COMMENT AND ANALYSIS

RESALE PRICE MAINTENANCE UNDER REVIEW

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The treatment of price maintenance under the Competition Act reflects the social perception of this practice at the time the provisions were enacted. In the 1950s and 60s, it was widely believed that the suppression of price competition in retail markets, even within a single manufacturer's brand, was inherently harmful to consumer welfare. In the 1970s and 80s, this view has been challenged by academic commentators, who argue that the use of price maintenance within individual product distribution chains may in some cases be welfare enhancing. For the present, however, there seems to be no consensus in the Canadian and business legal communities on the need for reform of the price maintenance provisions.[1]

Introduction

Doubts about Canada's price maintenance law as it now stands were first publicly raised to a high level in Ottawa by the Royal Commission on the Economic Union and Development Prospects for Canada (MacDonald Commission). The Commission, after noting the conclusions of a staff study by G. Frank Mathewson and Ralph A. Winter[2] stated:

> While Commissioners are not in a position to reach any conclusion on this issue, we do recommend a review of the provision making it illegal in any circumstances to require compliance with resale prices. It might be determined that resale-price maintenance should be illegal only when its detrimental effects on competition demonstrably outweigh its benefits. Alternatively, resale-price maintenance could be made a matter for review by an administrative tribunal, just as exclusive dealing and tied selling are now reviewed by the Restrictive Trade Practices Commission.[3]

The Staff Study expressed support for the view that single manufacturers (i.e., not cartelized) should be free to choose the retailing environment that they consider to be the most efficient. The authors stated:

> We are sympathetic to this position and we carry the analysis a significant step further by considering five specific motivations for RPM by a single manufacturer, and for these, investigating formally the relationship between a manufacturer's willingness to trade off higher retail prices for great product information, quality or availability, and society's willingness to accept the same trade-off. Our general finding is that the private desire to effect such a trade-off through price restraints signals the social efficiency of RPM.
>
> We offer a rule-of-reason as an efficient candidate for policy on RPM in Canada: *RPM [resale-price maintenance] should be legal unless conclusive evidence is presented that the price floor supports a producer cartel or protects a cartel of established retailers against entry by more efficient (discount) retailers.*[4]

The purpose of this paper is to examine in lay terms the process that brought Mathewson and Winter to the conclusion that, absent cartelization, Resale Price Maintenance (RPM) is socially efficient when it is profitable for the supplier. The task is not easy. Essential parts of the authors' reasoning are in two mathematical models, the comprehension of which calls for familiarity with the esoteric discipline of formal welfare economics.

Differing Perspectives on RPM

Most disinterested experts prior to the 1960s regarded RPM as anticompetitive and contrary to the public interest. B.S. Yamey[5], perhaps the foremost economist in the field, based his case against RPM on a number of grounds. One of his concerns was that, by widening retail margins, it attracts more scarce resources into distribution. It obstructs the competitive prices whereby interfirm differences in costs and efficiency lead to the elimination of the least efficient retailers "and to the availability of a range of competing offerings of different combinations of retail prices and services to meet the varied and varying preferences of consumers".[6] Another of his concerns was adverse effects on price competition among suppliers even when RPM is not linked to a supplier cartel. For example, a supplier imposing RPM may be inhibited from offering price concessions on his direct sales to consumers or users. Also, the unnatural stability of retail prices under RPM may have a similar effect on suppliers' wholesale prices; a supplier imposing RPM is less likely to respond to a fall in market share by cutting his wholesale prices.

Beginning in the 1960s, however, many but by no means all experts began to view RPM from different and more favourable perspectives.[7] Defenders of RPM had for many years credited RPM with the prevention of loss leader selling, which is among the defences against a charge or price maintenance in Canada. The new thinking concentrated upon other reasons why suppliers impose RPM in pursuit of more efficient distribution. In particular, RPM was credited with the prevention of "free riding" whereby consumers obtain information about a product at a full service outlet and then buy at a discount house not offering similar services. More generally, RPM was said to increase demand for a product because existing retail outlets increase their sales efforts and new outlets appear; consumers benefit from more readily available information and better service.

