RESALE PRICE MAINTENANCE:

ECONOMIC THEORIES AND EMPIRICAL EVIDENCE

BY

Thomas R. Overstreet, Jr.

Bureau of Economics Staff Report
to the Federal Trade Commission

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This report has been prepared by an individual member of the professional staff of the FTC Bureau of Economics. It reflects solely the views of the author, and is not intended to represent the position of the Federal Trade Commission, or necessarily the views of any individual Commissioner.

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I. INTRODUCTION

(A) Purpose of the Report

The purpose of this report is to review and evaluate the current economic theories and the available empirical evidence concerning vertical price restraints or resale price maintenance (RPM). In light of this review, the appropriateness of the current legal treatment of the practice is considered and contrasted with several policy options.

What should become clear from the following discussion is that neither the economic theories nor the existing empirical evidence currently offer overwhelming support to any single view concerning RPM. A single view is simply not tenable on the basis of current economic theory. Neither is it well supported by available empirical evidence.

The general conclusion drawn here is that the current rigidly applied standard of per se illegality appears to be unnecessarily costly when evaluated in terms of economic efficiency. Further, if sufficient economic evidence can be obtained, it is possible to analyze RPM matters and make reasonable judgments whether particular uses of RPM are, on balance, more likely to be beneficial or harmful to competition or consumers. This suggests the appropriateness of adopting a policy which recognizes explicitly that RPM can have both desirable and undesirable competitive effects. A rule-of-reason standard is one such policy option.

Clearly, a rule-of-reason approach should dominate per se rules in terms of the potential for minimizing application errors, and in the abstract seems the most desirable policy option.[1] Obtaining the information necessary to implement a rule-of-reason could be difficult and costly, however, and theoretical limitations might confound unambiguous interpretations. In addition,

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[1] Assuming the purpose of per se illegality is to deter anticompetitive and welfare-diminishing uses of RPM, from an efficiency perspective, an application error results if the rule of law also deters a procompetitive or welfare-increasing use of the practice. Similarly, if the rule were per se legality, an application error would result if an anticompetitive or welfare-diminishing use of RPM were allowed.

"rule-of-reason" is a vague concept, and as applied by the courts might differ significantly from a reasonably complete and sophisticated economic analysis. If so, then another policy option, such as articulating explicit exemptions or exceptions to the strict standard of per se illegality, designed to reduce the frequency of application errors while maintaining the litigating efficiencies and clarity of a per se rule, might be a more appropriate policy option.

Each of the policy alternatives considered here has certain imperfections. However, all have the virtue of potentially moving policy closer to the goal of maximizing economic efficiency, because all are more consistent with the theories and the evidence concerning RPM than is the current standard of strict per se illegality.

(B) Organization of the Report

In the next three sections the various theoretical explanations for RPM are discussed in some detail. Section II presents three theories explaining how RPM can be harmful. Two of these theories explain RPM as a device which might facilitate collusion, either among dealers or among suppliers. The third explanation suggests that RPM can be harmful to consumers if suppliers use RPM for longer than is necessary to enhance demand or procure dealer services. In Section III two theories with ambiguous welfare effects are presented. The first concerns RPM as a device which might be used to facilitate price discrimination. The second concerns how RPM might be used to facilitate contractual integration of vertical functions, and/or to eliminate successive monopoly markups in bilateral monopoly situations. Section IV discusses the procompetitive theories of RPM. The first of these explanations suggests that RPM might be useful as a device to obtain shelf space in a wide variety of resale outlets. Two theories are presented which suggest that RPM can be used to correct free-rider problems. The first concerns special dealer services. The second concerns quality certification based upon product availability in outlets with particular characteristics which provide valuable information to consumers. When possible, empirical tests for distinguishing between or among the various

explanations are identified. Section V reviews recent FTC enforcement efforts in RPM cases. Section VI analyzes the existing empirical literature on RPM. Finally, Section VII summarizes the theoretical and empirical evidence and suggests policy options to the strict application of per se illegality.

Before turning to the economic theories, a summary of the history of resale price maintenance in the U.S. and of the ongoing policy debate is presented. This background material helps to put the discussion which follows into perspective.

