

6.2 A Case for the Rule of Reason Treatment of Vertical Restraints in Dynamic World Markets

In section 6.1, we have emphasized the importance of the rule of reason approach to competition policy in dealing with vertical arrangements in a multilateral trading system. We now discuss how the rule of reason treatment would impact on players in the vertical chain operating in global markets.

The Manufacturers

The major distortion that vertical restraints can inflict is market foreclosure which blocks entry in the long run. The efficiency argument for vertical restraints is that they provide a healthy retail margin to both the manufacturer and to retailers. Are such margins permissible in international markets, even though they often translate into higher consumer prices?

The quasi-rents that the manufacturer pockets by using vertical restraints are, as was argued above in sections 3 and 4, to be counted as a return on his investment in inventing and introducing products and processes. In today's post-industrial society, a good number of goods are produced by employing knowledge intensive techniques and skilled workers. Companies often have to incur substantial sunk costs in doing research and development (R&D) and product development. One property of products that are knowledge and skill intensive to produce is that, once they are introduced on the markets, they may be copied within the space of a few years, if not months. The protection that intellectual property (IP) rights confers on such products can be effectively porous long before the formal expiry of the legal right.⁹²

If not domestic, then foreign, rivals ready themselves to enter these new markets. In concentrated world markets, there is intense oligopolistic competition. The quasi-rent that the innovator enjoys as a first mover is contested by these rivals. In theory, it is true that the manufacturer, having a vertical restraint agreement with its dealers, appears to transfer a part of the consumer surplus to itself. Yet, this inducement may be necessary for him to continue to invest in R&D and product innovation on a continuous basis and does not necessarily (or

⁹² This analysis, however, does not address the legal capacity of owners of intellectual property rights to utilize those rights to foreclose import competition in certain circumstances. A discussion of these issues, inter alia, can be found in R.D. Anderson, P.J. Hughes, S.D. Khosla and M.F. Ronayne, "Intellectual Property Rights and International Market Segmentation: Implications of the Exhaustion Principle", A Working Paper, Bureau of Competition Policy, Hull, Quebec, October 1990; and Nancy T. Gallini, "An Economic Analysis of Grey Market Imports in Canada", A Paper Prepared for the Bureau of Competition Policy, Hull, Quebec, November 1992.