

**A CRITICAL EVALUATION OF RESALE PRICE MAINTENANCE
IN SOUTH AFRICA - AN EFFICIENCY INTERPRETATION**

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EXCEPT FOR QUOTATIONS SPECIALLY INDICATED IN THE TEXT,
AND SUCH HELP AS I HAVE ACKNOWLEDGED,
THIS THESIS IS WHOLLY MY OWN WORK AND HAS NOT
BEEN SUBMITTED FOR DEGREE PURPOSES AT ANY OTHER UNIVERSITY.

A SMITH,
DECEMBER 1991

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‘All forms of striving to enhance one’s situation are competition. Indeed, there is competition wherever there is self-interest and scarcity. In the broad sense, neither government nor business policies affect the presence of competition , for neither self-interest nor scarcity is eliminated ... Laws and rules of business conduct cannot increase or decrease competition, but they can and do alter the form in which competition occurs’

Marvel and McCafferty 1985, p.384.

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Abstract

The purpose of this study is to evaluate South Africa's treatment of resale price maintenance in terms of the efficiency school of thought. To regard resale price maintenance as an anticompetitive practice indicates a belief that it blunts the effectiveness of those mechanisms which drive competition. Consequently, the first section of this dissertation develops the theoretical tools required to evaluate this belief. Chapter One critically analyses the nature of the competitive process. Whilst competition is multifaceted, embracing both price and non-price elements, neoclassical economics has typically attached primacy to the role price competition assumes as market regulator. However, controversy has brewed over the primary form competition takes. Structuralists emphasise *actual* price competition amongst incumbent firms, whilst efficiency authors argue that it is *potential* price competition or *actual entry* that is crucial. Believing that it forms an integral part of the efficiency framework, Chapter Two reviews the important contribution made by the new institutional approach. Whilst the institutional framework does not set itself up as an alternative to neoclassical economics, it intends to correct what it perceives as received theory's inability to properly treat intra-firm and inter-firm relationships. These institutional techniques are used to strengthen the efficiency arguments normally raised to defend resale price maintenance. Chapter Three critically analyses the theoretical controversy surrounding resale price maintenance. It concludes that many of the anticompetitive arguments raised to discredit resale price maintenance are of limited relevance. Evidence is gathered to suggest that resale price maintenance can have important procompetitive qualities. In terms of the literature review, the conclusion is made that resale price maintenance does not warrant a *per se* prohibition and should be subjected to a rule of reason test.

Drawing on the theoretical tools examined, the second half of this dissertation critically examines South Africa's treatment of resale price maintenance. It will be argued that the blanket prohibition of resale price maintenance imposed by the Board of Trade and Industries and the Competition Board was ill considered. Two reasons are advanced. First, because the theoretical debate concerning RPM is still not resolved, a more pragmatic policy stance would be more appropriate. Second, important flaws exist within its own policy framework to suggest that it has not consistently and correctly dealt with resale price maintenance. It will be shown that many of the reports which dealt with resale price

maintenance often fail to justify its alleged anticompetitive effects in terms of the arguments normally raised against it. After looking at the way in which the alleged procompetitive properties of resale price maintenance have been dealt with by South African analysts, Chapter Five identifies an interesting disjuncture. In the Board of Trade and Industries' pre-1967 reports the relevance of resale price maintenance's procompetitive properties was often accepted and this led to its justification. Following the 1967 prohibition of resale price maintenance little or no importance was attached to these same procompetitive properties.

A number of policy recommendations are made to the Competition Board, namely to:

- rescind its decision prohibiting resale price maintenance and subject it to ad hoc investigation as it does with all other non-prohibited practices.
- make explicit those mechanisms it understands the competitive process to assume. Whilst the Competition Board argues that competition is of primary importance, it fails to explicitly mention what form this takes. From available evidence it appears as if the Competition Board applied a structuralist understanding to the meaning of competition.
- reevaluate its use of the workable competition framework. A pragmatic approach to monopolistic regulation can still be employed in terms of the efficiency interpretation.
- reconsider its treatment of resale price maintenance's procompetitive arguments, particularly with respect to the relative efficiency of price restraints over non-price restraints.

A Note on Scope and Method

Following the recent reform initiatives precipitated by the De Klerk Government and the African National Congress, South Africa stands at one of the most crucial crossroads in its history. The unbanning of formerly banned organisations, the initial 'talks-about-talks' sessions, the Tuynhuis and Pretoria minutes, and the establishment of joint working and monitoring groups have culminated in the hope that a new democratic society will be forged which will secure the dignity of all its citizens. But the political aspirations to be guaranteed in a post-apartheid constitution will remain, at best, political rhetoric or, at worst, a blueprint for disaster unless attention is given to the economic issues associated with this political transformation. Consequently, the focus of much South African research has been on developing alternative solutions which are capable of correcting past racial imbalances whilst remaining economically credible. It is this climate of policy reevaluation which sparked the basic motive to investigate an element of South African Competition Policy. However, unlike most other research initiatives which have concentrated on aspects of redistribution, this investigation will consider an issue of resource allocation. The author believes that any redistribution programme will be ill-fated unless it is preceded by policies which secure an efficient allocation of the country's scarce resources.

However defined, most commentators believe that South Africa will adopt a *mixed economy* containing elements of both private initiative and state intervention. Whilst calls for 'one-step' or 'two-step' socialism have been made by certain parts of the liberation movement, recent statements suggest that the African National Congress is currently reassessing the relevance of its strategy of a state-led economy (Harris 1989 and 1990). This investigation makes the assumption that competition will have an important role to play in the post-apartheid economy. Consequently, appropriate policy must be in place to remedy anticompetitive practices. It is within this context that this dissertation intends to critically analyse South Africa's past treatment of Resale Price Maintenance (RPM) and suggest relevant policy recommendations to shape future policy. RPM is a vertical price restraint imposed to enforce fixed resale prices or gross margins set across one or several tiers in a product's distribution network. Due to RPM's ability to impede free price determination, both the Board of Trade and Industry (BTI) (1967) and the Competition Board (CB) (1985) recommended that RPM be declared anticompetitive. Parliament accepted these recommendations and outlawed RPM. The following analysis concludes that this prohibition is too severe and demonstrates that RPM has several important

procompetitive qualities which cannot be ignored. A more pragmatic rule of reason approach is called for. The remainder of the introductory note will define the boundaries of this investigation and outline its purpose and method of analysis.

Between the mid-1950s and the early 1980s controversy persisted within the neoclassical paradigm over the so-called 'Concentration-Profits Debate'. Following the earlier Chicago-Harvard exchange and a flood of contradictory empirical evidence, the efficiency and structural interpretations evolved, locked over the central issue of seller organisation. No present definition, however comprehensive it might be, is able to describe either framework. Two tentative reasons are suggested to explain this failure. First, much of the literature appears to be more concerned with the critique of opposing views rather than the construction of explanatory theory. Second, certain taxonomic problems exist. It is often difficult to classify authors into neat groups. Whilst authors might agree on broad principles, there is seldom complete agreement. Thus, even within a particular framework several different splinter groups might exist. Consequently, only loose working definitions can be provided for the efficiency and structuralist approaches. These definitions are stated below and will be used throughout the remainder of this investigation. Drawing on the earlier criticisms raised by Chicagoan authors against the structuralist Limit Price models, the efficiency hypothesis encompasses a broad set of aligned approaches committed to deriving those solutions - *whatever their form or contractual nature* - which minimise the cost of economic organisation. In contrast, the structuralist framework views market structure, particularly seller organisation, as the key causation factor in determining a market's final performance¹.

An efficiency stance is taken because the author believes that it provides a more apt framework, better suited to explaining real world phenomena than the structuralist alternative². Four aspects will be considered in this investigation and are briefly mentioned

1. The monotonic line of causation purported between structure and performance has come under scrutiny. Most contemporary structuralist theorists now concede that the relationship is bi-directional (Geroski, 1988).
2. In drawing this distinction it is not suggested that these are the only two interpretations which make up the neoclassical paradigm. However, these two approaches have dominated the theoretical literature dealing with seller concentration. A detailed classification of divergent interpretations within the neoclassical framework are provided by Auerbach (1986) and Reid (1989). It is not within the scope of the study to consider the more radical neo-Austrian or Marxist schools of industrial thought.

below because they justify the author's reasons for adopting this stance. First, this study questions the apparent exogenouity surrounding the form market structures assume. Structure is simply a 'given' in the analysis. Structuralist analysis has traditionally paid little attention to those factors which influence the evolution of market structures. Second, exception is taken to the generality of collusive behaviour presupposed upon dominant firms operating in concentrated markets. Several necessary conditions must first be satisfied to vindicate the rationality of this behavioural assumption. Third, the structuralist interpretation of barriers to entry is too strict. Traditionally this approach viewed all entry barriers as being anticompetitive, irrespective of whether or not a superior structural configuration - expressed in welfare terms - existed. Certain structural features, such as economies of scale or absolute cost advantage, do impede market entry, but are not anticompetitive in the strictest sense. Much work was done during the 1970s to demonstrate that these 'barriers' represented evidence of superior efficiency, which would not otherwise be realised if these structural conditions were reversed. Four, structuralist analysis often regards efficiency in very narrow terms. The structuralist approach is concerned with efficiency in technological terms and is insensitive to the broader transaction efficiencies.

The controversy surrounding the economic desirability of RPM centres on different perceptions concerning the form competition assumes. Consequently, this investigation must first consider those underlying mechanisms which drive the competitive process in order to establish whether RPM enhances or retards competition. Whilst Chapter One argues that competition is multifaceted, encompassing both price and non-price aspects, neoclassical analysis has typically attached greatest importance to price competition¹. The primacy given to price competition is partly attributable to the relative ease this mechanism affords both buyers and sellers to determine prevailing market signals. However, controversy has persisted within the neoclassical framework over the primary form price competition assumes. Structuralist analysis has typically given emphasis to *actual* price competition. This approach argues that market competitiveness hinges on market structure, particularly seller organisation. In contrast, the efficiency hypothesis argues that *potential*

1. Of course neo-Austrians would reject the importance attached to price competition. They maintain that competition is driven by differential information holdings and on the ability of entrepreneurs to act on it. Distinction is drawn between the Neoclassical Auctioneer and the Neo-Austrian Entrepreneur.

price competition represents the primary form assumed by price competition. Efficiency theorists maintain that it is the condition of entry and evidence of significant sunk cost barriers which determine market competitiveness. In making this distinction, however, it is not suggested that either interpretation excludes the relevance of the other mechanism.

Extending the institutional writings of Commons (1934) and Coase (1937), Williamson (1979, 1983, 1988b, 1989) formulated his New Institutional or Transaction Cost framework. Like his predecessors, Williamson's approach recognised the contract as the ultimate unit of economic inquiry. This followed from his belief that the concluded contract specified the conditions and obligations contracting parties agreed to abide by. The contract was, therefore, the primary vehicle which coordinated all market activity. The significance of Williamson's work lay in his ability to extend the original institutional framework by incorporating those internal and external factors which influenced the transacting process into his analysis. The basic motive to promote efficient contracting between economic institutions led Williamson (1979, 1983 and 1988) to regard his Transaction Cost framework as an integral part of the greater efficiency approach. This tradition was carried forward in the property rights literature pioneered by Coase (1960), Alchian (1965) and Demsetz (1966 and 1969), and the agency approach developed by Hurwicz (1972 and 1973), Spence and Zeckhauser (1971), Ross (1973) and Mirrless (1976). Chapter Two will consider those factors which influence the contracting process in order to incorporate them into the efficiency arguments normally raised to support RPM.

Drawing on the knowledge developed in the opening two chapters, Chapter Three will review the theoretical controversy surrounding RPM. This survey is necessary preparation for the subsequent evaluation of South Africa's treatment of RPM. Whilst some attention is given to the structuralist's anticompetitive arguments, Chapter Three will demonstrate that RPM has important procompetitive properties that cannot be ignored. It will be argued that a blanket prohibition of RPM is excessive and the practice should rather be subjected to the milder *ad hoc* rule of reason test. By incorporating the institutional tools surveyed in Chapter Two, Chapter Three adds to the literature by extending the efficiency arguments normally raised to defend RPM.

The final section of this dissertation will critically evaluate South Africa's treatment of RPM. Chapter Four will demonstrate that the decision taken to prohibit RPM was incor-

rect. Two factors justify this view. First, the decision does not take into account many of the theoretical developments discussed above. Second, in deciding to prohibit RPM, local regulators have not correctly or consistently applied the policy framework to which South African competition policy is committed. Chapter Four will demonstrate that many of the reports dealing with RPM fail to justify its alleged anticompetitive effects in terms of the arguments normally expected to be raised against it. Whilst RPM represents a restrictive trade practice in terms of local legislation, local policy places the onus on regulators to demonstrate that it is on balance contrary to the public interest. Chapter Five will consider how the BTI and CB have treated RPM's procompetitive qualities. This study will demonstrate that both Boards have, over time, attached less importance to these considerations. Moreover, Chapter Five will continue to justify the claim that the BTI and CB have typically assumed a 'soft' structuralist stance in their dealings with RPM.

Chapter Six concludes the investigation and outlines appropriate policy recommendations.

Chapter One: Competition and Resale Price Maintenance

1.1 Introduction

Within a neoclassical paradigm the activities of market economies are coordinated through the actions of individual agents and collective groupings endeavouring to maximise divergent utility functions. However, this self-interest motive is problematic since its realisation often limits the choices available to others. Neoclassical writers have traditionally paid particular attention to sellers believing that they are better placed in the market to disrupt the competitive process. These abuses of market power are undesirable because of their adverse welfare implications¹. Provided that sufficiently competitive conditions prevail, neoclassical authors maintain that all latent market power could be neutralised.

To appraise the economic character of RPM, the study must determine whether it enhances or retards the competitive process. However, such assessment is difficult. Controversy has persisted within the neoclassical framework over the primary form competition assumes. Historically, emphasis has been given to different mechanisms believed to drive competition. These differences have resulted in divergent sets of policy recommendations being compiled to deal with RPM. Before the desirability of RPM can be assessed, it is necessary to consider the controversy surrounding the form competition takes. The chapter will first trace the development of neoclassical thought concerning competition and will demonstrate why the study favours the efficiency interpretation. Thereafter, attention will be given to examining the different welfare criteria each approach has employed. Some of the controversy surrounding the nature of the competitive process and the desirability of RPM stems the use of different welfare tests. Finally, the chapter attempts to elucidate whether any relationships exist between the divergent frameworks. These links or forms of equivalence will have important bearing on the latter part of this study.

1. Extreme Chicagoans would deny the very existence of latent market power (see Bowman 1955, Director and Levi 1956, Bork 1969 and 1978, and McGee 1980). The efficiency approach tempered this view, accepting that market power abuses could occur but only under certain conditions (see Coase 1972, Posner 1979 and Williamson 1988). These conditions will be considered later in this chapter and illustrated throughout the study.

1.2 A Response to Imperfect Competition

The imperfect competition literature developed by Chamberlain (1933) and Robinson (1934) envisaged a continuum of market structures ranging from the most desirable, perfect competition, to the socially sub-optimal, monopoly. Perfect competition's deconcentrated decision-making structure ensured that its agents acted independently. Moreover, its assumption of perfect information enabled market participants to fully understand all pertinent market signals and select those actions which maximised their utility functions. Consequently, these authors believed that it was competition driven by *large numbers* that brought about the desired efficiency gains. In contrast, the single seller's ability to abuse his latent market power resulted in the typical monopolistic distortions - where price charged exceeds marginal cost, $P_m > MC$, and quantity supplied is lower than the perfectly competitive alternative, $Q_m < Q_c$. It was this ability to abuse market power which concerned the imperfect competition literature and became the focus of its policy recommendations. Any arrangement which entrenched a dominant firm's position by restricting free price determination was anticompetitive.

Whilst perfect competition represented the benchmark ideal, in terms of the Pareto optimality criteria, its practical relevance was questioned. Both Clark (1940) and Sosnick (1958) charged that perfect competition ignored several factors, which often have important bearing on real markets. Real markets do not generally consist of a series of spot and forward markets whose auctioneer is guided by the bidding preferences of its many buyers and sellers. Moreover, perfect competition implicitly assumes away any influence that economies of scale, poor management, external economies and diseconomies, dispersion and individuality in traders, variety in outputs, capital shortages and immobile excess capacity might have on the performance of this structure. In many cases, these factors made the real market more desirable than the perfectly competitive ideal. This premise led Sosnick (1958, p.384) to conclude that: "the closest possible approximation (to perfect competition) would entail actual and even equilibrium performance of dubious desirability" (parenthesis added). Correspondingly, these authors rejected perfect competition as a benchmark ideal and developed an alternative framework - workable competition. Besides considering this approach to contextualise the historical development of neoclassical industrial thought, attention is given to workable competition because it will be argued later that both the BTI and CB adopted this stance in its dealings with RPM.

1.2.1 *The Workable Alternative*

Perhaps the fundamental feature which distinguishes workable competition from imperfect competition stems from different perceptions about the monopoly problem. Workability proponents no longer view the problem as an issue of *small numbers* abuse, which causes higher prices and reduces output. Rather, workability authors restated the problem into the broader context of deriving solutions that best alleviated scarcity. Consequently, no *ex ante* presumption was made against any practice or arrangement. Using the public interest test as its welfare standard, this framework adopted a pragmatic case study approach as its method of analysis. This approach often translated into a two step assessment being made. An arrangement might initially be declared anticompetitive in terms of the Pareto optimality criteria, but later might be regarded as being procompetitive once assessed against the broader public interest measure. If, after investigation, a practice satisfied the public interest measure, it was workable. Clearly the public interest measure differs from the Pareto optimality test. The former measure attaches importance not only to a broader set of economic considerations, but also gives attention to those political and sociological factors which effect distribution. The latter measure is concerned with assessing a market's ability to internally allocate and productively use resources. Welfare yardsticks will be reconsidered in Section 1.3.

Markets which were workable represented a first best solution because they maximised society's interest. However, an important qualification is necessary. Due to practical limitations it might not be possible to derive a first best solution in terms of the public interest measure. In these circumstances the second best alternative would be optimal because it was the best solution that could be practically attained.

1.2.2 *A Framework for Workable Competition*

Workable competition has never been rigorously defined. This is perhaps due to the normative nature of the public interest measure. Three factors make it difficult to specify the prevailing public interest. First, changing environmental circumstances might lead to the inclusion of certain elements at one point in time and render them irrelevant later. Second, the impact of certain factors specific to an industry cannot be ignored. Elements

included within one definition of the public interest might be of no relevance when considering another market. Third, the construction of the public interest is based on the normative judgments and personal biases of the policy analyst. Due to divergent value systems, analysts might differ over the form the prevailing public interest takes. In his survey of the literature, Sosnick (1958) noted wide discrepancies in the evaluative criteria used in the public interest definitions compiled by eighteen different authors. This inability to specify the exact nature of the public interest measure led Markham (1950) to propose a loose working definition for workable competition. A market was workably competitive if, and only if, no further state intervention could make the characteristics of structure, conduct and performance more effective and efficient.

In conjunction with its public interest test, the workability approach incorporated three market components into its framework. Each component is briefly considered. *Structure* summarises the relevant horizontal and hierarchical relationships which characterise the organisation of a particular industry. *Conduct* embraces those behavioural actions adopted by incumbent firms. *Performance* represents that final outcome resulting from the economic activity. Welfare is a function summarised by:

$$W = W(S, C, P) \quad (1)$$

The set of structure, conduct and performance characteristics are denoted by S , C , and P vectors respectively. Regulatory policy would only be advocated if after intervention:

$$W^* = W(S^*, C^*, P^*) > W = W(S, C, P) \quad (2)$$

where W^* represents the societal norms set by policy makers.

The imperfection arguments raised by Chamberlain and Robinson against tight oligopolies can be translated into the workability framework. The high seller concentration characterising this *structure* facilitates collusive *conduct* amongst dominant firms. This cooperation allows dominant firms to abuse their market power by raising prices above marginal costs, $P_m > MC$, and restricting output below the competitive level, $Q_m < Q_c$. The absence of large numbers competition to check against collusion, results in an economic *performance* having negative resource misallocative implications. An alternative

argument might claim that highly concentrated structures are not necessarily anticompetitive but are workable. Besides allowing for higher wages or maintaining international competitiveness (Brozen 1982), concentrated markets might allow for the realisation of important scale economies. If effective demand is limited and efficient production requires large scale production, then preventing continued concentration would incur serious efficiency losses.

1.2.3 The Limitations to Workable Competition

Whilst developments made by the workability framework were significant, its broader acceptance was limited. Two factors are responsible. First, the broad and unspecified nature of its public interest measure created uncertainty about its use. Inasmuch as the workability framework redirected the focus of the monopoly problem into its broader context of alleviating scarcity, the changeable nature of the public interest measure prevented consistent policy conclusions being derived. Second, workability analysts failed to make explicit the primary form competition assumed. Whilst this framework cast doubt on the appropriateness of *large numbers* competition, it did not provide an alternative explanation. Workable competition simply relaxed some of the stringency surrounding the assumptions underlying perfect competition.

The remainder of this chapter will consider the subsequent theoretical and empirical writings, which refined the workability framework and culminated in the concentration-profits debate. Important insights can be gained from this debate, particularly about the nature of competition and the welfare standards used to conduct policy investigations. This knowledge will be used later to determine whether RPM enhances or retards competition and to assess the local decision to outlaw RPM.

1.3 The Concentration-Profits Debate

This debate centred on the alleged positive relationship between seller concentration and market profitability. The structuralist approach argued that market structure represented the key causation factor responsible for determining a market's performance. Dominant

firms were believed to have sufficient monopoly power, which they actively abused to impair the free price-setting ability of impersonal market forces. These market power abuses have serious welfare implications. Using profits and seller concentration as proxy measures for welfare and monopoly, a positive relationship was postulated: $r = f(C)$ and $f' > 0$. Here dependent variable, r , denotes a measure of profitability and independent variable, C , a measure of seller concentration. Structuralists argued that the validation of this relationship implied acceptance of the proposition that as seller concentration increased, the more potent dominant firms' market power became, and the greater the likelihood that it would be abused.

Limit price models were formulated to demonstrate how *small number* arrangements would abuse their market power to create abnormal profit-making opportunities (see Bain 1956 and Modigliani 1958). Market power abuses occurred through:

- i. Dominant firms collusively setting limit prices or monopolists setting their own limit prices. In either instance, RPM could be used to set these.
- ii. Raising sufficient barriers to entry to dull potential competition. These entry barriers excluded potential rivals from being able to compete for, and thus neutralise, abnormal profits.

Structuralists were suspicious of those arrangements imposed by dominant firms that interfered with the pricing mechanism because they prevented free price determination and the arbitrage interplay. These 'non-standard' arrangements were channels which facilitated market power abuse. Because RPM interferes with the price mechanism and requires sufficient market power to enforce its set prices, structuralist analysis argued that it would be abused and have anticompetitive consequences. It was only in an environment characterised by *large numbers* competition that these power abuses could be checked¹.

The efficiency hypothesis, led initially by the Chicago School, responded on two fronts to the challenges posed by the structuralist framework. First, the validity of the purported

1. Policy recommendations advocating deconcentration measures reached their peak in the US during the early 1970s following the Johnston Administration's *Antitrust Task Force Report*.

positive relationship between seller concentration and market profitability was contested. A proliferation of inconclusive empirical studies followed, each attempting to demonstrate that no such positive relationship existed¹. Various studies applied new techniques of analysis, lengthened the time series and expanded the cross section but no conclusive evidence could be produced. Second, it was argued that even if the positive correlation was accepted, it did not necessarily represent a net welfare loss. The Chicago School argued that higher profits could only be made in circumstances of superior efficiency (Bork 1978). However, this statement must be qualified. At this stage certain members of the Chicago School must be distinguished from what has become known as the mainstream efficiency approach. Posner (1979) labels these extreme elements as 'Diehard-Chicagoans'. Whilst many of the Diehard criticisms made against the structuralist limit price models were incorporated into mainstream efficiency analysis, several authors argued that their treatment of strategic behaviour was myopic and simplistic (Turner 1969, Posner 1979 and Williamson 1983b and 1988). The Diehard approach refused to recognise that persistent abnormal profit-making arose from strategic abuse. These theorists argued that abnormal profits would attract potential rivals, who were capable of neutralising any strategic abuse. Dominant firms were expected to always act in an efficiency enhancing manner. In short, the Diehards denied the very possibility of market power abuse. Mainstream efficiency authors maintained, on the other hand, that this conclusion was only plausible when the strict assumption was made that markets operated without friction. They recognised that market imperfections existed, which incumbent firms would exploit to raise significant sunk cost barriers to entry. When prohibitively high entry barriers were in place, potential rivals could not enter the market and neutralise the abuse. The mainstream efficiency approach accepted that strategic abuse could occur². Thus, the necessary qualification must be made to the Diehard view: higher profits represent evidence of superior efficiency only when no significant sunk cost barriers to entry are in place. Consequently, if RPM is imposed alongside significant entry impediments and the set margins are in excess of the competitive minimum, then it is anticompetitive. The nature of these sunk cost entry barriers and market frictions will be reconsidered in

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1. An interesting exchange occurred between Weiss (1974) and Demsetz (1974). A tabulated summary of all empirical studies conducted until the mid-70s is recorded and critically reviewed by Weiss.
 2. Chapter Two will formally introduce the behavioural assumption that dominant firm's are motivated by guileful self-interest.

Section 1.2.3 and Chapter Two.

