The Competitive Effects of Resale Price Maintenance*

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Abstract

The rise of chain and department stores in the 1930s elicited a backlash from small businesses. To protect these retailers from their larger brethren, resale price maintenance (RPM) laws were enacted. While seeming to foster anti-competitive behavior, these contracts may benefit producers through the provision of services by retailers as a form of non-price competition. Event studies under different regulatory regimes to the stock prices of manufacturers that used RPM are used to judged the competitive effects of these laws. The appropriate legal standard for RPM cases is discussed, as is the scope for these contracts to counterbalance big-box retailers today.

America is currently engaged in debates over the effect of Wal-Mart on small businesses across the country. Critics allege that the retailer forces smaller stores to close their doors and takes money out of the community. Proponents of the company reply that such creative destruction yields lower prices to the benefit of consumers. These debates are not original, however. As retailing gained a bigger share of the economy and products became standardized in the late nineteenth and early twentieth centuries, larger retailers began to emerge. Small outlets railed against the emergence of chain and department stores for the very same reasons that Wal-Mart critics purport today. States responded to these concerns in the 1930s by adopting resale price maintenance (RPM) laws, which permit manufacturers to dictate the minimum resale price for their goods to their sellers.[1] RPM contracts became unpopular politically and corporations began to abandon the contracts. After forty years in use, RPM laws were rescinded and these contracts were banned by the courts. Examining the historical context and consequences of these laws can better inform our policy toward big-box retailers today.

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[1]The other major anti-chain policy of the period was the Anti-Price Discrimination Act of 1936. See Section 4.3.

1 A brief legal history

In 1911, in *Dr. Miles Medical Co. v. John D. Park and Sons Co.*, the Supreme Court declared that RPM was *per se* illegal under the Sherman Antitrust Act. The Court handed down a similar ruling in the *Federal Trade Commission v. Beech-Nut Packing Co.* in 1922. To control chain and department stores, states imposed taxes on large-scale retailers, but were also rebuffed by the courts on due process grounds. The Court finally accepted RPM in *Appalachian Coals v. US* and *Nebbia v. NY* in 1933 and 1934 respectively, but only on the grounds that the Great Depression was a national emergency. Returning to its original position, the Court upheld the dissolution of the Sugar Institute by the government in *Sugar Institute v. US* in 1936. Congress had the authority to exempt RPM from the Sherman Antitrust Act and received 30 bills proposing just that between 1913 and 1931, though the body enacted none.

Small retailers were finally able to convince state and federal governments of their plight. In 1931, California was the first state to adopt a law permitting RPM in intrastate trade and other states followed with their own 'Fair Trade' Acts. The Miller-Tydings Act was established in 1937, officially condoning the state restrictions in interstate trade as well. President Franklin Roosevelt signed the bill, though he disagreed with its economics, not wanting to weaken antitrust statutes, and the tactics used to ensure its passage, as a rider to a tax bill.

In May 1951, the Court invalidated a part of state RPM laws in *Schwegmann Bros. v. Calvert Corp.*, specifically non-signer clauses. Non-signer clauses bind all retailers of a product, not just signers of the contract, to the terms of the RPM. Congress replied in July 1952 with the McGuire Act, once again permitting this restriction.

The Miller-Tydings Act was repealed by the Consumer Goods Pricing Act of 1975. RPM was declared to be *per se* illegal in the 1980 case *California Liquor Dealers v. Midcal Aluminum* and again in 1984 in *Monsanto Company v. Spray-Rite Service Corporation* under the Sherman Antitrust Act. These cases served to affirm the ruling in *Dr. Miles*.

On March 26, 2006, the Supreme Court heard *Leegin Creative Leather Products v. PSKS*. Leegin's pricing policy did not permit retailers to sell its clothing on sale. Upon learning that PSKS (doing business as Kay's Kloset in Flower Mound, TX) was doing so, it suspended new shipments to the retailer. Upon finding a violation of antitrust statutes, PSKS won a $1.2m jury verdict, which is tripled as per the Sherman Antitrust Act. Leegin argues on appeal that *per se* illegality is too strict a standard for RPM based upon pro-competitive economic arguments and asks the Court to overturn its decision in the *Dr. Miles* case.

