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I. INTRODUCTION

In its most recent budget released on February 11, 2014, the Government of Canada announced its intent to introduce new legislation guarding against what it terms "unjustified cross-border price discrimination" resulting from "country pricing strategies—that is, when companies use their market power to charge higher prices in Canada that are not reflective of legitimate higher costs."[2] Some evidence exists that Canadians pay more than Americans for identical goods: recent estimates from various sources of the Canada-U.S. price gap range from 10 to 25 percent, after adjusting for sales tax differentials.[3]

In this article, we discuss the potential economic factors driving such price differentials, and provide our views, as economists, on the implications of this proposed amendment to the *Competition Act* on consumers and on the Canadian economy.[4]

II. WHAT IS PRICE DISCRIMINATION?

Price discrimination is a term used by economists to describe a firm's practice of charging different prices to customers for the same good or service. Airline tickets for a given flight are a commonly cited example, whereby the prices paid by different passengers typically vary widely, depending mainly on when a ticket was purchased and for what fare class. Other examples occur in homogeneous goods industries with high relative transportation costs and economies of scale, such as cement or fertilizer. In such industries, firms generally compete on the delivered price to each customer, so customers located close to the factory will pay more for the good net of transportation costs than customers located farther away with more alternative sources of supply. This form of price discrimination, despite being frequently perceived as proof of the firm in question unjustly exercising market power, can in fact be a more competitive and more efficient market outcome than if all customers were charged the same net price.

The potential efficiency of price discrimination and the possibility that it does not constitute evidence of anticompetitive behaviour were previously recognized by the Canadian

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[2] Minister of Finance of the Government of Canada, "The Road to Balance: Creating Jobs and Opportunities," February *11, 2014 (*henceforth referred to as the "Federal Budget"*).*

[3] *Id.*, Chart 3.4.1 at 181.

[4] We note that it is not clear from the Federal Budget whether this proposed legislation would be applied only to price discrimination between Canada and the United States. For simplicity, we focus on the Canada-U.S. price differential in this article.

Government when it repealed the criminal pricing provisions concerning price discrimination in its 2009 amendments to the *Competition Act*. In addition, the view that higher prices in Canada relative to the United States are not necessarily indicative of a lack of competition was echoed by the Canadian Competition Bureau in a recent report by the Standing Senate Committee on National Finance entitled "The Canada-USA Price Gap."[5] This same report notes that officials from the Competition Bureau said that "the Competition Bureau is not a price regulator and that Canadian businesses are free to set their own prices at whatever levels the market will bear, provided that these high prices are not the result of anti-competitive conduct such as price-fixing or abuse of a dominant position."[6]

Current provisions in the *Competition Act* already address issues of excessive market power from explicit coordination and abuse of dominance. The Canadian Government's proposed new legislation is thus fundamentally at odds with the Competition Bureau's past positions, as well as with developments in competition laws in other jurisdictions.[7]

III. POSSIBLE CAUSES OF CROSS-BORDER PRICE DIFFERENTIALS

Aside from border costs, which are the traditional transaction costs associated with selling goods across borders (*e.g.*, import tariffs), there are two types of non-border costs that can lead to cross-border price differentials: local transaction costs and differences in local market conditions. The latter include factors such as dissimilarities in supply conditions like the availability of substitute products.

We are not aware of any research that has pinpointed a single explanation for the differential in average prices of retail goods between Canada and the United States. Some of the key reasons that have been identified as contributing to the Canada-U.S. price gap—and are explained in more detail below—are: exchange rates, population and demographics, operating costs, and country pricing strategies.

A. Exchange Rates

In a recent article published in the *American Economic Review*, the premier journal in economics, its authors find that differences in prices between Canada and the United States for identical goods sold at retail outlets operated by the same grocery store chain could in part be explained by exchange rate differentials. Specifically, their research found that average prices (and costs) in Canada were comparably higher than those in the United States in 2007, after the appreciation of the Canadian dollar relative to 2004.[8]

This result would seem counter-intuitive, as a higher relative value of the Canadian dollar could be expected to bring Canadian prices closer to U.S. prices once adjusted for the exchange rate, not farther away. Moreover, as the Canadian dollar continued to appreciate toward parity with the American greenback, the number of Canadian shoppers travelling across the border

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[5] Senate Canada, "The Canada-USA Price Gap: Report of the Standing Senate Committee on National Finance," February 2013 (henceforth referred to as the "Senate Committee Report"), p. 56.

[6] *Id.* at 56.

[7] COMPETITION BUREAU CANADA, A GUIDE TO AMENDMENTS TO THE COMPETITION ACT (April 22, 2009).