Those arguments in favour of RPM are by no means accepted by all experts. For example, F. M. Scherer and Robert Pitofsky in the United States and David McQueen, Paul Gorecki and William Stanbury in Canada are among those who have raised dissenting voices.[8]

The MacDonald Commission Staff Study

The MacDonald Commission Staff Study reviews recent literature on RPM, describes RPM laws in Canada and elsewhere, and analyzes RPM in practice as revealed by enforcement experience. Several motivations for RPM are discussed separately – the promotion of wider product availability, more point-of-sale product information and servicing, a generalized service motivation such as quality certification through the stature of the retailer, and a specialized service motivation such as the provision of refrigeration.

However, the feature of the Staff Study that lends apparent authority to the conclusions about the "social efficiency" of RPM consists of two abstract models. They are designed to show the effects on welfare of RPM imposed by a monopolistically competitive supplier under two different sets of conditions. One model incorporates the "availability" hypothesis; i.e., RPM to encourage wider distribution. The other one incorporates the "informational" hypothesis – RPM imposed by a supplier faced with free riding and inadequate provision of point-of-sale information about the product.

The reader is informed that the authors have worked out a proof in each case that under the conditions specified, when RPM is imposed profitably by the supplier acting independently, welfare is improved thereby.

Some general concerns about the authors' methodology are discussed below, followed by an examination of some of the assumptions specific to one or other of the models.

General Methodological Concerns

A feature common to both models is the use of partial equilibrium analysis and certain concepts of formal welfare economics. While both approaches are widely applied by economists, the conclusions flowing therefrom are generally extrapolated to the real world with the utmost caution, if at all.

Partial, as distinct from general, equilibrium analysis refers in the present context to the practice of isolating for study just some of the effects of a market change. For example, the Staff Study examines the effect of a change in the price of a product upon the demand for that product following the imposition of RPM. In the real world, any such change may exert secondary effects throughout the economy, but to take them into account would simply not be possible. As one consequence, the models in the Staff Study ignore a central concern of Yamey and others about the waste involved in attracting additional resources into distribution by the maintenance of artificially high retail margins.

The limitations of partial equilibrium analysis become awesome when welfare conclusions are reached as in the case of the Staff Study. In broad terms, a convincing case is made in formal welfare economics[9] that, *ceteris paribus*, a perfectly competitive economy is conducive to optimal resource allocation. With some additional assumptions, the theory associates optimal resource allocation with optimal welfare in some sense. Unfortunately, as real world factors such as the structure of income distribution, social values, state activities and oligopoly are taken into account, the implications for welfare become more and more uncertain.

As a consequence of the foregoing and other problems, many writers in the field of industrial organization take great care in reaching real world conclusions on the basis of partial equilibrium analysis and welfare economics. That applies to F. M. Scherer who, incidentally, is highly critical of RPM. He relegates mathematical principles of welfare economics to an appendix in his text book[10] and opts for a more intuitive approach. After illustrating by partial equilibrium analysis that output under conditions of competition is higher than under conditions of monopoly, he adds:

> Of course, the resources needed to expand production...must come from somewhere, which (assuming full employment) means that consumption of some other end product must be reduced. The problem of efficient resource allocation is a general equilibrium problem, involving the balance of all sectors in the economy. Unfortunately, the analysis of general equilibrium takes us between Scylla and Charybdis. The rigorous models lack intuitive appeal and the intuitive models lack rigor. Because it is so important to understand the common sense of monopoly resource allocation, we opt for an intuitive approach here.[11]

In addition to the pitfalls of partial equilibrium analysis, the measurement of changes in welfare is by no means free of controversy. A standard approach, and the one used in the Staff Study, is to take changes in "consumer surplus" and "producer surplus" as measurable proxies; if both rise or if a rise in consumer surplus exceeds a decline in producer surplus, welfare is said to have increased.