2 Economics of RPM

At first glance, it appears that RPM is an anticompetitive behavior, serving to enforce collusive contracts among the distributors. All jobbers agree to raise their prices, incorporating the average mark-ups of 20-40%, with the greatest increases arising at chain, discount, and department stores.[2] It follows that the quantity purchased will fall with these retail price increases. But, RPM is initiated and enforced by the manufacturer and the preceding analysis suggests that the manufacturer loses sales without wholesale price increases, making them worse-off. But the existence of thse contracts implies that they must benefit the manufacturer in some way.

2.1 Horizontal efficiency

The desire to increase horizontal efficiency lies at the root of most arguments for RPM by manufacturers. The most famous was Tesler's (1960) "special service" proposition. Some goods require that retailers provide pre-sale services, such as educating consumers about the product and assisting them make their decisions among similar goods. The manufacturer requires that these services be offered for his goods to be sold, but the retailer will not provide

[2]This could be thought of as a middle-man monopsony.

them at a loss. Tesler suggested that RPM provides the margins necessary for a jobber to supply these services and, since all distributors have agreed upon a minimum price, they will use the provision of services as a form of non-price competition.

The oft-cited contemporary example is that of a computer. Assume that there is a high-priced store offering pre-sale services and a low-priced store offering no such assistance. A consumer could go to the former store to educate himself about the devices, but make his purchase at the low-priced outlet. Because of consumer arbitrage, then, the high-priced store will lower its prices and discontinue its provision of service. RPM, Tesler argued, could internalize the costs of service to the manufacturer and eliminate the free-rider problem of low-priced stores.

Implications of this theory are that RPM is only necessary if there is separate ownership of distribution and production, products are complex, in that they need ancillary pre-sale services, or if a product is not established or understood by the public. Additionally, services would need to be customer-specific and consumers would need to be sufficiently diverse to prevent national, manufacturer-led advertising campaigns from providing the necessary information. RPM is useful if a product is new or purchased infrequently. Also, post-sales assistance, such as warrantees, is not important, because retailers only provide such service for their own sales and could be sold separately.

Returning to the computer example, it is true that the device is complex, purchased infrequently, and consumer needs are relatively heterogeneous. This only implies, however, that some consumers will need service, while others will know precisely what features they desire. The knowledgeable consumers could go to a low-service store and the uninformed could go to a high-service store. Given that a consumer incurs a cost from going to the store, the high-service store can raise their prices by as much as this transaction cost to cover their service expenses. This would seem to resolve the issues set forth by Telser. Under Telser's model, however, both stores offer the same price (somewhere between the low- and high-priced offerings) and same level of service. The knowledgeable consumer, therefore, pays a

higher price for service that he does not need.

Another point is that, while consumers can shop around for the lowest price and easily find such information in newspapers and advertisements, consumers cannot shop around for pre-sale service. Price is a fixed, objective value, while a consumer cannot evaluate the quality of the salespeople precisely because he is uninformed. Also, a qualitative measure, like service, cannot readily be discerned from advertisements, forcing the customer to go to each shop to compare their non-price offerings. This suggests that the hearty non-price competition that Telser predicts will not occur because of consumer ignorance about service quality differentials among retailers. Intrabrand prices are easier to compare than interbrand prices because of product differences, but both are easier to compare than intra- or interbrand non-price competition.

Some manufacturers are dependent upon retailers to push their products into the hands of consumers. Kleit (1993) examined the testimony before Congress in 1915-17 on RPM. He found that many manufacturers claimed that retailers would convince consumers to purchase items yielding the highest margins and low-margin goods would be placed under the counter or in other inconspicuous places. Edwards (1940) offered the example of Pepsodent toothpaste. After the company ended its RPM contracts, the tubes were placed under the counter and sales plummeted. The company was forced to return to the RPM system, including retail mark-ups of 40% and donated $25,000 (over $360,000 in 2007 dollars) to a trade organization to promote fair trade acts across the country. RPM, then, would help manufacturers by getting retailers to move their products and induce sales effort. RPM was a way for manufacturers to purchase shelf space. He found that national advertising and shelf space were compliments, helping to explain why RPM and advertising campaigns arose concomitantly. This could also explain why manufacturers did not discuss marginal benefits of increases in service, only the size of mark-ups.