Deviating from the structuralist ideal of deconcentrated structures and *large numbers* competition, efficiency authors revealed no preference for any single structure or arrangement. Rather, they endeavoured to derive solutions which minimised the costs of economic organisation. To this end, the efficiency framework adopted a broader view about the nature of these costs. Attention was not only given to the immediate technological considerations, but also to the broader transaction costs. Efficiency authors argued that many 'non-standard' arrangements, such as seller concentration or restrictive trade practices, were not necessarily devices used to abuse market power but might have greater efficiency enhancing properties. These cost considerations underlie agency theory and the property rights literature. The different welfare measures used by each framework are reconsidered in Section 1.4. The desire to economise on the costs of industrial organisation can be translated into Baumol's (1982) notion of sustainability. A sustainable industry configuration is not only financially viable and satisfies market demand, but also represents the lowest cost alternative. A sustainable industry configuration displays no external allocative, productive, distributive or internal firm specific inefficiencies (described by Liebenstein's (1966) X-inefficiency). Firms are forced to operate at the minimum points of their long run average cost functions. Within this framework, market competitiveness is determined by the *condition of entry*. In the sustainable ideal, potential entrants enjoy free entry and exit. Evidence of abnormal profits attracts entry into the market, thereby neutralising any market power abuse. It is the *threat of entry* or *potential competition* which checks market power abuse.

The purpose of this chapter has been to highlight those mechanisms that drive the competitive process in order to determine whether RPM enhances or retards competition. However, due to the controversy surrounding the meaning of competition, two contradictory preliminary conclusions have been drawn. First, structuralists would argue that RPM is anticompetitive because it interferes with the free price-setting ability of impersonal market forces. Thus, RPM is a contractual arrangement dominant firms use to abuse their market power. Second, efficiency authors argue that RPM is only anticompetitive once significant entry impediments accompany it. Whilst arguments for and against RPM will be examined in Chapter Three, two further aspects concerning RPM and the competitive process must first be considered:

- i. RPM agreements can be imposed collectively by a group of incumbent firms. Opponents of RPM argue that when this vertical arrangement is used collectively it facilitates horizontal collusion, which violate the strict Pareto optimality conditions. However, collusive action cannot always be presupposed. Unless certain conditions exist to make collusion a rational action, it becomes increasingly difficult to demonstrate that RPM is being used to administer a cartel. This chapter will critically examine the theoretical foundations which underlie the concentration-profits debate to identify those conditions necessary to induce collusion¹.
- ii. Whether RPM is imposed individually or collectively, efficiency analysis argues that it can only be abused if sufficient sunk cost entry impediments exist. Attention will be given to the nature and form that entry barriers can assume.

1.3.1 The SCP Paradigm - The Concentration-Collusion Relationship

The Structure-Conduct-Performance (SCP) paradigm was formulated by structuralist analysts to provide a theoretical rationale to justify the purported empirical relationship between seller concentration and profitability. Drawing on the same classification used by workable competition, the SCP paradigm argued that a monotonic line of causation ran between these market elements. In short, it argued that a market's *performance* depended on those *conduct* options selected by incumbent firms. *Conduct* depended upon the nature of the market *structure*. The SCP paradigm maintained, therefore, that concentrated markets necessarily lent themselves to anticompetitive conduct.

Collusion eliminates competition by replacing the independent profit motive with joint industry profit maximisation. The joint setting of prices and output quantities creates abnormal profit-making opportunities for cartel members, which would not otherwise be realised under competitive circumstances. Consequently, collusion is an attractive conduct

1. RPM can also be imposed independently of other firms, provided that these firms have sufficient market power. Structuralists would argue that RPM is anticompetitive because it interferes with the actual price mechanism. Efficiency proponents, on the other hand, would maintain that RPM is not necessarily anticompetitive unless it is accompanied by sufficient sunk cost barriers to entry.

option sellers would wish to assume, whatever the market structure they operate in. However, the process of collusion is not costless. Before deciding to collude, firms must compare its associated costs and benefits. Obviously, it is rational for firms to collude only when the benefits outweigh the costs at the margin. Structuralists thus argued that the net benefits derived through collusion were greatest in concentrated markets. Three cost considerations justify this claim¹. First, the direct bargaining costs associated with setting the cooperative agreements increase as the number of members in the cartel increase. Scherer (1980, p.200) demonstrated that when two firms collude, only one communication channel was required to promote effective coordination. If the number of firms increased to six, a minimum of fifteen channels would be required to facilitate collusion. Second, higher seller concentration afforded cartels relatively lower monitoring costs. A cartel can only be effective if its members abide by the rules set out in the cartel agreement. Fewer market participants, require fewer policing checks to ensure compliance. Third, dominant firms in highly concentrated markets often have greater scope for retaliatory action than firms in less concentrated markets. Cartels in highly concentrated markets are better placed to coerce members back into line. Consequently, the non-compliance costs are greater in concentrated markets.

1.3.2 An Efficiency Response to Collusion

The efficiency approach contested the apparent presumption made that firms operating in highly concentrated markets necessarily acted collusively. Rather, seller concentration was only one of several factors which affected the decision to collude. Efficiency proponents maintained that unless suitable conditions prevailed, it became increasingly difficult to presuppose collusive behaviour and argue that RPM was being used to administer a cartel. The five factors they believed to influence the decision to collude are now considered.

1. The costs associated with collusion are also influenced by the type of collusion adopted. Tacitly colluding firms do not share in the lower costs that direct bargaining affords. Tacit collusive information is obtained from monitoring the market and observing what other firms are doing. These probes, especially in conditions of uncertainty, add to the costs of tacit collusion.

1.3.2.1 The Degree of Product Homogeneity

It is only in the special case of perfect competition that consumers display complete indifference to products on offer by competing firms. Within this market, the assumption of product homogeneity results in competition taking place across one dimension - price. However, easing this strict assumption, to allow for even moderate degrees of product differentiation, introduces price and non-price competition. Where sufficient product heterogeneity exists, different firms will endeavour to secure *brand loyalty* for their products because consumers value the product's non-price attributes more than its immediate price considerations. In these conditions it often happens that non-price competition becomes more important than price competition. Consequently, the incentive to collude generally increases the lower the degree of product homogeneity. It is expected, therefore, that RPM will be used to administer a cartel where close but not perfect substitutes for the products of member firms exist in a market.

1.3.2.2 The Nature of Inter-Firm Cost Structures

The motive for firms wanting to collude follows from the expected gains joint profit maximisation brings. The size of individual cartel member's profits depend partly on the agreed volumes they are permitted to supply. Where wide cost differences exist between member firms, the incentive to collude decreases. More efficient firms can outmanoeuvre less efficient members and realise greater individual gains than those attainable from the cartel agreement. If wide inter-firm cost discrepancies prevail, it is unlikely that the more efficient firms would want to collude or use RPM to administer a cartel.

1.3.2.3 Uncertainty

Forecasting is an activity most firms perform to secure their longer term survival. However, the accuracy of forecasts is partly dependent on the degree of market uncertainty. The more erratic and uncertain prevailing market conditions are, the more costly and difficult forecasting becomes. Shepherd (1979) argued that concluding collusive arrangements was often a response invoked to reduce uncertainty. Setting mutually agreed upon parameters

stabilises the market, thereby making forecasting more certain. Consequently, there is greater incentive to collude and use RPM to administer the cartel when market conditions are uncertain.

1.3.2.4 The Level of Market Profits

There exists a general presumption that firms collude simply to create abnormal profit-making opportunities. However, Brozen (1982, p.209) argued that collusion was often a defensive tactic firms adopted during periods of low profitability to secure survival. Tracing American history, he maintained that cartelisation was most prevalent during periods of recession, reaching its peak during the Great Depression of the 1930s. Brozen rejected the concentration-profits hypothesis, offering its antithesis - a *negative collusion-profit* relationship. This negative relationship is supported by studies conducted by Asch and Seneca (1976) in the US, and Hunter (1966) in the UK. Consequently, consideration has to be given to the level of market profitability before judging whether RPM is being used to administer a cartel.

1.3.2.5 Rate of Innovation

Innovation can occur through organisational change, improved production techniques or product enhancement. In its first two forms innovation has important cost implications. Lower costs afford the innovator more scope to deviate from the rules of the cartel agreement and act independently to raise individual profits. Environments characterised by high rates of innovation place great pressure on member firms to break away from the cartel. Furthermore, changing cost structures necessitates new agreements having to be negotiated. High rates of innovation could thus add significantly to the costs of colluding. Each time an individual firm's cost structure changes, existing agreements have to be renegotiated. However, drafting new contracts is not costless. Simply put, rapid technological change adds to the cost of colluding. Consequently, if RPM is being used to administer a cartel, consideration must be given to the rate of cost reducing technological change in that industry.

Product development can enhance a firm's competitive edge. Consequently, these firms may not be willing to sacrifice the improved market position these innovations bring in favour of acting collusively. Hence there may be little incentive to collude or to use RPM to administer a cartel under conditions of rapid product innovation in a market.

1.3.3 Persistent Profitability - Barriers to Entry

The presence of barriers to entry provides the dynamic rationale both the structuralist and efficiency approaches use to explain how anticompetitive behaviour can persist in the long run. Sufficiently high barriers, whether invoked innocently or strategically, prevent potential rivals from disturbing abnormal profit-making arrangements. However, controversy exists over the form entry barriers take. The following section will briefly consider this controversy, highlight the weaknesses in the structuralist interpretation and describe the form efficiency pundits believe entry barriers take.

In his seminal work, *Barriers to New Competition*, Bain (1956) argued that limit pricing strategies were employed when sufficiently high entry barriers excluded potential rivals. Bain argued that entry barriers arose from certain advantages incumbent firms enjoyed over potential rivals. These advantages allowed incumbent firms to set prices above competitive levels but not high enough to attract entry. Although limit prices did not maximise profits, abnormal profits could still be made. Bain maintained that entry barriers arose from either absolute cost advantages, economies of scale, advertising or product differentiation. Whilst these advantages do in the strictest sense restrict entry and will delay the erosion of abnormal profits (Posner 1976), many efficiency critics (Demsetz 1974, Bork 1978 and Williamson 1983b) argue that these 'barriers' are not anticompetitive. Rather, they bear testimony to the superior efficiency achieved by incumbents. The scale economies argument is used to illustrate this. Assume that a market is characterised by a few large firms each enjoying scale economies. Structuralist theorists would argue that these scale economies restrict entry because of the high fixed costs entrants have to incur to compete favourably. Consequently, economies of scale represents an entry barrier because it prevents entry and does not promote competition in the structuralist sense - *large numbers*. However, efficiency authors would argue that increasing the number of firms in these circumstances, reduces the savings longer production runs afford. Allowing

these scale economies would be procompetitive because of their lower cost implications.

Stigler (1968) argued that entry barriers resulted from those costs potential rivals had to bear to enter a market, but which firms already in the market did not incur. Unless the alleged barrier raised potential rivals' cost curves above those of incumbent firms, the efficiency framework did not regard it as a barrier to entry. Demsetz (1974) suggested that government regulation and intervention represented the ultimate costs which restrained entry. If potential entrants could not satisfy regulatory requirements they would be unable to enter the market. However, the form these entrance costs assumed was extended by Baumol (1982). He argued that entry barriers arose only if entrants had to incur significant sunk (non-recoverable) costs on entry or exit. These sunk costs are broader than the interventionist costs envisaged by Demsetz because they can include the fixed cost barriers described by Bain above. However, the important qualification is made that these fixed costs must be non-recoverable. Unless RPM or any other restrictive arrangement results in potential rivals having to incur significant sunk costs, or are used alongside other arrangements which result in these sunk costs, they are not necessarily anticompetitive.

1.4 Welfare Yardsticks

Neoclassical economics argues that the promotion of competition is significant because it has important welfare implications. One of the purported advantages is that it allows for efficiency gains not attainable in non-competitive environments. However, what is efficiency and against what yardstick should it be measured? Much of the controversy surrounding RPM hinges on the welfare test used to measure efficiency. The following discussion will briefly demonstrate how applying different yardsticks can lead to divergent policy conclusions and justify why the efficiency framework's measure is superior.

Part of the justification given for adopting an efficiency stance follows from a belief that the structuralist view of efficiency is too narrow. Typically, structuralist analysis used profitability as its proxy measure for welfare. Evidence of abnormal profits implied that important resource misallocation or usage inefficiencies had occurred. Because RPM prevents free price determination, structuralists expected dominant firms to abuse their

market power to set excessive price margins. Consequently, RPM is inefficient because of its misallocative implications. However, two problems exist with this measure. First, structuralists view costs simply in terms of the seller's technological considerations. They are often insensitive to the broader transaction cost considerations: Restrictive trade practices such as RPM might be imposed to compensate contracting agents for the negative effects of market failure. For example, consumer ignorance compounded by seller opportunism add to the transaction costs of prospective buyers. If these costs are excessive, buyers might be forced into making sub-optimal decisions. Applying a restrictive agreement might eliminate many of these uncertainties, thereby reducing transaction costs and allowing buyers to benefit from transaction economies. Factors which cause these market failures are considered in Chapter Two. Second, structuralist analysts give little attention to the broader distributional aspects associated with economic activity. The Pareto optimal measure only considers resource allocation and usage. Is such a narrow yardstick appropriate in the post-apartheid era? Perhaps distribution should be an important consideration in any welfare measure. In this regard, RPM might have important product distributional implications, which cannot be realised in conditions of free price determination. Certain distributional effects are considered in Chapter Three.

The efficiency approach advocated a broader rule of reason test for policy assessment. This test was similar to the public interest measure because it considered a wider set of costs, the interests of participants other than sellers and the broader distributional implications. However, the rule of reason test was narrower and more specific than the public interest measure. Demsetz (1974) suggested a composite set of elements which could be employed to assess the efficiency of an industry: Relative price trends, the extent of product development and cost innovation, the amount of research and development evident and the industry's ability to improve the welfare of its workers. Williamson (1983b) argued this could be extended to incorporate relevant transaction factors.

1.5 Workable Competition and the Concentration-Profits Debate

Accepting that perfect competition is not attainable or even desirable, workable competition endeavoured to derive solutions which made 'competition work' (Sawyer, 1985, p.252). However, finding these solutions can be difficult because workable competition

failed to explicate those mechanisms it perceived to be responsible for driving competition. Relying on some of the later refinements developed by the concentration-profits debate the efficiency and structuralist views can be used to derive 'workable' solutions. Due to their divergent views on the form competition takes, each might not reach the same decision about which arrangement should be deemed 'workable'. Consequently, it must be determined whether any linkages exist between workable competition and the structuralist and efficiency approaches. An understanding about the nature of these linkages is important because Chapter Four will argue that local competition policy has adopted the workability framework. If it can be demonstrated that a close relationship exists between workable competition and the structuralist view, then it can be argued that the local decisions taken to prohibit RPM were consistent with the boundaries set by workable competition. Otherwise, if workable competition is closely related to the efficiency framework, then the decision taken to outlaw RPM is not consistent in terms of its policy framework. Sawyer argued that two distinct strands or versions of workable competition exist. Each is discussed in turn.

Three factors suggest that workable competition and the structuralist framework are closely linked. First, Sawyer argued that both approaches adopted a discretionary technique to determine whether the performance of an industry was acceptable. If after investigation it was revealed that an industry's performance was unacceptable, then both approaches advocated policies to alter malleable elements of structure, conduct and performance. The subdivision into these three categories was not used as a methodological tool by the efficiency framework. Second, Shepherd (1970) argued that the structuralist version of workable competition maintained that there was a natural tendency for market power and seller concentration to increase over time. Existing structures were seldom optimal, nor did they display a tendency to become more competitive. Consequently, policy was often directed towards deriving structures which were desirable. Third, some quarters argued that the workable competition approach was not a rejection of imperfect competition but rather an attempt to qualify its use (Reid, 1989). Wilcox and Shepherd (1975) argued that neither workable competition or the structuralist approach viewed perfect competition as practically attainable. However both shared the same policy goal of finding some middle-of-the-road solution, which promoted actual competition amongst incumbent firms and prevented excessive seller concentration. Chapter Four will argue that the South African BTI and CB have adopted this stance in their dealings with RPM.

Likewise, a strong case can be made to suggest that workable competition forms an important part of the broader efficiency approach. Four factors are considered. First, workable competition, like the efficiency approach, accepts that 'good performance' can result from structures which are not necessarily atomistic. Both approaches accept that 'non-standard' arrangements, such as a concentrated market structure, might offer important cost savings which could not otherwise be attained. However, the workability approach did not specify the form it understood competition to take. Second, both views did not openly argue in favour of a line of causality, running between structure and performance. Structure and market power abuse are not used as their principal means to explain market performance. Sawyer (1985) held that there was a distinct view within the workability framework which believed that existing structures evolved towards 'optimal' solutions. By stressing a dynamic role for competition, Clark (1955 and 1961) rejected the rather static nature of market structures presupposed by the SCP paradigm. Linking Clark's work to contestable market theory, Reid (1989, p.137) argued that the workability and efficiency frameworks favoured a 'hands-off' policy approach. Provided that no restrictions are placed on entry, markets will move towards competitive solutions. Third, workable competition rejected the strict use of Pareto optimality as a welfare measure. Workable competition and the efficiency framework both applied similar welfare tests. Whilst the public interest test is broader than the efficiency rule of reason measure, both adopted a wider view about the nature of the costs to be considered. Four, workable competition and the efficiency paradigm both apply a pragmatic case study technique to conducting policy investigations. Whilst it is true that Diehard-Chicagoans would reject this discretionary approach, it has become an integral part of the efficiency mode of analysis (Reid, 1989). This study favours this interpretation.

1.6 Summary

This chapter has attempted to critically analyse the controversy surrounding the form competition assumes. An understanding of those mechanisms which drive the competitive process is necessary to appraise the economic character of RPM. Following the lead given by the imperfect competition literature, structuralist authors argued that *actual* price competition represented the primary form of competition. Limit price models were used

to describe how dominant firms could abuse their market power to create abnormal profit-making opportunities for themselves. Any arrangement imposed by dominant firms which restricted the arbitrage process was anticompetitive. Because RPM interferes with the price mechanism and requires sufficient market power to enforce its set prices, structuralist analysis argued that it had anticompetitive consequences. To this end, perfect competition represented a benchmark ideal because the insignificant size of its incumbent firms prevented them from having latent market power reserves which could be abused. Consequently, RPM cannot be imposed in *large numbers* arrangements. Important weaknesses were identified with the structuralist interpretation of competition and justified support for an efficiency stance. Three factors were considered. First, opponents of RPM argue that it can be imposed collectively to administer a cartel. This study has considered five factors which effect the desirability to collude. These factors were never incorporated into structuralist analysis. Unless these five conditions are conducive to collusion, it becomes very difficult to demonstrate that RPM is being used to administer a cartel. Second, a more specific interpretation was made about the form entry barriers assume. Third, attention was given to the welfare yardsticks employed by the divergent frameworks, which resulted in different policy recommendations. It may be argued that the structuralist use of the Pareto optimality measure, and profits as its proxy, was inappropriate. This measure failed to take into account a wider set of cost and distributional implications. In contrast, efficiency proponents have argued that competition was driven by potential price competition. It was the threat of entry which prevented incumbent firms from abusing their market power. Efficiency authors maintained that market competitiveness hinged on the condition of market entry. Unless sufficient sunk cost barriers to entry existed, entry by potential rivals eliminated market power abuse. Provided that no significant entry barriers accompanied its imposition, RPM is thus not necessarily anticompetitive.

Chapter Two: Vertical Considerations - A Transaction Approach

2.1 Introduction

The previous chapter considered the controversy surrounding the form competition took. Structuralists feared those arrangements which restricted *actual* price competition because they allowed dominant firms to hold industries or consumers to ransom. Because RPM was an enforced agreement, which prevented free price determination, the structuralist approach maintained that it was anticompetitive. Efficiency authors rejected this view and argued that competition was driven by the condition of entry into a market. Unless sufficient sunk cost barriers to entry were in place, arrangements that restricted actual price competition were not necessarily anticompetitive. Moreover, in terms of its broader welfare perspective, Chapter One tentatively suggested that the efficiency framework believed that RPM might have important cost saving implications.

An important development within neoclassical industrial economics has been the popularisation of the *new institutional* paradigm. This development is significant because it provides analysts with a set of highly focused tools suitable for analysing vertical market relationships. The institutional approach places the contract at the centre of its analysis and maintains that it is ineffective contracting which allows market power abuse. Ineffective contracting results from the interplay of a set of internal and external factors. This chapter will review these factors with a view to incorporating them into subsequent chapters, which deal with RPM. Two aspects of this framework are considered. First, the historical development of the institutional framework is reviewed in order to demonstrate how it forms an integral part of the broader efficiency approach. Second, consideration will be given to those internal and external factors which allow these market power abuses.

2.2 The New Institutional Framework

Commons (1934) argued that within market economies the transaction represented the ultimate unit of economic enquiry. This followed from his belief that it was this mechanism which formally integrated economic activity. The contract specified the responsibilities and obligations market participants agreed to perform. The nature of the concluded contract ultimately determined resource allocation, use and distribution.

In a perfectly competitive environment it was the Walrasian auctioneer who brought together the revealed preferences of buyers and sellers to transact in highly specialised spot or forward markets. Agents acted rationally because of perfect knowledge. However, Coase (1937) argued that perfect competition's assumption of complete information could not be vindicated in real markets. Real markets were characterised by varying degrees of uncertainty. This uncertainty implied that transacting was no longer costless. Agents transacting in markets with less than perfect information incurred two types of transaction costs, namely search and negotiating costs. It was these costs which led early institutional writers to argue that the market might not always be best at allocating resources. Coase concluded that markets and firms represented alternative institutional arrangements both equally capable of integrating market activity.

Although this early article was well received, no subsequent work followed for approximately thirty-five years. Alchian and Demsetz (1972) argued that this lull resulted from a failure to develop a systematic technique whereby the efficacy of alternative contracting forms could be considered. Coase's work examined only one issue - the extent to which the boundaries of the profit-maximising firm should extend¹. It was only after the path-breaking work of Williamson, whilst developing his *new institutional* framework (1979, 1983b, 1988 and 1989), that the widespread applicability of transaction cost analysis became evident. Williamson did not regard his approach as an alternative to conventional microeconomic analysis, but in keeping with the Coasian tradition intended to supplement the latter's inability to adequately deal with intra-firm and inter-firm relationships. The modern firm was more than a production function which mechanically responded to the orders given by its profit-maximising entrepreneur. Rather, its behaviour ultimately depended upon its ability to contract. Consequently, Williamson's transaction cost analysis was primarily concerned with reversing the contractual frictions that emerged from the transacting process.

1. Certain non-economic explanations have been given to explain the extent of the firm. These range from 'power-hungry' entrepreneurs intent on empire building to: "the adventitious result of legal, historical or political forces" (Granovetter, 1985, p.488). Transaction Cost analysis accepts the relevancy of these arguments but distinguishes between core and auxiliary purposes. It argued that the primary reason for the existence of any economic organisation stemmed from attempts to economise on the costs transacting.

At a first glance it might be expected that the transaction cost analysis should be classified as a structuralist development due to its suspicion of small number arrangements. However, the transaction cost approach, like the broader efficiency framework, is guided by the overriding principle of *cost minimisation*. Although the institutional approach looked hesitantly at the small numbers case, it did not exclude its relevance as a competitive alternative. Unlike the structuralist interpretation, no monotonic relationship was purported between structure and final performance. Market power abuses did not necessarily follow from structure. Rather, both the transaction and efficiency approaches accepted that strategic abuse arose from those market frictions which invoked significant sunk costs to entrants. The transaction cost literature argued that these entry barriers resulted from a set of factors which influenced the contracting process¹. A further similarity between the transaction cost and efficiency approaches is evident and centres on their broader view of welfare. Unlike the structuralist approach which used profits as its proxy measure, the more contemporary efficiency literature incorporates these transaction cost considerations into its welfare measure. These institutional techniques will be incorporated into the efficiency arguments used to defend RPM.

The institutional approach has important implications for competition policy because it directs policy's attention towards deriving efficient contracts. Contracts which are efficient and effective prevent any form of market power abuse. Consequently, regulatory policy must examine those factors which influence the efficacy of contracting. The remainder of this chapter will, in Section 2.1 and 2.3 respectively, consider those internal and external factors which affect the contracting process.

2.2.1 The Behavioral Assumptions of Transaction Cost Analysis

The new institutional framework criticised the neoclassical assumption of self-interest. Adam Smith argued that economic man was best motivated by those actions which maximised self-interest. This behavioural assumption filtered through to most standard microeconomic formulations as sellers maximising profits and buyers maximising personal

1. An interesting rendition of the property rights literature's understanding about barriers to entry is given by Demsetz (1982).

utility functions. Optimisation requires rational behaviour. However, agents can only act rationally once they can properly process and understand pertinent market information. Simon (1957) rejected this notion of rationality. He argued that whilst economic agents wanted to act rationally, such behaviour was intrinsically constrained by personal neurological and language limits. He maintained that economic agents were generally unable to: understand and interpret all available market signals, always accurately state their true preferences and communicate these to other participants, and understand all economic processes. Simon concluded that economic agents intended to act rationally, but were limited by internal constraints. Williamson incorporated this notion of *bounded rationality* into his transaction cost analysis.

Williamson further argued that this constraint of bounded rationality was exacerbated by opportunism. He rejected the traditional neoclassical assumption that economic man was motivated by self-interest. Williamson argued that this posit was too simple and naive an explanation of human behaviour. This self-interest motive assumed a far greater magnitude than that normally credited by conventional neoclassical economics. Egocentric man did not necessarily subscribe to a set of moral guidelines - as the standard neoclassical assumption suggested - but robbed, murdered, lied and cheated. In short, economic agents were motivated by guileful self-interest. Williamson expected agents to act opportunistically and actively exploit the bounded rationality of others. When informational mismatches arose between agents, strategic abuse followed. Consequently, the new institutional framework introduced moral hazard into its analysis. Due to their superior information holdings and better familiarity with environmental conditions, it is assumed that sellers will act opportunistically and that buyers suffer from bounded rationality.