Consumer surplus is defined as the excess of total consumer utility derived from a product over the price paid; it is the area under the demand curve above the price line. The concept, which was popularized by Alfred Marshall, stems from the observation that a consumer would pay more than the market price for a product rather than forego its consumption entirely. It has had many critics including economists of the stature of I.M.D. Little and Paul Samuelson, although its supporters now appear to be in the ascendancy.[12] Producer surplus is simply the producer's profit and is readily measurable.

Thus, whatever its merits, the concept of consumer surplus is different from that of producer surplus. Combining changes in each to obtain the net change in "welfare" is an exercise the meaning of which is not entirely clear. Michael Waterson, while agreeing that account should be taken of the effects of a price change on producers as well as on consumers, stated:

> However, there is the question of the appropriate weighting to be attached to the gains/losses in producer surplus as against consumer surplus. It is the usual practice in industrial economics to weight these equally (*without any particular justification*).[13]

The following statement by E. J. Mishan is also of interest:

In sum then, as a method of capturing data on which to exercise the compensation tests, consumers' and producers' surpluses suffer not only from the distributional complications common to comparisons based on such tests but also from difficulties in their measurement, largely owing to their essentially partial character.[14]

Concerns About Specific Assumptions

Some of the assumptions specific to one or other of the two models raise further questions about the relevance of the authors' welfare conclusions to the real world.

In their availability model the rise in retail price as a result of RPM has two analytically separate effects. Sales at previously existing outlets decline because of the price rise. However, the number of outlets offering the product increases because of the higher retail margins, resulting in an increase in the total number of consumers. A net increase or decrease in sales will occur, depending upon the relations between the elasticities[15] of individual consumer demand and of the number of outlets with respect to the price change. The supplier will impose RPM only if the elasticities are conducive to higher producer surplus.

The puzzling part is the treatment of consumers' surplus, an increase in which is necessary if RPM is to be portrayed as increasing welfare. As would be expected, the model shows a decline in consumers' surplus for previously active consumers following the RPM-imposed price rise. Consequently, any net rise in consumers' surplus requires a rise at the new outlets in excess of the fall at the old outlets. Measuring the change at the new outlets is complicated by a lack of information about what those consumers sacrificed because of preference for the supplier's product. The model seeks to circumvent that problem simply by assuming changes in consumers' surplus are related to changes in the number of outlets by precisely the same function as sales are related to the number of new outlets.[16] Producer surplus is also some function of sales, so the assumption concerning consumers' surplus undoubtedly contributes to the finding that welfare is enhanced whenever RPM is profitable.

The fact of the matter is that changes in consumers' surplus at the new outlets would vary widely according to all the circumstances, and it is doubtful that any *a priori* assumption about it would be convincing. Much would depend upon the intensity of the consumers' preferences for the supplier's product over what they were buying before. Moreover, it is easy to envisage circumstances in which the change would be negative. For example, the new outlets may have decided to stock the supplier's product in place of one that was not price-maintained. Or, RPM may also have been imposed on the product that the consumers were previously buying.

The second model, as already mentioned, is designed to analyse a situation in which consumers require both a product and information about it, and where "free riding" is prevalent. Point-of-sale is the only source of information, and retailers may or may not supply it at their own expense. The required information consists of informing consumers of the existence of the product and providing expert advice about its characteristics. The cost of supplying one consumer with the information is the same as the supplier's unit cost of manufacture (one dollar). Prior to the imposition of RPM by the supplier, there are informing stores and noninforming discount stores. There are two types of customers, those with prohibitive search costs who buy at informing stores and those with zero search costs who obtain information at informing stores but search for and buy at noninforming stores. There are also potential consumers who, due to a less than optimal supply of information, are unaware of the product. Joint supplier-retailer profit maximization is not achieved because of insufficient information and excessive costs and prices of informing stores. In fact, retailer profits will always be zero because of free entry.

