclosure may also make the accountants vulnerable under law to suits by shareholders and others. The latter part of this study includes recommendations to strengthen the hands of accountants in forcing their clients to disclose additional information.

Political Theorists' Views About Corporate Disclosure

Political theorists generally tend to look at the question of corporate disclosure as a part of the overall question of legitimacy of corporate power. Many theorists argue that the exercise of power can only be legitimate if it is representative.

That power may be rendered legitimate by demonstrating its representative quality has been one of the foundations of democratic theory. Where power is exercised by - and within - government agencies and voluntary associations, it can usually be shown that


officials are elected by constituents who have consented to the use of authority and who cast equal votes in determining the personnel and policies that are to prevail. Authority may be delegated rather than direct, and consent may be tacit rather than active but the presumption remains that power in public and private life has a representative base.  

When corporations were granted the status of legal entities, it was assumed by the legislature that the source of power was the entrepreneur who combined with one or more others to carry business in a manner which could not be done by a single person.

For purposes of scholarly inquiry, the corporation has a sharp legal image. Its purpose is to do business as an individual would but with the added ability to assemble and use the capital of several or numerous persons. In consequence, it can undertake tasks beyond the reach of any single person. And it protects those who supply capital by limiting their liability to the amount of their original investment, insuring them a vote on the significant affairs of the enterprise, defining the powers and the responsibilities of directors and officers, and giving them access to the courts to redress grievance. Apart from its ability to mobilize capital and its lessened association with the active life of any individual, the corporation is not deemed to differ functionally from the individual proprietorship or partnership. Its purpose, like theirs, is to conduct business on equitable terms with other businesses and make money for the owners.

It was recognized that the entrepreneur may delegate some of this power to a subordinate, but the subordinate remains accountable to the entrepreneur.

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9 Hacker (Ed), op. cit., pp. 6-7.
As the entrepreneur was normally a substantial investor in the business, he was considered an unquestioned authority in the exercise of corporate power which was regulated by the market forces.

With the rise of the 'mature',\(^{11}\) corporations run by the 'technostructure',\(^{12}\) the base of corporate power has changed considerably. In practice, the shareholder has little say in the running of corporations. Corporate power is exercised by professional executives who have relatively little stake in the risk capital of the corporation. They virtually appoint those members to the Board of Directors who will support their policies.\(^{13}\) Many of the large corporations have numerous shareholders, each holding a small proportion of the total outstanding stock. The professional executives are practically free from control by the shareholders. This separation of ownership from control is on the increase, according to studies carried out by R. J. Lerner.\(^{14}\)

\(^{11}\) Ibid, p. 71.

\(^{12}\) Ibid, p. 92.

\(^{13}\) Ibid, pp. 83-84.

Its principal finding is that management control among the 200 largest non-financial corporations has almost doubled in incidence since 1929. In that year 44 per cent of the "200 largest" and 58 per cent of their assets were management controlled; in 1963, 84.5 per cent of the "200 largest" of that year and 85 per cent of their assets were so controlled. Management control increased substantially within each of the three major industrial groups (industrials, public utilities and transportation companies) and became the overwhelming predominant type of corporate control within each group.  

In addition to the shift in the base of corporate power, the regulation of this power by market forces has become less effective due to many factors including the sheer size of mature corporations, oligopolistic tendencies of the market and the intervention by the government in the market to regulate employment and income.  

With these drastic changes in the base and exercise of corporate power, it is argued by some political theorists that the whole structure on which corporate legitimacy and power are based should be changed to make the corporations more democratic. As a part of this democratization process, adequate disclosure of the affairs of the corporations should be made to the public.

Yet we are so inured to the notion that business is private that we have not yet faced the fact that the only respectable, democratic solution to the problem of the loss of control is to build new external controls, with the government as the instrument of popular control, either directly through over-all public regulation of a continuing sort or indirectly through reconstructing of business institutions. The basic problem, then, is to find ways to hold economic decision-makers to account for their actions and to ensure that their decisions are made in conformity with community values.