(C) Historical Background: Ambivalent Rules of Law

Although the U.S. Supreme Court has rather consistently found RPM to be illegal, the practical legal status of the practice has, in fact, vacillated in the United States between the extremes of per se legality and illegality since the turn of the century. Prior to 1908 RPM was legal.[1] From 1908 until the early 1920's the legality of the practice was largely uncertain. Although the Supreme Court had declared RPM contracts per se illegal in the Dr. Miles case in 1911,[2] contradictory and close lower court decisions, divided opinions, lack of a general rule for non-contractual forms of RPM, and uncertainty as to the exact meaning of the Clayton Act of 1914 precluded consensus. From 1921 to 1929

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[1] The Supreme Court first broke with common law precedent and curtailed manufacturers' rights to maintain resale prices in two cases decided in 1908 (Bobbs-Merrill v. Strauss, 210 U.S., 399; Scribner v. Strauss, 210 U.S., 352). These decisions related to copyrighted goods and RPM notices. The court indicated its ruling did not apply to patented goods, and avoided the issue of the legality of RPM contracts. In J. D. Park and Sons v. Hartman (March 1907, 6th C.C.A., 153 Fed., 24, reversing 145 Fed., 358) a lower court ruled for the first time that a system of RPM contracts was illegal under common law and the Sherman Act in the absence of proof showing the necessity for such a system. Then in Dr. Miles Medical Co. v. J. D. Park and Sons (January 1911, 220 U.S., 373) the Supreme Court, with the Hartman case as precedent, held that RPM contracts were illegal. This decision, however, did not settle the question of the legality of RPM contracts on patented goods or on true agency sales. The legal history of RPM in the United States through the early 1930's is discussed in detail in E.R.A. Seligman and R.A. Love, Price Cutting and Price Maintenance, (New York: Harper and Brothers, 1932).

[2] Dr. Miles Medical Co. v. John D. Park and Sons, Co., 220 U.S., 373 (1911).

various court and FTC decisions narrowed the scope of permissible RPM to virtual per se illegality.[1]

Even as the court decisions were restricting manufacturers' rights to maintain resale prices, beginning in 1914, legislative proposals to reestablish those rights were being introduced annually in Congress.[2] In 1931 California enacted the first state fair-trade act legalizing RPM contracts. This act was amended in 1933 to include a nonsigner provision.[3] Other states subsequently passed similar acts and by 1937, the year in which the Miller-Tydings Act was passed as a rider to the District of Columbia appropriation bill, 42 states had enacted state fair-trade laws. Of the fifty states, only Missouri, Texas, Vermont, and Alaska never legalized RPM achieved through fair-trade contracts.[4]

With the Miller-Tydings Act[5] Congress amended Section 1 of the Sherman Act to permit RPM contracts affecting interstate commerce if such contracts were valid under state laws. This

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[1] See Seligman and Love (op. cit.). RPM achieved through agency (consignment) sales, or by unilateral refusals to supply price-cutters, under the "Colgate" doctrine (U.S. v. Colgate & Co., 250 U.S., 300 (1919)), has sometimes been permitted by the courts as an exception to the general rule of per se illegality. The legal status of alternative methods of implementing RPM in the mid-1950's is summarized in Walter Adams, "Resale Price Maintenance: Fact and Fancy," 64(7) Yale Law Journal, 967 (June 1955). For a summary of the current state of the law see, ABA Antitrust Section, Monograph No. 2, Vertical Restrictions Limiting Intrabrand Competition (1977); or P. Areeda, Antitrust Analysis, 3rd edition, (Boston: Little Brown, 1981).

[2] Report of the Federal Trade Commission on Resale Price Maintenance U.S. G.P.O., Washington, 1945, pp. 39-43. From 1933 to May 27, 1935 resale prices were established under the various NRA codes. There were no efforts to pass a federal law allowing RPM during these years. Such efforts resumed in 1935 after the NRA was declared unconstitutional and culminated in passage of the Miller-Tydings Act in 1937.

[3] The nonsigner provision allowed enforcement of RPM contracts against price cutters, whether or not they had signed a fair-trade contract with a supplier, so long as some reseller in the state had agreed to such a contract. Prior to this modification suppliers could enforce fair-trade prices only against dealers willing to sign a contract.

[4] The District of Columbia has never had a fair-trade law. The Miller-Tydings Act amended Sherman Section 1, whereas RPM contracts in the District are governed by Sherman Section 3. Alaska never had a valid fair-trade law as a state. The Congressional Record of December 2, 1975 at 38,050 reports that 40 of the states adopting fair-trade did not hold hearings, and those that did kept inadequate transcripts.