The supplier finds it most profitable to impose RPM at a level somewhere between the former prices of informing stores and those of noninforming stores. Free riding is eliminated and more informing stores enter, thereby eliminating the cost of providing information to consumers who buy elsewhere.

The reduced prices at informing stores attract more sales, and total sales increase as information becomes more readily available.

In addition, we are told that welfare is enhanced. Consumer surplus is measured by "expected consumer surplus (*ex ante* to the event of becoming informed) accruing to both low search-cost and high search-cost consumers".[17] In an earlier article dealing with the same model, the authors expanded somewhat on their measurement of consumer surplus. They stated:

> Expected welfare for each consumer is the probability of being informed times the surplus generated for the consumer at the appropriate purchase price...
>
> Since RPM forecloses discount houses, low search-cost consumers face a higher purchase price in the single price RPM equilibrium. Product information must therefore increase if these consumers are to benefit form RPM.[18]

Returning to the Staff Study, the authors report that the welfare effects have been calculated under a range of values for key variables including the proportion of consumers with prohibitive search costs and the relative size of the market composed of previously uninformed potential consumers. They find that, *ceteris paribus*, when the former is small and the latter is large the welfare of all consumers is enhanced by RPM. Within certain other ranges of the variables, while the welfare of low search-cost consumers is reduced, they find that total welfare rises. They state:

> An increase in information with administered pricing implies an increase in welfare. Again, this is an intuitive result: The marginal social value of point-of-sale information (PSI) exceeds its marginal private value to the manufacturer by its positive marginal impact on consumers' surplus. If product information is less than optimal for the manufacturer, it must also be less than socially optimal. The profitable use of RPM to increase product information is therefore welfare-improving.[19]

Several aspects of the model raise questions about its relevance to the real world, particularly since the authors apply the results directly in policy recommendations. One difficulty is the placing of an apparently arbitrary value on information such that the welfare of low search-cost consumers is found to rise under some circumstances with a rise in price. Also, as with the first model, it is difficult to understand how changes in welfare of new consumers can be measured realistically without more information about their previous state. The extreme nature of some of the assumptions is also troublesome. For example, while information is portrayed as crucial for the supplier, he engages in no informational activities and depends entirely upon RPM to ensure the optimal level.

The finding that RPM is imposed at a level lower than the former price of informing stores is not surprising in view of other assumptions. With the cost of informing a single casual shopper equal to the supplier's unit cost of production, the mark-up of an informing store would be extremely high at best and would rise rapidly with every non-buyer to whom information was provided. Such outlets could have remained solvent only because of the unshakeable loyalty of consumers with prohibitive search costs.

A comment by Joseph Stiglitz in his introduction to a volume of papers is germane here. The volume includes a paper by Mathewson and Winter in which they reach much the same conclusions as in the Staff Study about the welfare implications of RPM as a remedy for free riding. Stiglitz stated:

> In traditional economic theory, competition performs an important role: if all markets are perfectly competitive, resource allocations by those markets will be Pareto efficient. Unfortunately, the standard welfare analysis has little to say about modern industrial economies, where technical change and information problems (explicitly excluded from traditional analysis) are of central importance. We do not have, nor is there likely to exist, a welfare theorem for such economies possessing the generality of the fundamental theorem of welfare economics...What we do have is a number of 'insights' and 'examples' which serve more to make us cautious in applying standard welfare economics than to provide us with a basis for policy prescriptions.[20]

Cartels

The Staff Study also includes a discussion of RPM when imposed by a cartel of suppliers or dealers, both of which the authors find to be socially detrimental. Since few readers are likely to dispute that conclusion, there is no need to dwell on the details of their reasoning in that regard.