To derive efficient contractual relationships, policy analysts must be concerned with minimising the degree of moral hazard associated with contracting. The priority given to this hazard will depend on the mismatch between these internal factors and external factors still to be considered. Subsequent chapters will argue that RPM has important procompetitive qualities, which protect agents from opportunistic abuse.

2.3 The Process of Contracting

Consideration will now be given to those external factors that influence the form transactions take. Williamson (1989) regarded three factors relevant: asset specificity, uncertainty and the dynamic nature of contracting. This list is extended to incorporate a fourth factor - the assignment of property rights. Although the relevance of this factor was implicit throughout the entirety of Williamson's analysis, its explicit treatment is important here because it has important bearing on later discussion dealing with RPM.

2.3.1 The Assignment of Property Rights

It is the transfer of property rights, which explains why agents enter into contractual agreements. Agents agree to these exchanges because they are mutually beneficial. No rational agent will agree to an exchange if he cannot obtain the desired property rights. Moreover, an agent will not be able to act in a desired manner if he cannot obtain the necessary property rights to execute that action. For example, potential rivals will not be able to enter a profitable market unless they can secure the necessary raw materials from an upstream supplier. In this case, a misassignment or non-assignment of rights can represent a sufficiently high sunk barrier to entry.

Contracts are distinguished by the rights each assigns. For example, the only material difference between RPM and an agency agreement is that ownership title of the product is transferred. Both these agreements are vertical contracts, each authorising the downstream retailer to sell the product at fixed resale prices. However, in terms of RPM the retailer receives ownership title, whilst in terms of an agency agreement he receives stocks on a consignment basis. The agency agreement absolves the retailer from most risk because he can return excess stocks. The assignment of property rights will be reexamined in Chapter Three.

2.3.2 Asset Specificity

The successful execution of an economic contract might necessitate the deployment of certain assets to a specific transaction. However, whilst risk is a normal feature which contracting agents have to incur when transacting in a market economy, these asset specific deployments can be subjected to a particular form of opportunistic abuse. Goldberg (1976) argued that a sufficiently empowered agent can 'hold up' the other contracting party if an incomplete or short term sequential contract was concluded. Assume that a downstream buyer refuses to renegotiate with an upstream supplier who has invested heavily in certain transaction specific assets. Due to the special nature of this investment and the unlikelihood that these assets can be reallocated to other purposes, the downstream agent is able to hold the upstream supplier to ransom. The downstream agent can coerce the upstream supplier into accepting new conditions which are no longer mutually beneficial. If the upstream supplier does not accept these new conditions, he faces the prospect of not being able to recoup the sunk costs from the original contract. Similar sentiments were expressed by Klein and Leffler (1981) and Williamson (1983a) in separate hostage models. To minimise exposure to *ex post* haggling, Perry (1989) suggests that various *ex ante* monitoring controls can be built into the contract¹. Klein, Crawford and Alchian (1978) argue that RPM might represent a control device suitable to enticing agents into making these transaction specific investments. By providing a fixed margin, contractual risk can be reduced to acceptable levels and these assets can be sufficiently rewarded to cover those alternative uses foregone. Chapter Three will demonstrate how RPM can satisfy these specificity requirements.

2.3.3 Uncertainty

Environmental uncertainty has important bearings on the transacting process because agents are exposed to increased moral hazard. Uncertainty can cause three kinds of anti-competitive abuse, each depending on the duration length of the contract. The effects of

1. It is noted that exposure to asset specificity abuses could be circumvented by drafting an all claims contingency contract. These long term contracts specify all future conditions and obligations that agents agree to adhere to. However, section 2.3.3 considers certain of the practical difficulties involved with the implementation of this type of contract.

three different time lengths are considered.

A long term *all claims contingency contract* can be concluded, which takes cognisance of all future contingencies and specifies all future obligations. Although the initial costs of concluding this once-for-all contract are significant, it is advantageous because no subsequent renegotiating is required. However, only a few transactions can be concluded in this manner. Economic agents are intrinsically limited by bounded rationality and cannot accurately foresee all future contingencies. Thus, it is unlikely that agents will be able to specify all future obligations necessary to conclude this type of contract.

Short term *sequential contracts* can be used to circumvent the bounded rationality constraint. These spot contracts avoid forecasting errors because efficient adaptations can be made to the contract once market conditions become better known. However, Williamson (1983b) identified two potential problems with this type of contract. First, an efficient contract might require one or both parties to invest in transaction specific assets. These asset specificity requirements infer that agents will not contract, unless they can be given some form of security. Short term contracting does not necessarily give this security because no guarantee exists that subsequent contracts will be concluded between the original contracting parties. Agents will not incur these sunk costs if a short term sequential contract has been entered into. Second, sequential short term contracts are open to first mover advantage abuse. Before the first round of contracting is concluded, all competing parties enjoy some degree of parity with respect to the initial winning of the contract. However, if nontrivial advantages accrue to the original contract winner, these information advantages might be opportunistically abused at later rounds of renegotiation. In these circumstances the original contract winner enjoys certain monopolistic advantages over his competitors and can hold the other contracting party to ransom.

The third contract option takes the form of longer term *incomplete contracts*. This alternative represents a compromise between the other two options discussed above. General principles are drafted into the incomplete contract and are later elucidated once market conditions become better known. The incomplete long term contract has two advantages. First, the problem of bounded rationality associated with the complete contingency contract is avoided because efficient adaptations can be made at later periods. Second, incomplete contracts can provide the security necessary to satisfy any asset specificity condi-

tions. It can be agreed in principle that contracting agents will not enter into any other contract, which would compromise the other agent's specificity requirements. However, incomplete contracts can be exposed to other forms of *ex post* abuse caused by contractual ambiguity. If the general principles agreed to in the incomplete contract are ambiguous, unscrupulous agents can abuse this uncertainty at later renegotiations. This *informational impactedness* stems from a sufficient mismatch of private information between contracting parties to allow one agent to exploit the other. The effects of information impactedness are further experienced if contracting agents display false preferences. Such fraudulent behaviour leads to strategic abuse and direct exploitation of the other contracting agents.

Williamson held that efficient contracting demands that policy analysts give specific attention to the effects of uncertainty. Suitable *ex post* remedies must be incorporated into the contract to lower its exposure to uncertainty. Williamson argued that contracting parties should make explicit the private ordering required to rectify potential disputes. For this purpose Chapter Three that RPM can be used to eliminate these anticompetitive pricing disputes.

2.3.4 The Dynamic Nature of Contracts

It has been argued that the conclusion of efficient contracts hinges on the correct assignment of property rights, whilst the transaction's exposure to information impactedness and opportunistic abuse are reduced. Consequently, it must be ensured that effective *ex ante* negotiation occurs and adequate *ex post* remedies are in place to resolve any disputes. However, many transactions are recurrent in nature and have to be renegotiated. Williamson stressed that account has to be taken of the dynamic nature of contracts to ensure that they remain efficient. Even if the original bargaining was conducted under competitive conditions, there is no guarantee that these conditions will continue during later renegotiations. The interplay of the three static factors described above can seriously impair intertemporal contracting, making later contracts less effective. In short, policy analysts should not assume that efficient contracts will continue to remain so. Drawing from an earlier example, assume that an incomplete contract was concluded under competitive bargaining conditions. During later rounds the original contract winner abuses his first mover advantages. These tactics effectively exclude non-winners from

participating in later bidding and, thus, represents a prohibitively high sunk cost barrier to entry. This exclusion can allow the contract winner to hold the other contracting party to ransom. In this context, RPM might be used by contracting agents to protect themselves from later anticompetitive pricing abuses.

2.4 Summary

New institutional economics regards the contract as the ultimate unit of economic enquiry. Consequently, policy analysts have to take cognisance of those factors which affect the contracting process. Believing that the new institutional approach forms an integral part of the efficiency framework, consideration was given to those factors which influenced the contracting process. These techniques will be used to strengthen those efficiency arguments normally used to defend RPM. Consideration was given to the behavioural assumptions which underlie the contracting process. Transaction cost analysis dismissed the neoclassical assumption of self-interest, believing that it was too simplistic and naive an explanation of behaviour. This approach argued that buyers were typically constrained by bounded rationality, which sellers abused in order to maximise individual gain. Contracting agents had guileful intent. Four external factors were then considered, which influenced the form contracts took: The assignment of property rights, asset specificity, uncertainty and the dynamic nature of contracts. The central motive for contracting stems from a desire to exchange *property rights* between agents. Efficient contracting demands that all obligations will be effectively concluded in the contract. Before an agent commits resources to specific purposes, the agent might require certain *asset specificity* conditions. These conditions often require some assurance of compensation to cover these sunk costs. Transactions are seldom concluded in a perfect markets. Efficient contracting demands that cognisance be taken of environmental *uncertainty*. Different environmental conditions can lead to the adoption of contracts of different time duration. Many contracts are *recurrent* in nature. Consideration has to be given to those factors which influence dynamic contracts. These factors, combined with the underlying behavioural assumptions, determine both the form and welfare effects of concluded contracts. Due to the interplay of these factors, the tentative conclusion is made that RPM might represent an arrangement agents impose to protect themselves from opportunistic abuse.

Chapter Three: A Survey of the Literature - Resale Price Maintenance

3.1 Introduction

A purported advantage of the market orientated economy is the greater freedom individual decision makers enjoy over their centrally planned counterparts. However, how far should this ability to contract freely extend in a market system? Fair trade insists that contracting parties should possess the individual freedom to transact in any manner they find mutually acceptable. This freedom should allow contracting agents to specify and accept those obligations they find necessary to fulfil a contract. Within the literature the term fair trade has become synonymous with resale price maintenance (see for example Andrew and Friday 1960; Telser, 1960; and Bork, 1978). Fair trade maintains that if agents mutually accept the inclusion of an RPM clause, then its validity should be accepted. Fair trade does not necessarily imply free trade. Free trade argues that market participants should not be discriminated against when transacting. Agents should be free to participate without any restriction placed on their transacting activities. If a contract disadvantages other participants, then this doctrine maintains that its relevance should be questioned. Whilst the ability to restrain conduct is necessary to initiate anticompetitive behaviour, Chapter One argued that it was not sufficient. Does the fact that RPM restricts the price mechanism necessarily make it anticompetitive? The purpose of this chapter is to critically review the controversy surrounding the economic character of RPM. This review is necessary before any assessment can be made of South Africa's treatment of RPM. This chapter will demonstrate that any *per se* prohibition of RPM is excessive. Whilst extreme Chicagoans favour its *per se* legality (Bork, 1978), a less strict rule of reason test will be advocated. Due to the stand taken earlier that the Chicagoan's treatment of strategic behaviour was simplistic and myopic, an outright call for RPM's legality is not made. It will be demonstrated that RPM can have anticompetitive consequences.

RPM is a vertical price restraint that is imposed across the horizontal tiers in a product's distribution network. RPM sets some maximum or minimum resale price that downstream agents must charge. These arrangements can be applied collectively or individually. *Collective Resale Price Maintenance* occurs when firms coordinate their actions through a vertical price-setting agreement to cooperatively set horizontal resale prices. Similarly, agents can act independently when setting resale prices and be the sole participant applying *Individual Resale Price Maintenance*. Using the distinction between these two forms of RPM as an outline, the following discussion will separately analyse the controversy sur-

rounding collective and individual RPM. Before this controversy is examined, however, the chapter will briefly review those conditions necessary for a vertical price restraint to represent RPM.

3.2 Preconditions for Resale Price Maintenance

Two necessary conditions must be satisfied before any vertical price-setting agreement qualifies as RPM. The following discussion will briefly consider them.

3.2.1 Separate Ownership

A vertical price-setting agreement constitutes RPM only when two ownership requirements are satisfied. First, separate ownership must exist between firms at different stages in the distribution network. Downstream firms accepting the vertical price restraint must be vertically separated in terms of ownership from the upstream supplier. Suppose that an upstream supplier has obtained ownership rights to his downstream distributor. Any vertical price set by the manufacturer for his distributor to charge does not represent RPM. The vertical price is simply a directive sent from the owner to his subordinate. As owner of the downstream distributor, he is fully entitled to set the downstream price. Second, ownership title of the product must be transferred across the tiers of distribution. Until ownership is passed, the downstream distributor acts merely as an agent to the upstream supplier. In this instance, the margins set by the vertical price agreement is nothing other than a handling fee (or fixed commission) awarded for successfully marketing the product. In those circumstances where ownership title of the product is not transferred, a principal-agent relationship exists.

To simplify the analysis, RPM will henceforth be considered in terms of a two tier ownership structure.

3.2.2 Possession of Market Power

At least one of the contracting parties must possess sufficient market power to successfully implement and enforce the RPM arrangement. An individual perfectly competitive supplier would, for example, experience great difficulty enforcing a minimum retail price if downstream retailers objected to it. Perfect competition's assumption of complete product homogeneity ensures that competing products are perfect substitutes. If downstream retailers are not satisfied with these arrangements, they can easily select other suppliers who do not insist on RPM. However, if the upstream tier was a tight oligopoly displaying little product homogeneity, downstream retailers would not have the same scope to make these product substitution decisions. With product differentiation as a source of market power RPM could be successfully enforced.

3.3 The Anticompetitive Effects of Resale Price Maintenance

Chapter One argued that structuralist theorists developed their bias against high degrees of seller concentration because of its alleged ability to facilitate collusion. In concentrated structures, dominant firms were expected to abuse their market power and restrict price competition. This abuse allowed limit prices to be set, which violated the Pareto optimality yardstick. RPM was a vertical price technique that sufficiently endowed firms could use to coordinate horizontal collusion at some tier in the distribution network¹. Consequently, collective RPM had anticompetitive implications which violated the following free trade conditions:

- Firms were prevented from competing across inter-firm cost differentials. Collective RPM facilitated price collusion.
- Consumers no longer had the individual freedom to make purchase decisions based on price differentials.

1. Posner (1976) observed that collective RPM could be applied to circumvent horizontal price fixing legislation.

The structuralist framework maintained that collective RPM was used to coordinate cartels at either the upstream or downstream level. It was in terms of these cartel arguments that the structuralist approach justified its policy decision to prohibit collective RPM. Section 3.3.1 and 3.3.2 will consider how collective RPM can facilitate collusion at either level.

3.3.1 Collective RPM and Downstream Distributor Cartels

Early economic literature (Frankel, 1955; Andrews and Friday, 1960; and Yamey, 1966) pointed towards collective RPM being used by retailers to promote collusion at the downstream tier of distribution. By eliminating intra-brand price competition, collective RPM allowed prices to be set in excess of the competitive minimum. Such action was anticompetitive because it held markets to monopolistic ransom. Powerful retailers coerced manufacturers into providing collective RPM conditions. If manufacturers were not prepared to offer these conditions, retailers replied by instituting some form of sanction against them (Scherer, 1980).

In terms of the structuralist analysis, it would be expected that such coercion would only be possible in retail markets characterised by high degrees of seller concentration. However, similar results have also occurred in highly deconcentrated structures. Yamey (1966) noted how a highly deconcentrated retail market coerced a reluctant manufacturer into providing a collective RPM agreement. During the late 1940s/early 1950s American druggists (pharmacists) represented by the National Association of Retail Druggists (NARD) lobbied strongly for support of fair trade policies in the pharmaceutical industry¹. This organisation represented some 52000 druggists. The manufacturer of Pepsodent toothpaste withdrew his RPM agreement concluded with Californian retail druggists. NARD responded by asking its Californian members to place this product 'under the counter'. The effect of the boycott was dramatic. Pepsodent's Californian sales dropped by 40% in the first month. This reduction in sales was sufficient to prompt the manufacturer to reinstate the collective RPM agreement and donate US\$ 25000 towards further-

1. Although resale price maintenance was illegal in terms of Federal statute, certain states including California, continued to tolerate its legality.

ing NARD's lobby. Although highly deconcentrated, this market structure was able to pressurise a reluctant manufacturer into maintaining cooperatively set price margins.

3.3.2 Resale Price Maintenance and Upstream Supplier Cartels

Much of the later controversy surrounding the economic character of collective RPM focused on the role it played at facilitating collusion amongst upstream suppliers (Andrews, 1964; Yamey, 1966; and Pickering, 1974). Unlike downstream distributor cartels which used collective RPM to eliminate intra-brand price competition, these opponents argued that upstream suppliers used it to restrict inter-brand competition. By eliminating price competition at the downstream level, collective RPM restricted price competition amongst upstream suppliers. Consequently, dominant suppliers used collective RPM to set collusive limit prices in excess of the competitive minima. Due to its negative resource allocation implications, such action violates the Pareto optimality yardstick.

Overstreet and Fisher (1985) identify a practical problem that can arise when collective RPM is used to administer an upstream cartel. The above discussion was based on the assumption that suppliers sold only to retailers. It can happen that upstream agents supply both retailers and end-consumers. In these circumstances a two tier price structure must be developed, where retailers are supplied at prices lower than those offered to end-consumers. However, this two tier pricing structure must be applied at the correct level. If the margins between the price structure are too narrow, the upstream supplier will compete directly against his retailers. Incorrect margins would disrupt the distribution process and result in a breakdown of the RPM system.

3.4 An Efficiency Response to Collective RPM

The efficiency framework responded on two fronts to the outright prohibition advocated by the structuralist approach. First, it challenged the argument that collective RPM was anticompetitive because it restricted the price mechanism. Efficiency authors maintained that certain strict conditions had to be satisfied before they would accept that collective RPM was anticompetitive. Second, the efficiency approach argued that collective RPM

had important qualities which enhanced the competitive process. Provided that no barrier to entry were not in place, the efficiency approach held that by restricting price competition amongst incumbent firms, a higher level of welfare could be attained. These responses are considered in Sections 3.4.1 and 3.4.2 respectively.

3.4.1 The Anticompetitive Effects of Collective RPM - An Efficiency Interpretation

Efficiency analysis examines two aspects to determine whether collective RPM is necessarily anticompetitive. Both these factors are now considered.

3.4.1.1 Collective RPM and Market Prices

A necessary feature to support the anticompetitive cartel argument is that collective RPM raises and sustains prices above comparable competitive minimums. An early efficiency argument (Hollander, 1955 and 1966; Kidston, 1963 and Yamey 1966) maintained that collective RPM had no or little effect on prices because firms had to meet some *fixed quantum of costs*, irrespective of their chosen conduct¹. Whilst the removal of collective RPM might lead to a lowering of prices on individual commodities, these authors maintained that this would not necessarily translate into a general lowering of average prices. To meet this fixed level of costs firms could not lower their overall revenues. If, for example, prices on individual commodities were lowered, then the prices of other products would have to be raised to offset these revenue losses. The validity of this fixed cost hypothesis has important bearing on any policy decision taken to prohibit collective RPM. If the removal of collective RPM has no serious impact on the average level of retail prices, then its continued prohibition must be justified by some other infringement.

Yamey (1966) raised two arguments to dispute the notion of this fixed cost hypothesis. First, he argued that a large component of retail costs were essentially variable, not fixed, in nature. Giving particular attention to small retailers, Yamey maintained that a signifi-

1. In terms of this argument, variable factor payments are those rents paid to entrepreneurs, and fixed costs are all other payments made to the other factors of production.

cant portion of gross profits were allocated to variable costs (entrepreneurial profits), rather than fixed overheads. Entrepreneurs could simply run down their proportionally larger share of variable costs to permit price reductions. However, this argument is problematic. Yamey does not provide any empirical evidence to confirm that entrepreneurial profits do represent a significant portion of the retailers cost structure. Furthermore, he fails to consider those factors which influence the size of entrepreneurial profits (variable costs) relative to fixed overheads. One such determinant is prevailing market profitability. The greater the general level of market profitability, the larger variable costs become relative to fixed costs. Without taking account of market profitability, it would appear incorrect to believe that variable costs constitute a significant portion of gross profit.

Second, Yamey argued that even if the major component of an incumbent's retail costs were fixed, they would not necessarily be fixed at the same level. Rather, a host of factors such as location, density of shopping traffic, range of quality and services and scale of operations (Yamey, 1966, p.8) cause inter-firm cost differentials. These cost differentials would allow 'lower cost' retailers to charge lower prices under conditions of free trade than fair trade¹. It is only in a perfectly competitive environment that incumbent firms face the same cost conditions. Consequently, Yamey's argument is difficult to refute.

Whilst conceding that the fixed cost hypothesis has limited relevance, more contemporary efficiency literature has refocussed the direction of the argument away from the fixed costs thesis towards profit considerations. Posner (1976) and Bork (1978) argued that RPM prices could not be excessive because the competitive process equalised all rates of return within a market. Unless significant barriers to entry were in place between market segments, higher cost 'full-price' retailers could not make greater net returns than the lower cost 'discount' retailers. At the point of long run equilibrium firms do not necessarily have the same cost curves. However, all rates of return have to converge. Otherwise, if 'full-price' stores enjoy higher rates of return, relative to the 'discount' retailers, new rivals would enter this segment of the market and contest these profits. The more contemporary literature argues that collective RPM can only be anticompetitive - used to administer a cartel that sets excessive price margins - when sufficient sunk cost entry barriers are in

1. An analytical model describing why such cost differentials arise between retailers is given by Lewis (1945).

place¹.

Available empirical work is indecisive. A US Federal Trade Commission Report (1945) concluded that collective RPM did result in distinct price increases. Whilst investigating pharmaceutical prices before and after the imposition of fair trade, Grether (1936) concluded that prices in 'full-price' stores decreased. However, these decreases were more than offset by significantly greater increases in 'cut-price' firms. Similar results were obtained by Lewis (1939) in a later study. McEwan, Smith and Scully (1956) noted that the price of photographic equipment remained generally constant in comparable fair trade and non-fair trade areas. Conclusions derived from more contemporary studies echo this uncertainty. Mathewson and Winter's (1984) theoretical formulation concluded that fair trade prices could be lower than comparable free trade minimums. Conversely, in their investigation into the distilled spirits industry, Ornstein and Hanssens (1987) observed that the imposition of RPM resulted in higher prices and restricted output.

3.4.1.2 Collective RPM and the Conditions for an Effective Cartel

The cartel argument raised against collective RPM hinges on the critical assumption that dominant firms necessarily want to collude. Chapter One noted that collusive behaviour was not always rational. Individual gains might not be maximised by acting interdependently². Five factors were reviewed which effect the decision to collude: the degree of product homogeneity, the nature of inter-firm cost structures, the nature of demand, the level of market profitability and the rate of innovation. Unless an adequate matching of these factors exists, it is irrational to collude. Consequently the relevance of the cartel argument is limited. In terms of the efficiency framework, the cartel argument can only be supported when prevailing market conditions make collusion a rational alternative.

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1. Posner (1976) argued that even if collective RPM arrangements were abused to administer a cartel, a general prohibition of collective RPM was still not justified. Rather, regulatory policy should address the real culprit, the cartel, and not RPM. By rescinding RPM authorities would not be neutralising the underlying motive of securing joint industry profit maximisation. Cartel members would make alternative arrangements to regulate their activities.
 2. The rationality of this decision depends on the comparison of the relative gains and costs at the margin.

3.4.1.3 When is RPM Anticompetitive?

Section 3.4.1 has demonstrated that collective RPM can be anticompetitive. However, the following qualifications must be made to the cartel argument:

- Collective RPM can only set limit prices once prohibitively high entry barriers are in place. But unlike the structuralist definition, only those costs which are of a sunk nature can prohibit entry.
- The motive to collude is overstated in structuralist analysis. Cognisance must be taken of those factors which affect the desirability to collude. Even in highly concentrated markets, independent action can realise higher individual gain than interdependent action.

3.4.2 The Procompetitive Effects of Collective RPM

Efficiency proponents argue that collective RPM might have important qualities which enhance competition. In this regard, many of these procompetitive qualities hinge on the broader welfare yardstick used by the efficiency approach. Incorporating certain of the new institutional techniques developed in Chapter Two, this section will consider four procompetitive properties of collective RPM.

3.4.2.1 Collective RPM, Orderly Distribution, Opportunistic Abuse and Asset Specificity Requirements

A purported advantage of the free price mechanism is its ability to accurately reflect current market preferences. Knowledge of these preferences is believed to bring about an efficient allocation of resources. However, the price mechanism's ability to efficiently allocate resources might be impaired if it is exposed to erratic market fluctuations. An uncertain environment exposes agents to opportunistic abuse. In such an environment, Skeoch (1966) and Goldberg (1980) argued that contracting agents might be unwilling to allocate resources to certain transaction specific purposes. Thus upstream suppliers might

be concerned that distributors will not allocate sufficient resources to secure the best possible distribution for their product. Overstreet and Fisher (1985) argued that collective RPM could sufficiently stabilise market conditions to promote orderly product distribution. By eliminating erratic price changes, risk is lowered to more acceptable levels, information asymmetries removed, opportunistic abuse reduced, and asset specificity conditions satisfied. Collective RPM is thus procompetitive if it can be demonstrated that it secures an orderly product distribution in conditions in which supply would otherwise have been erratic.

It is stressed that by restricting price competition to satisfy asset specificity requirements amongst incumbent firms, providing RPM margins does not imply that sellers have been exonerated from all market risk¹. These firms still have to compete against each other in terms of non-price criteria. Providing fixed retail margins is not sufficient to ensure that suppliers and distributors stocks will be sold.

Opponents have argued that collective RPM cannot maintain the required level of stability it sets out to establish. Hollander (1966) argued that collective RPM agreements are inherently unstable and will eventually breakdown. He maintained that certain distributors would not require this fixed margin and would undercut the RPM price. Exception is taken to this charge. After reviewing available empirical evidence from the United Kingdom, Yamey (1966) concluded that it was ambiguous. Whilst many examples of broken down RPM agreements existed, just as many continued to be successfully enforced over long periods of time². In terms of the efficiency paradigm, the stability of the RPM agreement hinges on the set margin and the condition of entry. If RPM margins are excessive, new rivals will either enter the market to contest these abnormal profits or incumbent firms will undercut the set margins to maximise individual gain.