[5] 50 Stat. 693, 15 U.S.C.A. §1 (1937).

amendment was intended to remove federal antitrust obstacles to effective enforcement of RPM contracts sanctioned by the states. However, the Supreme Court's Schwegmann Brothers[1] decision in May 1951 limited the application of the Miller-Tydings Act to actual parties to an RPM contract, i.e., not enforceable against non-signers. The following year Congress passed the McGuire Act[2] amending section 5(a) of the FTC Act to allow enforcement against both signers and nonsigners of RPM contracts affecting interstate commerce. Thus, from 1952 until the repeal of the Miller-Tydings and McGuire Acts in December 1975[3] RPM contracts affecting interstate commerce were enforceable in states with valid fair-trade statutes.[4] RPM again became per se illegal subsequent to the repeal of these enabling statutes.

The political agitation for both fair-trade and anti-price-discrimination laws occurred contemporaneously in the U.S. during a period in which there were major economic disruptions in traditional channels of distribution. Many in the distributive trades, particularly those with relatively high costs, felt threatened by new and unfamiliar competition which frequently involved aggressive price cutting. The political pressure for protection against such competition culminated at the state level in enactment of various "unfair practices" acts and the state fair-trade laws, and at the federal level in passage of the Robinson-Patman Act in 1936, and the Miller-Tydings Act in 1937. Both laws were enacted to protect high-cost distributors from price-cutting competition.

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1 Schwegmann Brothers v. Calvert Distillers Corp., 341 U.S., 384 (1951).

2 66 Stat 631, 15 U.S.C. §45 (1952).

3 Consumer Goods Pricing Act of 1975, Public Law 94-145, 89 Stat. 801 (1975).

4 By the end of 1975 24 states plus the District of Columbia, Puerto Rico, Samoa, and the Virgin Islands had no valid fair-trade law. This left 26 states with fair-trade statutes of which only 10 had valid nonsigner clauses. For an historical summary of legal developments concerning state and federal fair-trade laws see, Legal and Economic Issues in Price Maintenance and Occupational Licensing, The National Association of Attorneys General Committee on the Office of Attorney General, June 1975.

In defense of the fair-trade laws, there were two major arguments advanced to reconcile protection of high-cost distributors and the public interest. The first held that RPM was necessary to protect manufacturers' property rights in the goodwill associated with their trademarked or branded products. The second held that "loss-leader" selling was a form of monopolistic predation upon "legitimate" full-service retailers. By preventing price competition among dealers, RPM was viewed both as a means of protecting manufacturers' goodwill, and small, independent, full-service retailers from the "predatory" tactics of discounters.[1]

However, even during the era of the fair-trade laws, when the legal environment in the U.S. was most favorable for RPM, no more than a tiny fraction of manufacturers ever employed RPM contracts. Edward S. Herman concluded that "there is little doubt that fewer than 1 percent of the total number of manufacturers in the United States have [used fair-trade contracts] in any one year."[2] Estimates of the volume of goods which have been sold under fair-trade contracts in the U.S. generally range between 4 and 10 percent of

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[1] The term "free riding" (see Section IV) did not appear in the literature until sometime later. However, while the jargon of the day was different, the substance of the arguments is easily reconciled with contemporary notions of a "free-rider" problem. The belief that the fair-trade laws could protect both manufacturers' goodwill in trademarks and small dealers is amply documented in numerous sources. See J. C. Palamountain, The Politics of Distribution, (N.Y.: Greenwood Press, 1968); E. T. Grether, Price Control Under Fair Trade Legislation, (N.Y.: Oxford U. Press, 1939); C. Edwards, The Price Discrimination Law, Brookings Institute, Washington, D.C., (1959); 1945 FTC Report; and Seligman and Love (op. cit.); E. W. Hawley, The New Deal and the Problem of Monopoly, (N.J.: Princeton U. Press, 1966), especially ch. 13; 81 Congressional Record 7,487-97 (1937) and 98 Congressional Record 4,896-5,026 (1952). The view that price cutting could actually be contrary to the public interest received judicial recognition in Justice Holmes' vigorous dissent in the Dr. Miles case. He wrote, "I cannot believe that in the long run the public will profit by this court permitting knaves to cut reasonable prices for some ulterior purpose of their own and thus impair, if not destroy, the production and sale of articles which it is assumed to be desirable that the public should be able to get."