Economists' Views About Corporate Disclosure

Economists have been in general agreement with the arguments of corporate power put forward by political theorists, but their case for corporate disclosure is based on the economic implications of large corporations. As a starting point, the importance of corporations in the modern economy is emphasized.

Nothing so characterizes the industrial system as the scale of the modern corporate enterprise. In 1962 the five largest corporations in the United States, with combined assets in excess of $36 billion, possessed over 12 per cent of all assets used in manufacturing. The fifty largest corporations had over a third of all manufacturing assets. The 500 largest had well over two-thirds. Corporations with assets in excess of $10,000,000, some 2,000 in all, accounted for about 80 per cent of all the resources used in manufacturing in the United States. In the mid-nineteen-fifties, 28 corporations provided approximately 10 per cent of all employment in manufacturing, mining and retail and wholesale trade. Twenty-three

corporations provided 15 per cent of all the employment in manufacturing. In the first half of the decade (June 1950 - June 1956) a hundred firms received two-thirds by value of all defence contracts; ten firms received one-third. In 1960 four corporations accounted for an estimated 22 per cent of all industrial research and development expenditure. Three hundred and eighty-four corporations employing 5,000 or more workers accounted for 85 per cent of these expenditures; 260,000 firms employing fewer than 1,000 accounted for only 7 per cent. 17

It is clear from these statistics that corporations are not just a passing phase as Adam Smith had envisaged18 but are here to stay. From all indications, large corporations will increase their hold over the market, and will extend their already large influence in the political and social fields.19

With the market forces not strong enough to regulate corporate power, many economists believe that additional forces should be injected into the economy to regulate the performance of the corporations to achieve the national objectives. As the national objectives are taken to be achieved with less costs under the normative model of Effective Competition, it is submitted that the characteristics of this model should be used as guides to the type and extent of disclosure required from corporations.

18 Adam Smith, op. cit.
Inadequacy of the Present Level of Disclosure

That the present level of corporate disclosure, especially in the case of Canada, is grossly inadequate is not disputed by the majority of accountants, economists and progressive businessmen. The recent Watkins Report on Foreign Ownership and the Structure of Canadian Industry makes some pertinent observations on this unsatisfactory situation.  

The disclosure by corporations of their affairs and operations is of great importance to a broad spectrum of interests in society, including shareholders, creditors, prospective investors, employees, suppliers, consumers, governments and others. Informed discussion and the analysis of the issue raised by the multi-national corporation depend on the quantity and quality of relevant information available to the public and the government. In spite of a decade of intense concern about these issues, and in spite of recent additions to knowledge, a substantial data gap remains to be filled.  

The nature of corporate disclosure requirements in Canada significantly reduces the quantity of information available to the public. The most serious problem with respect to the issue of foreign ownership and control, is the extent to which foreign-owned firms are relieved of the necessity of public disclosure by virtue of their status as private companies.  

In the nature of the case, that is, the failure of private companies regardless of size to disclose, it is impossible to determine precisely even the number of large private companies in Canada.  

Far too little is known in Canada about the operations of large corporations, both Canadian-owned and foreign-owned, which often dominate the industries in which they operate. Without adequate information, it is difficult to formulate policy. One of the most insidious forms of monopoly power is the monopoly of knowledge. The privileges that accrue from incorporation must be matched by obligations to disclose fully and widely to the variety of interests on whom the activities of corporations impinge. 24

The blame for this state of affairs must properly be put at the door of Canadian government for not insisting on public disclosure. 25

Information for purposes of public disclosure is grossly inadequate and the federal government should leave no stone unturned to rectify this situation. 26

Recommendations

Based on the characteristics of Effective Competition, the following specific recommendations on disclosures are made, with respect to corporations operating in Canada.

1. Which type of corporations should disclose? Under the present Canadian Company Law, only those corporations offering shares to the public are required to submit Annual Financial Statements to the Registrar General. As about 60 per cent of the largest Canadian companies are private in that they do not offer their shares to the public, they are exempt from disclosing

24 Ibid, pp. 356-357.
26 Ibid, p. 185.
their financial affairs to anyone but their share-
holders, and tax authorities.

The informational requirements of Effective
Competition necessitate disclosures to the public by
all the corporations. The consumption, productive
and investment activities of persons and firms are
dependent on what is happening in the market. As
the movement of price is no longer a sufficient
indicator of the state of supply and demand in the
market, a host of other types of information is
required by consumers, producers and investors.