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1. Assumptions of perfect information and knowledge ensure that it is only in the perfectly competitive ideal that agents transact free from risk.
 2. Yamey reports that certain RPM agreements dealing with the grocer trade had been enforced for approximately twenty five years and showed no sign of being disrupted.

3.4.2.2 *The Cross Subsidisation Effects of Collective RPM*

Chapter One criticised the Pareto yardstick because its notion of welfare was simply tested in terms of seller efficiency. This measure is too narrow. The efficiency approach is favoured because it applies a broader welfare measure. This section will demonstrate that the free price mechanism is not always able to allocate resources in a welfare enhancing manner. Collective RPM can have two important cross subsidisation effects, which satisfy this broader welfare measure.

Protected margins and a uniform price can provide upstream suppliers with an increase in the number and geographic dispersion of retailers marketing their products. Uniform margins allow cross subsidisation between areas of lower cost to areas of corresponding higher cost. This cross subsidisation is of particular importance among traders who, because of local cost conditions and limited market size, would normally be unable to operate. By applying collective RPM to facilitate cross subsidisation, underlying asset specificity conditions could be satisfied. Upstream suppliers would benefit from the broader distribution of their products. However, this broader distribution might further benefit consumers. Whilst price represents an important consideration, it is only one of several product attributes consumers consult when making their purchase decision. Wide and easy access to a product is of particular importance when *search costs* become significant, making transacting no longer costless. By using collective RPM to promote wider distribution, consumers benefit from lower transacting costs and greater product availability.

To determine whether this cross subsidisation argument is procompetitive, policy regulators must compare the trade-off between those consumers paying higher prices and the savings consumers in higher cost areas enjoy. It is noted that this idea of a trade-off was rejected by Gould and Preston (1965). In terms of their *Outlets Hypothesis* these authors demonstrated that by applying collective RPM to promote broader product distribution, it actually led to a general lowering of prices in all areas. Mathewson and Winter (1986, p.214) criticised this model. They argued that the validity of the outlets hypothesis hinged on the assumption that the downstream market was perfectly competitive. They believed this condition to be too simplistic an approximation of reality. Using a similar framework, but easing the assumption of perfect competition, Mathewson and Winter concluded that a price ceiling (maximum resale price) was more efficient and less likely to be abused,

than a price floor (minimum price).

Efficiency proponents maintain that collective RPM might have a second cross subsidisation effect. af Trolle (1966) argued that collective RPM could promote the broader distribution of products which, because of their special nature, would be discriminated against due to their prohibitively high prices. In this context Silcock (1938) argued that RPM arrangements would be used to impose higher margins on normal stock items and cross subsidise lower margins on special products. This rationale justified the temporary exemption afforded to the book industry by Swedish authorities. Prices on faster moving 'popular books' were raised to keep the prices of slower moving 'specialist books' within affordable limits. However, other regulatory restraints were introduced to prevent RPM from being abused. It was stipulated that booksellers would receive new stocks - with some degree of discretion applied - on a consignment basis. The application of this consignment restraint was significant. First, Swedish authorities accepted the principle that the free price mechanism could be superseded in order to secure a higher level of social welfare. Second, excess stocks were returned to the supplier. Accepting stocks on this contingency basis implied that booksellers no longer obtained ownership title. An important inconsistency is evident. By not satisfying the necessary vertical separation condition, this vertical price-setting arrangement no longer represented collective RPM. Booksellers simply acted as agents for publishers, passively fulfilling a retail function for which they received a fixed sales commission. Even after making these modifications the exemption granted to the book industry was rescinded. Although the cross subsidisation argument appeared plausible to Swedish authorities, empirical research concluded that specialist books accounted for only 4% of books sold within Sweden (af Trolle, 1966, p.131). The Freedom of Competition Board concluded that only a very small portion of books would be affected by the lifting of RPM. This Board held that it was unfair to raise the prices of all other books.

Yamey (1966, p.16) cautions that cross subsidisation can only be successful once all manufacturers have an equal interest in the marketing of slow moving items. If certain suppliers do not carry these slower moving stock items, the RPM agreement will come under pressure. By not having to cross subsidise these suppliers can maximise individual gain by undercutting the higher margins set on faster moving stock items.

3.4.2.3 Collective RPM and the Promotion of Small Business

RPM is condemned because of its ability to protect margins and restrain competition. However, these protected margins can assist in promoting the small business sector. Depending on the nature of the welfare measure, small business can have an important role to play in the economy. They can:

- assist with the orderly distribution of manufacturers products - especially when large downstream retailers are unwilling to allocate resources to manufacturers distribution networks.
- serve as a valuable source of employment.
- act as a competitive fringe against larger dominant firms (Bain, 1956).

Early evidence presented to American congressional hearings (1959) suggested that collective RPM could help reduce failure in the small business sector. Testimony presented to these hearings argued that the percentage of retail failures between 1953-59 were greater in non-fair areas than those in comparable fair trade areas. Available evidence is, however, contradictory. A later study, which employed a longer time series to the original data (1946-62), concluded that the annual failure rate for small businesses was higher in fair trade retail markets than in comparable non-fair trade markets. Because many factors influence firm profitability, it is difficult to isolate the extent to which RPM influences firm survival. To justify collective RPM's relevance, policy analysts must demonstrate that promoting small business is an over-riding welfare consideration and the collective RPM agreement caters specifically for this sector. RPM and the promotion of small business will be reconsidered in Section 3.5.2.

3.4.2.4 Collective RPM and The Development of New Products

One of the most important difficulties manufacturers experience when promoting new products is getting retailers to carry stocks. Retailers are often reluctant to stock products, which do not have an established market demand. Upstream suppliers could use collective RPM to 'buy shelf space' for their products by providing protected margins. These fixed margins might make the new product relatively more attractive to retailers because

it could offset those uncertainty costs. Consequently, it has to be determined whether the imposition of a price restraint during the initial stages of the product life cycle is necessarily anticompetitive. Whilst the strict conditions of Pareto optimality are violated, the promotion of new products might have broader welfare implications. The *Wall Street Journal* (September 1981, p.36) noted a Federal Trade Commission decision that prevented a group of fledgling stereo component manufacturers from employing RPM to assist in the launching of their products. Was this decision correct? Due to their small scale of production, it would be unlikely that this restraint could interfere in any material respect with prevailing market forces. By not affording these entrants this form of protection, the possibly greater procompetitive effects of new products being launched onto the market were lost.

A similar argument could be used to defend collective RPM's relevance when products face a declining market share. This typically occurs when a product enters the late stages of its product life-cycle. Collective RPM could be used by upstream suppliers to make their products relatively more attractive to retailers. By providing fixed margins, the competitive forces might be reignited as retailers take more interest in that product. However, to determine whether collective RPM has this procompetitive property it must be demonstrated that it forms one of several marketing strategies used to relaunch the product.

3.5 Individual Resale Price Maintenance

The previous section considered the collective application of RPM and its use to coordinate horizontal cartels. This section will consider the controversy surrounding individual RPM. Individual RPM is a vertical price restraint normally imposed by a single upstream supplier onto downstream retailers. Its opponents (amongst others Allen, 1953; Yamey, 1966; and Comanor, 1968) argued that this practice impeded the price mechanism's ability to accurately reflect existing market preferences. Like its collective counterpart, this practice violated the free trade conditions because it impaired the arbitrage interplay - firms were unable to compete across price and consumers were unable to make purchase decisions based on price differentials. Individual RPM allowed abnormal margins to be set, which had negative resource allocation implications. As was discussed throughout

most of Chapter One and Section 3.3, unless RPM was imposed alongside significant barriers to entry, price competition was not retarded. If excessive margins were set, these would be eliminated by the arrival of new entrants.

The literature has, however, been more concerned with examining individual RPM's so-called non-price procompetitive properties. Debate has typically focused on RPM's ability to function as a control device, established to enhance certain non-price aspects of a product throughout its distribution. The literature has identified four elements: the provision of adequate pre-sale services, gross margin cover, quality certification and protection from loss leader abuse. The remainder of this section will consider each in turn.

3.5.1 Individual RPM, the Free-Rider Problem and Bounded Rationality

Conventional economic wisdom holds that a negative relationship exists between product price and consumer preference quantity. Known in most introductory textbooks as the *law of demand* this postulate maintains that price increases result in a decrease in the quantity demanded for a particular product, *ceteris paribus*. Expecting that profit maximisation represents the upstream supplier's primary marketing objective, suppliers should want retail prices minimised. Thus it initially appears inconsistent for a manufacturer to eliminate price flexibility amongst his downstream distributors. However, product demand is also influenced by certain non-price considerations¹. These attributes are conveniently summarised in terms of a set of *ceteris paribus* assumptions. A violation of any of these conditions results in an increased or decreased preference for that product at any given price. This section will consider the role individual RPM can play at alleviating consumer ignorance, thereby stimulating an even greater product demand than would otherwise occur under conditions of free trade.

In less than perfect markets the transacting process is exposed to uncertainty. Moreover, since agents suffer from Williamson's notion of bounded rationality, they do not neces-

1. Warren-Boulton (1978, p.52-54) demonstrates that there exists no incentive for vertical restraints to be imposed if demand for a product depends only on price. The assumption is made that technology embraces fixed factor proportions.

sarily act in an optimising fashion. Telser (1960) maintained that by providing adequate pre-sale services to appropriate markets, consumer ignorance would be alleviated and demand stimulated. He held that $Q_d = f(1/P, S)$, where P represents market price and S the extent of product related services provided by retailers. By increasing S , Q_d would be greater at any given price, *ceteris paribus*.

Why then would downstream retailers not spontaneously provide these pre-sale services? After all, retailers have a vested interest in maximising a manufacturer's product sales since this has important bearing on their own profit functions. Telser maintained that due to their special nature, these services could not be provided freely. Their cost of provision is significant. Consequently there exists some incentive for a subset of retailers not to offer these services and free-ride on those retailers who do provide them. If a manufacturer believes that the successful marketing of his product depends upon an adequate provision of pre-sale services, then two opposing action conjectures await him under a free price regime:

- (i) All downstream retailers provide the required services to end-consumers and maximise the manufacturer's sales.
- (ii) A set of retailers free-ride on other retailers who provide the required service.

Option (ii) has two further opposing implications:

- (a) Free-riders enjoy greater margins by not providing the required services.
- (b) Free-riders deviate from the minimum resale price and undercut those firms providing the service.

Unless accompanied by sufficient entry restrictions, option (a) is short-sighted. Consumers will eventually realise that they can obtain the same product, at the same price, with the required pre-sale services, and will redirect their purchases accordingly. Rational firms endeavouring to secure their long run survival would not choose this alternative. Selecting option (b) implies that free-riders believe their individual profits will be greater through price-cutting, than by providing these pre-sale services. Moreover, some consumers might benefit from a lower purchase price. After receiving all the necessary pre-sale services from the 'full-price' store, the consumer could make his purchase at a lower price

from the free-rider. However, if the successful marketing of a manufacturer's product depends upon an adequate provision of pre-sale services, the welfare gains stemming from the free-rider's lower prices might be offset by increased consumer ignorance. Bounded rationality, exacerbated by an asymmetrical information structure, might make consumers reluctant to purchase these products. The net effect of the free-riding would be a lower output taken up by the market. Thus, Telser argued, the competitive process would be enhanced by giving more attention to these non-price factors.

He further argued that RPM represented a control mechanism upstream suppliers could use to secure the better provision of downstream pre-sale services for their products. The setting of a uniform price allows manufacturers to minimise free-riding because firms can no longer compete over price. To remain competitive, retailers respond by providing the desired level of pre-sale services. RPM could be used to minimise the degree of free-riding prevalent in a market.

Structuralist analysts have taken exception to this free-rider argument. They maintain that the free price mechanism or competitive tournament is most efficient at providing the required level of information. Rey and Stiglitz (1986) and Rey and Tirole (1988) argue that consumers should be free to choose between different levels of services and prices. However, their arguments overlook the bounded rationality constraint. It cannot be expected that consumers will be aware of the exact level of services they require to offset their ignorance. How, then, can the price mechanism be relied upon to adequately provide these services? This notion of RPM providing sufficient market information is reconsidered in section 3.5.3.3.

It is noted that manufacturers could employ advertising to inform ignorant consumers. This technique would appear to be advantageous because no restrictions are placed on the price mechanism. However, Telser argued that the spread of consumer information requirements can be diffuse. Providing personalised dealer services would allow for individual needs to be assessed and met. Advertising makes a blanket provision unable to distinguish between individual needs. All consumers receive the same level of services, whether they require them or not.

3.5.1.1 *The Practical Implementation Problems Associated with Individual RPM*

Whilst RPM can solve the free-rider problem, its practical implementation can prove to be problematic. RPM is an *average cost* technique used to set prices. Correspondingly, all consumers bear the same financial costs for services provided. However, due to asymmetrical information conditions and differences in consumer bounded rationality, better informed consumers are forced to pay for services they do not require. Consequently, this average cost technique can only approximate the ideal level of pre-sale services society requires. Nevertheless, this technique does permit a certain degree of cross subsidisation, which might be in the broader welfare interest. Depending on the spread of consumer information requirements, the welfare benefits accruing to ignorant consumers might outweigh the individual losses of better informed consumers.

Two other forms of price restraints can be applied to control free-riding. These are considered below.

3.5.1.2 *Other Price Restraints and The Free-Rider Problem*

In its ideal form the *marginal cost* technique represents the best mechanism suited to remedying asymmetrical information requirements. Under this regime consumers purchase the exact level of services they require. If individual consumers require additional pre-sale services, they pay a higher fee for their provision. This arrangement circumvents the problem of better informed agents having to pay for unnecessary services. However, this technique has certain practical limitations. First, consumers might be detracted from purchasing an item if an information fee has to be paid before the product can be previewed. Consumers might be reluctant to add to their search costs before deciding whether they will actually purchase a particular item. Second, this approach could be opportunistically abused. By exploiting consumer bounded rationality, unscrupulous retailers can overcharge for services provided and create abnormal profit opportunities for themselves.

A second price restraint can be employed to circumvent the free-rider problem and minimise exposure to opportunistic haggling. By imposing *price discrimination* on wholesale prices, upstream suppliers can manipulate the level of services provided by retailers.

Under this regime a retailer's wholesale price is determined by the amount of pre-sale services he spontaneously offers. A greater provision of services leads to bigger discounts being given on wholesale prices. It would be to the retailer's advantage to offer the desired level of services and not free-ride. However, this technique has three difficulties. First, sufficient controls must be in place to ensure that 'discriminated' retailers are unable to purchase the manufacturer's product at lower prices from more favourably treated retailers. If the 'discriminated' retailer can make these purchases, free-riding will continue. Second, it can prove difficult to quantify the amount of services retailers provide, in order to determine the discount rate they qualify for. Third, whilst representing a practical alternative to the marginal cost technique, price discrimination is unlikely to optimise information transfer. Like the average cost RPM method, this technique can at best only approximate an ideal level.

In those instances where policy analysts believe that price restraints represent more efficient information control devices than the competitive tournament, consideration must be given to determining which restraint is most effective. Whilst RPM might not provide an optimal level of information transfer, it may constitute the best practical alternative. Efficiency proponents would only accept the relevance of RPM as an information control device, once it has been demonstrated that it was more efficient than the two alternatives.

3.5.2 Individual RPM, Gross Margin Cover, Small Business and Asset Specificity

Telser's seminal paper is often only attributed with justifying individual RPM's relevance as a means to remedying the free-rider problem. However, he did hint at a second reason to explain why individual RPM might be procompetitive. This argument has been subsequently developed in the literature. Telser argued that the provision of adequate pre-sale services hinged on a sufficient allocation of resources. The free price mechanism might not always be able to provide sufficient cover to satisfy retailers' asset specificity requirements. By imposing individual RPM, Bork (1978) argued that retailers might be given the gross margin cover required to provide these services. This gross margin cover argument might be of particular relevance when free price competition has developed a bias against small business. Due to their relatively limited resources, small retailers might be hesitant or unable to make the necessary investments to provide adequate pre-sale

services. These asset specificity requirements might disadvantage smaller firms from competing against larger firms. By imposing RPM to provide small firms with this gross margin cover, the competitive process might be enhanced in terms of the advantages described previously in section 3.4.2.3.

Legislative precedents exist to justify using RPM to provide this gross margin cover to small firms. In the US, for example, the Robinson-Patman Act endeavoured to foster the development of small business and lent RPM a sympathetic ear. The former Federal Republic of Germany declared RPM arrangements illegal. However, exemption clauses existed for small to medium size firms who could prove that they were structurally discriminated against by larger firms.

Doubt has been cast about the appropriateness of providing retailers with financial incentives to provide pre-sale services. Rey and Tirole (1986) demonstrated that the competitive tournament was more efficient at providing information than RPM. They argued that the competitive process was better served when retailers had to provide these services spontaneously rather than having to rely on RPM incentives. These sentiments were echoed by Rey and Stiglitz (1988). Three criticisms can be raised against Rey and Tirole's argument. First, they assumed that firms were of similar size and enjoyed equal access to the same resources. The structural disadvantages that small firms might experience were ignored. Second, they failed to consider the price mechanism's ability to provide adequate information under conditions of different firm and market size. By strategically manipulating the price mechanism large firms could eliminate the competitive fringe. Third, no account was taken of consumer rationality. It was implicitly assumed that consumers had identical information requirements and ability to process information. This is not a realistic assumption.

3.5.3 RPM and The Quality Certification Argument

An important feature that characterised the service argument was the narrow definition applied to determining which services should be provided. Telser (1960) argued that the individual application of RPM was relevant only where it was applied to control the provision of *tangible* pre-sale services. Explicitly excluded from this definition were those

intangible services that enhanced the nature of a retailer or his mode of conducting business. Telser maintained that if individual RPM were imposed solely to have a manufacturer's product sold at 'fancy shops', then such action was contrary to the revealed consumer preference of purchasing the commodity at lower priced 'budget stores'. Marvel and McCafferty (1984) took exception to this narrow definition. These authors maintained that it was this narrow definition, which gave rise to the service argument's limited applicability:

- After surveying recent Federal Trade Commission reports which dealt with RPM, Marvel and McCafferty concluded that the service argument had limited relevance. These sentiments were echoed by Overstreet (1983). Overstreet concluded that US antitrust cases dealing with individual RPM in the raincoat, motor spares and shoe industries could not be validated in terms of the service argument.
- The service argument could not explain why RPM tended to be imposed on higher quality products.

These weaknesses led Marvel and McCafferty (1984 and 1985) to develop an alternative explanation to justify the efficient use of RPM. A two-stage argument was used to formulate their quality certification argument. This section will extend this argument further by incorporating the relevant institutional tools.

3.5.3.1 Individual RPM, Quality Certification, Bounded Rationality and Opportunism

The majority of this past chapter's discussion has implicitly assumed that retailers behave like warehouses, passively responding to the distribution directives handed down by upstream suppliers. Marvel and McCafferty argued that retailers assumed a more assertive role than this in the distribution process. Retailers have an important intermediary function to play. They must choose between available goods on intermediate markets and select those items which best match with the needs of their particular portfolio of consumers. Consequently, rational retailers can be expected to stock only those items which are congruent within their overall marketing strategy. It is unlikely, therefore, that established 'high-quality' firms would stock 'low-quality' items. These firms can ill-afford to

have their reputations tarnished because their competitive position would be compromised. In this regard, upstream suppliers might have to provide fixed margins to ensure that their products will be stocked by these retailers. This argument was central to a ruling handed down in the 1977 US Supreme Court case *GTE-Sylvania Inc*¹. Overruling the previous *Schwinn*² decision, the *GTE-Sylvania* case concluded that price restraints gave the necessary incentive for retailers to provide both higher quality tangible and intangible services.

The second aspect Marvel and McCafferty considered was the difficulties consumers experienced when identifying and ranking their respective purchase preferences. When transacting in an asymmetrical information structure, the bounded rational consumer is often unable to assess the intrinsic merits of individual products. To minimise this uncertainty, ignorant consumers consider several product attributes. One attribute consumers might consult is the reputation or trustworthiness of the retailer supplying the product. If consumers wish to purchase a superior quality item, but are uncertain about the nature of the product, then they might be made more sure of their decision after consulting with high-quality retailers. Consumers actively look to retailers to endorse the quality of an item because the retailer stakes his reputation on the stocks he holds. In terms of the quality certification argument, the manner in which a retailer conducts its business affairs - those intangible services Telser argued against - has important bearing when validating the reputation of a product.

The quality certification argument not only reinforces the service argument but extends it further by taking explicit account of the effects of opportunism. Quality certification represents a means through which consumers can protect themselves from opportunistic abuse. It was this fear which led Marvel and McCafferty to suggest that consumers look to the good name of reputable retailers not to exploit their bounded rationality. However, the free price mechanism is not above opportunistic haggling because sufficiently powerful retailers can exploit consumer ignorance. It is to this end that individual RPM can secure reputable dealers and eliminate price uncertainty.

1. *Continental TV Inc vs. GTE-Sylvania Inc.*, 433 US 36, 1977.

2. *United States vs. Arnold Schwinn and Co.*, 388 US 365, 1967.

The quality certification argument can incorporate other attributes that consumers might consider when reducing the moral hazards associated with transacting. Within certain markets, consumer preferences are strongly guided by existing fashion trends and styles. However, consumers might be uncertain about a particular season's fashion trend, or whether certain products are in vogue. Consequently, consumers look to 'high-quality' retailers to provide them with the necessary *style certification*. Consumers will feel confident about certain 'styles' because reputable dealers have put their image at stake. This latter consideration might appear trivial but the successful marketing of many luxury items hinge on this aspect.

3.5.3.2 Individual RPM and Quality Certification - An Efficiency Enhancing Response

A weakness with the service argument was its inability to adequately defend RPM in recent US antitrust cases. Using two of the cases identified by Overstreet (1983), the quality certification argument will be used to demonstrate how a stronger line of defence could have been raised to favour RPM.

A recent US antitrust case dealing with motor spares considered the relevance of individual RPM. At the time of trial the service argument was used to defend RPM. However, judgment rejected the merits of this argument and held that the free price mechanism best provided these services. The quality certification argument will now be employed to provide a tentative defence. Motor spares often exhibit indistinguishable characteristics making the bounded rational consumer's purchase choice difficult. Providing individual RPM arrangements would ensure that superior quality items are matched to higher quality stores and consumers would be protected from the proliferation of inferior pirate parts, which would be sold at the same price as the quality branded item. Likewise, a similar defence could have been made to justify RPM's relevance in the shoe industry. Shoe manufacturers argued that RPM ensured that adequate pre-sale services accompanied the marketing of their products. The Federal Trade Commission rejected this argument. RPM could have been better defended in terms of *style certification*. RPM could give retailers the confidence to reflect existing fashion trends by lowering product risk to acceptable levels. Furthermore, RPM would ensure that their shoes were placed with

'higher quality' retailers, thereby reassuring bounded rational consumers that their purchase was in vogue.

Insofar as the quality certification rationale strengthens the service argument, it also reinforces another procompetitive argument. As was argued previously, RPM could be used to 'buy shelf space' for a new product and get it distributed through appropriate channels. However, getting retailers to stock an item is not sufficient to ensure that the product will be successfully marketed. Within an asymmetrical information structure, the demand for a new entrant's product might be influenced by important quality or style certification considerations. Consequently, RPM would increase the probability that the product would be successfully marketed since it would be directed through a distribution network based on existing consumer goodwill.

3.5.3.3 The Limitations of the Quality Certification Rationale

Whilst the quality certification argument extends the applicability and relevance of the service argument, it has been criticised. The following discussion considers two factors.

The quality certification argument has failed to develop a suitable retort to satisfy allegations made that RPM overvalues the amount of information consumers require. Scherer (1983) and Comanor (1985) argued that wide discrepancies existed between the amount of information firms perceived consumers needed and the levels consumers actually required. In these circumstances the imposition of individual RPM, motivated by quality certification, was not first best since it over-allocated resources to the distribution network. Scherer and Comanor each maintained that the competitive tournament best satisfied these information requirements.

The quality certification argument is still open to free-rider abuse. Just as free-riding can occur when tangible services have to be provided, so firms of more dubious reputation can market 'higher quality' products. These 'lower quality' firms would be able to exploit the goodwill established by 'high quality' stores and divert sales towards themselves. Consequently, retailers of high reputation might be unwilling to stock this item because it would no longer be congruent with their overall marketing strategy.

3.5.4 *Loss Leading and Individual RPM*

A traditional argument¹ raised in defence of RPM maintains that without sufficient price protection, individual brand items could be perceived by consumers to be loss leaders. Prolonged price-cutting of individual brands, at below competitive minimum levels, could damage a product's brand image. A tarnished price image might be sufficient to cause consumers to substitute away from the product used as a loss leader. Presuppose that a new market entrant, such as a new retailing chain, attempts to gain a foothold in an established market. To attract new customers the entrant offers substantial discounts on a particular brand item well below the competitive minimum. Initially these lower prices would be to the manufacturer's advantage because his sales would increase. However, these short term gains would not necessarily extend into the long term if the continued application of this pricing strategy harmed the product image. A tarnished brand image might cause other retailers to substitute away from it in favour of substitute products with a more favourable brand image. Consequently, loss leader pricing tactics restrict the ability of certain manufacturers to compete fairly against other firms over non-price aspects. By imposing individual restraints over retail prices, susceptible products can defend themselves against these tactics.

Whilst accepting the plausibility of this argument, Porter (1976, p.64) and Scherer (1980, p.592) maintained that manufacturers did not impose RPM to defend their products against legitimate abuse but to raise retail prices in excess of competitive levels. These authors maintained that other techniques could be employed to protect products from loss leading abuse. For example, wholesale prices could be manipulated in such a way as to provide adequate protection from excessive price cutting.