A similar argument is that retailers use RPM to purchase certification of quality (Marvel and McCafferty 1984). By providing guaranteed mark-ups, they are able to obtain

agreements with retailers that consumers associate with quality products. The fact that such a store carries the product sends a signal to the customer about the good's imputed quality. Marvel and McCafferty used this hypothesis to explain why they found RPM used mostly by new entrants in competitive markets, supplying a high-quality good relative to similar, but inferior, competitors. In their model, a retailer chooses a minimum quality level to sell and can perfectly identify the quality of all goods. Consumers consistently underestimate quality, however, and look to retailers for signals about true quality levels.

2.2 Vertical efficiency

Klein and Murphy (1988) examine RPM from a vertical efficiency perspective. They noted that all explanations for RPM require that manufacturers cannot write explicit, court-enforceable contracts for what they would like retailers to provide, be it pre-sale service or sales effort. The horizontal arguments hold that retailers can only compete in providing the desired service, though this clearly is not true. Klein and Murphy emphasize the role of the manufacturer in monitoring performance of retailers in the desired areas and require that the manufacturer be willing to terminate underperformers. RPM induces good behavior because it limits the short-run gains of non-performing retailers and increases long-run gains to compliant jobbers by generating a stream of quasi-rents.

The authors point out that non-price competition is inefficient, in that one dollar of non-price competition does not necessarily yield one dollar to consumers (if it did, then RPM would not be effective). The value to the consumer of an additional dollar of service spending is the effectiveness of non-price competition. Because of these inefficiencies, even perfect competition in the realm on non-price competition will not exhaust the mark-up (ie, the price of the good will not equal the marginal cost of the good plus the service). Non-price competition becomes stronger as the mark-up, elasticity of demand, and the effectiveness of non-price competition increase. If the mark-up is low, then non-price competition is unlikely. This mark-up is the stream of quasi-rents that Klein and Murphy consider to be main driver

of the service arguments. The manufacturer would be likely to provide the service itself if its gains were very large and the desired service was large, but not easily measurable.

2.3 A re-assessment of the anti-competitive argument

The preceding sections have set forth arguments that RPM increases efficiency, but is it anticompetitive? Klein and Murphy (1988) contended that vertical constraints employed by parties with no market power cannot be anticompetitive, since, if the retailers were behaving as a cartel, the manufacturer could find alternate sellers and vice-versa. Marvel (1985) noted that RPM is qualitatively different from horizontal price fixing at the retail level because the manufacturer would need to enforce the contract, which it would not pursue unless it did so for the efficiency reasons set forth above. And, while fair trade acts were promoted mostly by retailers, manufacturers were the entities that imposed the contracts.

Sharp (1985) took a critical view. He argued that even if manufacturers did initiate RPM contracts, retailers prevent the firms from abandoning them through sales retaliation. The Pepsodent anecdote proffered earlier underscores this point. He also contended that collusive, retailer-driven, rather than service-based, manufacturer-driven, contracts are "the principal cause of RPM." Other authors assume that the permitted mark-up exists only to offset the cost of the desired service level, but there is no evidence to suggest that this calculation is made by producers. Additionally, this system harbors inefficient firms and retards the spread of new, low-cost retailing strategies, "possibly the greatest cost" of permitting RPM. To the contrary, however, Overstreet (1983) discussed several studies that found that the failure rate of small businesses was higher in fair trade areas. Sharp did admit that new manufacturers are dependent upon retailers to reach consumers and RPM may be useful in this regard. He did not explain how his proposal of permitting RPM for new manufacturers can be reconciled with his preceding point that retailers prevent manufacturers from abandoning their contracts.