Disclosure by all corporations will also
provide a better basis for the use of anti-trust and
other regulatory devices to gear the economy to the
desired ends. Under the 1967 Companies Act of the
United Kingdom, all corporations with minor ex-
ceptions are required to disclose certain types of
financial information to the public by filing this
information annually in the Companies Registry.27
The Watkins Report recommends changes in the Canadian
law to require all corporations to disclose certain
financial information to the public by filing with the Registrar General.

27 See J. F. Flower, ACA "Accounting in Britain
and the New Companies Act." Canadian Chartered Accoun-
tant Vol. 92 No. 2 February 1968, p. 113.
also Lord Jenkins and others, Report of
the Company Law Committee, Cmnd. 1749, 1962, pp. 94-98,
141-147, 351-352.
The protection of the public, and the ability of individual members thereof to make informed decisions in their dealings with corporations, required disclosure to the public, and not simply to shareholders, of basic financial information about individual firms.\(^28\)

In principle, disclosure should be gotten from private companies under company law without issue of shares to the public, that is, there could be "disclosing" private companies.\(^29\)

2. To Whom Should Corporations Disclose? Under the present Canadian law, exempt private companies are required under contractual obligation to disclose to their shareholders. Those public companies offering shares to the public are required by law to issue a prospectus and to file annual accounts with the Registrar General.

To promote effective competition in the economy, it is essential that certain 'strategic' information should be made available to all the participants in the economy, and not just the shareholders. It is recognized that this disclosure to the public may result in the management or auditors of corporations being made liable in law for damages resulting from misrepresentation in such information.\(^30\)


\(^{29}\) Ibid, p. 176.

This problem can be partly solved by requiring the corporations to submit certain strategic information to the Registrar General, who in turn makes it available for public inspection without guaranteeing its accuracy.  

3. 'Strategic' Information: Based on the normative model of Effective Competition, the following types of corporate information are considered 'strategic' for the attainment of national objectives. The list is not exhaustive, and may be altered once more information is available about the relationship of the structure of the economy to the performance of the corporations functioning within the economy:

a) Income Statement: The Income Statement of a corporation is used by the present and prospective shareholders, long-term creditors, employees and general public to project the profitability of the corporation. It is also used as an indicator of how efficiently the management of the corporation is utilizing the resources under its control. Comparisons are made between firms in the same industry and between industries.

Any meaningful comparison requires segregating current income from past income and using similar bases for valuation of assets. At present, firms

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32 The word "strategic" is purposely used to emphasize a plan of action designed to fulfill
use many types of methods of valuing inventory.
Assets are usually recorded at cost (less depreciation) and the 'cost of sales' contains a part which is based on this historical cost valuation of assets. It is now recognized by the American Accounting Association that this method of valuation is unsatisfactory. 33

To provide meaningful comparisons of the profitability of different firms in the industry, 'operational' income should be segregated from 'holding' gain. 34 Valuation based on historical cost should not be used to compare the profitability of two firms. The author prefers the incorporation of 'business profit' as defined by Edwards and Bell. 35

b) **Balance Sheet:** The Balance Sheet is 'a statement of financial position of any economic unit, disclosing as at a given moment of time its assets, at cost, depreciated cost, or other indicated value, its liabilities, and its ownership.' 36 The original purpose behind the preparation of the Balance Sheet was to show the 'Net Worth' of the firm. Under the present national objectives through the normative model of Effective Competition. For definition, see Webster's Third New International Dictionary, p. 2256.