[2] E. S. Herman, "A Statistical Note on Fair Trade," 4 Antitrust Bulletin, 583 (1959), p. 583-4. Herman's data were derived from returns of a 1956 Senate questionnaire survey of all firms known or believed to have been fair-trading.

retail sales.[1] Although including noncontractual forms of RPM would undoubtedly inflate these estimates somewhat, RPM does not appear ever to have been very pervasive in the U.S.

These estimates suggest that even if the current legal environment for RPM were made far more permissive, the vast majority of firms would be unlikely to find RPM attractive. This implies that two common assertions concerning the effects of changing the legal status quo to permit some RPM are exaggerated: (1) that it would facilitate large numbers of supplier and/or dealer cartels, and (2) that it would result in enormous efficiency gains in distribution.

(D) Historical Background: Economists' Ambivalence

Among economists the "consensus" view of appropriate public policy concerning RPM also seems to have varied considerably through time, although perhaps not as dramatically as has the legality of the practice. Economists in the United States were aware as early as 1916 that RPM could have socially beneficial consequences.[2] Yet, the results of an early 1930's questionnaire survey of members of the American Economic Association, conducted by Carroll W. Doten of M.I.T., showed economists in substantial

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[1] Herman (ibid.), p. 586; E. T. Grether, Price Control Under Fair Trade Legislation, (New York: Oxford University Press, 1939), p. 322; John W. Anderson," Interview on Voluntary Fair Trade," (Pamphlet, 1950), pp. 5-6; Fair Trade: The Problem and the Issues, House Report No. 1292, 82nd Congress, 2nd Session (1952), pp. 20-21; Fair Trade Laws, Hearings before the Senate Committee on the Judiciary on S. 408, February, April, and May 1975; and Fair Trade, Hearings before the House Committee on the Judiciary on H.R. 2384, March 25, and April 10, 1975. During the 1975 hearings various estimates of the cost of fair trade to consumers were presented. The largest estimate placed the annual sum at 6.5 billion dollars. However, even this estimate amounts to only 1.2 percent of 1975 personal consumption expenditures on durable and nondurable goods. These results are discussed in Section VI.

[2] F. W. Taussig, "Price Maintenance," 4 American Economic Review Supp., 1916, pp. 170-84. In England Alfred Marshall's classic, Principles of Economics, published in 1890, was the first major publication sold subject to RPM. Marshall's ambivalent attitude concerning the benefits of price maintenance is reflected in a series of letters to his publisher. See C. W. Guillebaud, "The Marshall MacMillan Correspondence Over the Net Book System," The Economic Journal, September 1965, pp. 518-38.

opposition (401 to 87) to granting manufacturers blanket legal rights to maintain resale prices.[1]

Subsequent developments in the economics literature, however, have tended to place much more emphasis on the likelihood of beneficial competitive effects (efficiencies) from all vertical restraints including RPM.[2] Nonetheless, during Congressional hearings on fair trade in 1952, seventeen University of Chicago faculty members from the law school and the economics department signed a letter urging Congress to repeal the fair-trade laws; in a separate letter to Congress, sixteen professors of law and economics from various other U.S. colleges and universities also urged repeal.[3] In 1975 the balance of economist testimony again favored repeal of the federal fair-trade enabling statutes.[4] Of course, dissatisfaction with the effects of RPM under the fair-trade laws does not necessarily imply approval of a strict rule of per se illegality. Since 1975 the prevailing consensus among economists, to the extent that it can be inferred from the current literature, would appear to have moved somewhat further toward the view that the current rule of law is overly restrictive and for

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[1] Reported in 81 Congressional Record, p. 7,490 (1937).

[2] An example which has had a major influence on contemporary economic views of RPM is L. G. Telser, "Why Should Manufacturers Want Fair Trade?" III J. of Law and Economics, 86 (October 1960). See also F. R. Warren-Boulton, Vertical Control of Markets (Ballinger Publishing Co., 1978).