However, a noteworthy feature of the authors' approach is the high standards that they set for the identification of a cartel. There must be "conclusive evidence" that RPM is a consequence of a cartel. They doubt that retailer associations now have sufficient monopoly power to induce suppliers to impose RPM. The observable conditions they set for a manufacturers' cartel are "high concentration, barriers to entry into manufacturing and homogeneous products with RPM being applied to maintain a common price for all brands in the market". [21]

A question raised by those high standards is where forms of business organization and conduct such as monopoly, tight oligopoly, conscious parallelism and tacit agreements fit into the Staff Study. The only place left for them appears to be the two models discussed earlier that deal with a monopolistically competitive supplier acting independently.

Conclusions

The conclusion is simply that the Staff Study falls far short of establishing that RPM enhances welfare. The reason is the authors' reliance upon abstract models with assumptions that do not reflect the real world.

That is the only claim made herein. The debates about RPM will undoubtedly continue and it is to be hoped that a credible consensus will emerge. As one suggestion, emphasis upon detailed analysis of the copious records of Canadian price maintenance law enforcement might help to keep the debate founded upon facts. In the meantime, policy makers would be well advised to leave Canada's carefully qualified price maintenance ban as it now stands.

Notes

1. Notes for an Address to the Distribution Law Seminar, B.C. Continuing Legal Education Society, Vancouver, by Ian Nielsen-Jones, Deputy Director of Investigation and Research (Services), S. Dev Khosla, Chief, Economic Policy, and Robert D. Anderson, Senior Economist, Bureau of Competition Policy, Vancouver, October 18, 1988.
2. G. Frank Mathewson and Ralph A. Winter, *Competition Policy and Vertical Exchange*, Vol. 7 of studies commissioned by the Royal Commission on the Economic Union and Development Prospects for Canada, Toronto, 1985.
3. Royal Commission on the Economic Union and Development Prospects for Canada, *Report*, Vol. 2, Ottawa, 1985, p. 224. Contrary to the Commission's statement, the law does not make price maintenance illegal "in any circumstances". Loss leader selling and inadequate servicing are among the defences against a charge.
4. G. Frank Mathewson and Ralph A. Winter, *supra* note 2, page 103.
5. B. S. Yamey, *Resale Price Maintenance*, Chicago, 1966.
6. *Id.* page 4.
7. For a brief review of some of the more recent literature, see R. D. Anderson and S. D. Khosla, "*Recent Developments in the Competition Policy Treatment of Resale Price Maintenance*", *Canadian Competition Policy Record*, December, 1985, pages 1-14.
8. See F. M. Scherer, *Industrial Market Structure and Economic Performance*, Boston, 1980, pages 591-2; Robert Pitofsky, *Why Dr. Miles Was Right*, Regulation, January/February, 1984, pages 27-30; Bruce Dunlop, David McQueen and Michael Trebilcock, *Canadian Competition Policy*, Toronto, 1987, pages 263-4; Paul K. Gorecki and W. T. Stanbury, *The Objectives of Canadian Competition Policy, 1888-1983*, The Institute for Research on Public Policy, Montreal, 1984, page 127.
9. For a fairly readable text book on welfare economics, see Allan M. Feldman, *Welfare Economics and Social Choice Theory*, Kluwer Boston Inc. (distributors), 1980.
10. F. M. Scherer, *supra* Note 8.

11. *Id.* Page 18.
12. See, for example, Robert D. Willig, "*Consumer's Surplus Without Apology*", *The American Economic Review*, September, 1976, pages 589-97. He cites criticisms of the concept by I.M.D. Little, Paul Samuelson and others.
13. Michael Waterson, *Economic Theory of the Industry*, Cambridge University Press, 1984, page 6 (emphasis added)
14. E.J. Mishan, *Welfare Economics*, New York, 1964, page 78.
15. The elasticity of demand with respect to price is the percentage change in quantity demanded over the percentage change in price.
16. *Supra* Note 2, pages 20-21.
17. *Id.* page 52.
18. G. F. Mathewson and R. A. Winter, "*The Incentives for Resale Price Maintenance Under Imperfect Information*", *Economic Inquiry*, July, 1983, page 343.
19. *Supra*, Note 2, pages 52-53.
20. Joseph E. Stiglitz and G. Frank Mathewson (Editors), *New Developments in the Analysis of Market Structure*, the MIT Press, Cambridge, Mass., 1986, pages XX and XXI.
21. *Supra*, Note 2, page 37.