36 Kohler, *op. cit.*, p. 53.
system of recording assets at acquisition costs less depreciation, the Balance Sheet no longer reflects what is the present 'worth' of the firm; it has therefore been relegated to a secondary place while assessing the profitability of a firm. 37 This is unfortunate as the Balance Sheet, in a modified form, can prove a useful document to be used in conjunction with say the Income Statement and the Flow of Funds Statement to assess the efficiency and profitability of a firm. There is at present no agreement as to what basis of valuation should be used in place of, or in addition to, 'historical cost'. But the modern trend is to use the 'Market Value' basis, 38 and the author agrees with it.

The chief features of the recent trend are (1) the much stronger emphasis put upon market or replacement values, and, in connection with this, (2) the articulate distinction between gains derived from holding assets, on one side, and from operating profits on the other. The subordination of the cost basis in favour of the assigning of current values results from a shift in the objective of accounting, a shift away from the custodial aspect of documentable evidence toward the goal of facilitating managerial decisions as well as decisions about managers. One has become painfully aware that while traditional accounting has always stressed pure custodial control it neglects too much

37 See W. Paton and A. Littleton, An Introduction to Corporate Accounting Standards (Iowa City: American Accounting Association, 1940).


the control of efficiency. This becomes most obvious if we remind the reader that the income statement shows only how large or how small the profit (or loss) is, but fails to indicate what the profit could have been if certain investments or dis-investments (e.g., decrease of inventory), certain more realistic policies, or more efficient management had been chosen. Obviously, such an indicator can hardly be attained by switching from the cost to the current value basis. But a shift towards market values is a first step in the direction of an accounting for "decision-making" purposes; it leads to a closer connection between the "is" of the balance sheet and income statement and the "ought to be" of the budgeting system. It enables accounting to provide information for evaluating actions of the past to the benefit of the future.39

c) **Statement of Retained Earnings:** This reflects the accumulated net income, less distributions to shareholders and transfers to paid-in capital accounts. It is the amount of profit ploughed back into the firm.

Under present Canadian Company Law, corporations offering shares to the public are required to submit a statement of retained earnings to all the stockholders. As this information is useful to assess the 'net worth' of a firm, it is recommended that all corporations should disclose the information about retained earnings, showing clearly what amount has been appropriated.

d) **Statement of Financial Activities:** The Statement

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of Financial Activities, commonly referred to as the Statement of Source and Application of Funds, is "a condensed report of how the activities of the business have been financed, and how the financial resources have been used, during the period covered by the Statement. It shows more clearly than the Income Statement, from what sources the firm receives cash and how this cash is used by the firm by way of dividends or plant expansion. Many ordinary shareholders cannot comprehend why the firm is short of cash for payment of dividends even if it has earned substantial net profits; conversely, how can a firm commit such large amounts in plant expansion or takeover of other companies at a time when it has not made large profits? The Statement of Financial Activities is designed to answer these questions by segregating 'accrued' profits from actual receipts and disbursements of cash. Although not required by law to be submitted to stockholders, there is a steady increase in the number of firms that provide this statement to its stockholders as part of published accounts. It is being widely used by financial analysts and others to project the future growth of firms.

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It is recommended that all corporations should be required to disclose this statement.

e) **Key Financial Ratios:** Financial analysts and prospective investors have used some key financial ratios to judge the profitability of a firm, or an industry. These ratios are also of vital importance to a firm investigating whether to enter a particular industry. The key financial ratios commonly used are:

- **Profitability Ratios:**
  - Return on Shareholders' equity.
  - Return on operating assets.
  - Turnover of operating assets.
  - Operating contribution margin.
  - Fixed costs to sales.

- **Risk Ratios:**
  - Working capital ratio.
  - Non current liabilities to total assets.
  - Shareholders' equity to total assets.

- **Other Ratios:**
  - Net income per common share.
  - Book value per common share.

Once these ratios are available over a period of years, this information can be used by different parties in the economy to make the factors under their control more productive by diverting them to those areas in which the return is expected to be the highest.