[8] G. Gopinath, et al., *International Prices, Costs, and Markup Differences*, 101(6) AMER. ECON. REV. Fig. 3 and p. 2458 (October 2011).

increased.[9] This increase in cross-border shopping could be expected to put downward pressure on prices in Canada. But recent measures of the Canada-U.S. price gap indicate that parity between the Canadian and American dollars did not lead to price equalization, at least on average and for some categories of goods.[10]

The recent changes in the value of the Canadian/U.S. dollar exchange rate have been accompanied by greater volatility in exchange rate fluctuations. This creates added uncertainty and could therefore explain part of the price gap from the risk premium associated with this increased volatility. In other words, the uncertainty surrounding the future value of the Canadian dollar may lead companies to price their goods at a higher level in order to compensate them for the risk of losing money on imported products and the costs of frequently changing their prices to adjust to all exchange rate movements.

The risk with pricing in a fluctuating exchange rate environment is especially relevant given the historical context, where the value of the Canadian dollar was substantially lower than its U.S. counterpart in the not-so-distant past. Thus, manufacturers may be reluctant to price goods at equivalent values when the two dollars are at par, especially when there are non-negligible costs to changing prices (*e.g.*, prices printed on books), as there is substantial risk that such prices will imply a considerable discount in Canada when the value of the Canadian dollar depreciates. For example, over the period of about a year from the beginning of 2013 to the beginning of 2014, the Canadian dollar fell from approximately par to below U.S. $0.90, implying a 10 percent discount on any prices that are listed as equivalent in Canadian and U.S. dollars.[11] Changes in the exchange rate and exchange rate volatility may therefore explain at least some of the Canada-U.S. price gap.

B. Population and Demographics

Customers that buy in larger quantities generally benefit from lower per unit prices, a concept known in economics as buyer power. Given that the population of Canada is approximately one-tenth of the population of the United States, the relative size of the Canadian market may contribute to lower levels of competition and explain at least part of the Canada-U.S. price gap.[12] For imported goods, it could be expected that per unit prices are higher in Canada as compared with the United States due to smaller volumes being purchased from foreign manufacturers. For domestically produced goods, perhaps American manufacturers are better able to profit from economies of scale and cost efficiencies due to the larger pool of proximate buyers at their disposal.

Other than differences in the size of each market, there are a number of differences in the characteristics of the population. In particular, as compared to the United States, Canada has, among others, (i) substantially more foreign-born people, (ii) lower personal disposable income per capita, (iii) lower per capita retail spending, (iv) a relatively older population, and (v) a

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[9] *See* Figure 3 of the Senate Committee Report, *supra* note 5.

[10] *Id.*, Ch. 4, *supra* note 5.

[11] Bank of Canada, Noon Exchange Rates, *available at* http://www.bankofcanada.ca/rates/exchange/ (accessed March 9, 2014).

[12] World Bank, Population by Country, 2012*, available at* http://data.worldbank.org/indicator/SP.POP.TOTL (accessed March 9, 2014).

greater percentage of the population living in the country's largest cities.[13] These distinctions may contribute to differences in demand for certain products.

The differences in demand may also manifest themselves through dissimilarities between versions of a given type of product to cater to consumer preferences in the given market, such that many products may not be considered "the same."[14] Such differences in population, demographics and versions of a given product type may thus be factors in explaining the Canada-U.S. price gap.

C. Operating Costs

Although the Canadian Government has not yet provided details on the framework it is proposing to introduce,[15] it appears as though firms would be required to justify charging higher prices in Canada than in the United States on the basis of their operating costs.[16] Higher taxes, higher labor costs (potentially resulting from higher minimum wages), and the higher cost of distribution (distances between major population centers are generally larger in Canada and the price of fuel is substantially higher) are a few factors that are likely to provide some basis for firms' higher operating costs in Canada.

However, some costs likely stem from differences that cannot be easily quantified, such as cross-country productivity differences. More fundamentally, prices need not be directly tied to operating costs in a market that is not perfectly competitive, but this does not imply that firms are behaving anticompetitively. Such differences in local transaction costs are likely to explain at least part of the Canada-U.S. price gap.

D. Country Pricing Strategies

Certain factors prevent price arbitrage by consumers and retailers who would purchase cheaper goods in one market to resell them in another market. Such market segmentation factors include differences in commercial practices, corporate agreements requiring that retail stores purchase only from own-country distributors (*i.e.*, supply chain segmentation), and government regulations (*e.g.*, safety standards and language labelling requirements). As a result of market segmentation, profit-maximizing firms may be able to price discriminate by selling products at different prices in different markets in response to differences in supply and demand conditions across the segmented markets. Market segmentation factors may therefore inhibit prices from converging until price differentials can be eliminated.

This is the reason for the Canada-U.S. price gap that is being targeted by the Canadian Government in its proposed amendment to the *Competition Act*. However, the government appears only to be addressing goods for which prices are *higher* in Canada relative to the United

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[13] Statistics Canada, Canadian Demographics at a Glance, 2008, Catalogue no. 91-003-X; TD Economics, "Comparing and Contrasting Canadian and American Consumers – Some Stylized Facts," December 18, 2013; OECD.