2.4 Effect on prices

There is much debate about the effect of RPM on prices. Again, the obvious answer reflecting the presumed cartel-like behavior of the participants would be that prices increase. Indeed, the question would be uninteresting unless the contracts were binding for at least some retailers. Broadly, both the pro- and anti-competitive theories suggest that prices will rise. Theories of collusion suggest that retailers will entertain quantity reductions for price increases. Efficiency arguments for RPM also suggest that prices will increase, but will be commensurate with service quality increases. Silcock (1938) pointed out that sales should decrease at low-priced stores, but increase at high-priced ones. Edwards (1940) noted that some believed that prices will go down across-the-board towards the contracted minima and manufacturers would be competing to lower their prices to retailers, rather than the "traditional" notion of retailers lowering prices for consumers. Both sides agreed that the variance of prices for a product should decrease. Ultimately, Edwards concluded, the effect on prices will depend upon the degree of substitution by consumers from manufacturers' brands to store labels, the efficiency of detecting and prosecuting violators, and the willingness of manufacturers to reduce their wholesale mark-up to keep prices low. Lastly, he concluded that the overall price level should not change greatly because he estimated that only 15% of products utilized RPMs, including drugs, cigars, cosmetics, books, and liquor.

Marvel and McCafferty (1986) examined a model of pricing under RPM. Assuming arbitrage opportunities, prices must be the same in areas where RPM contracts can be enforced and those where they cannot. The price in RPM areas will equal the price in non-RPM areas plus the marginal cost of service. Prices will be higher in RPM areas for lower elasticities of consumers to price and higher to service. As in several of the other models presented, a result is that the wholesaler will reduce its own margins to offset the increase in retail margins. Additionally, both wholesale and retail prices fall as the percentage of RPM districts increases. Their theory also implies that prices in urban areas will go up, but will fall in rural regions.

3 Empirical studies

Frankel (1955) categorized the empirical studies of RPM into four groups: (a) comparisons of price changes over time in states with and without fair trade acts to examine the stability of prices, (b) comparisons of prices between fair trade and non-fair trade areas to look for direct effects of RPM contracts, (c) calculations of operating ratios between the two areas to determine if RPM increases mark-ups, and (d) a group of miscellaneous studies, mostly performed by the Federal Trade Commission. The most significant studies fit into category (b).

3.1 Interstate comparisons

Edwards (1940) found that prices had increased substantially in large stores and less-so in smaller ones in metropolitan areas after the legalization of RPM contracts. Stores in small towns experienced a decrease in prices. Similar results were obtained by Bowman (1954) for toothpaste. He found higher prices in fair trade states compared to non-fair trade areas for all store types and community sizes. The weighted difference was approximately 4% lower prices in non-fair trade states. Prices fell after the *Schwegmann* decision, which invalidated non-signer clauses in 1951, but they did not increase after the McGuire Act once again permitted these regulations. Bowman also examined liquor prices between St. Louis, Missouri, a city without fair trade, and a neighboring city in Illinois, which did have such a law. Prices were 16% higher under the fair trade regime.

Another intercity study was performed by Lewis (1939), comparing Wilmington, Delaware, the non-fair trade city, with Chester, Pennsylvania, the fair trade locale. For orthodox (ie, non-chain) drug stores, he found that prices on price controlled and non-controlled products to be 2.48% and 2.73% higher in the non-fair trade area. Chain store prices were 10% lower in Wilmington, however. Lastly, the spread in prices was higher in Wilmington. Lewis drew the conclusion that the price reduction in orthodox stores was

small relative to the increase in chain stores from non-fair trade to fair trade areas.

The final intercity study was performed by Seelye (1941) in Kansas City, the Kansas side having fair trade provisions, while the Missouri side lacked the laws. Chains undersold orthodox stores on 45 of 50 items by an average 9.6% in Kansas and on 47 in Missouri by an average 7.5%. Independent stores sold their products for an average 11.2% above the minimum price, compared to 1.6% for chains in Kansas. Independent stores in Missouri undersold their Kansan compatriots by 2.5%, though chain stores had almost identical prices across the state line, to which the author attributes the interstate advertising by the interstate chains. He noted, though, that sale prices at Missourian chains were 22.8% below the best Kansan prices.