After reviewing available literature, it would appear as if the efficiency stance has accepted this argument's limited relevance. Conclusions drawn from separate literature surveys conducted by Marvel and McCafferty (1985) and Mathewson and Winter (1986) confirm this.

1. See Skeoch (1966) for a useful survey of the literature.

3.6 Summary

The purpose of this chapter has been to critically analyse the theoretical controversy surrounding the economic implications of RPM. An understanding of this debate is necessary if South Africa's treatment of RPM can be evaluated in terms of the efficiency hypothesis. Using the distinction drawn between collective and individual RPM as an outline, this chapter reviewed the arguments raised describing how RPM might enhance or retard the competitive process. Structuralist authors argued that RPM represented an anticompetitive device imposed by dominant firms to eliminate price competition. Eliminating price competition allowed these firms to raise price margins in excess of competitive norms. Evidence of excessive margins violated the pareto optimality conditions because it resulted in a misallocation of resources to an industry. Whilst efficiency proponents agreed that RPM eliminated *actual* price competition, they argued that *potential* price competition was not necessarily impaired. Unless sufficient barriers to entry existed, potential rivals would enter the market and disrupt any abnormal profit-making price agreements. However, it is insufficient to contend that RPM is not necessarily anticompetitive in order to argue against its *per se* prohibition. Rather, it has to be demonstrated that RPM has important procompetitive qualities. This chapter critically reviewed seven efficiency enhancing properties: orderly distribution, cross subsidisation, promotion of small business, development of new products, service argument, quality certification and protection from loss leader abuse. Whilst strong arguments can be made to favour these procompetitive arguments, controversy still surrounds their validity. The uncertainty surrounding the nature of RPM motivates the study to conclude that it should be subjected to the milder *rule of reason* test and not outlawed. No call is made for its *per se* legality because it is accepted that RPM can have anticompetitive consequences when imposed alongside sunk cost barriers to entry.

*Chapter Four: The Per Se Prohibition of Resale Price Maintenance
and the Efficiency Paradigm*

4.1 Introduction

The preceding three chapters have assembled the tools necessary to analyse local policy's treatment of RPM. The first chapter examined the competitive process to determine why RPM might be considered to be anticompetitive. The second chapter developed various institutional techniques to augment the standard efficiency arguments used to defend RPM. The development of the institutional approach was significant because it directed policy attention towards those factors which influenced the contracting process. Chapter Three reviewed the theoretical controversy surrounding RPM and concluded that any policy decision taken to outlaw RPM was excessive. Using these building blocks the remaining two chapters will evaluate South Africa's treatment of RPM from an efficiency perspective.

To understand why the BTI and CB prohibited RPM, consideration must first be given to determining their understanding of competition. It will be argued that both agencies committed local legislation to a policy framework of workable competition. However, it is difficult to determine whether the structuralist or efficiency version of this framework was favoured. It will be argued that in their dealings with RPM the BTI and CB adopted a structuralist stance. If this interpretation is indeed correct, then the decision taken to ban RPM would appear to be consistent with the theoretical framework set by local policy. Although relevant, it would be superficial to simply repeat the structural-efficiency debate. At this level, the debate is ideological and would result in an endless circular argument. A more convincing way to challenge the prohibition would be to discredit it in terms of the BTI and CB's own arguments. Two aspects will be considered:

- The use of the public interest test.
- The nature of the anticompetitive arguments raised against RPM.

A third factor is relevant to challenge the prohibition of RPM but it is considered in the next chapter due to the length of the discussion. It will be argued that neither the BTI nor the CB correctly understood or applied the arguments describing RPM's procompetitive properties. However, before the local prohibition is assessed, it is timeous to review the historical development of official policy dealing with RPM in South Africa. This is done in

order to clarify the legal position surrounding RPM.

4.2 The Historical Development of RPM Policy in South Africa

The development of local competition policy dealing with RPM can be divided into three stages and is used to review the development of RPM policy.

4.2.1 Competition Policy before 1955

The first piece of competition policy set up to deal with RPM was enacted in the Board of Industries Act, No.33 of 1924, and later reenacted in terms of the Board of Trade and Industries Act, No.19 of 1944. The imposition of this legislation was significant because RPM was no longer scrutinised in accordance with the court's interpretation of common law. Rather, on instruction from the relevant Minister, the BTI was required to investigate and advise the Government about alleged monopolistic conditions. Prior to the establishment of the BTI, monopolistic conditions were only investigated once a civil complaint had been lodged with the court. Part of the 1944 Act was later superseded by the enactment of the Restraint of Trade Act, No.59 of 1949. Unlike its predecessor, the new legislation authorised the relevant Minister to initiate remedial action necessary to rectify conditions deemed monopolistic. Previously the Trade and Industries Act had made no provision for this and relief could only be obtained through the court.

4.2.2 The Legislation of 1955

One of the most comprehensive attempts to establish wide ranging competition policy followed from the passing of the Regulation of Monopolistic Conditions Act, No.24 of 1955. This Act was committed to deriving economic solutions that made competition 'workable'. This commitment to workable competition made the 1955 Act an enabling act, containing no prohibitions against any market arrangement or practice, including RPM. Consequently, no part of the Act could be contravened. Unlike its predecessor, the Undue Restraint of Trade Act, investigations into monopolistic conditions were no longer

initiated once voluntary complaints had been received. Provision was made in terms of Section 3 of the 1955 Act to authorise the relevant Minister to conduct investigations based on his own initiative.

This legislation applied a very broad definition to describe what constituted a monopolistic condition. Section 2 of the Act declared any market practice or arrangement which: "directly or indirectly restrict(ed) competition ... or is calculated to have the effect of ... enhancing or maintaining prices". Because RPM interferes with the price mechanism, it was regarded as a monopolistic condition. However, in terms of the 1955 Act it was not enough to demonstrate that a practice was monopolistic to have the Minister act against it. It had to be demonstrated that it contravened the public interest. Only once this second step had been taken could a recommendation be made to the Minister requesting him to terminate it.

On 22 March 1962 the Minister of Economic Affairs issued a directive in terms of Section 3(1)(b) of the Act, instructing the BTI to investigate whether collective and individual RPM could be justified in terms of the public interest. The detailed report, *Investigation into Individual and Collective Resale Price Maintenance in the Republic of South Africa* (Report 1220(M), 1967), was compiled and submitted to the relevant Minister for consideration. Parliament accepted the report's recommendations and passed a general prohibition against both practices. In terms of the report, affected parties were able to apply for exemption from the general prohibition. In total, nineteen applications were made, of which only one received permanent exemption and another temporary exemption¹. The BTI's treatment of these applications will be considered during the course of the chapter. It is interesting to note that the Minister rejected one of the Board's recommendations that the tyre industry not be granted exemption. A temporary exemption was granted to the industry. This overturned decision will be considered in the next chapter.

1. The permanent exemption was issued to newspapers and periodicals, and the temporary exemption to books (BTI, Report 1262(M) Part II).

4.2.3 *The Legislation of 1979*

Following the recommendations of the 1977 Mouton Commission, the Regulation of Monopolistic Conditions Act was replaced with the Promotion and Maintenance of Competition Act, No.96 of 1979. On 14 November 1984 the CB decided to initiate its own investigation, in terms of Section 10(1)(c) of the Act, into certain trade practices which it generally regarded as being restrictive. The findings of Report 15¹ echoed the sentiments expressed in the BTI's 1967 report and concluded that both individual and collective RPM were still contrary to the public interest. By way of notice served in the Government Gazette, 2 May 1986, RPM was declared illegal in terms of an Amendment to the Maintenance and Promotion of Competition Act of 1979. However, recourse could be made in terms of Section 9 of the Act to obtain exemption from the general prohibition. Exemption was granted if it could be demonstrated that RPM was in the public interest.

Before examining the decisions taken to prohibit RPM, consideration is given to the problems the BTI and CB experienced in confusing RPM with other trade practices.

4.2.4 *Problems of Identification*

Although the BTI and CB have generally recognised the necessary conditions that must be satisfied before a vertical price agreement represents RPM, it has in certain of its reports confused RPM with other trade practices. Two examples are given to illustrate this argument.

In its investigation into alleged monopolistic conditions in the liquor trade (BTI, 1958b), the BTI examined the role Fedhasa played at setting minimum liquor prices in the bars and public lounges of its member hotels. The BTI noted how "These associations draw up lists of recommended prices for use by their members ... Members on joining these associations undertake to maintain prices ... The effect of this system of collective enforcement is that resale price maintenance at the retail level is applied very effectively" (BTI,

1. Competition Board, 1985, *Investigation into Collusion on Prices and Conditions, Market Sharing and Tender Practices*, Report No. 15.

1967, p.35). However, this price-setting arrangement was not collective RPM. Fedhasa did not negotiate with upstream suppliers to set downstream retail prices. No vertical price-setting occurred across the tiers of distribution between upstream supplier and downstream retailer. Fedhasa acted simply as a retailer's cartel. This identification error was repeated when the hotel industry had to later reapply for exemption from the general prohibition (BTI, 1969c).

The BTI has also confused RPM with upstream distributor cartels. In its investigation into the South African wine and spirits industry the BTI concluded that the price-setting of imported liquor, especially whisky, by the Association eliminated price competition amongst its members. The price mechanism was restricted by agreements that "maintained ... collective minimum wholesale prices" (BTI, 1958b, p.28). But when it examined the nature of this price agreement, the Board remarked: "the prices fixed by the Importers' Association did not compromise the retail selling price to the public (this being fixed by the retail associations themselves)" (BTI, 1958, p.30). The Importers Association was merely an upstream distributor cartel responsible for setting wholesale prices. It had no influence over downstream retailer prices. The BTI again incorrectly confused collective RPM with a cartel agreement when it required the Importers Association to apply for exemption from the prohibition¹.

A second type of identification error arose when the BTI and CB confused RPM with principal-agent relationships. Examining alleged monopolistic conditions in the newspaper and periodicals trade (BTI, 1964), the BTI partly justified RPM's desirability because retailers received stocks on a consignment basis. Receiving stocks on this basis implied that ownership title of the product was not transferred. As the BTI noted: "It may therefore be asserted that the distributor never becomes the owner and strictly speaking, also therefore cannot be the "seller" (BTI, 1964, p.45). In short, the retailer acted simply as an agent to the upstream publisher. The inconsistency should be apparent. If ownership title of the product has not passed, the vertical separation condition is not satisfied. Consequently, the BTI was wrong to view this vertical price-setting arrangement as RPM. The fixed margin provided by the RPM amounted to nothing other than a commission fee

1. Further confusion between RPM and cartel agreements occurred in the food trade, Report 437(M), and the book trade, Report 1071(M).

paid by the principal to his agent. This identification error was repeated by the BTI and CB when these same commodities had to apply for exemption in terms of the 1967 and 1985 prohibitions. Following this precedent a similar decision to prohibit RPM in the cigarette trade might have been overturned had a defence been made in terms of the agency argument. In presenting its evidence a tobacco wholesale association argued that: "stale stock is taken back from retailers and constitutes a loss to the manufacturer" (BTI, 1969b, p30). If this evidence was correct, it would suggest that stocks were received on a consignment basis by retailers. If so, there would have been no scope to act against the principal-agent relationship. These agency considerations were not examined again in this report by either the applicant or the BTI.

The remainder of this investigation will put aside these identification errors in order to evaluate other relevant arguments raised by the BTI and CB in their treatment of RPM.

4.3 The BTI, CB and their Policy Framework

The BTI and CB view competition as a necessary and vital feature of a healthy market economy. In Report 1220(M) (1967, p.23) the BTI argued that competition benefited society not only by promoting better resource allocation and usage, maintaining economic freedom and preserving equal opportunity, but also by acting as an important regulator of market power. Within this context the Mouton Commission (1977) argued that the purpose of South African competition policy was to eliminate those environmental imperfections which impaired the effectiveness of firms and their markets. In order to identify these imperfections and to establish appropriate remedial policy, an important question must be answered: what form did the BTI and CB understand competition to take? Four factors are considered to justify the belief that both agencies adopted a workable competition policy framework.

First, the 1955 and 1979 Acts, the Mouton Commission, and Reports 1220(M) and 15 all claimed that local competition policy was committed to finding solutions that were 'worka-

ble' or 'effective'¹. Whilst these terms can be used within other policy frameworks, the explicit use of its terminology and the extensive use made of its salient works as source material when policy reports were compiled, give the South African approach a distinct workability flavour. In the Mouton Commission's section that dealt with the philosophy of competition policy it was only Clark's definition of 'effective competition' and his criteria for evaluation, which were considered. Similarly, in its chapter dealing with competition, Report 1220(M) (1967, p.22-24) viewed effective competition as that practical solution whose structure, conduct and performance dimensions best satisfied the public interest test.

Second, like workable competition, the BTI and CB accepted that perfect competition was not an appropriate ideal suitable against which to test real markets. Report 1220(M) argued that market structures which deviated from the perfectly competitive ideal were not necessarily less competitive. In terms of its structure test, the BTI accepted the premise that: "Competition may conceivably be workable ... even if they are few sellers" (1967, p.23). Furthermore, the Mouton Commission argued that the historical development of the South African economy, coupled with its limited market size, made high seller concentration unavoidable². Within this context perfect competition was inappropriate as a policy benchmark. Similar sentiments were expressed by Tregenna-Piggot (1980).

In setting up workable competition as its benchmark it appears as if the BTI and CB misunderstood its intended purpose. These agencies seemed to believe that workable competition could only at best approximate the performance of perfect competition. In listing the virtues of competition, the BTI noted that: "If theoretically perfect and pure competition prevailed in all industries the equilibrium set of prices that would be established ... would bring about an allocation of resources that would maximise welfare" (1967,

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1. Fourie (1987) incorrectly argued that the concept of effective competition was first used by the Competition Board in 1984. This label was used liberally throughout Report 1220(M) and the Mouton Commission.
 2. Smith (1991a and 1991b) argues that the South African manufacturing sector displays a high degree of seller concentration, which has increased steadily over time.

p.20)¹. However, the BTI never attempted to demonstrate how workable competition might best replicate or even improve on these 'optimal' results. Sosnick was emphatic when he argued: "The point is that ... 'perfect competition' constitutes individually or collectively neither a normative ideal nor a satisfactory basis for appraising actual competition" (1958, p.383). The workability framework rejected perfect competition and regarded itself as the optimal solution. Chapter One argued that perfect competition omitted various key factors, which often made real markets more desirable than the perfectly competitive ideal. Moreover, whilst perfect competition satisfied the Pareto optimality criteria, it was not necessarily first best when scrutinised against the broader public interest measure. A similar misunderstanding is evident in Report 15².

Third, the BTI and CB were committed to testing their monopolistic conditions or restrictive trade practices against the public interest measure. It was not enough to demonstrate that a restrictive trade practice violated the Pareto optimality test or its profits proxy, to demonstrate that it was anticompetitive. Like workable competition, South African competition policy required regulators to take the distinct second step of assessing trade practices against the broader public interest test.

Fourth, local competition policy adopted a discretionary approach in its mode of analysis and made no presumption against any market practice or form. This discretion explains why both the 1955 and 1979 Acts were enabling acts. If a market's performance was found to be unacceptable, an investigation into its structure, conduct and performance was initiated against the backdrop of the public interest test. A similar approach was employed by workable competition.

Knowing which version of workable competition was favoured by the BTI and CB would make it easier to assess their decision to prohibit RPM. If a structuralist stance had been

1. Although speculative in nature, it is suggested that the 1967 Report drew on inaccurate source material. Sosnick (1958) argued that some writers and groups failed to acknowledge or accept workable competition's relevance as an 'optimal' ideal rather than a second best alternative. One such report he identified making this error was the *Report of the Attorney General's National Committee to Study the Antitrust Law*. In compiling its relevant chapter dealing with competition and RPM, the BTI referred several times to this particular report. *Could it not be that this inconsistency trickled through, thereby affecting the Board's understanding of RPM?*
2. See for example paragraph 195, p.30.

adopted, then at least the prohibition would be theoretically consistent with its policy framework. Likewise, if it could be demonstrated that an efficiency view was favoured, then there is some scope to suggest that these agencies were incorrect to outlaw RPM. The following section will attempt to identify which view was adopted by the BTI and CB.

4.3.1 Which Version of the Workability Framework was Adopted?

After reviewing available policy documents, no categorical statement can be found claiming that the BTI or CB favoured a particular stance. Neither agency made an unequivocal declaration defining what form they understood competition to take. Their view on what mechanisms are responsible for driving competition must be reconstructed from available *ad hoc* investigations. However, this reconstruction is problematic because policy decisions often do not fit neatly into either the structuralist or efficiency category. For example, if it were to be demonstrated that the BTI and CB favoured a structuralist view, then it would have to be demonstrated that both agencies made a presumption against excessive seller concentrations. But they have seldom acted against the high degree of seller concentration, which characterises the South African manufacturing sector¹. More often than not policy documents dealing with concentration simply reiterated arguments favouring the greater efficiency implications of concentration and the unique nature of local conditions². Furthermore, no evidence can be found to suggest that either agency established any structure-performance tests which, when exceeded, initiated remedial intervention³. However, both the BTI and CB were quick to act against trade practices, especially RPM, which impeded or restricted the price mechanism. Section 4.3.2 will tentatively argue that South Africa's regulatory agencies adopted a structuralist approach in their dealings with

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1. The only noteworthy exception was the recent preemptive report that prohibited the intended Minorco take-over of Consgold (CB, 1989).
 2. Perhaps the only exception to the view that South African competition policy has been lenient on concentration, can be found in Report 1220(M). Whilst conceding that solutions which have a few sellers could be workable, the BTI made the presumption that competition becomes more "effective if the numbers are so large that each sellers' impact on the market is small" (BTI, 1967, p.23). But this is hardly enough to support a claim that the BTI favoured the structuralist version.
 3. In the UK, for example, if an intended merger results in a firm having a market share in excess of 25%, the merger must first be scrutinised by the Monopolies and Mergers Board.

RPM.

4.3.2 RPM and the Structuralist Version of Workable Competition

Three factors are considered to suggest that the BTI and CB adopted a structuralist stance in their dealings with RPM. The next chapter will argue that their attitude towards RPM's so-called procompetitive properties further confirms their structuralist stance.

First, the CB and BTI were suspicious about any trade practice or form of government intervention that interfered with the price mechanism. The CB (1982, p.4) viewed these infringements as "extreme measures in a free enterprise system" because they conflicted "with the most fundamental requirement of ... *price formation through the free interplay of impersonal market forces*" (author's emphasis). Although this view would be at home in either a structuralist or efficiency framework, the CB failed to make the necessary efficiency qualification that would distinguish it from the structuralist view. Provided that the condition of entry was unaffected and no significant sunk cost barriers to entry were in place, the efficiency approach viewed these 'non-standard' agreements as a response by firms to become more competitive. By superseding the price mechanism, RPM could achieve efficiencies that would not otherwise be realised.

Second, in its two reports that outlawed RPM, both the BTI and CB (1985, p.30) viewed structure as the key factor responsible for determining a market's performance. In its chapter dealing with the nature of competition, the BTI (1967, p.22) argued that "market conduct and economic performance tend to differ significantly according to ... differences in structure". In fact, the BTI (ibid) went a step further and argued that structure-performance tests could be established to determine whether RPM was indeed workable: "links between market structure and performance which can be confirmed or refuted by comparing observable structural characteristics ... (and) blended with abstract price theory to develop concepts of workable or effective competition". The prominence given to structure and its ability to influence performance suggests some overlap with the structuralist version of workable competition discussed in Section 1.4.

Third, the actual anticompetitive arguments raised by the BTI and CB against RPM have

a distinct structuralist flavour. They argue that RPM is a tool used by dominant firms to dull competition and create abnormal profit-making opportunities for themselves. No consideration was given to the efficiency approach's longer term view of the competitive process and the fact that competitiveness hinged more on the condition of *entry* than actual *price* competition. Repeating the arguments raised in Report 1220(M), the CB (1985, p.39) argued that individual or collective RPM has the following anticompetitive consequences:

- Eliminates price competition amongst resellers and sets prices in excess of competitive levels.
- The selling price bears little resemblance to the cost structure of each individual reseller and cost savings cannot be passed on to buyers.
- Restricts the distribution of the target-commodity to particular groups (resellers), namely those who are prepared to maintain the prescribed prices.
- Restricts entry of a new product in the market by downstream agents not willing to carry their stocks without this form of fixed margin incentive.

These anticompetitive arguments will be reexamined in Section 4.4.2.

4.4 Challenging the Prohibition of RPM in South Africa

Two aspects of the BTI and CB's policy framework are considered to challenge their decisions to outlaw RPM.

4.4.1 The Public Interest and RPM

By adopting workable competition as their policy framework, local authorities committed themselves to testing restrictive trade practices against the public interest yardstick. It is not enough to demonstrate that a practice is monopolistic or restrictive to have action

taken to remedy the situation. Consideration must also be given to assessing its wider implications within the context of the broader public interest. The following discussion challenges the BTI and CB's application of its welfare measure. It will be argued that prior to the 1967 prohibition, the public interest test was correctly applied and the desirability of RPM often accepted. Then it will be argued that after the prohibition this test was not correctly applied. Due to these inconsistencies, suspicion is cast on the validity of the *per se* prohibition

4.4.1.1 The Public Interest Test before the 1967 Prohibition

In its early investigations dealing with RPM, the BTI correctly applied the 'two-stage' method of assessing the desirability of permitting this practice to continue. In these reports the BTI expressed its concern at the possible economic consequences of allowing RPM. It disliked practices which interfered with the price mechanism. However, after applying the public interest test, the BTI found in favour of RPM in four out of five investigations¹. It concluded that curtailing RPM would have, on balance, negative consequences for society. In its investigation into the liquor trade (BTI, 1958b) the Board regarded the price-setting actions of the South African Wine and Spirit Importers Association as being monopolistic. This Association circulated schedules to its members specifying collective minimum wholesale prices for whisky. But in its assessment the Board held that without these minimum resale prices, South African viticultural products would be exposed to excessive competition. In its analysis, it made the implicit assumption that wine and whisky were close substitutes. By allowing RPM to continue, the Board accepted the protection afforded to the local viticultural industry was more important than the arrangement's supposed negative economic effects. Likewise, the desirability of RPM was accepted in the tyre industry and book trade after it had been scrutinised against the broader public interest measure. One of the non-economic arguments accepted by the BTI in its investigation into the tyre industry (BTI, 1959) was that public safety should not be compromised. In its defence, the Tyre Manufacturers' Conference (TMC) argued that without sufficient price stability, regulated by collective RPM, the quality of pneumatic

1. See table A.1, Appendix One.

tyres would be lowered. Similarly, in its investigation into the book trade (BTI, 1964) the Board regarded the 'Price and Discount Schedule' set by the Associated Booksellers of Southern Africa (ABSA) as a collectively applied monopolistic condition. However, the Board held that "books (were) not ordinary commodities" but were "vehicles of a nation's culture, knowledge and civilisation" (BTI, 1964, p.34). The BTI accepted the argument that some degree of cross subsidisation was in the public interest because it ensured the widespread distribution of these special products.

4.4.1.2 The Public Interest Test and the 1967 Prohibition

Whilst there is some scope to challenge each of the economic arguments raised against RPM, it is conceded that the BTI did make a detailed assessment of RPM in terms of what it perceived the public interest test to be. Elements considered by the Board (1967, p.128) when it assessed RPM were:

- (a) What are the economic implications of the practice?
- (b) Are the effects compatible with an efficient use of the country's resources, progressiveness and innovation in the economy and their raising of the living standards of the South African people.

It will be argued in the next section that in its dealings with RPM, the BTI did not consistently apply the workability framework.

4.4.1.3 The Public Interest Test after the 1967 Prohibition

Whilst the BTI correctly applied the two-stage approach welfare assessment in the compilation of its pre-1967 reports, this approach was not used in many of its later investigations. Table 4.1 summarises the BTI's use of the public interest test in its evaluation of applications received for exemption from the 1967 prohibition. Two important conclusions are drawn from this table and will be discussed below. First, the Board generally failed to specify what the public interest was. Second, the Board seldom took the neces-

sary 'second-step' of assessing RPM against the public interest yardstick. The columns in Table 4.1 represent the following:

- Column one denotes those reports that made proper use of the public interest measure. In these cases the BTI first considered RPM's immediate economic consequences, before assessing it against the broader backdrop of the public interest test.
- Column two summarises those applications where the 'public interest' was mentioned but the BTI effectively applied the narrower Pareto optimality test.
- Column three denotes those reports which made no mention of the public interest but applied the narrower Pareto optimality test.
- Column four summarises those reports that give no attention to any welfare yardstick at all.