RESALE PRICE MAINTENANCE UNDER REVIEW
A RESPONSE TO J. W. MORROW

By: Frank Mathewson and Ralph Winter

In his article in this volume, J.W. Morrow argues in favour of the *status quo* for the current legal treatment of resale price maintenance (RPM) in Canada. That treatment is spelled out in section 61 of the current *Competition Act*, a section that remains virtually unchanged from the previous *Combines Investigation Act*.

In our study[1], as Morrow points out, we proposed a rule of reason for RPM whereby the practice would be allowed unless conclusive evidence were presented that it supported a cartel. The burden of proof would be on showing that RPM facilitated collusive pricing among a cartel of manufacturers or protected a cartel of established retailers against entry by new discount retailers. Because cartel practices are already illegal under other sections of the *Act*, we also find convincing the argument put forward by some policy analysts (as in Richard Posner, "The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality", 48 *U Chi L Rev* 6) that RPM should be *per se* legal. Our argument is tantamount to a call for a treatment for RPM similar to other vertical practices such as exclusive dealing or territorial restrictions or tying where such practices might be challenged on the basis that they represent, in certain circumstances, a substantial lessening of competition. This is not a radical proposition. At one level of generality, it is the suggestion that it is likely efficient for the law to treat practices that are substitutes to some degree in a like fashion. In this article we respond to the specific points raised by Mr. Morrow's provocative review.

General Methodology

First, the models we have used to make our point are, in our view, not fraught with the kinds of fragility that Morrow has in mind. Nor is there much disagreement in the economics profession, contrary to Morrow, over the appropriateness of the analytical vehicle that we use.

To be specific: in studying RPM, or any other vertical contractual clause, the choice is not between partial and general equilibrium analysis. Nor is the choice between welfare analysis and something else undefined. If RPM is practiced by computer manufacturers by enforcing price floors upon their dealers or preventing dealers from advertising below list prices, the relevant model for analysis is the production and distribution of computers, a partial equilibrium analysis. If the policy question concerns the impact of this restriction upon the welfare of consumers who would buy and use computers, then welfare analysis permits us to reach some policy conclusions. These are not controversial positions.[2]

If any analyst believes that RPM, or any other vertical contractual restriction, is anticompetitive, then the analyst has an obligation to demonstrate this. The challenge would be to specify a coherent economic model of an industry with rational parties engaging in production and distribution and enforcing some contractual restriction(s) in the interest of the enforcing player but not in society's interest when measured from the perspective of society's overall wealth. The general methodology would be the same as ours; the disagreement would centre on the reasonableness of the specification and the tests of the competing predictions of the alternative models. In suggesting that the use of RPM to encourage promotion or distribution of a product may be inefficient, Morrow does not offer a model. Instead, he cites the view (expressed by Basil Yamey) that any scarce resources devoted to distribution or promotion, as opposed to genuine production, are wasted. If this view ever had credibility among economists or serious policy analysts, this credibility has disappeared. Goods need to be distributed to be consumed, and consumers need to be informed about goods for there to exist a market. Society has not chosen to put restrictions on the amount of promotion and distribution expenses undertaken by vertically integrated manufacturers. It should not constrain the distribution systems of manufacturers who are "quasi-integrated" through vertical restraints with distributors and retailers.

Specific Assumptions in Mathewson and Winter and Their Relevance

Our second point concerns the specifics of the role of vertical contractual restrictions, RPM in particular, in contracts between manufacturers (or franchisors) and retailers (or franchisees). In general, if entry into retailing and manufacturing is easy, then it is unlikely that vertical contractual practices reduce wealth. A computer manufacturer that set up a distribution system that offered less than a fair return to retailers and an unfavorable combination of prices and service to consumers, would not last long in the Canadian market. There are too many computer manufacturers and potential entrants into this market to allow inefficiency to persist.