3.2 Transition to fair trade status

Some of these authors also examined prices as cities transitioned to fair trade policies. Lewis (1939) found that prices in Knoxville, Tennessee fell by 1.55% from January 1937 to April 1938, though this decrease was less than the average U.S. experience. Frankel (1955) criticized Lewis' use of an unweighted average, which exaggerated the reduction in prices or may have hidden an overall price increase and his reliance on the memories of jobbers to get his data. Seelye (1941) cited two studies that found sale price increases of 15.7 to 30% in Michigan and 29% in New York City with the induction of a fair trade regime.

3.3 Nationwide studies

Phillips (1941) and Frankel (1955) cited a National Association of Drug Stores study which found that the price for a basket of drugs increased by only 3.1% after the enactment of fair trade acts and covered a span of eight years. Frankel noted that the prices used for the basket were contract prices, not retail prices, which one would expect to move less than the actual selling prices. Phillips pointed out that the Bureau of Labor Statistics drugs and pharmaceutical price index fell by nearly 6% over this period, implying an actual price

increase of 9% after the enactment of RPM. Upon examining the study more closely, he also found that prices in non-fair trade states actually fell over the same time period.

3.4 Conclusions and criticisms

Among these studies, there seem to be broad conclusions that can be drawn. First, RPM does force prices up in some places, mostly cut-rate chain stores, while prices seem to fall in independent stores, though the former effect is larger than the latter. Fair trade acts also reduced the variance of prices. Lastly, manufacturers set minimum prices between cut-rate prices and actual list prices.

A final interesting finding of these studies reveals the lack of policing of prices by manufacturers. Lewis (1939) found that chain stores set prices lower than the proscribed minimum on as much as 38% of its price-controlled products. Only 1.5-5% of products were priced above their minima in chain stores, compared to 66% in orthodox stores. One-third of toothpastes in Bowmans's (1954) study were priced below minima. It is clear that these laws were not effective in eliminating the gap between large and small retailers or in actually controlling prices.

As mentioned earlier, both pro- and anti-competitive theories predict price increases. Hence, such a finding cannot affirm either theory and none of the aforementioned studies actually reveals the welfare implications of RPM. Ideally, changes in quantity could be studied, but these data do not exist.

Frankel (1955) took a critical position on many famous RPM studies. His first qualm was that drug stores are the focus of many studies because such a high proportion of sales in these outfits are subject to protection by RPM, but questioned what generalizations can flow from a narrow industry study. Additionally, most studies do not control for systematic price changes unrelated to RPM enactment. His last complaint was that many studies rely upon the memories of shopkeepers to obtain price data from as long as three years prior. Since small retailers were the major proponents of fair trade laws, these merchants had an

incentive to understate the impact of RPM on their prices. This is less of a problem for studies of chain stores because these prices can often be located in company records.

4 Empirical analysis

The preceding discussion underlined the difficulties in using prices to study the effects of RPM. Quantities sold could be examined, but these data were not recorded. Pro-competitive theories imply that RPM would be good for manufacturers since their sales would increase, while retailers would not benefit from the policy because higher margins would be competed away via non-price competition.[3] Anti-competitive policies suggest that quantities would decrease, hurting manufacturers, while retailers would experience gains from higher prices. Because the theories offer opposite hypotheses about the effect on manufacturers, examining the fate of these firms under RPM may reveal which theory is correct.

One way to do this is via an event study. A composite basket of manufacturers who sell goods under RPM that are listed on the New York Stock Exchange was created and the returns to this index were followed for approximately one-and-a-half months before and after three 'events': the passages of the Miller-Tydings (August 17, 1937) and McGuire (July 14, 1952) Acts, and the *Schwegmann Bros.* ruling (May 21, 1951).

This approach is not without its own complications, however. The pro-competitive theory posits that smaller, newer companies would be more likely to use RPM. These companies are less likely to appear on the NYSE—indeed, it seems that few members of the Exchange used the scheme. Even for these companies, only a small fraction of their goods were sold via RPM and a smaller fraction still were sold in areas where RPM is permitted. Lastly, as mentioned in Section 3.4 it does not appear that RPM contracts were strictly enforced. Taken together, these facts imply that RPM may have little effect on a company's bottom line and thus stock prices.

[3]Retailers could benefit if RPM contracts were used by manufacturers to buy shelf space, which is costless for the retailers to provide.

