MARKET-SHARE DISCOUNTS AND INCENTIVES IN A VERTICALLY RELATED INDUSTRY

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Extended Abstract.

The paper investigates anti- and pro-competitive aspects of market share discounts (MSD). MSD are discounts that a manufacturer offers to its distributors or retailers if their sales of the manufacturer's brand comprise a sufficiently high percentage of their total sales of a given class of goods. After several cases of MSD examinations by court (which include the cases Concord BoatCorp. v. Brunswick Corp. (2000), LePage's Inc. v. 3M (2003), Virgin Atlantic Airways Ltd. v. British Airways (2001)), the use of market share discounts had got attention in the antitrust law literature. But still, pro- and anticompetitive sequences of the MSD use have not got enough attention in the economic theory yet and formal analyses of efficiency promoting uses of MSD have not been undertaken. There are no systematic empirical analyses of why or when firms use MSD to distribute their products, and the theoretical literature on discounts has not generally considered efficiency based reasons using market share discounts.

In the paper I analyze a role of the MSD as a device that can be used by the upstream firm to create incentives for the downstream firm to undertake efficient level of promotional effort. The problem is analyzed in a framework of game-theoretical model with the following setup. The vertically related two-level industry is considered. The upstream level is presented by the upstream manufacturer and the competitive sector that produce imperfect substitutes. At the downstream level there is the only reseller named the downstream firm. I consider the role of MSD in two different cases. In the first one, the downstream firm has no possibility to affect the consumers' preferences (and demand curves). In the second case, the demand for the upstream manufacturer's good depends on downstream firm's promotional effort. In both cases the results of the MSD use are compared with a wholesale price setting.

In the first case the use of MSD by the upstream firm leads to the following result. Comparing to the wholesale price settings, both the quantities of manufacturer's good in final sales and the manufacturer profit increase while the quantities of the competitive sector's goods decreases. The total profit of the industry decreases (because of decreasing in the profit of the downstream firm) as well as consumer surplus decreases. The only agent that gains from the MSD use is the upstream manufacturer. That allows us to make a conclusion about anticompetitive character of the MSD use in these settings.

In the second case the downstream firm makes a decision about its level of promotional effort as well as about quantities of both goods. Because the level of effort is not observable by the upstream firm, the MSD scheme cannot be contingent on the effort level. Thus the MSD scheme should be designed by the upstream firm to motivate the downstream firm to choose a desirable (by the upstream firm) level of the effort and quantities. The main results obtained in this part of analysis are the following. First, the use of MSD allows to motivate the downstream firm's to make the desired by the upstream firm level of the effort of the downstream firm and, second, this level is efficient from the social point of view. It is shown as well that the efficient effort level cannot be achieved if the upstream firm is restricted to use the wholesale price. Both the industry profit and the consumers surplus is higher in the case of the use of MSD comparing with the wholesale price use. Another important result is that while the MSD increases sales of the manufacturer's good, and decrease sales of alternative good, their use do not drive these competing firms out of the market except under extreme conditions. Thus, in this setting, the MSD use leads to increasing in social welfare and in this sense it has pro-competitive role.

Finally, combining the results obtained in the first and the second case, I conclude that judgment on either the MSD has the anti- or pro-competitive effect crucially depends on features of market environment. While the MSD may serve for a redistribution of the profit between the upstream and the downstream firms and may lead to increasing in social welfare it may also be efficient instrument for incentives creation. Thus the MSD should not be treated as the anticompetitive practices a piori, but rather the treatment of the MSD should be based on the principle of a case-by-case basis.