[14] Indeed, Gopinath and co-authors found a very small percentage of all products offered across the grocery store chain were sold both in Canada and the United States, where identical products were matched on the basis of unique product (UPC) codes. Gopinath, et al., *supra* note 8 at 2455.

[15] As noted in the Federal Budget, "details will be announced in the coming months." *Supra* note 2 at 182.

[16] *Id.* at 182.

States. But some goods' prices may indeed be *lower* in Canada as a result of firms' pricing-to-market strategies. For example, although most cars' list prices are higher in Canada, including for vehicles manufactured in Canada, some cars are listed at lower prices.[17, 18]

The fact that price differentials are lower or even reversed for certain products or product types is likely due to differences in supply and demand across the two markets, which affects the prices that firms can charge in that given market. Indeed, competition for the sale of compact and subcompact vehicles, which are in higher demand in Canada relative to the United States, has kept relative price differentials for these types of cars lower as compared with luxury vehicles.[19]

In the same *American Economic Review* article mentioned above, the authors found that the price gap they detected was due to wholesale price differences, not differences in retail markups or non-traded retail costs.[20] This finding of pricing-to-market at the wholesale level is consistent with what the Retail Counsel of Canada reported to the Standing Senate Committee on National Finance, namely that the majority of products sold by Canadian retailers are purchased in Canadian dollars through Canadian wholesalers, distributors, and multinationals with subsidiaries in Canada—thus retailers were not to blame for the lack of adjustment of retail prices to the exchange rate.[21] Higher wholesale prices (and, consequently, higher retail prices) may in part result from import tariffs, which the Canadian Government is currently exploring through a program to provide tariff relief on certain categories of consumer goods.[22]

Another market segmentation factor that inhibits arbitrage, and therefore cross-border price convergence, is the *de minimis* threshold on the value of goods that can be shipped into Canada without being subject to import duties or taxes. This threshold is currently set at $20 in Canada, but other countries have substantially higher thresholds. For example, the United States' threshold is U.S. $200.[23]

The lower *de minimis* threshold in Canada may reduce competition and may also increase costs for companies that import low value input components, thereby contributing to the Canada-U.S. price gap. Similarly, an increase in the allowable exemption limits for travellers, including allowing an exemption for travel under 24 hours, may also contribute to reducing the Canada-U.S. price gap by enhancing competition.

IV. CONCLUSION

In sum, companies will charge whatever prices the market will bear, which is likely not reflective of anticompetitive behavior on their part as the highest possible price a firm can charge will be reflective of the level of competition in the market. If there are relatively few substitutes for a good and buyers are not very sensitive to the price, then manufacturers can sell at relatively

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17 Senate Committee Report, *supra* note 5 at 33-35.

18 Car prices in 2002, when the Canadian dollar was only worth about U.S. $0.64, were *lower*, after adjusting for exchange rate differentials. (*Id.* at 38.)

19 *Id.* at 39.

20 Gopinath et al., *supra* note 8 at 2475.

21 Senate Committee Report, *supra* note 5 at 8.

22 Federal Budget, *supra* note 2 at 182; Senate Committee Report, *supra* note 5 at 13-19.

23 Senate Committee Report, *supra* note 5 at 28.

higher prices. This is not against the current *Competition Act*. Most firms operate in markets that are not perfectly competitive, as perfect competition is rare, thus some degree of market power should not be a concern. Furthermore, increases in internet purchases and awareness of cross-border prices from web-based price comparisons will likely lead to enhanced price competition, thereby decreasing the Canada-U.S. price gap for many identical consumer goods.

Finally, the implications of the Canadian Government's new proposed legislation may not have the intended benefit on Canadian consumers. This legislation would entail an additional burden on companies operating in Canada or selling into the Canadian market, where firms may be required to provide details of a complex price and cost analysis, which could ultimately have the undesired effect of further reducing competition by driving out (or failing to attract) competitors.[24]

Indeed, the "insufficient competition in the retail market" that was noted as being one potential factor for the Canada-U.S. price gap in the Federal Budget may be further exacerbated by the Government's latest proposed amendment to the *Competition Act*.[25] Particularly since the bulk of the Canadian population lives in close proximity to the American border, the simplest way to decrease the Canada-U.S. price gap for identical consumer goods would be to allow consumers to freely purchase goods in the United States without any exemption limits, thereby requiring prices in Canada to gravitate toward those across the border in response to competition. But this would likely not have a favorable impact on Canadian businesses, and would not address perhaps more fundamental issues driving the price gap, such as productivity differentials. Thus, the Canadian Government should carefully consider how its pro-consumer stance backed by this proposed legislation may adversely affect the Canadian economy as a whole.

[24] Such a price and cost analysis would likely be complex as it may require data over a sufficiently long period of time to explain how input costs purchased at a given price in one period affect output prices in another period, and how contracts may affect prices and costs.

[25] Federal Budget, *supra* note 2 at 181.