Restricted Dealing Is a Way to Compete

Frank Easterbrook

NEITHER RESALE PRICE MAINTENANCE nor any other restriction adopted by a manufacturer for its dealers should be a subject of serious antitrust attention. It should make no difference whether the manufacturer prescribes territories, customers, quality standards, or prices. It should make no difference whether the restrictions are set by contract or by manufacturers' ownership of the retail outlets, the most "extreme" form of control. They are all the same.

This is not a radical proposal. Most of these practices—which I lump under the term "restricted dealing"—are in common use. All of them except the prescription of prices are dealt with under a highly deferential standard of review and are lawful except in the rarest of cases. The treatment of prices is an anomaly that should be brought in line with the treatment of vertical integration and other restrictions on distribution.

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If restricted dealing arises out of a cartel among dealers or manufacturers, by all means let us prosecute. Cartels are unlawful per se and should remain so. But restricted dealing is not often used by cartels, and most of it is just a way by which one manufacturer competes with others. Our economy has many ways of assembling and distributing products. The more routes to market, the broader the consumers' choice. The broader their choice, the better off they are. Cartels restrict rather than increase the range of choice. We should welcome restricted dealing as a benefit to consumers and not lump it with cartels, with which it has nothing in common.

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LET US BEGIN AT THE BEGINNING, with the purpose of antitrust. The antitrust laws are a prescription for consumer welfare. They exist to stop trusts or cartels from reducing the output of goods and services. The reduction brings about monopoly prices, the conspirators' goal. It also causes a misallocation of resources, as people shift to things that seem "cheaper" but really cost society more to produce in order to get the same level of satisfaction.

Cartels cooperate to cut output. Yet other forms of cooperation are procompetitive. All large firms entail a great deal of cooperation. Within Ford Motor Co., the engine and body divisions cooperate, and someone "dictates" a price at which things will be sold. The firm dictates to a plant manager what to make and how. Sears tells its store managers what to sell and at what price. Antitrust law tolerates, indeed encourages, such agreements. Agreements like these create the goods and services we value.

Just as there can be cooperation within a firm, so there can be beneficial cooperation across firms. Restricted dealing is a form of cooperation. One firm (the retailer) agrees to

do things the way a manufacturer specifies, just as an employee does things within an integrated firm. The agreement is not a displacement of the market. Such contracts are the market at work. All contracts restrain in the same sense that restricted dealing restrains.

Why, then, should cooperative agreements in the chain of distribution be subject to antitrust scrutiny? The usual reason given is that restricted dealing is "like" a cartel in the sense that firms agree on price (or quality, or place of distribution). True enough. But one can find such agreements inside every firm too. The fact that two practices have such a feature in common is just the beginning of analysis.

Before going on, I want to put to rest a line of argument one hears too often in political discourse. It is that restricted dealing, and especially resale price maintenance, is bad because it enables manufacturers to jack up the retail price of its products. So it does. Resale price maintenance is no different in this respect from other restrictions (for example, if there are fewer dealers, each can charge more).

So what? If Lacoste wants its shirts, with the little crocodile emblems, to sell for $50 each, it can achieve this easily enough. It may raise the wholesale price, or it may improve the product's quality or style. The observation that these things influence retail prices is not even interesting as an antitrust concern. Every manufacturer may sell what it wants and charge what the traffic will bear. Other manufacturers, perhaps those using dragon emblems, may sell different goods and charge less. This is competition. Consumers will choose. The question is whether restricted dealing affects price in an *anti*competitive way. If manufacturers may affect retail prices by changing wholesale prices or quality, why may they not affect prices through restricted dealing?

THE ARGUMENT MUST be that restricted dealing can facilitate a real cartel, such as an agreement among manufacturers or dealers to charge an elevated price. One of the cartel arguments might run like this. Dealers—say, druggists—in some city collude to drive up the price of toothpaste. Each dealer is worried that the others will "cheat"—that is, that other dealers will reduce the price in order to make additional sales at the expense of those adhering to the fixed price. So the dealers conscript the manufacturers to help them out. The manufacturers set a fixed resale price and penalize dealers that sell at a lower price.

The argument that restricted dealing is a way of enforcing a dealers' cartel conceals substantial problems. First, the industry must be one in which the dealers can form a cartel. But when will this be? Most retail markets have free entry, and retailing is about as close to an atomistic market as you get. There is a drug store on every other corner. There are so many retailers (and potential retailers) of toothpaste and other consumer goods that the firms could not form or sustain a cartel with or without the aid of manufacturers.

As for the manufacturers, why should they go along? What's in it for them? A manufacturer that helps dealers form a cartel is doing itself in. It will sell less, and its dealers will get the monopoly profits. Manufacturers could be "paid" in higher wholesale prices for cooperating, but that would increase the incentives of dealers not to join the cartel—to cheat by buying the product at a lower price and selling on a lower margin. If significant numbers of dealers cheat, bye bye cartel.