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Such a move is bound to make the economy more competitive.

f) **Separate Information by Products or Departments:** Modern corporations are increasingly diversifying their activities into non-related products or businesses. This diversification is made either to spread the risks or to avoid the risk of anti-trust or anti-merger suits. It is no longer unusual to find diversification such as an electronics company engaged in tourist development projects,\(^{43}\) or a railway company engaged in real estate business.\(^{44}\)

Under the present accounting regulations, a corporation is not required to prepare separate financial statements for each of its products or departments. A consolidated financial statement is frequently prepared in which all the activities under the umbrella of the corporation are merged together showing, among other items, the 'Net Income' for the entire operation. This information is practically meaningless to a person assessing the prospects of entering a particular product market.

It is recommended that all corporations should be required to provide information on costs


\(^{44}\) See the Prospectus of Canadian Pacific Investments Ltd., Sept. 1967.
and profits by products or departments. It is realized that this will require concise definitions to be agreed for 'product' and 'department', and will entail extra work by corporate accountants. However, the information supplied on a product or departmental basis can act as a spur to new investments in profitable industries, thus generating competitive forces in the market.

Under the United Kingdom Companies Act, 1967, all companies are required to provide turnover figures by 'classes of business', but the term is not defined in the Act.

g) **Turnover**: The importance of information on the turnover of a corporation was emphasized in the last chapter.46

Every corporation should be required to disclose to the public information on monetary turnover by product or department.

h) **Advertising and personal selling expenditures**: The advertising industry in the United States and Canada is one of the fastest growing industries. Between 1939 and 1966, total advertising expenditures in the


46 See pp. 68-69.

47 Advertising is defined to include expenditures in recognized media (radio, newspapers, magazines, television, out-door advertising, and direct mail).
United States increased from $2 billion to $16.5 billion, or by about 725 per cent. During the same period, personal consumption expenditures increased from $67 billion to $465 billion, or by about 600 per cent. Advertising expenditures constitute about 3.56 per cent of total consumer spending. 48

The large and increasing outlay in advertising by large corporations has been the subject of controversy among politicians, economists and businessmen. Economists generally argue that advertising, as practiced today, does not promote additional sales and is therefore 'wasteful'. They also argue that advertising is a potent aid used by large corporations to discourage entry by new firms in the market.

1. Advertising can make products appear different enough from those of a competitor that consumers will buy the advertised product in preference to the non-advertised one; the advertiser can therefore capture substantial market shares.

2. Large companies have available more resources to devote to consumer advertising and promotion than do smaller ones.

3. Small companies without funds for substantial budgets will hesitate to enter heavily advertised fields.

4. Advertising thus becomes a barrier to entry into national markets by new small business firms; economic concentration results.

5. The large companies in the market, not faced by prospects of new competition can

point of purchase materials, transportation advertising, the cost of corporate advertising departments and some miscellaneous items.

charge higher prices than otherwise, both
to recover promotion costs and to earn
monopoly profits.49

Some economists have argued that advertising
increases the unit cost of production which the con­
sumer has to pay. Therefore, a specific tax on adver­
tising expenditure should be imposed.

First, a substantial tax on advertisement. Of course, much advertisement of an informative
nature is necessary and desirable. But much
advertisement is not of the kind. A tax on
advertising would increase the incentive for
firms to seek markets by cutting prices and
costs rather than by persuasive bamboozlement.50

Based on the belief that the high level of
advertising in the detergent industry of the United
Kingdom was 'socially undesirable', the Monopolies
Commission in 1967 asked an immediate 40 per cent
across-the-board reduction in detergent promotion
expenditures, coupled with a 20 per cent reduction
in detergent prices.

The movement in the United States is towards
some control on advertising expenditures. Relying on
an unpublished study made in 1966 by W. S. Comanor and
T. A. Thomas,51 which showed 'monopoly' profits earned
by the six industries that spent more than 6 per cent

49 Alex Graner, A Report Prepared for the
Association of National Advertisers.
50 See Meade, op. cit., p. 389.
51 William S. Comanor and Thomas A. Wilson,
"Market Structure, Advertising and Market Performance"
an unpublished study, Harvard University, 1966.
of sales on advertising, Donald Turner, head of the Department of Justice Anti-trust Division made the following proposals on advertising expenditures:

1. Prohibit or "drastically limit" discounts granted, for purchases of network television time, even if this means higher network profit margins for large purchasers than for small.

