



# Brand-specificity of pre-sale services and inter-brand competition with resale price maintenance



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## ABSTRACT

We analyze the competitive effects of resale price maintenance (RPM) in circumstances in which multiple manufacturers use RPM and distributors have incentives to free-ride on other distributors' pre-sale services, which can be specific to a manufacturer's brand to some extent. In the antitrust literature and practices, RPM solving the free-rider problem is perceived mostly as pro-competitive, while multiple manufacturers' RPM is perceived as anti-competitive based on their collusive incentives. In our circumstances, distributors' services may differentiate manufacturers' brands *ex post*, as is desired by manufacturers. Thus, despite solving the free-rider problem, multiple manufacturers' RPM may harm consumers by softening inter-brand price competition.

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## 1. Introduction

In *Leegin*, the U.S. Supreme Court replaced the century-old *per se* rule against resale price maintenance (RPM) with a rule of reason approach.<sup>1</sup> This decision has affected antitrust regulations regarding RPM internationally. The European Commission (EC), for example, abolished its former 'form-based' approach to RPM, employing an 'effect-based' approach and included economic theories regarding the competitive effects of RPM in the revised 'Guidelines on Vertical Restraints' (hereafter 'the EC Guidelines').<sup>2</sup> The Korean Supreme Court has also suggested some market conditions that can justify RPM in a few recent cases.<sup>3</sup> These changes imply that the courts and competition authorities, influenced by

economic theories, have acknowledged the possibility of RPM being either pro- or anti-competitive depending on situations.

One of the major theoretical backgrounds of pro-competitive RPM, which competition authorities have commonly adopted, is a free-rider problem.<sup>4</sup> This theory poses a market situation in which a single manufacturer's RPM induces each of its distributors to provide product-related information, or 'pre-sale services', by eliminating the incentives to free-ride on the services provided by other distributors. Such services increase the overall demand for the manufacturer's product and therefore are likely to improve consumer surplus ultimately. Further, RPM of this kind may enhance inter-brand service competition among manufacturers' brands though it limits intra-brand price competition between distributors. At the same time, one of the main theoretical bases for anti-competitive RPM, adopted in countries' antitrust laws, is (tacit) cooperation

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<sup>1</sup> *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007). RPM in this paper refers to minimum resale price maintenance or resale price fixing. We do not discuss maximum resale price maintenance in this paper.

<sup>2</sup> *European Commission (2010)*. RPM is still under 'hardcore restriction' in the EC. However, the defendant firm may demonstrate the efficiency or the pro-competitiveness of its RPM practice with a burden of proof.

<sup>3</sup> Korean Supreme Court decision no. 2009Du9543, November 25, 2010 and no. 2010Du9976, March 10, 2011. Conditions are such that RPM promotes inter-brand competition; promotes competition for customer service among distributors; diversifies consumer choice in terms of products; enables new firms to smoothly secure distribution channels to make entry into the relevant product market easier. The

firm under investigation has the burden of proof to establish a justification. See *Winter (2013)*.

<sup>4</sup> In particular, the approach in the EC guidelines is close to binary: either RPM is used to solve a free-rider problem and is justified, or it is anti-competitive. *Winter (2013, pp. 25)* points out, "the EC Guidelines place undue emphasis on free-riding as an evidentiary requirement for the proposition that RPM is efficient for established firms". A similar view is central to the dissent in the *Leegin* ruling. See *Winter (2013, pp. 24–25)*.

between manufacturers.<sup>5</sup> This approach poses a circumstance in which multiple manufacturers' RPM facilitates collusive pricing.

In short, antitrust laws and their theoretical backgrounds address RPM's competitive effects in the two environments separately: a free-rider problem matters in a single manufacturer's RPM whereas collusive incentives matter in multiple manufacturers' RPM. However, the two market conditions – a free-rider problem and multiple manufacturers' RPM – are frequently intertwined in practice. In such situations, the approaches above may fail to provide adequate guidance for assessing RPM's competitive implications.

We fill this gap by bridging these two approaches. Specifically, we consider circumstances in which multiple manufacturers use RPM to solve their free-rider problems in the absence of collusive incentives. In this circumstance, we analyze the competitive implications of service characteristics and of the cost of service provision. Manufacturers' RPM can be anti-competitive in the equilibrium of these circumstances, though it solves the free-rider problem and hence induces distributors' provision of services. To be more specific, let us suppose that the services provided by distributors are specific to a manufacturer's brand, to a certain extent. At the same time, suppose also that those services cost distributors some pecuniary or non-pecuniary expenditure but do not bind consumers to purchase a product.<sup>6</sup> The services in this case increase the degree of differentiation in manufacturers' brands, which consumers perceive *ex post*, that is, after receiving the services. Consumers then become less responsive to price increases. This enables manufacturers to set a higher RPM price and, in turn, a higher wholesale price. Accordingly, manufacturers gain more profit but consumers can be harmed, depending on the level of RPM price and cost of services, which affects the level of RPM price. By contrast, the role of RPM, which eliminates free-rides and induces pre-sale services, is limited when services are generic to manufacturers' brands.