Table 4.1: Formulation of the Public Interest

	Column One	Column Two	Column Three	Column Four
Industry				
Report No.1262(M) Part I				
a) Electrical Cables				*
b) Ladies' Shoes				*
c) Simulated Pearls				*
d) Ceramics			*	
e) Sports equipment			*	
f) Watches				*
g) Chain hoists, pullers				*
Report No.1262(M) Part II				
a) Pharmaceutical				
(i) Medicines		*		
(ii) Franchised items				*
b) Gramophone records	*			
c) Sugar			*	
d) Black bolts and nuts				*
e) Tobacco			*	
Report No.1262(M) Part III				
a) Newspapers and Books				
(i) Newspapers		*		
(ii) Books	*			
b) Clothing	*			
c) Liquor	*			
Report No.1262(M) Part IV				
a) Petrol		*		
Report No.1262(M) Part V				
b) Tyres	*			
Incidence of Occurrence	5	3	4	7

In eleven of its nineteen applications the BTI made no mention at all of the public interest (Columns Three and Four). These applications were rejected out of hand, with the BTI giving no or little explanation to justify why RPM was anticompetitive. Even if these industries had no significant bearing on society's interests, this should have been stated. Column Two notes that in three of the applications, the BTI mentions the public interest test but bases its assessment solely on RPM's ability to efficiently allocate resources within a particular industry. Two examples are given to illustrate that if attention had been given to a broader set of welfare factors, the BTI might have found in favour of RPM. In their application for exemption, various South African pharmaceutical associations proposed two non-economic reasons to suggest why RPM might be desirable (BTI, 1969b). First, they argued that pharmacists assumed an important link in the health care chain. RPM provided the fixed margins necessary to promote cross subsidisation, which provided for a more convenient and widespread location of pharmacies than would otherwise have been possible. Second, removing RPM would result in wide urban-rural price discrepancies. These discrepancies would effectively raise the real cost of rural medicines, making it relatively more costly for the rural population to purchase these necessities. Yet in its assessment the BTI did not consider these non-economic arguments. *Did the BTI really count the true costs associated with prohibiting RPM?* Likewise in its assessment of an application brought by petrol suppliers (BTI, 1970a), the BTI failed to construct a broad welfare measure. Its evaluation simply examined the economic impact RPM had on manufacturers, distributors and consumers. No consideration was given to the strategic nature of petrol or its importance to the economy at large. The BTI's decision to reject this application was overturned by the Government. The Government argued that RPM formed an integral part of its attempt to rationalise the distribution of petrol. A form of RPM is still imposed on retail petrol sales today.

It was only in five of the nineteen applications that the BTI looked beyond the narrow Pareto optimality yardstick and attempted to construct the broader public interest welfare measure. Two of these formulations are given to illustrate. In rejecting an application brought by representatives from the South African music industry (BTI, 1969b), the BTI not only considered the immediate economic implications RPM had for distribution, but also assessed RPM on its ability to develop new music talent and promote music as a cultural commodity. Similarly, broader welfare aspects were considered by the Board in its evaluation of an application brought by representatives from the clothing industry (BTI,

1969c). Although the Board rejected the arguments made in the application, it did examine at some length RPM's role at promoting South African clothing exports.

The second conclusion drawn from Table 4.1 is that the BTI did not take the distinct 'second-step' of assessment required by the workable competition framework. Within this policy framework it is not enough to argue that because a trade practice has restrictive properties it is necessarily anticompetitive. This decision can only be made once it has been scrutinised against the public interest measure. Table 4.1 notes that it was only in five of the nineteen applications that the BTI correctly applied this separate 'second-step' test¹. It would appear sufficient for a trade practice simply to be restrictive for the BTI to regard it as being anticompetitive. Similar sentiments are echoed by Fourie (1987, p.383). Would the BTI (and for their part the CB) have been more sympathetic towards RPM had they correctly applied the public interest test?

4.4.2 The Anticompetitive Effects of Resale Price Maintenance

By prohibiting RPM, the BTI and CB must have been convinced that it was a tool dominant firms used to dull competition and raise margins in excess of competitive levels. However, the following section will consider how the BTI and CB have dealt with the anticompetitive arguments used to condemn RPM. It will be shown using the distinction drawn between collective and individual RPM that the agencies failed to use arguments correctly and thus the validity of their discussion is cast in doubt.

4.4.2.1 The Anticompetitive Effects of Collective RPM Revisited

The previous chapter described how the cartel argument was the principle argument used by structuralists to conclude that collective RPM was anticompetitive. When prohibiting collective RPM and granting it very few exemptions, the BTI and CB should have based these decisions on the cartel argument. However, this section will demonstrate that:

1. Likewise, the CB's Report 15 made no attempt to formulate what the public interest was or to judge RPM against it.

- the BTI and CB made very little reference to these collusive considerations, especially after the post-1967 reports.
- an important disjuncture can be identified. In its pre-1967 reports the BTI focused on RPM's role at regulating a cartel. But even after making this link, the agency still found in favour of collective RPM in four of its five investigations.
- important qualifications to the cartel argument were ignored by the BTI and CB. Whilst the pre-1967 reports gave some consideration to these aspects, the post-1967 reports gave little or no attention to them.

The BTI's Report 1220(M) and the CB's Report 15 argued that collective RPM removed the incentive for firms to operate efficiently and allowed prices to be set above competitive levels. However, both agencies were vague when they attempted to describe how collective RPM dulled price competition. Instead of making the cartel argument the focus of their analysis to explain why collective RPM was anticompetitive, both agencies simply made off-handed comments stating that RPM simply raised price margins or eliminated competition. In recommending its prohibition, Report 1220(M) made only one reference which linked collective RPM with collusion "RPM can ... be a means of eliminating or restricting price competition ... Resale Price Maintenance sometimes serves to reinforce horizontal price agreements between manufacturers" (BTI, 1967, p.76). Likewise, Report 15 made only two references about collective RPM's and collusion when it referred to RPM as "vertical price collusion". On balance, the prohibitions do not seem to have been substantiated by sufficient economic analysis, according to the criteria set out in Chapter Three, and the robustness of the decisions can be questioned.

The lack of analytical depth was further evident in the BTI's later evaluation of applications received for exemption. Table 4.2 summarises the BTI's use of the cartel argument in all of its reports dealing with collective RPM. Column One denotes the industry and report number dealing with collective RPM. Column Two records the decision taken by the BTI. Column Three notes whether the cartel argument was used by the BTI in its assessment. No consideration is given to the CB's treatment of collective RPM because they have not compiled any *ad hoc* reports dealing with it. The CB might have dealt with

collective RPM on an informal basis but has not published any of these decisions.

Table 4.2: The BTI Collective RPM and the Cartel Argument

	Industry	Decision	Cartel Argument
1.	Report 437(M)		
	a. Grocery	Prohibited	Yes
	b. Biscuit	Prohibited	Yes
2.	Report 465(M)		
	a. Imported Liquor	Justified	Yes
	b. Hotel Trade	Justified	Yes
3.	Report 489(M)		
	a. Pneumatic Tyres	Justified	Yes
4.	Report 940(M)		
	a. Cigarettes	Justified	Yes
	b. Pipe Tobacco	Justified	Yes
5.	Report 1071(M)		
	a. Books	Justified	Yes
	b. Newspapers	Justified	Yes
6.	Report 1262(M) Part I		
	a. Sports Equipment	Prohibited	No
	b. Watches	Prohibited	No
7.	Report 1262(M) Part II		
	a. Medicines	Prohibited	No
	b. Franchise Items	Prohibited	No
	c. Records	Prohibited	Yes
	d. Sugar	Prohibited	No
	e. Tobacco	Prohibited	No
8.	Report 1262(M) Part III		
	a. Books	Prohibited	No
	b. Imported Liquor	Prohibited	No
	c. Hotel Trade	Prohibited	No
9.	Report 1262(M) Part IV		
	a. Petrol	Prohibited	No
10.	Report 1262(M) Part V		
	a. Tyres	Prohibited	No

Two interesting features are evident. First, the BTI used the cartel argument in only ten of its twenty-one reports dealing with collective RPM¹. In the other eleven instances no or little reference was made to collective RPM being used to set prices above competitive levels. Further inspection reveals that the BTI dealt with collective RPM twelve times after the 1967 prohibition (Report 1262(M) Part I to Part V). But in only one of these applications did the BTI actually consider the cartel argument. Surely if collective RPM was anticompetitive, as implied by the prohibition, it would have been relatively simple to demonstrate that it was being used to facilitate horizontal collusion? Second, certain cases investigated by the BTI before the prohibition and found to be in the public interest, had to reapply for exemption in terms of the 1967 prohibition. However, in each instance the BTI recommended that collective RPM should be prohibited and the application rejected. But in considering these applications the BTI did not justify these decisions based on the cartel argument. In its first investigation into the tyre industry (BTI, 1959) the BTI's main concern was how the Tyre Manufacturers' Conference (TMC) used RPM to coordinate market activity: "Although the TMC also performs other functions, it acts mainly as a price cartel" (1959, p.8). Whilst the BTI was aware that the TMC circulated a price list amongst its retailers, it still found RPM to be in the public interest. But in rejecting its application for exemption (BTI, 1970a), the BTI gave no attention to the collusive price-setting activities of the TMC. Similar comparisons can be made in the book trade (BTI, 1964; BTI, 1969c and BTI, 1977), the tobacco industry (BTI, 1962 and BTI, 1969b) and the liquor trade (BTI, 1958b and BTI, 1969c).

In terms of the structuralist version of workable competition, the cartel argument is the primary argument used to conclude that collective RPM is anticompetitive. When adopting this policy framework why did the BTI not aggressively apply this argument? Without linking collective RPM to collusion, there is little to justify the BTI's belief that collective RPM raises prices above competitive levels. These unsubstantiated decisions cannot just be accepted. Until further evidence is gathered, a question mark hangs over the validity of these prohibitions.

1. It is interesting to note that in seven of the instances where the cartel argument was used, the BTI still found collective RPM to be procompetitive.

Chapter One argued that two important efficiency qualifications had been made to the collusive Limit Price model. These were highlighted because they have important bearing on the argument linking collective RPM to collusion. Neither of these factors were adequately considered by the BTI or CB, when dealing with collective RPM. If taken into account, these factors would have resulted in the BTI and CB concluding less hastily that collective RPM was anticompetitive. Each factor is considered in turn.

First, the profit-maximising firm must consider whether it is in its own best interest to cooperate with other firms. After all, it is possible that independent action can realise greater individual gains than interdependent action. To determine whether profit-maximising firms should collude, Chapter One argued that five factors must be considered: the degree of product homogeneity, the nature of inter-firm cost structures, the nature of demand, the level of market profitability and the rate of innovation. Unless a sufficient matching occurs between these factors, collusion is unattractive because it fails to maximise the individual firm's profits. It is worth repeating the example given in Chapter One to illustrate: if wide cost discrepancies existed between two firms in a duopoly, there would be little incentive to collude because the more efficient firm would maximise individual profits by undercutting his less efficient rival. Using collective RPM to facilitate collusion would not make any sense because collusion is not a rational alternative. Consequently, arguments linking collective RPM with collusion are only valid when these five conditions lend themselves to collusion. In arguing that collective RPM was anticompetitive, the BTI and CB failed to consider what effect these factors had on collusion and hence RPM being anticompetitive.

Second, the success of a cartel depends partly on the ability of its members to prevent outsiders from entering the market to disrupt it. Consideration must be given to the condition of entry. However, as Chapter One discussed, controversy exists over the form these entry barriers take. Structuralists argue that these barriers result from factors such as economies of scale, absolute cost advantage, product differentiation and advertising. Efficiency authors reject this claim and argue that these features represent evidence of the greater efficiencies achieved by incumbent firms. However, sunk cost barriers to entry act as the ultimate deterrent. After inspecting the pre-1967 reports dealing with collective RPM, it becomes clear that the BTI did consider the role played by barriers to entry in sustaining prices above competitive levels. However, it does appear as if the BTI favoured

the efficiency 'sunk cost' interpretation. In its investigation into the tyre industry (BTI, 1958b) the BTI examined the requirements necessary to become a signatory to the Tyre Trade Register. Inclusion in this register constituted a necessary condition retailers had to satisfy before they could obtain stocks from manufacturers belonging to the TMC. Several of these preconditions necessitated retailers having to incur certain sunk costs - such as those costs associated with training staff to provide the required pre-sale services - before they could enter the market. These sunk cost barriers to entry were considered in other investigations. In the BTI's investigations into the tobacco industry (BTI, 1962) and the book trade (BTI, 1964), the entrance requirements necessary to become an accredited downstream wholesaler and retail distributor respectively were considered in some depth. Two conclusions can be drawn. First, in linking collective RPM with collusion, the BTI recognised that to demonstrate that RPM was indeed anticompetitive it would have to show that adequate barriers to entry were in place. Otherwise excessive profit-margins would be eliminated by potential rivals. Second, no consideration was given to the structuralist interpretation about the form these entry barriers took. Given the BTI's consistent use of the public interest measure and use of sunk cost barriers to entry in its earlier reports, could one not speculate that the BTI adopted an efficiency stance in its earlier dealings with collective RPM? If this were indeed correct it would imply an important shift in policy position, for which the BTI or CB gave no justification.

In making their later prohibitions and evaluating applications for exemption, the BTI and CB gave no consideration to the role barriers to entry played in allowing collective RPM to raise prices in excess of competitive levels. Without a sufficient explanation given to describe why abnormal margins persisted under the collective RPM regime, a question mark hangs over the validity of their conclusions.

4.4.2.2 The Anticompetitive Effects of Individual RPM Revisited

The following discussion considers how the BTI and CB have dealt with the anticompetitive arguments used to discredit individual RPM. It will demonstrate that:

- in passing their prohibitions, both the BTI and CB adopted a structuralist stance in their treatment of individual RPM.

- the BTI and CB failed to consider the efficiency qualifications before individual RPM could be declared anticompetitive.
- precedents exist to suggest that the BTI has accepted that competition can be driven by factors other than structure. Using evidence from available *ad hoc* reports, it will be argued that individual RPM could enhance competition by overcoming weaknesses in the price mechanism.

The BTI and CB argued that the extent to which resale prices are set in a downstream market reflected "the relative economic strength of the parties" (BTI, 1967, p.225). The greater a firm's market power, the greater is its discretion to set price margins in excess of the competitive norm. Because RPM requires sufficient market power to have the agreement enforced, the BTI (1967, Chapter 6) and CB (1985, Chapter 5) argued that dominant firms used individual RPM to dull competition. In a competitive environment these agencies maintained that the price margins depended on inter-firm cost differentials. Competitive pressures coerced competing firms to cut their prices until all remaining firms minimised their costs and made a normal rate of return. However, the BTI and CB argued that individual RPM dampened these competitive pressures. Consequently, these agencies expected the RPM-price to have no resemblance to the respective cost structures of those firms enforcing it and allowed inefficient firms to continue to operate¹. The latter outcome had serious ramifications for society because it attracted "more labour and other resources into distribution than is desirable from the point of view of optimum utilisation of resources" (BTI, 1967, p.225). Hence both agencies viewed individual RPM as an anticompetitive device because it impaired the market's ability to properly allocate and utilise resources.

These arguments have a distinct structuralist emphasis because their primary concern focuses on RPM's ability to impair *actual* price competition. In contrast, the efficiency approach holds that by restricting actual competition, the price mechanism's ability to regulate market power is not necessarily impaired. The state of market competitiveness is

1. See for example Competition Board, 1985, p.39.

contingent upon the condition of entry rather than seller concentration. In the absence of sunk costs it was the *threat of entry* that prevented dominant firms from abusing their market power. Even if individual RPM is used to set excessive margins, the entry-exit mechanism will reverse any abuse of market power provided that no entry restrictions exist. Consequently, the efficiency paradigm would not accept that RPM is anticompetitive unless it was imposed in conjunction with an effective sunk cost barrier to entry.

The BTI and CB have given no consideration to the role potential competition could play at regulating market power abuse. The BTI (1967, p.75) made only one comment about how excess profits would induce newcomers into the market and reverse the profit-opportunities made by RPM. However, this principle was not incorporated into their analysis nor its effects widely examined. No mention was made of the regulatory effects of potential competition in the 1985 report. Perhaps if the entry-exit mechanism had been given greater attention, the BTI and CB would have placed some important qualifications to their policy conclusions concerning individual RPM.

It was noted in the previous chapter that factors other than the price mechanism were equally able to prevent dominant firms from abusing their market power. One factor identified was the availability of *substitute* products. If the resale price for an individual product is set too high, end-consumers might substitute in favour of a lower priced alternative. In its investigation into the book trade (BTI, 1964) the BTI accepted the substitute argument. ABSA argued that the RPM arrangement imposed on imported books could not set excessive margins. If these margins were too high, unsatisfied end-consumers would import the product themselves from foreign retailers. In the same investigation dealing with newspapers and periodicals, the BTI accepted that advertising rates acted as important control device that prevented the RPM arrangement from being abused. Advertising forms an important source of revenue for these products. Circulation rates determine the amount of advertising and the corresponding tariff rates these publications can charge. If retail prices are set at excessively high levels, this would have serious bearing on circulation rates. Consequently, large printing houses were limited to the extent to which they could raise prices.

Just as it was accepted that these 'other factors' could prevent the price mechanism being abused, could individual RPM not be used as a similar control device? Three different

applications for exemption were made by upstream manufacturers fearing that, without protection from RPM, downstream retailers would exploit the intrinsic quality of their product and overcharge end-consumers¹. These applicants argued that by imposing a fixed maximum resale price, downstream retailers would be prevented from setting excessive margins. The BTI rejected these arguments and held that unfettered price competition was sufficient in each case to keep prices in line. Underlying the Board's argument rested the traditional neoclassical assumption that agents act out of self-interest. However, the inter-firm competition envisaged by the BTI took no account of firms purposely miscommunicating information or abusing any form of consumer ignorance. Agents do not always act honestly and within the confines of some moral framework. Introducing the new institutional assumption that agents act out of guileful self-interest, it is not inconceivable to expect firms to opportunistically abuse the price mechanism. Was the BTI (and the CB for that matter) correct to expect that the price mechanism would always give the most efficient solution? Could not individual RPM be viewed as an efficient control device capable of preventing opportunistic abuses to the price mechanism. Perhaps if these factors had been considered by the BTI and CB they would have been more hesitant to prohibit RPM and quicker to grant exemptions.

4.5 Summary

The purpose of the second section of this investigation has been to critically evaluate the separate policy decisions taken by the BTI and CB to prohibit RPM in South Africa. Specifically, this chapter has endeavoured to demonstrate that the *per se* prohibition passed on RPM was too severe. It was argued that this practice should rather be scrutinised on an *ad hoc* basis based on a rule of reason test. Before making this assessment, however, the chapter reviewed the historical development of South African competition policy. This review was done to explicate the legal status of RPM in South Africa.

In order to understand why the BTI and CB outlawed RPM consideration was first given to their understanding of the competitive process. Although these agencies have never

1. These applications were made in BTI 1969a, section b and c; and 1969b, section b.

unequivocally defined their position, it was argued that they adopted the structuralist version of workable competition in their dealings with RPM. In terms of this policy framework, it would appear as if the BTI and CB acted consistently in prohibiting RPM. However, it was decided that it would amount to more than 'soft criticism' to simply repeat the structural-efficiency debate. A more convincing way to challenge the prohibition would be to discredit it in terms of the BTI and CB's own arguments. Consideration was given to their use of the public interest test and the nature of the anticompetitive arguments raised against RPM. It was argued that the BTI and CB, especially after the 1967 prohibition, had not correctly applied the public interest test. Using the BTI's treatment applications for exemption to illustrate, it was shown that the broader welfare measure was seldom constructed nor the two-step method of assessment applied. Examples from the BTI's reports were used to demonstrate that if the broader public interest measure had been used, RPM might have found to have been procompetitive in certain cases. After considering the BTI and CB's use of the anticompetitive arguments normally used to discredit RPM, it was concluded that these agencies often failed to use them or apply them correctly. Moreover, once various efficiency qualifications not mentioned or considered by these agencies, were incorporated into the anticompetitive arguments many of the BTI and CB's arguments lost their bite.

This chapter seriously questions the validity of the prohibition and the treatment of various applications received for exemption.

*Chapter Five: Resale Price Maintenance's Procompetitive
Properties and the South African Authorities*

5.1 Introduction

The previous chapter considered the decisions taken to prohibit RPM in South Africa. After examining the BTI and CB's treatment of RPM, it highlighted important inconsistencies inherent in the application of their policy frameworks. It was argued that the BTI and CB seldom considered several key qualifications which limit the relevance of the anticompetitive arguments normally used to discredit RPM. On the basis of these inconsistencies Chapter Four concluded that the prohibitions were excessive and called for the adoption of the milder *rule of reason* approach. Extending these criticisms Chapter Five will consider how the BTI and CB have dealt with RPM's procompetitive properties. Two features will be highlighted throughout the chapter:

- The BTI and CB rejected most of the arguments claiming that RPM was procompetitive. These agencies refused to accept the central theme running through most of the procompetitive arguments that a more desirable allocation of resources could be brought about by superseding the price mechanism. Chapters Two and Three described the affects several key factors had on the transacting process. Within this context these chapters argued that RPM acted as a control device contracting agents used to minimise their exposure to moral hazard or to strengthen a weakened price mechanism. However, in virtually all circumstances the BTI and CB remained convinced that the free price mechanism could be relied upon to bring about the most efficient allocation of resources. Because the BTI and CB seldom considered these factors, it will be argued that they failed to fully appreciate RPM's procompetitive properties. Five factors are considered separately: orderly distribution, cross subsidisation, service arguments, quality certification and loss leading considerations.
- More circumstantial evidence is gathered to demonstrate the BTI and CB's adoption of a structuralist stance in their dealings with RPM.

Before considering these features brief mention is made of the tables in Appendix A, which analyse the *ad hoc* reports compiled by the BTI. Tables A.1 through A.3 break down each report dealing with RPM and summarise the respective arguments that were considered by this Board. In total, twelve *ad hoc* reports that examined RPM in thirty-two

different markets or sub-markets were compiled. Table A.1 refers to those reports compiled before the 1967 prohibition. Table A.2 deals with the applications made for exemption from the 1967 prohibition. Finally, Table A.3 considers the investigations conducted by the BTI into those industries, which received temporary exemption. These tables are important and will be referred to throughout Chapter Five. The CB has not published any *ad hoc* reports considering RPM and thus no table can be compiled. Following from the 1985 prohibition only one application for exemption has been received (newspapers and periodicals). No report was drafted by the CB and its only written statement is found in the 1986 Annual Report. It is noted that the brief comment given to it in the report makes analysis difficult.

5.2 *Orderly Distribution*

A purported advantage of the market based economy is the relative ease with which it coordinates economic activity. Unlike their centrally planned counterparts, who rely on detailed sets of instructions and directives, market based decision-makers simply have to follow the informational signals transmitted by the price mechanism. But the allocative efficiency of the price mechanism can be impaired if it is exposed to volatile or erratic market fluctuations. In these conditions uncertainty, exacerbated by opportunism, might raise asset specificity requirements above those levels that would be expected under normal competitive conditions. In these extreme conditions firms might, therefore, be unwilling to allocate resources in a socially desirable manner. To circumvent the '*volatility problem*' Chapter Three described how firms could use RPM as a control device to stabilise an erratic price mechanism. Stable prices might lower the moral hazard associated with contracting and thereby generate a more efficient allocation of resources. The following discussion will analyse the BTI's treatment of this procompetitive property.

One of the BTI's earliest reports (1959) which dealt with the orderly distribution argument accepted it. The Tyre Manufacturers Conference (TMC) claimed that RPM provided the necessary stability to secure a socially desirable allocation of resources within that industry. The TMC held that if its RPM agreements were removed, destructive price competition would ensue amongst wholesale and retail distributors. Such action would eliminate many of these firms and seriously disrupt manufacturers' marketing efforts. The

TMC further argued that the expected price instability in downstream markets was exacerbated by the erratic and volatile fluctuations in primary input markets. The TMC held that the rubber market was often characterised by periods of shortages or surpluses which, in turn, caused wide fluctuations in input costs. The interaction of the instabilities in both the primary input and downstream output markets would lead to serious 'leads and lags' in the production process. This instability, in conjunction with the highly capital intensive nature of the industry, led the BTI to conclude that reliance on free price competition would result in a sub-optimal allocation of resources. RPM allowed tyre manufacturers to compete under more realistic conditions. It is stressed that RPM does not exonerate manufacturers from all market risk. These firms must still compete against each other across various non-price attributes. However, these arguments were rejected by the BTI in later reports dealing with the tyre industry and are reconsidered at the end of the section.

Chapter Four gathered circumstantial evidence to argue that the BTI adopted a structuralist stance in its later dealings with RPM. This allegation follows from the BTI's insistence that the price mechanism should be allowed to operate without restriction. Further evidence is provided to suggest that this structuralist stance was carried over in the BTI's treatment of the orderly distribution argument. Report 1220(M) rejected the orderly distribution argument and held that this stability was desired because it provided firms with "a comfortable way of trading" (1967, p.54). The BTI viewed the stability argument as an attempt by incumbent firms to shelter themselves from competition. By restricting the price mechanism RPM neutralised competition's ability to regulate market power. Consequently, RPM provided the stability dominant firms required to abuse their market power and generate abnormal profits. *Does RPM necessary constrain the price mechanism?* In none of its reports dealing with RPM did the BTI attempt to establish the importance of conditions of entry to the competitive process. Provided no prohibitively high entry barriers are in place, dominant firms cannot abuse their market power because these abuses act as a signal to potential rivals to enter the market and contest these profits. Perhaps if the BTI (and the CB) considered the effects of *actual entry* on the competitive process, it would have been more hesitant to reject the merits of the orderly distribution argument.

Absent from the majority of the BTI's post-1967 dealings with the orderly distribution argument was any consideration of the volatility condition or the surrounding specificity

requirements. Whilst the BTI may have correctly judged these cases, its decisions were right for the wrong reasons. In its evaluation of an application made for exemption by a manufacturer of chain hoists and pulleys (BTI, 1969a), the BTI argued that exposure to price-cutting by downstream retailers would not disrupt its distribution network. Similarly, the BTI rejected an application made by various gramophone record manufacturers (BTI, 1969b). Both applicants claimed that price competition would eliminate their network of specialist retailers. In both reports the BTI held that RPM provided the stability dominant firms required to secure an easier mode of trading and blunt competition. However, unless RPM is accompanied with sufficient entry restrictions it can, at worst, only lead to short run abuse. Noticeably absent from the BTI's analysis was any assessment of prevailing market conditions. After inspecting each report it would not appear as if either industry was exposed to serious market fluctuations. Hence this study concludes that the free price mechanism could be relied upon to provide a socially desirable allocation of resources but not for the reasons given.