It won't do to get just one manufacturer of toothpaste to adopt restricted dealing. All or almost all must do so. If there are holdouts, noncooperating dealers can sell the holdouts' products for less, and that would destroy the cartel. Yet why would all manufacturers want to go along? It pays one or more to hold out. Dealers could conscript all manufacturers only when the conditions of a manufacturers' cartel existed.

Things are just as bad if the manufacturers make slightly different products. One manufacturer may hang back by setting the cartel price, but changing what it supplies for the price. It may put more paste in the tube, or use a formula that requires less paste per brushing. Differentiated products spoil the use of restricted dealing to enforce a cartel.

Then there is a problem of verification. Why are manufacturers any better at policing prices than fellow dealers are? The cheating dealer cannot attract extra business without advertising its lower prices. Then its fellow conspirators learn in the same way manufacturers do, and they could enforce the deal themselves. The extra enforcement from the threat

of cut-off by the manufacturer may be too late, or too little.

So the dealers' cartel explanation will not amount to much unless there are (1) few dealers, (2) few manufacturers, (3) homogeneous products, and (4) easy policing. If we see many dealers and many manufacturers, we can exclude the cartel possibility. And if we see some manufacturers using restricted dealing while others do not or if we see substantially differentiated products, we can exclude the cartel hypothesis no matter how many or few dealers and manufacturers there are.

The conditions for restricted dealing to be a useful part of a dealers' cartel just do not exist very often. (I could show the same for the use of restricted dealing as part of a manufacturers' cartel, but that is unnecessary. The argument proceeds in the same way.) We do not condemn business practices under the antitrust laws unless they are anticompetitive in a given case or unless—in the case of per se illegality—they are so likely to be anticompetitive that detailed investigation is unnecessary. The conditions under which restricted dealing is anticompetitive are rare, and automatic condemnation would pick up far too many procompetitive examples to be worthwhile.

IN ORDER TO MAKE HEADWAY in understanding restricted dealing, we must ask why a (sane) manufacturer would ever set up a system of distribution in which the *dealer* obtains the benefits of higher prices. The manufacturer wants to get its product from plant to customer. To do this, it "buys distribution." The difference between the wholesale and retail price is the "cost of distribution." If the manufacturer can create distribution more cheaply than other dealers, it will integrate and save this expense (although it incurs the new expense of operating a retail division). When Sears owns a store, the cost of distribution is the price of land, fuel, and staff, the same things an independent retailer must cover. Sears, like the nonintegrated firm, wants to hold this cost as low as possible.

The manufacturer's interest is the same as the consumers'. Both want to keep this cost down. For a given retail price, the manufacturer wants the highest wholesale price. For a given wholesale price, it wants the lowest retail price in order to sell more units. The manufacturer looks out for the consumer here, just as it does in picking the materials out of which to build the product. Few believe that manufacturers pay "too much" for their raw materials or labor—or that, if they did, this would be an antitrust problem. Yet critics of restricted dealing apparently accuse manufacturers of ill-serving their own interests when they buy distribution services. What can be going on?

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The essential point about restricted dealing is that these contractual provisions do more than just get "a product" from plant to purchaser. They affect what the product *is*. The manufacturer is buying something of value to itself and to consumers.

Some attributes of a product can be installed at the factory. A TV comes with a 19-inch tube or a 25-inch tube built in. Some attributes are added later on. Information is one. How do you use a computer? How do you connect one part to another? The manufacturer can "build in" some information by putting booklets in its boxes, but it can also supply information via trained salesmen. The more ways there are to do this, the more likely each consumer will find some satisfying combination of product attributes.

Look at the market in computers. There are at least four ways to sell machines, four different combinations of hardware and information. One combination is that the manufacturer puts a machine and a book in a box and sells the combination. The retailer sells the closed box, with minimal additional demonstration. If you don't like it or find that you can't make it work, you can take it back. That's the end of the service. Commodore, in conjunction with retailers such as K-Mart and Toys-R-Us, has followed this strategy with great success.

The second combination is to do what Radio Shack has done, to own some stores and franchise others. Then you can furnish special

information and display services in your own stores. Radio Shack charges for the service by setting a higher price. The problem with this arrangement is that the consumer cannot easily compare one brand against another and so may not appreciate your machine; worse, the costs of single-brand selling may be higher.

IBM has taken a third path, opening product centers that display its machines. A customer can learn all about the IBM's abilities and what products work in what ways with what peripherals. IBM charges for its information through the wholesale price to independent dealers, where consumers can compare different brands. This strategy works, though, only when the manufacturer has a very large volume. Other manufacturers do not sell enough to justify opening special stores.