Furthermore, even in cases where entry is difficult, analysis must show that a vertical practice leads to an increase in price and a reduction of output without any compensating increase in anything else desired by consumers before the practice is a candidate for reducing wealth.

The critical starting point in any given case involving any vertical contractual practice, including RPM, is to establish a persuasive economic explanation of the motive for a manufacturer to impose the restriction. This explanation should fit the facts of the case. Then, the policy or social implications of the practice can be evaluated.

Economists have explored several possible explanations for RPM. The fact that these explanations may be embedded in formal economic models is itself no sign that these explanations are esoteric or potentially suspect.[3] Nor is the observation that there is more than one possible economic explanation

a sign of any weakness. Any sensible role for RPM should be capable of translation into an economic model to test for the logical cohesiveness of the explanation and to yield testable predictions that are capable, at least in principle, of empirical refutation. That is what economics is all about.

But, in general, these explanations should equally well be capable of articulation in plain English. There are several possible explanations for RPM for example. In general, leaving aside the cartel explanations, RPM may be imposed by a manufacturer on its retailers or wholesalers in an attempt to align the interests of the downstream firm with those of the producers of the good. The classic explanation involves a 'free-ride' among retailers where point-of-sale information at the retail wholesale level is essential to the sale of the product. (This explanation was first proposed in Lester Telser, "Why Should Manufacturers' Want Fair Trade" 3 *J L & Econ* 86). The story is simple enough.

A discount retail outlet could free-ride on the provision of information by an informing outlet by attracting consumers from the informed outlet to the discount outlet through offering no information and a lower price. In the extreme, if the provision of this information at the retail or wholesale level were essential to the development of a market or product, the failure to collect a return on this investment for the informing outlet could lead to the collapse of the market. Manufacturers who had the option to eliminate discounters through the imposition of price floors could guarantee a return to the informing outlet, providing a rationale for the market to develop.

If RPM were *per se* legal, not all manufacturers would instantly choose to eliminate all discounters. Discounters could serve other roles.[4]

Whether this information role for RPM were relevant to a particular case would have to be decided on the facts. New markets for esoteric and technically complex products, such as the distribution of computers and their complex products to novice users in the late 1970s or early 1980s in Canada, would seem to be a likely use for RPM.

But RPM can be efficiency-enhancing even when the apparent role for retailer information would appear to be minimal. For example, jeans frequently have been subject to RPM. Yet, the information role for retailers of jeans would appear to be minimal. Realistically, consumers do not try on jeans at high-service stores then buy the jeans at discount stores. The interest of manufacturers in imposing RPM in cases like jeans can be explained without the free-rider argument.

Retailers offer many non-price services that encourage consumers to buy products. They display them for consumer inspection; they offer demonstrations of the product's capabilities and attributes. They engage courteous and polite sales help to accommodate consumers' search for products that meet their needs. And retailers affect the consumers' costs of purchasing by the length of the line-ups at cashiers.

Manufacturers are interested in setting price and non-price instruments to encourage consumers to purchase their products over those of their rivals. Manufacturers are less interested in which retail outlet is chosen by the consumer. Retailers, however, compete with each other to encourage consumers to purchase a particular good at their outlet rather than a competing outlet. This competition takes the form of both price and non-price competition and the differences between the objectives of the manufacturer and the retailer or wholesaler in the use of price and non-price instruments can give rise to the use of RPM to align the interest of both parties.

While these conditions are spelled out more fully elsewhere[5], the intuition is as follows. The consumers that a retailer attracts away from another retailer and who would buy the product anyway, have low opportunity costs of time and low search costs on average. (Busy people buy jeans from the nearest store, are less price conscious and more service conscious.) The retailer is overly concerned about low search cost consumers in its pricing and non-pricing or service decisions, from the perspective of the manufacturer, because this group of consumers is over-represented among consumers on the margin of buying between two retailers. The manufacturer focuses instead on consumers on the margin of buying the product instead of another product. These consumers are more concerned with the "non-price" costs of buying the product. The manufacturer realigns the retailers'

incentives by constraining them against too much price competition, which encourages more non-price or service competition.