In only one instance after passing the prohibition did the BTI actually consider the volatility condition. Representatives from the sugar industry claimed that RPM provided the stability necessary to ensure the orderly distribution of their products (BTI, 1969b). However, the study agrees with BTI's decision to reject these claims. The BTI argued that sufficient non-price controls, such as the formation of the sugar exchanges, were already in place and would prevent a return to the chaotic conditions which characterised the industry during the 1930s.

Not all the recommendations made to the Minister have been accepted. It was described above how the BTI supported arguments claiming that RPM provided the stability necessary to secure an orderly distribution of tyres (BTI, 1959). After the 1967 prohibition the tyre industry was obliged to apply for exemption. In its application the primary argument used by the TMC to support RPM again focused on its ability to stabilise market conditions (BTI, 1970b). However, on this occasion the BTI rejected the relevance of the orderly distribution argument. It reiterated its presumption made against the stability argument in its 1967 report "RPM guaranteed tyre suppliers a quiet life" (1970b, p.15). The Board held that RPM's only use was to eliminate price competition and allow tyre manufacturers "to dictate their marketing terms to dealers without having to tie or own distributive outlets" (1970b, p15). The BTI further argued that removing RPM would expose these

manufacturers to normal market risks - implying that tyre manufacturers had no reason to believe they had any special asset specificity requirements. The Minister rejected the BTI's arguments, particularly the inference that this industry should be exposed to normal market risks. In his defence of RPM, the Minister argued: "I also considered the effect of the abolition of resale price maintenance ... on the branch of industry and allied industries, and I arrived at the conclusion that such a step would ... have disruptive consequences for the tyre manufacturing industry itself, the local suppliers of raw materials to the industry as well as the distributors" (BTI, 1978, p.3). Clearly the Minister understood that volatile market conditions interfered with the free price mechanism's ability to derive efficient solutions. He viewed the setting of fixed margins as being necessary to secure a socially desirable allocation of resources, and not to satisfy anticompetitive greed. The Minister granted the tyre industry another temporary exemption. A third investigation was conducted to reconsider whether it should qualify for permanent exemption (BTI, 1978). In its assessment the BTI again rejected the orderly distribution argument and claimed that RPM was simply imposed to allow abnormal profit-making. The Minister accepted this argument and rescinded the exemption. It is speculated that the Minister believed that market conditions had changed sufficiently implying that the price mechanism no longer required some control placed over it. It would not be unrealistic to assume that market conditions had stabilised sufficiently from the date of the first to the third report, for the market to no longer require a price restraint. Consequently if normal market conditions did prevail, then the study would accept the BTI's decision to prohibit RPM in the tyre industry.

5.3 Cross Subsidisation

Chapter Three considered two arguments describing how RPM could be used to cross subsidise other activities which had socially desirable resource allocation implications. First, the distribution of *special* products would be jeopardised. Without RPM to facilitate cross subsidisation between merit products and normal items, the resale prices of these special products might be prohibitively high and discourage their purchase. These special products would be 'lost' because without cross subsidisation they would be uneconomical to produce. Second, cross subsidisation can provide the gross margin cover necessary to promote a product's *widespread distribution*. In this regard, the successful marketing of

certain products depends upon their broad based distribution. Implementing RPM might provide the asset specificity requirements needed to facilitate this distribution. The following discussion will consider how the BTI and CB have dealt with these arguments. The remainder of the section will discuss each in turn.

5.3.1 Special Products, Cross Subsidisation and Asset Specificity

In its first investigation into the book trade (BTI, 1964), the BTI's primary reason for finding RPM to be in the public interest centred on the *special nature* of books. The Associated Booksellers of Southern Africa (ABSA) argued that "books (were) not ordinary commodities" but were "vehicles of a nation's culture, knowledge and civilisation" (1964, p.34). However, ABSA held that trends in modern production and distribution emphasised the importance of rationalisation. This specialisation resulted in the mass production and distribution of a restricted range of profitable items. The applicants argued that the adoption of these production techniques by the book trade would be contrary to the reading public's best interests. Publishers would be exposed to the same business risks associated with the production of ordinary commodities. Increased risk would either restrict the number of 'culturally valuable' texts published, or raise the price of these titles to prohibitively high levels. Moreover, ABSA argued that due to the economic attractiveness of holding faster moving titles, retailers might be less inclined to stock the slower moving 'culturally valuable' texts. By facilitating cross subsidisation between 'normal' and 'culturally valuable' titles, ABSA argued that RPM could help overcome the inherent distribution bias displayed against these special products. The BTI accepted these arguments, implying that the free price mechanism could not be relied upon to bring about as an efficient distribution of resources. The merits of the cross subsidisation argument became less important in the BTI's later reports dealing with the book industry, as it began to adopt a more structuralist line of thought.

Unlike its first report, the BTI's second and third reports (BTI, 1969c and 1977) argued that RPM was not necessary to ensure the successful retail distribution of books. Drawing on foreign experience and the mix of products held by local booksellers, both reports held that relaxing RPM would initiate a very limited price response amongst retailers. Whatever price-cutting might occur would not be enough to deter any attempts by publishers or

retailers to cross subsidise faster and slower moving stock. Consequently, the BTI argued that the price mechanism should be left to operate freely in its capacity as resource allocator. Whilst the BTI favoured free price competition, the second report was still unsure about whether the free price mechanism would adequately subsidise specialist texts. This indecisiveness was enough for the second report to issue a further temporary exemption the: "Board is of the opinion that the possible economic gain of free pricing is not worth the cultural risk" (1969c, p.28). However, the third report was emphatic when it argued that RPM was being used solely for the purpose of setting excessive profit margins. In making its final decision to prohibit RPM, the BTI failed to consider two factors, which would prevent these price abuses:

- In its first report, the BTI accepted that the availability of close substitute titles and foreign suppliers were sufficient to regulate the setting of price margins. If price margins were excessive consumers could either substitute towards a cheaper title or purchase the book from a foreign supplier.
- Unless significant sunk cost barriers to entry are in place, the RPM arrangement cannot set excessive price levels without attracting entry. In neither of its second or third reports did the BTI consider the condition of entry into the market.

The special product argument was used by various South African record manufacturers in their application for exemption (BTI, 1969b). They held that gramophone records, like books, formed a medium containing many culturally valuable recordings. The applicants argued that RPM allowed manufacturers to cross subsidise and provide the asset specificity requirements necessary to promote local talent. A review of other countries' competition policy revealed that no other country classified records in the same category as books. This led the BTI to conclude that records were essentially ordinary products and would be best stimulated by free price competition. It appears from the evidence presented by the BTI to support their decision not to regard records as a merit product was correct.

Whilst it was implicit in their application (BTI, 1969c), various pharmaceutical trade associations should have placed more emphasis on the premise that ethical medicines are special products. These applicants claimed that RPM allowed upstream distributors to

cross subsidise between the prices charged on ethical medicines in urban and rural areas. Without cross subsidisation wide urban-rural price discrepancies would arise. These discrepancies effectively raised the relative cost of medicines to the relatively poorer rural population, especially in terms of their lower real incomes. Yet, whilst evaluating these considerations the BTI expressed no opinion about the nature of ethical medicines or the effects these price discrepancies would have on the health industry. Given the current crisis in the local health care industry, if this application were to be reconsidered today, greater stress might have been given to the special nature of ethical medicines. It is possible, therefore, that RPM would have received more favourable treatment.

5.3.2 Wide Distribution, Cross Subsidisation, Search Costs and Asset Specificity

Convenience items tend to be purchased at regular intervals and in small quantities. To minimise the associated costs of transacting, whilst simultaneously encouraging their sale, manufacturers would endeavour to secure their broad distribution. In certain circumstances efficiency proponents argued that the free price mechanism could not always be relied upon to bring about this broad distribution. By applying RPM to provide some degree of cross subsidisation, existing asset specificity requirements might be better satisfied. Permitting RPM in these instances would result in a more efficient allocation of resources. The BTI accepted this argument.

In its investigation into the tobacco industry (BTI, 1962), the BTI argued that promoting the wider distribution of cigarettes was essential for the industry and gave two reasons to justify this. First, consumers could make their purchases "at standard prices and at convenient selling points, so that buyers do not have to compare prices - they may simply obtain stocks from the seller situated most conveniently for them, without fearing that they may pay more ... than elsewhere" (1962, p.31). The BTI feared that the price-cutting activities of large chain stores and supermarkets would eliminate many of the smaller firms, which handle the majority of the trade. Second, RPM provided the necessary asset specificity conditions manufacturers required to secure the widespread distribution of their respective brands: "for manufacturers it has the advantage that the uniform and protected profit margins ensure that there will be adequate distributors to handle their products and to stock sufficient quantities" (BTI, *ibid*). However, the BTI dismissed these conclusions in

its later report dealing with the tobacco industry's application for exemption. It argued that free price competition would ensure a better allocation of resources than was possible under the RPM alternative. The BTI did not believe that removing RPM would necessarily narrow the industry's distribution network. Rather, it argued that small firms possessed certain advantages over larger chain stores, most notably closer proximity to consumers and after hour trading facilities. These factors justified smaller firms applying higher margins. If the BTI was correct in stating that smaller firms could realistically impose higher margins on tobacco products, then there was no need for RPM to be used to satisfy asset specificity requirements. In this regard the free price mechanism can provide a broader product distribution unassisted.

The BTI has accepted that RPM can be used to promote cross subsidisation and a broader distribution for products other than convenience items. In its first investigation into the liquor industry (BTI, 1958b) the Board maintained that the hotel trade required some degree of cross subsidisation between liquor sales and accommodation to foster its development. This was especially prevalent given the industry's recent commitment to upgrading local standards "the maintenance of a certain standard of accommodation is dependent upon an adequate income from the bar trade" (1958b, p.34). Justifying RPM's relevance, the BTI implied that the free price mechanism could not satisfy the specificity conditions necessary to bring about the desired distribution of resources. However, the cross subsidisation argument was rejected by the BTI when representatives from the hotel industry applied for exemption (BTI, 1969c). The BTI argued that conditions had changed since the last report. Bar receipts no longer formed the major source of liquor income for most hotels, but rather their off-site bottlestores. Thus, the BTI correctly noted that there was no need to rely on RPM imposed on bar prices to provide the required degree of cross subsidisation because conditions had changed sufficiently. The bottlestores now represented a sufficiently large alternative source of funding.

The Minister has not always accepted the BTI's recommendation that free price mechanism is most efficient at providing for a product's broad based distribution. In its application for exemption, the petroleum industry (BTI, 1970a) argued that RPM was necessary to ensure the widespread distribution of service stations. As in other reports, the BTI took exception to this and argued that free price competition was most efficient: "The Board cannot accept that price competition on the sale of petrol would necessarily lead to a

large scale elimination of service stations ... Where such price differentials did exist it would have a profound effect on the price cutting petrol reseller and less efficient uneconomic service stations might have to close down" (1970a, p.7). However, the Minister rejected the BTI's recommendation to prohibit RPM. In terms of his own attempts to rationalise the distribution of petroleum products in South Africa, the Minister argued that the provision of RPM was central to ensuring an efficient number of outlets. He obviously understood that distributors' asset specificity requirements could not be satisfactorily met under a free price regime.

5.4 The Service Argument and Bounded Rationality

Faced with the constraint of bounded rationality, manufacturers might believe that the successful marketing of their products hinges on an adequate provision of pre-sale services. By providing appropriate information this constraint might be eased and demand for that product stimulated. However, due to the special nature of these services, and the cost of their provision, certain retailers might be unwilling to provide them. These firms would rather *free-ride* on those retailers who do provide the required services and divert sales towards themselves by charging lower prices. If free-riding occurs on a large enough scale, the entire distribution of a product might be jeopardised. To overcome the free-rider problem and ensure that required pre-sale services are provided, manufacturers can impose RPM. Efficiency proponents maintain that by restricting price competition, profit-maximising firms must respond by competing across non-price criteria. The free-rider problem is solved because competitive pressures *coerce* other firms into providing adequate pre-sale services. The remainder of this section will consider the BTI's treatment of the service argument.

5.4.1 A Rejection of the Service Argument

After reviewing reports in which the BTI considers the service argument, it becomes apparent that it did not believe enforced margins were sufficient to ensure an efficient provision of pre-sale services. In its 1967 Report the BTI acknowledged that whilst a fixed margin "undoubtedly stimulates competition in services and thereby increases total

expenditure on them", it was not sufficient to ensure "the rendering of a particular service" (BTI, 1967, p.112). Similar sentiments were echoed by the BTI in its evaluation of the clothing trade's application for exemption (BTI, 1969c) and its investigations into the tyre industry (BTI, 1959, 1970b and 1978). Clothing manufacturers argued that without providing RPM margins to retailers, their higher quality products would not be distributed with the necessary pre-sale services. However, these claims were rejected: "the Board does not believe that RPM provides a guarantee that these services will be rendered" (BTI, 1969c, p.35). Likewise, tyre industry representatives maintained that RPM was necessary to ensure that retailers provided the necessary services to accompany the distribution of their products. They regarded tyres to be special products which could not be sold over the counter but required specialist services and fitting equipment. In rejecting the appropriateness of RPM to provide these services, the BTI observed that *"in spite of this practice, the tyre services provided by the many dealers leave much to be desired"* (author's emphasis) (1978, p.25).

The BTI's apparent presumption that RPM cannot efficiently provide pre-sale services is questionable. Although it is accepted that RPM will not always be most efficient, the BTI's decision to condemn the service motive may be incorrect because it omits three key qualifications.

- Unless sufficient entry restrictions are in place, the entry-exit mechanism will regulate market power abuses. If excessive margins are set, under the guise of providing adequate pre-sale services, it would attract potential rivals to contest these abnormal profits. Whilst RPM cannot ensure that these services will be provided in the short run, competitive pressures dictate that they will be provided in the long run if firms wish to survive. In its 1967 Report the BTI gave an example to illustrate how photographic dealers took full advantage of high fixed margins by not offering expected services. However, noticeably absent from the BTI's examples was any attempt to consider the role potential competition played at regulating incumbent firms' behaviour.
- The BTI's reports which dealt with the service argument only considered RPM in terms of its ability to provide the margins necessary to provide a satisfactory level of services. However, Chapter Three stressed that the motive behind imposing

RPM was to solve the free-rider problem. It has not been possible to find any reference made by the BTI acknowledging the free-rider problem or referring to RPM's relevance as a control mechanism to prevent it. The distinction between service provision and the free rider problem is more than a matter of semantics. Its validity implies that the BTI failed to consider RPM's ability to act as a control mechanism in circumventing the free-rider problem. This is in direct contrast to BTI's presumption of the passive role RPM played in providing the margins required to offer these services.

- The BTI believed that the competitive tournament could be relied upon to adequately provide the necessary information to consumers. The BTI did not consider the effects of consumer bounded rationality when it compiled its reports. Can the price mechanism rely on ignorant consumers to give it direction? Would it not be subjected to opportunistic abuse? Whilst it provides an average level of information, could not RPM be more efficient at solving these problems in some cases? Due to the length of discussion, the BTI's treatment of bounded rationality and RPM will be considered separately in the following section.

5.4.2 The Service Argument, Freedom of Choice and Bounded Rationality

RPM is an average price technique that provides all consumers with approximately the same level of services. However, this uniform provision violates two important free trade conditions. First, consumers are obliged to accept these services irrespective of whether they want them or not. Some consumers will be discriminated against because they are forced to pay for services they do not require. Structuralists allege that this discrimination misallocates resources to that industry. In a similar vein the BTI (1967) noted that South Africa's highly skewed income distribution made RPM inappropriate. Since some service factor had to be built into the final RPM margin, and due to limited incomes, many black consumers would be excluded from making these purchases. Under free price competition black consumers would be able to buy these products without the services but at lower prices. Would prices be that much greater? Whilst it can only be speculated, it is suggested that because RPM is an average price technique some degree of cross subsidisation would occur. Better informed consumers offset some of the service costs, thereby lowering

the burden for most black consumers. In this case it is stressed that RPM cannot be used to set excessive service margins because it would attract outside rivals to remedy the abuse.

Second, the free trade conditions are further violated because consumers are unable to choose between different levels of service and price. Imposing a uniform level of services prevents individual consumers from freely expressing their own preference between different levels of service and price. The BTI took exception to RPM and the service argument because it prevented consumers from being able to freely express their relative preferences. In evaluating an application made by various sport trade associations the BTI stressed "the importance of consumers having a choice between less service plus lower prices and more services plus higher prices" (1969a, p.11). The BTI argued that those consumers which required extra services would be prepared to accept relatively higher mark-ups. Similarly, in its evaluation of the book trade's application for exemption the BTI held that the competitive advantage specialist bookshops enjoyed would not be eroded by the price-cutting of non-specialist booksellers who did not provide these services "by reason of the stocks which they hold and the special facilities and services they offer the public" (BTI, 1969c, p.18).

Whilst it is true that markets should respect the sovereignty of consumers, institutional authors maintain that consumers are not always able to give it adequate direction. Exception is taken to the strong assumption of rationality which characterises traditional analysis. Chapter Two argued that it was naive and simplistic. The rationality assumption should be replaced with the more realistic notion of bounded rationality. In certain markets consumers might be ignorant of the exact levels of pre-sale services they require to satisfy their information needs. How, then, can the free price mechanism be relied upon to guide ill informed consumers in deciding which combination of price and service best satisfies their needs. As was suggested in previous chapters, RPM might represent a more efficient alternative to approximating a socially acceptable level of services. Perhaps if the BTI (1969c) had given attention to bounded rationality and the provision of services in its investigation into ethical and patented medicines, it might have found in favour of RPM. The applicants maintained that RPM was necessary to ensure that sufficient services accompanied the dispensing of ethical and patented medicines. For the most part patients are ill-informed about these products and require professional help to ensure

they obtain the correct medication¹. RPM could assist by directing competitive pressures onto pharmacists to adequately provide these services.

The electrical cable case was the only one in which the BTI actually considered the informational requirements of consumers. The decision to reject the claims that RPM was necessary to ensure certain electrical cable retailers provided these pre-sale services seems to be acceptable. The BTI argued that consumers in this industry "would have sufficient technological knowledge to demonstrate whether they preferred more or less service" (1969a, p.5). In this market, consumers could be assumed to be specialists whose decision-making ability was not impaired by bounded rationality.

5.4.3 Non-Price Restraints, Resale Price Maintenance and the Provision of Services

The proceeding discussion compared the relative ability of the free price mechanism and RPM to secure an adequate provision of pre-sale services. However, upstream distributors have recourse to a third alternative, namely non-price restraints. By restricting certain non-price attributes, downstream retailers can be 'coerced' into providing the necessary pre-sale services. In its 1967 Report the BTI argued that there was no need to use RPM because manufacturers could make use of non-price restraints to provide these services (1967, p.113). These sentiments were echoed by the BTI in its evaluation of an application made for exemption by a manufacturer of electrical cables: "The BTI does not believe that distribution through a small number of carefully selected distributors will lead to a reduction in the standard of service to the consumer" (1969a, p.10). Further use of this line of argument is evident from the BTI's reports dealing with the following industries: ceramics and sports goods (1969a, section d and e); books (1969b, section a); medicines and franchised items, and clothing (1969c, section a and c); and tyres (1970b).

By accepting that non-price restraints could be efficiently applied, it inferred that the BTI accepted that free price competition could not always solve the free-rider problem nor

1. This service goes far beyond simply providing an information role. Pharmacists have an important duty to ensure that patients obtain the correct prescribed medicines and ensure that no incompatibility problems exist with respect to the dispensing of certain drugs.

allocate sufficient resources to ease the bounded rationality constraint. The BTI failed to realise that the exclusive dealerships it favoured over RPM tend to be efficient only when they are imposed on a relatively small scale¹. As the incidence of exclusive dealerships increases, the (non-price) competitive pressures which 'coerce' the provision of these services become less effective. To attain an advantage in the market and distinguish themselves from their competitors, individual retailers might lower their provision of services to allow price-cutting. Furthermore, the costs manufacturers incur whilst monitoring their retailers increase, the broader the product distribution network becomes. After some critical level these policing costs exceed whatever benefits stem from providing the required services. In contrast RPM's average monitoring costs decrease the wider distribution becomes. It is possible, therefore, that these conditions might make RPM a more efficient control mechanism than non-price restraints. *Surely if the BTI had considered these cost considerations, it might have found RPM to be acceptable in the tyre, ceramics, sports goods and book trades?*

5.5 *Quality Control and Resale Price Maintenance*

The BTI and CB considered several arguments made claiming that RPM is a necessary contractual element required by manufacturers to safeguard the quality of their product throughout distribution. Typically these arguments focus on RPM's ability to secure either the tangible or intangible aspects of a particular product². The following discussion will consider these agencies treatment of each of these considerations. It is noted that efficiency proponents gave very little consideration to the role RPM could play at safeguarding a product's tangible properties. Thus, it is only given brief attention.

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1. Exclusive territorial dealerships were the only non-price restraints the BTI considered in its reports dealing with RPM.
 2. In compiling Tables A.1 to A.3 distinction has been made between the tangible and intangible arguments and is denoted by *T* and *I* respectively.

5.5.1 Tangible Quality Considerations and Resale Price Maintenance

In its 1967 Report the BTI concluded that the imposition of RPM was not necessary to safeguard a product's quality throughout distribution. It held that if firms could not meet required quality demands at prevailing market prices, then they should be eliminated. Simply put, the BTI believed that the free price mechanism was better than RPM at safeguarding product quality through distribution. In making their application for exemption representatives from the tobacco industry (BTI, 1969b) argued that the elimination of price-cutting was essential to ensure the quality of their products. Tobacco products have limited shelf lives and it is important for firms not to overstock to prevent spoilage. The applicants held that price-cutting would encourage firms to hold excessive stocks in order to benefit from the lower unit costs made available through bulk purchasing. Imposing RPM would encourage retailing outlets to hold sufficient stock to satisfy only their immediate demand schedules, whilst preventing waste. Drawing on foreign evidence, however, the BTI rejected this argument. It held that firms would have to learn to follow market signals transmitted through the price mechanism.

On only one occasion did the BTI accept the role RPM could play in preserving quality aspects of a product. In its first investigation into the tyre industry (BTI, 1959) the BTI accepted that some degree of price-cutting would follow the relaxation of RPM. To remain competitive tyre manufacturers would respond by reducing costs. Manufacturers feared that these cutbacks would eventually compromise the safety components of tyres. However, the BTI rejected this argument in two later reports dealing with the tyre industry. It maintained that reducing prices would not necessarily lower the safety components of new tyres. Rather, manufacturers could choose to lower the durability of tyres. The BTI held that sufficient legislative conditions existed to ensure that their safety would not be compromised. Moreover, the BTI held that consumers should enjoy some choice between price and tyre longevity.

5.5.2 Quality Certification, Asset Specificity, Bounded Rationality and Opportunism

By incorporating intangible quality considerations into their arguments, efficiency proponents extended the service argument to develop the quality certification argument. This

argument maintains that RPM is sometimes necessary to ensure that higher quality items are efficiently matched with reputable dealers. Typically price competition has a limited role to play in higher quality product markets. Consumers tend to attach more importance to product quality. In these circumstances the successful marketing of upstream suppliers' products hinge on securing *prestigious* distribution channels. Upstream suppliers realise that consumer decision-making ability is impaired by the extent of personal bounded rationality. To ease these constraints consumers actively look to reputable dealers to endorse the quality or style of a particular product or brand, thereby minimising their exposure to opportunistic haggling. Moreover, the setting of fixed resale prices, particularly for new quality products, might be necessary to secure these distribution channels by satisfying retailers' asset specificity requirements. In a recent report the CB accepted a clothing manufacturer's decision to employ non-price restraints, based on the quality certification argument, to secure reputable retailers who would endorse the quality of its products. In investigating a complaint brought against Christian Dior, the CB (1990) found that this manufacturer refused to supply its products to a low price retailer. Dior argued that their brand item was a status product whose successful marketing hinged on distribution through highly reputable retailers. Dior maintained that this retailer's methods of conducting business were not congruent with their very selective distribution criteria. By accepting this argument and its use of non-price restraints, the CB implied that the free price mechanism was not always able to efficiently allocate resources.

Yet in two reports dealing with RPM and quality certification, the BTI attached very little importance to them. In their application for exemption several clothing manufacturers argued that RPM was necessary to endorse the quality image and certify the styles of their brand items (BTI, 1969c). These applicants maintained that the successful marketing of their products hinged on exclusivity. Affording discount retailers the opportunity to aggressively market their products would damage their perceived quality image. Moreover, RPM lowers retailer's price risk and affords them the confidence to stock fashion items. Having reputable dealers stock these fashion items might ease consumer uncertainty about which styles are in vogue for a particular season. Similar arguments were made by a ceramics importer (BTI, 1969a). Three elements were absent from the BTI's analysis. First, RPM was assessed simply in terms of its ability to efficiently provide *tangible* pre-sale services. The BTI gave no attention to the underlying *intangible* quality certification considerations, consumer ignorance or moral hazard. Second, the RPM margins might

have been necessary to satisfy asset specificity conditions required by retailers to certify these products. If these certification requirements were not satisfied, the excessive margins would attract potential rivals to enter the market and contest them. Third, there is no evidence available to suggest that the BTI compared the relative costs and benefits of price versus non-price restraints. It was noted previously that non-price restraints tended to be more efficient when they were applied alongside narrow distribution networks. In both the clothing and ceramic trades it would be unlikely that the intended *selective* distribution, implied *exclusive* distribution. Thus within some demarcated area there might be several/many retailers distributing these products. If these distribution networks were wide, they could significantly increase upstream suppliers' monitoring costs and pressurise retailers into compromising quality certification to allow price cuts to maintain a competitive edge.

