1. Introduction

> Either from indolence, or carelessness, or because people think it fine to pay and ask no questions, three-fourths of those who can afford it give much higher prices than necessary for the things they consume; while the poor often do the same for ignorance and defect of judgement, want of time for searching and making inquiry, and not infrequently from coercion, open or disguised. For these reasons, retail prices do not follow with all the regularity which might be expected from the action of the causes which determine wholesale prices.
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> —John S. Mill[1]

Vertical relationships refer to private agreements among the manufacturer and wholesalers or retailers (i.e., distributors) in the chain running from input sourcing to production to retail marketing to consumers. The purpose of these contracts is to enable the distributors to become efficient and compete in the marketplace. A well-tuned distribution network efficiently delivers goods and services to their destination, makes the economy function better and contributes to economic well-being.

An hour-glass, such as in Figure 1, is often used to illustrate the two segments of the vertical chain. First, in the downstream vertical arrangements, contracts between the manufacturer and retailers contain terms that may affect decisions related to such issues as wholesale or retail prices, franchise fees, the purchase of other products that are tied to the sale of another product and which dealer is assigned to which territory. Second, in the upstream vertical contracts, the producer and input suppliers may agree to deal on an exclusive basis or may set a multi-part pricing formula and so on.

Consider the automobile business by way of illustrating a vertical structure depicted in Figure 1. Ford, for example, sources many parts for its cars from independent suppliers. These suppliers of intermediate inputs constitute the upstream segment of automobile manufacturing. Ford assembles cars and sells them through its retailers located at the downstream stage of the whole process. In a vertical business structure, the manufacturer does not make all the components in-house. Nor does it supply the final users himself. In contrast, a vertically integrated operation does all the processes in-house.

[1] John Stuart Mill, *Principles of Political Economy with Some of their Applications to Social Philosophy*, 1848, new edition Routledge and Kegan Paul, 1912, p. 441.