2. If mergers are permitted to take advantage of substantial economies of scale, the defense of those mergers should not extend to promotional economies.

3. Impose for a period of time an absolute or percentage limitation on promotional expenditures by a firm or firms that have obtained market power through violations of the Sherman Act ... even though the promotional expenditures as such were and are lawful.

4. Expand the law on false and misleading advertising to deal with the omission of information as in an example cited where a noiseless appliance may 'use considerably more electricity and wears out faster than rival models'.

5. Provide new sources of consumer information, either with governmental efforts in the direction of the Consumer Reports type of activities or financial support for private organizations of this type.

In 1967, Turner's proposals were applied by the Federal Trade Commission in an action against Proctor & Gamble to divest itself of Folger's Coffee.


53 Ibid, p. 91.
However, not all economists are of the opinion that advertising creates economic concentration.

... the barrier to entry created by large financial requirements for advertising is weak. The relationship between advertising intensity and high economic concentration is non-existent. There appears to be no link between advertising intensity and price increases. Intensive advertisers appear to have moderately higher profit rates than other companies. The record shows clearly that advertising is highly competitive, not anti-competitive. 54

Economists hold such divergent views about the relationship of advertising to competition, partly because sufficient information is not divulged by corporations to correlate advertising with indicators of Effective Competition. It is submitted that separate information on advertising and personal selling, given by all corporations, can prove of immense value to economists and others in their studies on the relationship between say advertising and monopoly profits, advertising and economic concentration, and advertising and unit cost of production. Such information on advertising can be used to formulate public policy towards advertising expenditures incurred by corporations.

1. Research and Development Expenditures: Research and Development is an area of corporate activity which has grown very fast, especially since the Second World War. In 1962, the United States incurred about $17.5 billion on Research and Development, of which nearly $6 billion was undertaken by corporations. The total expenditure on Research and Development was about three times the total expenditure in 1953. In 1962, the per capita expenditure on Research and Development was $93.7 in the United States, $33.5 in the United Kingdom, $20.3 in the Netherlands, $23.6 in France, $20.1 in Germany and $14.8 in Belgium.55

It is generally recognized that the comparatively larger expenditure on Research and Development incurred by the United States has been an important factor in the rapid economic growth of the country. To achieve the national objectives of a higher standard of living and economic growth, public policy should ensure that technological innovation is continuously undertaken. In those areas where corporations are not innovative, the government should step in and undertake basic research. The decision regarding the areas requiring additional research by the government, may be left with a body such as the Economic Council of Canada.

This action on the part of the government requires information on the amount spent by corporations on Research and Development and the areas in which corporations are carrying out these activities. Therefore, corporations should disclose the amounts spent on Research and Development and the areas in which the amount was spent. It is submitted that disclosure of such information to the public at large may make the public realize the importance of corporations and may encourage these corporations to spend the amount more wisely, in the direction of basic research.

j. **Statistics on Employees and Their Remuneration:**

Employees form an important part of a corporation. Their livelihood often depends on how the corporation is functioning. They should be informed of the proportion each of the factors of production receives from the total corporate revenue.

Further, the trend in the employment rate is an important indicator of the growth or contraction of the economy. All the actors in the economy are interested to know whether there is a net increase in employment by corporations, who are the biggest private employers of workers.

k. **Interlocking Shareholding and Directorships:**

Effective Competition requires that competing corporations act independently of one another. This in-
dependence of action can be promoted by preventing collusion between competing corporations through interlocking shareholdings and directorships. This requires information on the persons or corporations who, in reality, own the shares of the corporation. This information is not often available as shares are purchased in the names of nominees. For example, the public in Britain was shocked when it was discovered that the Imperial Tobacco Company had for many years secretly owned 36 per cent of the equity of Gallaghers, its principal competitor.56

Under the 1967 U. K. Act, a corporation must give full details of its shareholdings in companies in which it owns more than 10 per cent of the equity; in addition, it must disclose the names of persons who own more than one-tenth of its own equity. Such a disclosure to the public is likely to discourage collusion among competitors, thus furthering competition. It is submitted that the public should also be informed whether any person is holding Directorships or other advisory posts in competing corporations.

