2.2 Development of the Issue

The issues in vertical structure can be viewed in terms of (a) the functional division of responsibility among the manufacturer, suppliers and retailers, and (b) the control of vertical instruments to achieve targetted outcomes or agent performance. In each case, the incentives to take on a specific function or to turn in the desired level of performance depend on the reward structure in the vertical network. Before turning to the two approaches, we discuss the incentive structure in vertical arrangements as contrasted with vertical integration.

Vertical restraints are to be distinguished from horizontal restraints (e.g., price-fixing). Horizontal restraints are agreements that augment market power of firms in competition with each other. Horizontal restraints affect market competition by creating "private government". In contrast, some form of private agreement is necessary for the players in the vertical chain to be efficient and compete in the market. A manufacturer must enter into agreements with its suppliers and retailers. Vertical restraints do not carry much risk of aggregating power. In other words, horizontal and vertical restraints are not cut from the same fabric.

- *The incentive structure*

Conceptually, arm's length transactions could take place between firms at each stage in the vertical structure. In practice, players in the vertical chain from suppliers to the manufacturer, and from the manufacturer to the retailers will attempt to arrange their business dealings with each other in a way that maximizes their profit.

Input prices paid to suppliers and subcontractors feed into production costs, which in turn figure in the wholesale price the manufacturer charges its retailers. Suppliers make a profit when they get paid in excess of their resource costs. Competition among suppliers will ensure that they make normal profit only, while the manufacturer pays a competitive price and there takes place an efficient allocation of resources in the upstream segment of the vertical chain.

The wholesale price the manufacturer charges the retailer affects the final consumer price and the retailer profit. At the same time, retailers also affect the manufacturer's profit by making or withholding efforts in promoting the product and providing before and after sales services. In other words, the manufacturer and retailer interactions criss-cross in an interdependent loop that has a feedback track going from one to the other.

The decisions made at each segment of the vertical structure can be broadly classified as price and nonprice (e.g., quality, service and advertising) policy choices. Vertical price agreements primarily concern vertical price fixing cases, such as RPM. The vertical