The situation analyzed in this paper has real importance. The EC Guidelines, for example, state that antitrust practitioners should attend to the characteristic of services in assessing RPM cases that involve a potential free-rider problem.<sup>7</sup> More importantly, an actual RPM case occurred in which both multiple manufacturers' RPM and distributors' free-rides came into question at the same time. In the *Callaway* case (2010), eight golf club manufacturers in Korea practiced RPM simultaneously for almost eight years.<sup>8</sup> A golf club is a good for which a consumer needs substantial information to choose a product that fits his or her physical conditions. Such information can be provided by golf club distributors via pre-sale services.<sup>9</sup> A distributor, however, has incentive to free-ride on the services supplied by other distributors. At the same time, such an incentive is affected by the degree of brand-specificity of information.

An antitrust assessment of an RPM case like this may lead to an incorrect conclusion if it fails to consider the interaction of the

market conditions concerned – manufacturers' non-cooperative interaction, distributors' incentives for free-rides, and the brand-specificity of pre-sale services. In this paper, we construct a simple theoretical model which addresses these problems, and analyze manufacturers' incentives for RPM and their impact on consumer surplus.

The rest of this paper is organized as follows. We provide an overview of literature focusing on the competitive effects of RPM in the next section. [Section 3](#) develops a theoretical model and analyzes its equilibrium. [Section 4](#) discusses the competitive effects of RPM in our market environments, as opposed to a situation in which RPM is absent. In particular, we consider competitive effects in terms of a consumer surplus net of firms' profit in accordance with the general criteria of antitrust laws. The final section then summarizes our analysis and discusses its implications for RPM regulations.

## 2. Literature

Effects of RPM have been studied very extensively. [Rey and Vergé \(2008\)](#), for example, provide a comprehensive survey of the literature. In this section, we briefly review a few studies which directly match our interests. As noted in the previous section, we consider a situation in which the problems of both free-riding and multiple manufacturers' RPM mingle. Therefore, we first review studies regarding a single manufacturer's RPM which results in a welfare improvement.<sup>10</sup> Then, we discuss the literature that explains the collusive incentives of multiple manufacturers' RPM.

In many markets, distributors not only set their retail prices but make sales efforts. We call the latter 'services' in accordance with the literature. The services enhance the overall demand for a manufacturer's product and, therefore, are frequently welfare-improving. For some reason, however, a simple wholesale-price contract between a manufacturer and its distributors fails to generate the quantity of services that the manufacturer desires. [Winter \(1993\)](#) points out that this can happen when consumers are more responsive to prices than services. In this case, a distributor lowers its retail price rather than offering more services to attract consumers. This behavior, however, attracts consumers away from other distributors rather than from outside of the market. This is not, of course, aligned with the manufacturer's incentive to increase overall market demand. Manufacturer's RPM, in this case, prevents retail prices from falling, and increases distributors' incentives to offer more services.

[Marvel and McCafferty \(1984\)](#) focus on the positive externality of distributor's services. Let us suppose that a distributor's display of a product gives consumers information about the quality of the product. This increases the demand for the same product in other distributors' showcases as well and, therefore, increases overall demand. That is, market demand is more elastic to services than are the demands of individual distributors. Accordingly, the services provided by individual distributors turn out to be insufficient from the manufacturer's perspective. The manufacturer uses RPM to eliminate this distortion in distributors' incentives.

"Free-riding" is the seminal theory that explains RPM's pro-competitiveness. When a distributor provides services, or product-related information, other distributors can offer a lower

<sup>5</sup> The risk of a distributors' cartel is another explanation for anti-competitive RPM. See *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007), pp. 13 and Paragraph (224) of the EC Guidelines.

<sup>6</sup> The services are 'pre-sale,' in this sense. There also exists literature which considers 'point-of-sale' or 'post-sales' services to establish RPM's efficiency. See, for example, [Klein and Murphy \(1988\)](#) and [Winter \(1993\)](#). We consider only 'pre-sale services' in this paper.

<sup>7</sup> Paragraph (107) of the EC Guidelines states, "Free-riding between suppliers is also restricted to specific situations, namely to the cases where the promotion takes place at the buyer's premises and is generic, not brand specific."

<sup>8</sup> Korean Supreme Court decision no. 2010Du9976, March 10, 2011.

<sup>9</sup> Pre-sale services concerned with golf clubs are, for example, to measure a customer's height, arm length, swing mechanism, etc. and then to suggest a golf club specification (i.e., weight, length, loft, and so on) which best fits the characteristics of the customer. In the *Callaway* case, golf club distributors are sometimes equipped with a machine that analyzes the speed or the trajectory of a customer's swing.

<sup>10</sup> The literature survey of this section depends on [Winter \(2013\)](#) to a significant extent. [Winter \(2013\)](#) explains various incentives of a single manufacturer's RPM using an organized framework of vertical (i.e., manufacturer to distributor) and horizontal (i.e., distributor to distributor) externality. See [Winter \(2013\)](#), pp. 16–17. In this section, we discuss the literature that focuses mainly on horizontal externality. As for the literature regarding vertical externality, see [Klein and Murphy \(1988\)](#), for example.

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