1. Patents: Anti-competitive conditions are sometimes brought about either by not using a patent, and at the same time preventing others from using it, or by ex-

changing patents with competitors.

To discourage the abuse of monopoly powers granted by patents, disclosure should be made of those patents which have not been used for say two years. The public should also be informed of those patents which have been exchanged, giving the reasons for such exchange.

m. Non-business Contributions and Investments: It is common knowledge that large corporations have contributed fairly large sums to those organizations and political parties who have generally tended to further the interests of corporations in general and contributing corporations in particular. In the United Kingdom, corporations have been large contributors to the Conservative Party political campaigns. Under the present system, Directors are not required to seek permission from shareholders for such political contributions.

Many politicians and economists fear that corporations may abuse this power by contributing to those organizations who further the interest of such corporations by not seeking legislation to break up their monopoly powers. It is submitted that all corporations should be required to disclose to the public details of such non-business contributions and investments made by corporations. Under the new Act, all the companies in the United Kingdom are required to disclose such information.
n. Expectations and Plans of Corporations: The various actors in the economy are not only concerned with the past performance of corporations, but are interested to know what are their plans for the future. Many of the corporations are reluctant to disclose their plans or forecasts for the future on the grounds that:

1) These plans or forecasts, based on a host of assumptions about the future, are necessarily tentative and subjective. Disclosure of such information may give a false air of certainty to the existing and potential shareholder.

2) The disclosure of such plans or forecasts may jeopardize the competitiveness of the corporation, in relation to others.

3) The disclosure of such subjective information may make the corporation liable for damages incurred by an outsider who relied on such information to his detriment.\(^57\)

While no specific recommendation is being made on this point, every effort should be made to encourage corporations to disclose their plans and forecasts, at least for a period of one year. Some corporations are disclosing such information, and the number is on the increase.\(^58\)

\(^{57}\) A. M. Lewis, op. cit., pp. 177-180.

Methods of Disclosure: At present, the principal method of corporate disclosure used by public companies, is the Annual Report which normally contains the Income Statement, the Balance Sheet, the Statement of Retained Earnings, the Auditor's Report, the Directors' Report and often the Chairman's Report. The additional information recommended in the study should be incorporated in the Annual Report.

The present 'non-disclosing' corporation should be required to file all the recommended information with the Registrar General, at least once in twelve months.

Summary:

The principal points in the chapter are as follows:

1. The change in the role of the corporation has led to considerable discussion about its place in the social, political, economic and legal framework of the United States and Canada.'

2. Accountants, political theorists and economists give different interpretations to the role of the corporation in society. This is reflected in their differences in views about the type and extent of disclosure desired from the corporation.

3. Based on the informational requirements of Effective Competition, specific recommendations on disclosure are made, with respect to corporations operating in Canada.
CHAPTER VI

SUMMARY OF THE MAIN FINDINGS OF THE STUDY

Modern corporations in the United States and Canada perform a large and growing proportion of economic activities. They are by far the largest private employers of workers, the biggest investors and the predominant instrument of production. They are rapidly growing in size, and are expanding their operations in unrelated activities. A major proportion of financing of expansion programmes is obtained from large funds internally generated by these corporations. Thus, modern corporations have become virtually independent of their shareholders for financing of major operations.

Most of the large corporations are managed by professional executives who have little, if any, stake in the risk capital. They normally arrange for appointments of persons on the board of directors who will be sympathetic to their actions. The shareholders, who are legally presumed to exercise control over the powers and actions of corporate executives, are normally too numerous and scattered to be in a position to have a significant influence on the policies of the corporations.
The drastic change in the role of the corporations has led to considerable discussion about the place of the corporations in the social, political, economic and legal framework of the United States and Canada. More specifically, the argument centres around the legitimacy of corporate power and the accountability of corporations for their actions which affect others such as consumers, workers, suppliers, and the public. As part of this general accountability is the question of disclosure of information by corporations.