These are the only combinations that work well in a world without restricted dealing. Restricted dealing adds a fourth option, which Apple Computer and others seem to be pursuing. Apple places its computers in retail stores, requires the dealers to display them and provide extensive information and knowledgable support. It has no stores of its own. Such a method of distribution is very hard to sustain without restricted dealing, for the reasons Phillip Areeda gave. The customer may soak up all that information in the "full-service" store and then order the computer from a mail-order outlet. It then becomes difficult for a dealer to recover its costs, since it cannot charge by the hour for presale advice. Competition from low-service outlets—so-called free riders—slowly undermines the full-service stores. The drain of sales to low-service stores is a kind of tax on presale information. The tax leads to too little being provided, as consumers see things.

Restricted dealing makes it easier for manufacturers and dealers to pursue this fourth option, the option of full-service outlets by sellers too small to justify vertical integration. If all dealers charge the same price, the customer will go to the one with better service, just as the manufacturer intended. Or if the dealers are placed far apart, each must compete for customers (against the products of other manufacturers) by supplying better information and service.

Restricted dealing is procompetitive because it increases the number of ways manufacturers can compete to provide what some segment of the population wants to buy. The more ways there are to slice up the product-service continuum, the more likely any one customer's wants will be met. Banning any restricted dealing practice necessarily reduces the number and effectiveness of options available to consumers.

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IF RESTRICTED DEALING is indeed beneficial to consumers, it should be possible to observe the benefits. Several scholars have analyzed instances of resale price maintenance from the years when federal law authorized states to permit the practice within their territories. These studies showed that the resale price maintenance states had higher retail prices, lower sales per store, and more retail business failures. These conclusions often are cited to condemn restricted dealing, but in fact they support the thesis that consumers benefit.

The finding that prices are higher with restricted dealing is no surprise. The manufacturer cannot get a store to supply information for free. The question is whether the consumers value the new combination of product, information, and service they receive by at least the amount of the price differential. (I come back to that.)

The finding that sales per store drop with resale price maintenance is exactly what one expects if the mechanism promotes the provision of personalized information and service. These special services are more likely to come from smallish stores (hi-fi outlets, corner druggists) than from mass merchandisers.

The finding that the rate of business failure among stores is higher with resale price maintenance also supports my approach. Restricted dealing promotes a particular form of competi-

tion among dealers. If the dealers are smallish, this competition leads to a relatively larger number of failures. On the other hand, if restricted dealing comes about as part of dealers' cartels—or if it increases dealers' profits in some other way—we expect to see relatively fewer business failures among dealers. We see more failures, so we know competition has become more fierce.

What of other evidence? We would like to know effects on output. If the new information and product tailoring is worth the higher price, then sales will rise despite the increase in price. Market shares of those who use restricted dealing will rise relative to those who do not. If restricted dealing is anticompetitive, sales and shares will fall.

The evidence from the famous cases is illustrative. In the *GTE Sylvania* case, the defendant manufacturer's market share rose consistently after it adopted the challenged practices. In the *Spray-Rite* v. *Monsanto* case, now before the Supreme Court, Monsanto's market share and sales took a dramatic upturn at the time it adopted its practices. The list can be extended.

A more general study backs up this impressionistic information. John P. Gould, now dean of the Graduate School of Business at the University of Chicago, is at work on a large-scale study of restricted dealing in liquor. The variation among state laws provides a natural laboratory for analysis. Dean Gould's data show that the use of restricted dealing is associated with a 10 percent or greater increase in sales, after all other plausible contributing factors have been held constant. Restricted dealing also appears to go hand in hand with a rise in the rate of introduction of new brands.

The evidence is not definitive. Evidence never is. But the evidence is consistent with the theory. It is hard to point to any case in which restricted dealing has injured consumers. It is impossible to tell a coherent story under which restricted dealing does so frequently. Antitrust law therefore should leave manufacturers free to adopt such practices as they choose. Competition, not the courts, best corrects the mistaken judgments of manufacturers. ■

Why *Dr. Miles* Was Right

Robert Pitofsky

IT STRIKES ME THAT when debaters agree on basic premises but disagree on major conclusions—which is the case in this colloquium—it is worth asking why. I would suggest that there are two considerations that split those who want vertical price-fixing to remain per se illegal from those who would make it virtually per se legal. One has to do with whether they take a static or dynamic view of supplier-distributor relationships; the other has to do with whether they recognize the practicalities and limits of the litigation process.

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Let me begin with what I think is a premise that we appear to share. When a manufacturer-supplier sets the resale price to the dealer, it is doing something that, on the face of it, is rather odd. Ordinarily, it would seem, a supplier has everything to gain from fierce and vigorous competition among its distributors. After all, it has already received the wholesale price for its product, and the lower the retail price, the more likely the product will sell. So, why does the supplier not sit back and let its dealers cut each other to shreds?

There are four possible explanations. The first is dealer pressure on the supplier, either overt or anticipated, to participate in what is, in effect, a dealer cartel. The second explanation