Perhaps an even more important consideration is that stock prices are presumed to constantly and immediately update to reflect new information. This implies that stock prices begin to incorporate the effects of policies before they are enacted based upon the expected probability of the enactment of the policies. Investors may have anticipated the passage of the Miller-Tydings Act, for example, and incorporated its anticipated affects on companies before the actual date of passage. This implies that surprise changes in the law will best reflect the affects of policy shifts. Applying this logic to the current analysis suggests that the court ruling will display a more prominent affect than the law signings.

4.1 The model

A portfolio of the firms listed on the NYSE that were known to have employed RPM was created.[4] The stock price of each firm $y_{i,t}$ was weighted by w_i, the ratio of the market capitalization of the firm on the date of the policy change (t^*) to the total market capitalization of the portfolio:

$$w_i = \frac{y_{i,t^*} s_{i,t^*}}{\sum_i y_{i,t^*} s_{i,t^*}}$$

where s_{i,t^*} is the number of outstanding shares for the firm on date t^*. The portfolio's return on date $t+1$ is

$$r_{t+1} = \frac{p_{t+1} - p_t}{p_t} = \sum_i w_i \frac{x_{i,t+1} - x_{i,t}}{x_{i,t}} = \mathbf{d}'\mathbf{w}$$

where $\mathbf{w}$ is a vector of the weights and $\mathbf{d}$ is a vector of the returns to the individual firms.

The return to the portfolio was regressed on a dummy variable, which is equal to 1 on and after date t^*, the date of the policy shift, and the daily return to the NYSE, M_{t+1}.

$$r_{t+1} = \alpha + \beta \mathbb{I}[t+1 \geq t^*] + \gamma M_{t+1} + \epsilon_{t+1} \tag{1}$$

This regression was run separately for the enactments of the Miller-Tydings and McGuire

[4] See Appendix A for a list of the firms and their market capitalization weights.

Acts and the *Schwegmann Bros.* ruling. The timespan for each included approximately 6 weeks before and after the policy change.

4.2 Results

Recall that the Miller-Tydings and McGuire Acts permitted and expanded RPM. For these events, anti-competitive theory would predict that β is negative, while pro-competitive theory posits that it is positive. The *Schwegmann Bros.* ruling reduced the scope of RPM laws by invalidating non-signer clauses, so the hypotheses on the sign of β are the opposite of those for the enactments (ie, a negative β implies that the market valued RPM for these firms). The results for this coefficient are listed in Table 1.[5]

Policy change	β	Standard error	t-statistic
Miller-Tydings Act	-0.00107	0.00162	0.657
Schwegmann Bros. Ruling	-0.00234	0.000981	2.39
McGuire Act	-0.000515	0.000759	0.678

Table 1: Values of β for three policy shifts.

The values for β for the two acts are negative, though not signficantly different from zero. For the court ruling, the value is negative, which is consistent with pro-competitive theories of RPM. This is especially interesting given Bowman's (1954) finding that prices fell after the ruling—Overstreet (1983) described a subsequent ten-week "price war" among retailers. One would expect such price-slashing to buoy the manufacturers, and yet their stock prices fell.[6] These results may suggest that RPM is only useful when all firms, including non-signers, are compelled to follow the contracts. The value of β seems to be small—at most 0.234%. But this is a *daily* change. Over the 30 days following the decision included in the sample, the cumulative change is $(1 - 0.00234)^{30} = 0.932$, or a loss of 6.8% of the

[5]See Appendix B for complete regression results.

[6]Of course, these characterizations are broad and it is *not* clear that they apply to the goods sold by the firms in the portfolio.

portfolio's value in the weeks following the ruling. Such a decline is economically significant.

The caveats discussed earlier can explain the pattern of significance found in these results. Legislative activity is quite public—it is relatively easy for investors to assess the likelihood of the passage of a bill. Hence, the market could have incorporated the effects of the Miller-Tydings and McGuire bills as their passage seemed more evident. The Supreme Court, however, dwells in secrecy and the outcomes of cases are rarely known until the opinions are handed down. The markets, then, could not anticipate the *Schwegmann Bros.* ruling and thus its affect on stock prices is more apparent.

