3. The Logic of Vertical Restraints

Firms sign on to vertical contracts to agree on a number of factors, such as wholesale price, franchise fee, the quantity purchased by a retailer, the final consumer price, promotional effort, retail location and so on. For the contracting parties, specific vertical arrangements are instruments that can be used to target a number of objectives, such as the retail price, surplus extraction and the promotional effort by the retailer. Each party accepts the contract only if they find it profitable to do so. In general, vertical contractual relationships are just a special case that belong to a full range of contracting scenarios between the manufacturer and the retailers.

In deciding on which price and non-price vertical restraints to impose on its suppliers and retailers, the manufacturer has to balance the lure of extracting profit for itself against the size of the profit margin for the dealers. In situations where simple two-part pricing is not sufficient to increase his private profit, the manufacturer can put in more complex clauses in vertical contracts with dealers. For instance, the manufacturer may use one or more vertical restraints to provide retailers a large retail margin, i.e., a hefty difference between the final consumer price and the wholesale price paid by the retailer.

A number of different vertical restraints may address the same common situation that a manufacturer may be confronting, such as raising promotional effort by retailers to some desired level, getting retailers to protect the brand name image and reputation of the product, providing the retailer some measure of stability of profit over time, or preventing entry by potential competitors.[13]

In this section, we briefly review the literature concerning a selected number of vertical restraints. The discussion of the effect of vertical restraints on *intra*brand competition is followed by that on *inter*brand competition.

3.1 Vertical Restraints and Intrabrand Competition[14]

Consider a single manufacturer dealing with multiple retailers. In this case, an argument can be made that the manufacturer's profit will be greatest when his dealers are perfect competitors with one another. The manufacturer can set the wholesale price (WP) in

[13] Michael L. Katz, "Vertical Contractual Relations", in R. Schmalensee and R.D. Willig, eds., *Handbook of Industrial Organization*, Volume 1, North-Holland, 1989, chapter 11, p. 712-3.

[14] See footnote 8 above.