[3] The Chicago faculty members were Walter Blum, Ward Bowman, W. W. Crosskey, Aaron Director, Allison Dunham, Milton Friedman, Earl J. Hamilton, W. G. Katz, H. G. Lewis, Bernard D. Meltzer, L. A. Metzler, Robert W. Ming, L. W. Mints, Margaret G. Reid, T. W. Shultz, Malcolm Sharp, and Rosco Steffen. The other letter was signed by M. A. Adelman, Ralph S. Brown, Kenneth S. Carlston, J. K. Galbraith, Harold G. Havighurst, Edward S. Mason, Fritz Machlup, W. Rupert Maclaurin, John P. Miller, Frank Kennedy, Carl Fulda, James A. Rahl, Lloyd G. Reynolds, Eugene V. Rostow, O. Glenn Saxon, Louis B. Schwartz, George W. Stocking, James Tobin, John Thompson, Jesse W. Markham, and John P. Frank.

[4] Hearings before the Antitrust Subcommittee of the Committee on the Judiciary, House of Representatives, 82nd Congress, 2nd Session, on Resale Price Maintenance, February 1952 (Serial No. 12), pp. 868, 881; Congressional Record, Senate: December 2, 1975, January 27, 1975, and House: July 21, 1975.

reasons of economic efficiency should be modified to allow manufacturers some legal rights to impose RPM.[1]

(E) The Policy Debate: Should RPM Be Per Se Illegal?

It is currently firmly established that vertical price restraints are per se illegal.[2] The courts (or Congress), therefore, either implicitly or explicitly, have made a number of policy judgments concerning RPM. First, vertical price and nonprice restraints are sufficiently dissimilar in either causes or effects to justify differing legal treatment. Second, a full

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1 O. E. Williamson, "Assessing Vertical Market Restrictions: Antitrust Ramifications of the Transaction Cost Approach," 127 University of Pennsylvania Law Review, 953 (1979); L. J. White, "Vertical Restraints in Antitrust Law: A Coherent Model," The Antitrust Bulletin, Vol. 26, No. 2 (Summer 1981); W. J. Liebler, "Intrabrand 'Cartels' Under GTE Sylvania," 30 U.C.L.A. Law Review, 1 (1982); R. A. Posner, "The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality," 48 U. of Chicago Law Review (1981); R. H. Bork, The Antitrust Paradox, (Basic Books, 1978); M. Schwartz and D. Eisenstadt, "Vertical Restraints," Department of Justice E.P.O. Discussion Paper 82-8, December 2, 1982; Wm. F. Baxter, "Separation of Powers, Prosecutorial Discretion, and the 'Common Law' Nature of Antitrust Law," 60(4) Texas Law Review, 661 (April 1982); "Vertical Restraints and Resale Price Maintenance: A 'Rule of Reason' Approach," 14(4) Antitrust Law and Economic Review, 13 (1982); and, Brief for the United States as Amicus Curiae, No. 82-914, U.S. Supreme Court, October Term 1982, Monsanto Company v. Spray-Rite Service Corporation. These are recent examples of analyses which advocate a move away from a standard of per se illegality. Such a conclusion, however, while increasingly popular among economists and legal commentators, is not accepted universally. For example, F. M. Scherer in Industrial Market Structure and Economic Performance (1980), p. 593, n. 103 indicates his view that the empirical significance of "free-rider" problems justifying RPM appears modest; H. Michael Mann, in a recent draft, "Resale Price Maintenance, Antitrust and Per Se Illegality: Reason for a Change?", concludes that the case for allowing RPM is "frail"; and former FTC Commissioner Robert Pitofsky recently supported continuation of per se illegality in a statement before the subcommittee on Monopolies and Commercial Law of the House Committee on the Judiciary, March 9, 1983.

2 The legal status of vertical nonprice restraints changed from a virtual per se prohibition under the Schwinn doctrine (U.S. v. Arnold, Schwinn & Company, 388 U.S., 365 [1967]) to an apparent rule-of-reason approach following Continental TV, Inc. v. GTE-Sylvania, Inc., 433 U.S., 36 (1977). In the latter case the per se prohibition of vertical price restraints was explicitly supported. "The per se illegality of price restrictions has been established firmly for many years and involves significantly different questions of analysis and policy [than are involved with nonprice restrictions]." 433 U.S. at 51, n. 18. The Supreme Court recently repeated the rule of law in California Retail Liquor Dealers Association v. Midcal Aluminum, Inc., 445 U.S., 97, 102 (1980). However, the Supreme Court has not given guidance as to exactly how price and nonprice vertical restrictions are to be distinguished in practice.