The Economics and Competition Policy of Vertical Foreclosure

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Abstract

The paper reviews the economic literature on vertical foreclosure, and briefly discusses recent studies regarding the effect of resale price maintenance (RPM) on retail services. As for vertical foreclosure, the Chicago school puts forward the single monopoly profit theory and argues that a monopoly firm has no incentive to raise profit by foreclosing competitors. However, subsequent developments, employing game theory, emphasize that the monopolist cannot obtain the monopoly profit due to the commitment problem vis-à-vis the retailers. To alleviate the commitment problem and restore the monopoly profit, the monopolist needs to extend its market power to another segment by means of vertical integration, (industry-wide) resale price maintenance, or exclusive dealing.

The paper then discusses two other mechanisms for vertical foreclosure. First, by purchasing more intermediate goods (capacity), a vertically integrated firm can drive up the price of capacity and raise the cost of competitors. The competitive effect of this strategy, however, depends on the degree of downstream competition. When the downstream market is rather concentrated, competitors will not fully use their capacity in order to reduce output and raise the market price. In this case, "raising the rival's cost" will force competitors to buy less capacity, thus better utilizing existing capacity and improving production efficiency.

Second, RPM or territorial restrictions can be used by an upstream monopolist to share monopoly profit with downstream firms (retailers). By doing so, retailers will have an incentive to protect their monopoly profit and will refuse to deal with the potential up-

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stream entrant, whose entry would intensify competition and reduce total industry prof-it. In other words, sharing profits with retailers forecloses upstream competitors.

Lastly, in regard to RPM and retail services, the conventional wisdom holds that by guaranteeing retailers some profits, resale price maintenance boosts the incentives to provide retail services and improves welfare. Recent contributions, nevertheless, cast doubt on the competitive effect of RPM. When retail services help consumers better assess their willingness to pay, only marginal consumers will benefit from those services. As for the infra-marginal consumer, the willingness to pay and purchasing decisions will not be affected by the retail services. However, a higher price induced by RPM will reduce their consumer's surplus. The conventional wisdom thus tends to overestimate the benefits of RPM. Furthermore, when retail services are a scarce resource, manufacturers will need to offer better terms to retailers so that the latter will allocate more services to their product. Retailers, then, have incentives to reduce the provision of retail services in order to solicit a higher price margin from the manufacturer. In this case, RPM will discourage retail services.

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