The earlier example of point-of-sale information from retailers is one example of a retailer service but it is not essential to the argument. The point is that the use of RPM by a manufacturer in its retail contracts is by itself no indication of a substantial lessening of competition and therefore, should not be subject to virtual rules of *per se* illegality (loss leadering not withstanding).

What is critical for the successful application of this insight to competition policy is to move away from the excessively rigid position associated with Section 61 of the current *Competition Act*. The test would be the relevance of the facts in a particular application to the possible motivations for the practice.

The U.S. Supreme Court in its recent decisions on RPM seems to be inching to this position, a position which is an extension of the U.S. Colgate doctrine.[6] Under this doctrine, manufacturers are free to select the type and nature of competition at the retail level for their products provided that there is no conspiracy on the part of a manufacturer with an existing retailer to eliminate a price cutting competitor who is an alternative retailer.

Conclusion

Our position is simple: if RPM signals a price conspiracy and an attempt to monopolize the market through co-operative agreements, then the *Competition Act* is well prepared to promote action by the authorities through the general conspiracy sections. Vertical conditions that serve similar ends should logically be treated in a similar manner by the law.

The economics literature has offered several candidate explanations for RPM which, when modelled formally, show that RPM can be efficiency-enhancing when manufacturers decide to use the option. If RPM is permitted, not all manufacturers will choose to use it: discount outlets will not be eliminated. In the computer market for example, a large group of consumers needing no special information would be served by manufacturers or retailers who specialize in offering low-priced, low-service products. As markets mature and products become more familiar to consumers, the pressure for such discount outlets will increase.

Satisfaction that the use of RPM is efficiency-enhancing comes when (i) the cartel/price conspiracy explanations are inapplicable and (ii) the more general economic motive (outlined above) or, when the facts are rich enough, one of the more specific motives for the use of RPM by manufacturers provides a fit to the facts of the case, welfare analysis demonstrates that economic wealth is enhanced by permitting the use of RPM.

As a general methodological issue, any candidate economic explanation for RPM must be capable of articulation in the context of an economic model to test the logical consistency of the explanation and to generate the testable implications of the explanation. Welfare economics is the logical policy extension of the exercise of building this economic model. While specifications of models can be contentious and welfare economics has had methodological debates, neither of these considerations reduce the need to perform the analysis. Explanations or policy positions on RPM or any other economic phenomenon not amendable to these "tests" should likely be ignored.

Notes

1. G. Frank Mathewson and Ralph A. Winter, *Competition Policy and Vertical Exchange*, Volume 7, Studies Commissioned by the Royal Commission on the Economic Union and Development Prospects for Canada (1985), Toronto.

2. To be sure, if there were some consensus that general equilibrium analysis were needed to study such policy questions as the economic efficiency of RPM, or that welfare analysis of the type that we have conducted was fraught with fragility, then the issue of the reasonableness of the analytical vehicle would be relevant. This is not the case.

3. Nor is the observation that any explanation can be expressed in a formal economic model any indication of the power of the underlying ideas.

4. These roles include permitting manufacturers to service the more and less price or service sensitive segments of the market.

5. See Ralph Winter, *Vertical Control and Price Versus Non-Price Competition*, mimeo (1989), University of Toronto.

6. The relevant cases are *Spray-Rite Service Corp.* v. *Monsanto Co.*, 465, U.S. 752, 763 (1984) and *Business Electronics Corp.* v. *Sharp Electronics Corp.*, No. 85-1910 U.S.S.C. 1988.

CANADIAN COMPETITION POLICY RECORD

HIGHLIGHTS

COMPETITION ACT PROVISIONS HELD UNCONSTITUTIONAL

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