4.3 Comparison to a similar study

RPM laws were not the only attempts by the government to protect small businesses from chain and department stores. The Anti-Price Discrimination or Robinson-Patman Act of 1936 forbade distributors from selling products to different retailers at different prices. This legislation was a reaction to the now-common practice of wholesalers providing discounts on bulk orders by large retailers. Representative Wright Patman, the bill's namesake, declared that "there is no place for chain stores in the American system." This bill has received nearly-unanimous consternation from antitrust economists (Ross 1984).

Ross (1984) created portfolios of grocery, variety, chain, and drug stores and examined monthly changes in stock prices using equation 1, though t is enumerated in months, rather than days and the period covered by the analysis is much longer. Only grocers experienced a significant "negative abnormal return," amounting to a 58% depression in returns from June 1935 to December 1937, an average decline of 2.77% per month. This affect is concommitant with a decline in percentage of sales by and net profits as a percentage of net worth of large grocers declined. Since Ross was able to identify the affect of this bill without taking the perceived probability of passage of the bill by investors into account, the Robinson-Patman Act may have had a more pronounced affect on the economy than RPM laws. This is especially true since only a small fraction of goods were covered under RPM agreements,

but many more goods fell into the price discrimination bans.

5 Legal standards for vertical restraints

After the repeal of the Miller-Tydings Act, the Court returned to its RPM standard set forth in *Dr. Miles*, namely *per se* illegality. This implies that there are no scenarios under which RPM is permitted. In contrast to vertical price restraints, a category including RPM, the Court ruled that vertical non-price constraints would be held to a rule-of-reason standard. This means that these restraints, such as exclusive territories, would be examined on an individual basis and, if the contract generates net welfare benefits, then it is permitted by the courts. There are several possible flavors of this standard. Overstreet (1983) outlined the following four:

- *Evidence must support one and only one interpretation.* Prosecutors or plaintiffs must show that the only sensible assessment of the evidence is anti-competitive. It is very difficult to rule against restraints under this standard.

- *The "preponderance" of evidence must support the finding.* All evidence is weighed and the court finds in favor of the most likely assessment of the effects of RPM. This is the standard used in non-price vertical restraint, merger, monopoly, and predatory pricing cases.

- *A narrowly-focused investigation.* Rather than examine all available evidence and effects, the courts could focus on finding evidence that RPM was used to facilitate collusion. Benefits to consumers, through increased service as an example, would not be part of the analysis.

- *Reverse the burden of proof.* The courts would operate under *per se* illegality unless a defendant was able to demonstrate that RPM was welfare-enhancing, in which case the contract would be permitted.

Earlier in his book, Overstreet provided anecdotes of both collusive and pro-competitive uses of RPM.[7] He also outlined what he considered to be poor applications of the restraint.[8] He advocated a rule-of-reason approach to vertical price restraints because there were some welfare-enhancing uses of vertical price restraints and to align the treatment of RPM with that of vertical non-price constraints. Of course, Congress has the power to amend the Sherman Antitrust Act and that body, too, could change the legal standard used in RPM cases.[9]

6 Conclusions

The Fair Trade Acts were devised to protect small retailers from their larger counterparts. There are contemporary calls for similar protections against retailing giants like Wal-Mart. As discussed in Section 3, a re-instatement of RPM in the US would likely lead to higher prices with lower variance across retailers, with higher prices at discount stores partially offset by lower prices at smaller outlets. This result is contingent upon manufacturers actually enforcing the contracts—a lack of effort in this respect will result in small effects on the prices charged by chain stores and in the gap in prices between these and smaller outlets.

Were the contracts enforced, one might conjecture that RPM could be used to depress the power of big-box retailers like Wal-Mart, but the result could be just the opposite. Many of Wal-Mart's critics allege that the firm is able to leverage its size against even established manufacturers and force them to cut wholesale prices ever-lower. RPM contracts will not be able to change the initial structure of the retail market and it is foreseeable that Wal-Mart could force producers to keep costs and minimum prices low. If Wal-Mart has market

[7] Examples of dealer collusion are found in the liquor and drug trades. Examples of manufacturer collusion are electric lightbulbs and the Bakers of Washington case before the Federal Trade Commission. Examples of pro-competitive uses include Coors beer and Magnavox televisions.