An important feature of the quality certification argument was that it made explicit the effects of opportunistic haggling. Bounded rational consumers look to the good reputations of 'certified' dealers to protect themselves from abuse. The BTI twice considered arguments claiming that RPM was necessary to protect products from being opportunistically abused. A manufacturer of simulated pearls (BTI, 1969a) argued that the average consumer would be unable to distinguish between the various quality grades associated with his pearls. Unscrupulous retailers would be at liberty to either overcharge unsuspecting consumers, or sell lower grade pearls at higher grade prices. Likewise, a manufacturer of ladies shoes argued that his products were of superior quality (BTI, 1969a). This applicant maintained that retailers were selling products at prices greater than those intended by the manufacturer. In both cases it was argued that RPM could be used to set a price ceiling to prevent these opportunistic abuses. But in each evaluation the BTI maintained that these fears were unfounded. Holding to the traditional assumption of complete morality, the Board argued that "competition from other sources will act as a restraining force to dealers wishing to increase prices injudiciously" (1969a, p.7). However, these opportunistic abuses interfere with the normal interplay of market forces. If this abuse is widespread and sunk cost barriers to entry are in place, *can it be realistically assumed that the free price competition will remedy these abuses?*

5.6 Loss Leader Selling

Many branded items compete against each other over attributes other than price. When formulating purchase decisions consumers might consider brand image to be important. If this factor is important, manufacturers would want to protect their product's brand image throughout distribution. However, it can happen that downstream distributors sell a product at a price level well below the competitive minimum. Whilst upstream distributors might initially benefit from short term price-cutting, its continuance would eventually damage their product's image. The argument holds that consumers begin to equate the product's lower price with lower quality and eventually purchase a substitute brand. Imposing RPM allows manufacturers to prevent these loss leader abuses. The following discussion will consider the BTI's treatment of the loss leading motive, recognising that it no longer represents a primary argument used by efficiency proponents to defend RPM. Consequently, many of the decisions taken by BTI are confirmed.

Whilst the BTI recognised that the loss leader argument had some merit (for example 1967, p.107), it decided that it would lead to results which were on balance less efficient than free price competition. First, after conducting its own empirical survey into the frequency of loss leader selling in South Africa, the BTI noted that its occurrence was not widespread. However, some caution is expressed at this conclusion since the BTI did not make explicit its sampling techniques or its method of empirical testing. Second, the BTI argued that even when loss leading did occur, the use of RPM to remedy these abuses was inappropriate: "the effects of resale price maintenance in stifling price competition is more fundamental and far-reaching than its effects in promotion against loss leader selling" (BTI, 1967, p.112). There is some scope to quibble that the BTI did not consider the condition of entry but because the loss leader argument has limited relevance, no issue is taken. The remainder of the section considers the BTI's treatment of the argument in its *ad hoc* reports.

One of the first opinions expressed by the BTI about the loss leader argument accepted it. In its investigation into the tobacco industry (1962) the BTI accepted arguments claiming that cigarettes were convenience items, whose successful marketing depended upon their widespread distribution. Certain manufacturers held that without RPM, the existing distribution process would be jeopardised. Specifically large chain stores, supermarkets and

other discount houses would use them as loss leaders. These actions would interfere with the existing distribution network handling the vast bulk of the tobacco trade. In assessing this argument the BTI held that "If a sufficient number of buyers obtain(ed) their requirements from such price cutters this could lead to a reduction in the number of selling points, since it is a well known phenomenon that the ordinary retail trader ceases to stock articles used by the large retailers as loss leaders" (1962, p.20). The BTI concluded that any benefits end-consumers derived from lower prices would be neutralised by the increased inconvenience caused by restricted distribution. The loss leader argument was rejected by the BTI in its later report considering the tobacco industry's application for exemption (BTI, 1969b). The BTI argued that small retailers would not stop stocking tobacco products even if they were used as loss leader brands by large retailers. Small firms enjoyed specific advantages which would enable them to successfully compete against larger firms, these being after-hours sales facilities and greater convenience due to their broader distribution. Moreover, evidence compiled by the BTI from the Western Cape, United Kingdom and Sweden revealed that small retailers did not stop stocking these items following the dissolution of RPM.

Similar sentiments were expressed by the BTI in its evaluation of the sugar industry's application for exemption (BTI, 1969b). These applicants argued that their product was susceptible to loss leading selling by downstream distributors. They held that this posed a serious threat to the widespread distribution of sugar. However, the Board rejected this argument: "no ordinary grocer could afford not to stock sugar" (BTI, 1969b, p.16).

5.7 Summary

In contrast to allegations that RPM was imposed for anticompetitive gain, efficiency proponents argued that contracting agents might impose it to secure certain procompetitive effects. The purpose of the chapter was to review the BTI's treatment of five arguments more commonly used in defence of RPM.

The BTI typically regarded collective RPM as a device imposed by dominant firms to regulate a horizontal cartel. However, two procompetitive reasons for imposing collective RPM were considered. First, under highly volatile market conditions the free price

mechanism may not necessarily yield an efficient allocation of resources. RPM might be applied to stabilise these conditions and promote an *orderly product distribution*. After making its 1967 prohibition the BTI rejected this argument. It was argued that the BTI failed to take full account of the 'stability requirement'. Indeed, their failure to recognise this necessary condition led the Minister to reject the Board's recommendation that RPM should be prohibited in the tyre industry. Second, RPM allowed cross-subsidisation to promote lower prices or permit broader distribution than that would otherwise be possible. Prior to the 1967 prohibition, the BTI accepted the relevance of this argument. Subsequently, the Board rejected it.

Three other arguments were considered which might justify individual RPM's relevance, namely the provision of pre-sales services, quality certification and protection from loss leader abuse. These three motives are of particular relevance when dealing with the imposition of individual RPM. The *service argument* contends that the free price mechanism is not always able to provide sufficient pre-sale services to ignorant consumers. In these circumstances RPM can be used as a control device to curb free-riding. The study found that the BTI rejected the service argument and favoured the use of non-price restraints where the price mechanism was inadequate. When important qualifications were made to the BTI's decisions, doubt was cast on their validity. The pre-sale service argument was extended to incorporate intangible service considerations. The *quality certification* argument maintained that risk-averse consumers looked to reputable dealers to endorse a product's quality. In this regard consumers feared being exposed to opportunistic haggling by unscrupulous retailers. RPM might provide a contractual condition which downstream retailers require before they will commit assets to transaction specific purposes. The provision of these fixed margins is of particular importance when new products are launched. The BTI has typically rejected the role of price restraints from certifying the quality of a product. However, where the BTI argued that the free price mechanism would check against opportunistic abuses, it failed to take into account bounded rationality or guileful self-interest. The *loss leader* argument claimed that sufficiently endowed retailers would market upstream suppliers' products at abnormally low price levels. Prolonged price-cutting would adversely effect the product's image and result in a dramatic drop in sales. Because of the limited acceptance of the loss-leader argument amongst contemporary efficiency writers, the study confirmed several of the decisions taken by the BTI.

*Chapter Six: Policy Recommendations for Resale Price
Maintenance in South Africa*

6.1 Introduction

The pivotal role of the price mechanism in allocating resources prompted this study to investigate the allocative implications of vertical price restraints. Specifically, its purpose was to critically evaluate the policy decisions taken by the BTI and CB to prohibit RPM in South Africa. RPM is a vertical price arrangement imposed to enforce minimum or maximum resale prices across tiers in a product's distribution network. The study would be incomplete if, after making its evaluation, it failed to propose a set of policy recommendations. Chapter Six will reconsider the salient conclusions made earlier, to derive an appropriate set of policy recommendations.

6.2 The Controversy Surrounding RPM

Before attempting to evaluate RPM in South Africa, it was necessary to consider the theoretical controversy surrounding it. The literature is undecided about whether RPM is pro- or anticompetitive. Part of this controversy stems from the indecision evident in the neoclassical literature over the form competition takes. In an attempt to contextualise the controversy surrounding RPM, Chapter One analysed the debate surrounding those mechanisms responsible for driving the competitive process. Competition is multifaceted, embracing the rivalry of firms over both price and non-price attributes. However, the neoclassical framework has typically attached primacy to price competition. This belief stemmed from the neoclassical view that the price mechanism was most effective at transmitting current market preferences. Consequently, any arrangement which blunted price competition was anticompetitive. But controversy brewed over the primary form price competition took. Structuralists argued that competition was driven by price arbitrage between rival firms operating within a market. Because RPM eliminates the arbitrage interplay, Chapter One tentatively concluded that structuralists believed RPM was anticompetitive. The efficiency hypothesis maintained that market competitiveness depended on the condition of entry. Provided that no sunk cost barriers to entry were in place, any power abuse would be remedied. Hence RPM was not necessarily anticompetitive because it did not necessarily impair price arbitrage.

Chapter One further challenged the implicit presumption that highly concentrated struc-

tures necessarily lent themselves to collusion. This was done to qualify the structuralist argument that collective RPM was imposed solely to facilitate horizontal price collusion. Before deciding whether to collude or act independently, rational firms must decide which option maximises their private gain. The likelihood of collusive behaviour increased when:

- A high degree of *product homogeneity* exists - product differentiation makes collusion difficult.
- Firms display *similar cost structures* - cost differentials act as the catalyst for firms to compete.
- *Market conditions* are *volatile* - uncertainty costs make independent action more hazardous and costly.

Typically, these considerations were absent from most arguments linking collective RPM with horizontal cartels.

An important development within mainstream industrial economics has been the popularisation of new institutional economics. It was the inability of traditional analysis to properly deal with intra-firm and inter-firm relationships which led Williamson to formulate his transaction costs framework. This approach viewed the contract as the central mechanism responsible for coordinating economic activity. Hence it was primarily concerned with deriving those transaction types which were most efficient. Chapter Two reviewed those internal and external factors which affect the nature of concluded contracts. First, traditional neoclassical's behavioural assumptions were challenged. The new institutional approach replaced these with bounded rationality and opportunism. Guileful self-interest motivated better informed agents to abuse the bounded rationality of others. Second, the new institutional approach identified those external factors which affect the *process of contracting*. The central motive for contracting was to secure a suitable *transfer of property rights* between contracting agents. Efficient contracting demands that all obligations must be undoubtedly specified in the contract. Before an agent commits resources to a certain transaction specific purpose, he might require the inclusion of certain *asset specificity conditions*. These conditions often require some assurance that his sunk cost investment

will be recouped. Transactions are seldom concluded in isolation. Environmental *uncertainty* can have important bearing on the efficacy of contracting. Many contracts are *recurrent* in nature. Attention has to be afforded to those factors which affect the dynamic nature of contracts. It was this central desire to economise on the costs of organisation and the contractual nature of RPM coordinating inter-firm activity which allowed the author to link the institutional approach to the efficiency paradigm.

Chapter Three reviewed the controversy surrounding the economic character of RPM. Structuralists argued that RPM, whether imposed collectively or individually, restricted the price mechanism's ability to allocate resources in an optimal manner. RPM was used by sufficiently endowed firms to raise price margins in excess of competitive minimums. Hence RPM was anticompetitive because it contravened the strict conditions of Pareto optimality. As such it should be prohibited. In terms of the efficiency stance it favoured, this study challenged the prohibition. Unless RPM was imposed alongside prohibitively high sunk cost barriers to entry, potential competition would regulate any market power abuse. Entry would disturb any RPM arrangement used for monopolistic purpose. Chapter Three further challenged the apparent presumption that collective RPM was imposed solely to regulate horizontal cartels. Collusive action is only rational under the conditions outlined in Chapter One. These considerations were absent from the anticompetitive arguments levelled against collective RPM.

It is not enough to demonstrate that RPM is not always anticompetitive to have it subjected to the milder *rule of reason* test. It has to be demonstrated that RPM has important procompetitive properties. Five procompetitive qualities were considered, namely orderly distribution, cross subsidisation, provision of services, quality certification and loss leader protection. The *orderly distribution* argument maintained that under highly volatile or erratic conditions the free price mechanism might be unable to allocate resources in a socially acceptable manner. RPM could provide this stability. It might be socially desirable to allow some degree of *cross subsidisation* to permit lower prices on merit products or to increase product availability. In this regard, RPM might be more effective than the free price mechanism at initiating adequate cross subsidisation. Efficiency proponents argued that RPM could be imposed by upstream suppliers to ensure that their products were distributed with sufficient information. The *service argument* maintained that the successful marketing of certain products required that certain pre-sale services be provided to

circumvent bounded consumer rationality. However, due to the free-rider problem, the price mechanism might not always provide for a socially desirable level of pre-sale services. RPM could be used as a control device to provide these services and circumvent the free-rider problem. A recent development has been the *quality certification* argument, which holds that RPM might be required to match higher quality products with reputable dealers. Consumers look to these dealers to certify the quality of a product and to protect themselves from opportunistic abuse. The final argument considered was manufacturers imposing RPM to protect their products from *loss leading*. In this regard manufacturers fear that prolonged price-cutting by downstream retailers would compromise the brand image of their product. RPM would eliminate these abuses.

In the light of these arguments it was concluded that RPM should be scrutinised by policy analysts on an *ad hoc* basis against a rule of reason test.

6.3 *An Evaluation of RPM in South Africa*

Due to its ability to restrict the free price mechanism RPM was declared a monopolistic condition by the 1955 Act and a restrictive trade practice by the 1979 Act. Whilst given these 'negative' labels, the BTI and CB's commitment to workable competition implied that they neither Act outlawed RPM. Before remedial action could be taken it had to be demonstrated that RPM violated the public interest test. Between 1955 and 1967, the BTI conducted five *ad hoc* investigations into RPM. In four of these investigations RPM was found to be, *on balance*, in the public interest. Following Report 1220(M) (1967) the BTI recommended that RPM should be outlawed in South Africa. This decision was later ratified by the CB in Report 15 (1985). However, remaining within the boundaries set by its policy framework both agencies allowed affected parties to make application for exemption from the prohibition. Between 1969 and 1971 twelve applications were received with only one permanent exemption and one temporary exemption being granted. Temporary exemption was also given to the tyre industry when the relevant Minister rejected the recommendations made by the BTI. These temporary exemptions were subsequently reinvestigated in 1977 and 1978 but were rejected. Only one application was made by the newspaper trade to the CB and permanent exemption was granted. No documentation is available to analyse the CB's decision. The remainder of the section will briefly evaluate

the BTI and CB's treatment of RPM and make the necessary policy recommendations.

This study challenges the decision taken to prohibit RPM in South Africa and recommends that it be scrutinised against the milder *rule of reason* test. The following justification is given:

- (a) The theoretical controversy surrounding RPM's allocative and broader welfare considerations remains unresolved. Whilst Report 1220(M) considered several of the efficiency arguments raised by this study, its conclusions reflect the popularity enjoyed by structuralist approach in the late 1960s/early 1970s. Report 15, compiled seventeen years later makes no mention whatsoever of the many subsequent efficiency developments surrounding RPM. In terms of the state of the debate and the CB's failure to examine this in any great depth, *how much confidence can be placed in the CB's decision to prohibit RPM?*
- (b) In terms of the broader entry/exit mechanism it was argued that RPM did not necessarily dull price competition. Unless RPM was imposed alongside significant sunk cost barriers to entry, potential rivals would neutralise any market power abuse. Neither the BTI or CB attached much importance to the regulatory role of potential competition. It is recommended that the CB reconsider what it understands the primary mechanisms responsible for driving the competitive process to be, given their divergent policy implications.
- (c) The BTI and CB have not consistently applied their policy framework when dealing with RPM. Two factors were considered. First, the BTI incorrectly applied the public interest test in many of its post-1967 *ad hoc* investigations. It either failed to specify what the public interest constituted or to apply the two-stage test. It is noted that prior to the 1967 prohibition the BTI consistently applied the public interest test when conducting its investigations. Although the early reports declared their concern about RPM's ability to impair the competitive process, they still found RPM to be, on balance, *procompetitive*. Likewise in compiling Report 15, the CB failed to correctly assess RPM against the public interest measure. Second, the BTI and CB often failed to discredit RPM in terms of the anticompetitive arguments normally raised against it. In many of their *ad hoc* investigations the

arguments used to condemn RPM were often vague or unspecific. Moreover, these agencies failed to consider several key qualifications which underlie these anti-competitive arguments. The study demonstrated how different decisions could have been reached if they had been considered.

The study further considered five arguments used to explain why RPM might be procompetitive. These arguments maintained that the free price mechanism was not always able to bring about a socially desirable allocation of resources. Although the BTI's pre-1967 reports tended to accept these arguments, they were often rejected in later reports. The following discussion considers each argument in turn.

- (d) *Orderly Distribution*: The BTI typically failed to consider the requisite 'volatility condition' required by efficiency proponents to accept the orderly distribution argument. Whilst several of the BTI's pre-1967 reports identified and satisfied this condition, post-1967 reports tended to ignore it. These later reports regarded orderly distribution as an excuse used by powerful firms to secure quiet and stable trading conditions. The BTI's failure to recognise the volatility condition in the tyre industry, resulted in the Minister rejecting its recommendation that RPM should be prohibited.
- (e) *Cross Subsidisation*: A similar trend was identified. When the BTI correctly applied the workability framework in its earlier reports, it generally accepted the relevance of these arguments. However, in its post-1967 reports, the BTI rejected them and attached little weight or importance to them. The study demonstrated that in several of these reports if cognisance had been given to the 'merit product argument', RPM might have been found to be desirable.
- (f) *Service Argument*: The BTI did not accept the service argument and believed that the free price mechanism would provide these pre-sale services more efficiently. It is, however, contended that fixed margins would not be abused because of the regulatory effects of actual entry. The BTI accepted that the free price mechanism was not always most efficient at providing an adequate level of pre-sale services and justified the use of various non-price restraints in terms of this argument. The study demonstrated that the efficiency of non-price restraints was limited and in

certain cases price-restraints were more efficient.

- (g) *Quality Certification*: Although this rationale has only been recently formalised, several reports dealt with this argument. The BTI and CB typically rejected the notion that the free price mechanism could be opportunistically abused. They held that any opportunistic abuse would initiate a suitable response from other firms. However, no attention was afforded to bounded rationality or those abuses resulting from sunk cost barriers to entry. Again, these agencies accepted that non-price restraints might be more efficient than the free price mechanism at satisfying these certification requirements. The study highlighted several key qualifications which must underlie these arguments. These were absent from their analysis.
- (h) *Loss Leader Considerations*: Due to the literature's acceptance that this argument has limited relevance, this study confirmed several of the decisions reached by the BTI.

6.4 Policy Recommendations

The following policy recommendations offered to the CB may be summarised as follows:

- To rescind its decision to prohibit resale price maintenance in South Africa and subject it to the milder rule of reason test as it does with all other non-prohibited practices.
- To make explicit those mechanisms responsible for driving the competitive process. Whilst it argues that price competition is of primary importance, it fails to explicate the form it takes. From available reports this study inferred that the BTI typically applied a structuralist stance.
- To reconsider its treatment of RPM's procompetitive arguments, particularly with respect to the relative efficiency of price restraints over non-price restraints.

*APPENDIX A: An Analysis of Arguments Raised by the
Board of Trade and Industries*

The following tables summarise the respective arguments evaluated by the Board of Trade and Industries in their dealings with RPM. These tables consider the respective pro- and anticompetitive arguments raised in each report. In all, the BTI compiled twelve reports dealing with RPM in thirty-two instances. Table A.1 represents those investigations completed prior to the 1967 prohibition. Of the five reports compiled, four found RPM to be in the public interest justifying that *on balance* RPM was procompetitive. Table A.2 summarises those arguments contained in the BTI's reports dealing with applications received for exemption from the general prohibition. In only one application was permanent exemption granted, newspapers and periodicals, whilst temporary exemption granted to the book trade. It is noted that the Minister rejected the Board's recommendation that the tyre industry should not be given exemption from the prohibition. The Minister granted a temporary exemption to this industry. Table A.3 summarises those arguments raised in later investigations dealing with the Board's reassessment of these temporary exemptions. In both the tyre industry and the book trade the Board decided that *on balance* RPM was anticompetitive.

No tables have been compiled to summarise the respective arguments considered by the Competition Board. This study notes that the CB has not instituted any formal *ad hoc* investigation into RPM. This probably stems from the prohibition imposed on RPM. In terms of the 1985 prohibition the newspaper industry was required to reapply for exemption from the prohibition. The CB issued no formal report or note. This lack of documentation has prevented the author from examining the respective arguments considered. The CB granted this industry an exemption.

TABLE A.1 Investigation into Resale Price Maintenance. Various Industries (1956-1964)

INDUSTRY	FORM	DECISION	ARGUMENTS RAISED AGAINST RESALE PRICE MAINTENANCE				ARGUMENTS RAISED IN FAVOUR OF RESALE PRICE MAINTENANCE						
			RETAILERS CARTEL	MANUFACTURERS CARTEL	EFFECTS ON PRICE	BARRIERS TO ENTRY	ORDERLY DISTRIBUTION	SERVICE (FREE RIDER)	QUALITY CERTIFICATION	LOSS LEADING	CROSS SUBSIDISATION	AGENCY ARGUMENT	LOW PRICES
1. Report No. 437(m) a) Grocery* b) Biscuits*	collective RPM - wholesaler collective RPM - manufacturer	prohibited prohibited		1(a)* 1(b)									1(b)
2. Report No. 465(m) a) Imported liquor* b) The Hotel Trade*	collective RPM - distributor collective RPM - retailer	justified justified		2(a)* 2(b)*			2(a) other strategic interests - viticultural industry				2(b)		
3. Report No. 489(m) a) Pneumatic tyres	collective RPM - manufacturer	justified		3(a)			3(a)	3(a)	3(a)T				3(a)
4. Report No. 948(m) a) Cigarettes b) Pipe Tobacco	collective and individual RPM - manufacturer/wholesaler collective and individual RPM - manufacturer	justified justified		4(a) 4(b)	4(a) 4(b)					4(a)	4(a)		4(a)
5. Report No. 1071(m) a) Books b) newspapers and periodicals	collective RPM - retailer individual RPM - manufacturer	justified justified	5(a)*		5(a)		5(a)	5(a)			5(a)	5(b)	5(a)

TABLE A.2 Analysis of Applications for Exemptions to the 1967 Prohibition of Resale Price Maintenance.

INDUSTRY	FORM	DECISION	ARGUMENTS RAISED AGAINST RESALE PRICE MAINTENANCE				ARGUMENTS RAISED IN FAVOUR OF RESALE PRICE MAINTENANCE						
			RETAIL-ERS CARTEL	MANUFAC- TURERS CARTEL	EFFECTS ON PRICE	BARRI-ERS TO ENTRY	ORDERLY DISTRIBUTION	SERVICE (FREE RIDER)	QUALITY CERTIFI- CATION	LOSS LEADING	CROSS SUBSID- ISATION	AGENCY ARGU- MENT	LOW PRICES
Report No.1262(m) Part I a) Electric cable b) Ladies' shoes c) Simulated pearls d) Cereamics e) Sports Equipment f) Watches g) Chain hoists, pulleys and cranks	Individual - manufacturer Individual - manufacturer Individual - manufacturer Individual - wholesaler Collective - retailers Collective - retailers Individual - manufacturer	prohibited prohibited prohibited prohibited prohibited prohibited prohibited			1(c) 1(d) 1(e) 1(f)		1(c) 1(d) 1(e) 1(f)	1(b) 1(c) 1(d)					
Report No. 1262(m) Part II a) Pharmaceutical serv. b) Medicines c) cosmetics and toilet goods d) Gramophone records e) Sugar f) Black holes and nuts e) Cigarettes and tobacco	Collective - retailers Collective - retailers Collective - manufacturer Collective - manu. & distr. Individual - manufacturer Collective - manu. & distr.	prohibited prohibited prohibited prohibited prohibited prohibited		2(b)	2(a)(ii) 2(d)		2(b) 2(c)	2(a)(i) 2(a)(ii) 2(b)		2(c) 2(e) 2(f)	2(a)(i) 2(b)		2(d)
Report No.1262(m) Part III a) Reading matter b) Newspapers,periodicals c) books d) Clothing e) Alcoholic drinks f) Imported liquor g) Hotel trade	Individual - manufacturer Collective - manu. & Retailer Individual - manufacturer collective - distributor collective - retailer	exempt exempt exempt prohibited prohibited prohibited prohibited			3(b)			3(b) 3(b)		3(a)(ii) 3(c)(ii)	3(b)		
Report No. 1252(m) Part IV Petrol	collective - manufacturer	prohibited			4(a)		4(a)				4(a)		
Report No. 1252(m) Part V Types	collective - manufacturer	prohibited			5(a)		5(a)	5(a)	5(a)T				5(a)

TABLE A.3 Investigations into temporary exemptions granted.

INDUSTRY	FORM	DECISION	ARGUMENTS RAISED AGAINST RESALE PRICE MAINTENANCE				ARGUMENTS RAISED IN FAVOUR OF PRICE MAINTENANCE						
			RETAILERS CARTEL	MANUFAC- TURERS CARTEL	EFFECTS ON PRICE	BARRIERS TO ENTRY	ORDERLY DISTRIBUTION	SERVICE (FREE RIDER)	QUALITY CERTIFI- CATION	LOSS LEADING	CROSS SUBSID- ISATION	AGENCY ARGU- MENT	LOW PRICES
1. Report No. 1794(m)													
a) Local books	collective/individual - retailer/ manufacturer	prohibited	1(a)*		1(a)		1(a)	1(a)			1(a)		
b) Imported books	collective - retailer and manufacturer	prohibited			1(b)		1(b)	1(b)			1(b)		
2. Report No. 1840(m)													
a) Tyres and tubes	collective - manufacturer	prohibited		2(a)			2(a)	2(a)	2(a)T				2(a)

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