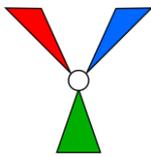


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<p><46/c></p>  <p>Key: Footprint ConEn1 Footprint ConEn2 Footprint ConEn3</p>	<p>. (v) Vertical Restraints and the ‘Externality Problem’ At first sight, it might be thought that a manufacturer would be keen on retailing being as competitive as possible. This argument goes as follows: There is a demand by consumers for the product of manufacturer X. But the manufacturer faces a derived demand from dealers/retailers in the product. If the retail sector is competitive, the derived demand curve will be the same shape as the final demand curve, and below it by a distance representing the marginal cost of retailing. If the retail sector were imperfectly competitive, the derived demand curve would be steeper in slope, and if it were inefficient the derived demand curve would be a greater distance below. Neither possibility would be in the manufacturer’s interest. All other things being equal, the smaller the retailing mark-up, the greater the profit share for the manufacturer. So what is wrong with this argument? In essence, the complication is that retailers provide ‘much more than mere warehousing’ (Marvel and McCafferty, 1984, p. 348). They provide both specific and general services to customers and potential customers - demonstration facilities, information, stocks, and so on. But these do not come free. Retailers incur fixed costs, many of which contain a sunk element, for example fixtures and fittings. Manufacturers gain through having their product demonstrated, or even through having it present in a store (or else they would be unwilling to pay ‘slotting allowances’ to supermarkets), so that demand is not exogenous to retailing. The fact that there are fixed costs means perfect competition is an unattainable ideal framework for retailing. Moreover, for many goods, competition is localized due to the spatial nature of retailing. When modelling vertical restraints, it becomes important to incorporate these features (see e.g. Dixit, 1983; Mathewson and Winter, 1984). Once a model incorporating a manufacturer with some monopoly power and (say) a monopolistically competitive retail sector has been set up, it becomes apparent that manufacturer and retailer interests diverge; the retailers may want more or less margin than the manufacturer would like to impose. For example, Gallini and Winter (1983) show that a typical retailer would want a margin [(price-input cost)/price] of $1/\epsilon_r$, whereas the manufacturer would want the retail margin to be ϵ_n/ϵ_R, ϵ_r being the elasticity of demand when one retailer changes price, ϵ_R the elasticity when all retailers do likewise and ϵ_n, the elasticity of demand with respect to changes in the number of retailers. Moreover, the numbers entering retailing may be sub-optimal from the manufacturer’s point of view</p> <p>. This divergence of views can be seen (following Mathewson and Winter, 1984) as arising out of a set of externalities. (i) Retailers do not gain all the benefits of action taken to improve sales; some goes to manufacturers. For every extra unit a retailer sells by modifying pricing or advertising strategies, the manufacturer gains an amount given by the difference between the wholesale price and marginal production costs. Thus, there is a positive externality bestowed on the manufacturer by such retailers’ actions, which in turn means that retailers will tend to set prices too high and advertising too low from the manufacturer’s point of view (i.e. high</p>
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prices are a negative vertical externality). (ii) On the other hand, retailers when raising price confer benefits on neighbouring retailers, by increasing demand for their products. This is a positive horizontal externality created by one retailer on others; in attempting to gain a greater margin for itself, it drives some custom away. It will tend to mean retailers will keep prices lower than they would be in the absence of rivals. Clearly, these two opposing effects imply that it is unlikely there will be a dominant direction to the outcome over all modelling variants. (iii) Each retailer confers a positive externality on other retailers and on the manufacturer by engaging in advertising of the product, unless the advertising is very specifically targeted. There is a similar effect regarding other services - demonstration facilities and so on. Because the horizontal and vertical externalities here operate in the same direction, the clear prediction is that, in **the absence of any agreements**, too little promotional and demonstration activity will take place. Some retailers will attempt to 'free ride' on others, perhaps offering low prices and a warehouse-type ambiance, once customers have had a product demonstrated elsewhere. (iv) Retailers left to themselves would be likely to set location sufficiently distant from rivals to permit supernormal returns to their location but not sufficient to make entry worthwhile. This assumes an element of sunkness about location (which Mathewson and Winter did not), so that potential entrants believe they are unlikely to be able to push established firms out of current locations. In this case, the retailers' locational choices confer a negative externality on the manufacturer leading to a suboptimal density of suppliers from **the manufacturer's point of view**. Vertical restraints imposed by the manufacturer can in principle control all these problems or deal with the externalities involved. Resale price maintenance, quantity forcing, specification of demonstration service and promotional facilities, franchise fees, allocation of territories, and so on, can all be used to this end, assuming the manufacturer