[8] Levi's jeans and low-end audio component manufacturers applied RPM in a pro-competitive way, but failed to abandon these contracts when they were no longer necessary to induce sales effort.

[9] Recent attempts to define the legal standard of RPM include "The Retail Competition Enforcement Act of 1987" and "The Consumer Protection Against Price-Fixing Act of 1989," both aimed at further *curtailing* the ability of manufacturers to use RPM.

power, then RPM contracts may simply not be binding. Additionally, the firm could use its ubiquitous store brand generics to hold prices down. RPM would not be an effective counterbalance to Wal-Mart and it could actually increase the retailer's power.

RPM rose to prominence prior to national marketing campaigns, a time when consumers relied upon druggists to tell them about Pepsodent toothpaste. Now, consumers get information from widespread media campaigns and on the internet. *Consumer Reports* magazine has broadened and expanded its readership greatly since its January 1946 launch, providing impartial reviews to buyers. While the need for pre-sale service provision may be diminishing, manufacturers may wish to purchase sales effort and shelf space. But in the 1950s, as RPM laws became settled and firms had an opportunity to experiment with the contracts, manufacturers began to willfully abandon their RPM schemes.[10] It is unclear how many of today's firms would initiate RPM contracts were they to be permitted, though the current case before the Supreme Court suggests that some firms would use these contracts.

Of course, the goal of RPM may not only be to combat Wal-Mart and even selective usage of the contracts could be welfare-enhancing. The results of the empirical analysis in Section 4 are consistent with justifications of RPM on efficiency grounds. Manufacturers could internalize costs of service and sales effort currently borne by retailers, resulting in efficient provision of these goods. Policy makers, though, must be wary of anti-competitive uses of RPM, namely collusion among manufacturers or retailers. However, these concerns are not qualitatively different from those arising in merger cases, for example. Because of the potential pro-competitive effects of RPM contracts and to align the legal treatment of price and non-price vertical restraints, the Supreme Court should reverse its *Dr. Miles per se* illegality standard for RPM in favor of a rule-of-reason approach.

[10] Lionel, Sheaffer Pen Co., and Westinghouse Electric ended their RPM contracts in 1956; Bell & Howell Co., Kodak, and Revere Copper & Brass in 1957; and General Electric, McGraw-Edison, and Sunbeam in 1958, as major examples.

Appendix A

Firms represented in the RPM portfolios of 1937, 1951, and 1952 and their market capitalization weights

	Capitalization weight w_i		
Firm	1937	1951	1952
Abbott Laboratory	0	0.0827	0.0791
American Home Products	0.0355	0.0513	0.0594
American Safety Razor Co.	0.0147	0.00463	0.00363
Bristol-Myers Co.	0.0277	0.0201	0.0415
Colgate-Palmolive-Peet Co.	0.039	0.0438	0.036
Coty, Inc.	0.0123	0.00284	0.00233
Gillette Safety Razor Co.	0.0323	0.0462	0.05
Johnson & Johnson	0	0.0572	0.0493
Lehn & Fink Products Corp.	0.00419	0.00256	0.00225
Minnesota Mining Co.	0	0.1493	0.134
Norwich Chemical Co.	0	0.00598	0.00673
Procter & Gamble Co.	0.398	0.281	0.256
Remington Rand Inc.	0.016	0.0363	0.0384
Westinghouse Electric Co.	0.4175	0.2136	0.240
Zonite Sales Corp.	0.00475	0.00165	0.0015

Daily stock and index prices and the number of outstanding shares were obtained from the Center for Research in Security Prices online database at the Wharton School of the University of Pennsylvania.

Appendix B

Regression results

Policy change	α	β	γ	R^2
Miller-Tydings Act	-0.000031	-0.00107	-0.734	0.772
	(0.0011)	(0.0016)	(0.493)	
Schwegmann Bros. Ruling	0.00092	-0.00234	0.777	0.652
	(0.00064)	(0.00098)	(0.072)	
McGuire Act	0.00017	-0.00052	0.664	0.445
	(0.00058)	(0.00076)	(0.101)	

Standard errors are in parentheses

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