There is no consensus of opinion on the type and extent of corporate disclosure desired because different parties look at the problem from diverse angles. Accountants and businessmen generally take a 'legalistic' view of corporate disclosure, conveying a certain set of information to the persons under contractual or legal relationships, which stipulate disclosure of this set of information. Their view is partly based on the premise that disclosure of additional information to the stipulated persons, and of corporate information to the persons not at present receiving such information under contract or law, should be based mainly on the cost-benefit relationship to the firm required to disclose such information. Political theorists generally tend to look at the question of corporate disclosure as a part of the overall question of legitimacy of corporate
power. They argue that the exercise of power can only be legitimate if it is representative. As the powers of corporate executives are not representative, they should be required to disclose to the public activities of the corporations which they manage. Based on the disclosure of corporate information, corrective actions can be taken by the appropriate government agencies. Economists generally agree with the arguments for corporate disclosure put forward by political theorists, but base their case on the economic implications of large corporations. They argue that large corporations can, and do, influence the external market forces that are presumed to regulate corporate power. Therefore, additional forces should be injected into the economy to achieve the national objectives. The nature of these additional regulatory forces can be determined by some knowledge about the activities of corporations, which can be gained through corporate disclosure.

An attempt is made in this study to examine whether the characteristics of 'Effective Competition' can provide criteria for the type and extent of disclosure to be made by corporations. Published literature on the subject of competition by leading American and Canadian economists and lawyers is reviewed to determine whether a normative model of Effective Competition can be devised. As the model is a normative one, it is based on value judgements about the objec-
tives that it is meant to accomplish. The national 
economic objectives of the United States and Canada 
are discussed and used as a framework within which 
the normative model was devised. Difficulties have 
been experienced in defining Effective Competition 
in a few sentences. However, the lines of demarca-
tion are drawn by discussing in detail those charac-
teristics in the economy which prevail under the nor-
mative model of Effective Competition.

It is recognized that the characteristics 
of Effective Competition are not self-generating and 
self-regulating but have to be created and preserved. 
These characteristics are the reflections of various 
actors in the economy, namely consumers, employers, 
workers, creditors, investors, government-run cor-
porations, foreign firms dealing with the United 
States and Canada, and government agencies whose ac-
tions directly affect the positions of other actors 
in the economy. The actors take decisions on the 
basis of information they receive about the state of 
the economy in general and the activities of other 
actors in particular. The type of information re-
quired by each of the actors is reviewed.

Based on the review of the informational re-
quirements of the actors, specific recommendations are 
made in respect of corporations operating in Canada, 
about the type and extent of disclosure that is con-
sistent with the normative model of Effective Com-
petition. The study recommends that all corporations - whether offering shares to the public or not - should disclose the following types of 'strategic' information to the public.

a. Income Statement - on market value basis  
b. Balance Sheet  
c. Statement of Retained Earnings  
d. Statement of Financial Activities  
e. Key Financial Ratios  
f. Separate Information by Products or Departments  
g. Turnover  
h. Advertising and Personal Selling Expenditures  
i. Research and Development Expenditures  
j. Statistics on Employees and Their Remuneration  
k. Interlocking Shareholdings and Directorships  
l. Patents  
m. Non-business Contributions and Investments  

The study does not go into methods of disclosure of such strategic information. Recognizing that corporations in Canada are subject to different laws, depending on the province of their incorporation, the instruments of achieving recommended corporate disclosure may form a subject of further research.  

It is realized that the specific recommendations about corporate disclosure made in this study, go far beyond what is considered as 'adequate' disclosure by accountants and businessmen. They will
question the desirability of requiring corporations to disclose such information, and the costs involved in such disclosure.

It is submitted that the people of the United States and Canada will receive greater benefits under the system of Effective Competition. The normative model requires disclosure of the recommended sets of information from corporations who play an active part in the economic development of these countries. Those persons who do not wish to disclose such information are not forced to do so, because the acquiring of corporate status is not compulsory. However, those who wish to take advantage of corporate status should be required to pay a price for it, partly by way of corporate disclosure.
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