

Many have claimed that the marketing of products in Japan is hampered by anachronistic, outmoded, and backwards customs and institutions and by practices that enlarge or perpetuate monopolistic distortions. What are the facts?

Japan's marketing system does indeed exhibit a number of peculiarities. Japan has far more retail stores per person than do most other developed countries, more than twice as many stores per person as the United States. Furthermore, Japan, more than other countries, exhibits convoluted marketing channels. Products typically pass through the hands of two separate wholesalers before reaching retail shops or industrial customers, and often through more—occasionally a lot more. In the USA passage through the hands of a single wholesaler is more typical. Finally, manufacturers, wholesalers, and retailers in Japan very frequently enter complicated contractual arrangements with one another. Minimum resale prices, customer restrictions, exclusive dealing stipulations, and other such “vertical restraints” have frequently run afoul of anti-monopoly laws in Japan but nevertheless remain pervasive there. So is the conventional view correct? Is Japan's distribution sector hopelessly mired in waste and inefficiency? Careful analysis argues generally against it.

The ubiquity of retail stores in Japan reflects its geography, transport system, and the relative scarcity of living space. The proliferation of small stores affords Japanese households the added convenience of next-door shopping, which they particularly value because it enables them to make

more frequent shopping trips, maintain low household inventories, and thus economize on scarce living space. At the same time, the geographic centrality of Japan and superabundance of commercial vehicles there imply that the added costs of restocking a multiplicity of small stores as opposed to a smaller number of large ones are less in Japan than they would be in many other nations. In short, the ubiquity of stores is an economic response to the peculiar local conditions of Japan. A retail structure in Japan resembling that of the USA, which is dominated by large “superstores,” would waste resources, rather than economizing, as so many have claimed. The complex marketing channels that often include multiples of wholesale steps are corollaries of the ubiquity of stores; when final destinations are more numerous, the efficient logistical artery has more branches. All this is very logical—and we shall explore the logic in a bit more detail—but in pondering Japan's retail structure, government regulations also merit attention.

Regulations restricting the building of new stores having large floor space have long been a fixture of Japanese law, even predating the Pacific War. More recently, Japan's so-called Large Store Law was fingered by US trade negotiators as a “structural impediment” to the sale of US products in Japan. In 1998 this law was repealed, leaving the regulation of store sizes and locations entirely to the prefectural governments. But evidence and reason indicate that the Large Store Law more reflected the structure of Japan's distribution sector

Marketing

than shaped it. Given that small stores are ubiquitous in Japan anyway, for the reasons mentioned above, regulations that protect small stores from competition by large stores imply only small economic distortions and encounter little effective resistance. If small stores had not predominated already, the Large Store Law could not have survived in Japan's political marketplace.

Economics also has a lot to say about the rationale for vertical restraints, and most of it is unsupportive of the conventional view that the ubiquity of these practices in Japan indicates the presence of monopolistic distortions there. Firms bound to one another by vertical restraints—in Japan referred to as “distribution keiretsu”—may run afoul of antimonopoly law, but in fact they are seldom seeking to exploit or perpetuate market power. More usual motivations for customer restrictions, price stipulations, exclusive dealing, and the like are to improve the incentives of firms to promote products, inform customers about products, or maintain the quality of products. The pervasiveness of vertical restraints in Japan may be a sign that marketing there is relatively unconstrained by inappropriate laws and regulations—and to that extent is more economically efficient than elsewhere, not less so.

Structure of Japan's distribution sector

The starting point in understanding the many apparent peculiarities of Japan's marketing system is the myriad of small retail stores there. Anyone who walks along an urban street in Japan for the first time is likely to be struck by the numerousness, smallness, and remarkable degree of specialization of retail shops. Here is a shop, which is little more than a stall, selling mainly shampoo, soap, and other toiletries. Here is another right next to it, the same small size, selling only vegetables. And here is yet another, selling electric appliances of the season—space heaters and the like in winter and electric fans in summer.

In most cities of the United States, zoning laws separate residential and commercial establishments. In Japan, on the contrary, residential dwellings and commercial establishments are interspersed. Many residents of Japan, perhaps

even most, are able to purchase daily necessities by shopping on foot in their own neighborhoods. It is as difficult to imagine daily life in Japan without small and familiar retail stores, where the proprietors are also neighbors, as it is to imagine daily life in the USA without trips to the nearest chain supermarket in the family car. Perhaps this is why cultural explanations for Japan's ubiquity of small stores are so often offered: “The Japanese people have a decided preference for fresh produce, which necessitates daily shopping trips”; “The Japanese people prefer dealing with friends rather than strangers”; and so on, as if other people in the world did not also enjoy fresh produce or congeniality. A more analytic approach is productive here. We begin by describing numbers that bear out the casual impression: Japan does have particularly many retail stores relative to its population.

Density of retail stores in Japan compared with other nations

Table 15.1 details the numbers of stores per thousand persons in Japan and selected other nations, based on censuses of business conducted by the nations' respective governments. The figures exclude eating and drinking establishments, to focus narrowly on “stores.”

Japan has about twice as many stores per person as does the USA, the UK, or Germany. In this respect, Japan, and not the USA, may be unusual. But notice that Greece seems to have even more stores per thousand persons than does Japan. Japan's fragmented retail sector may be peculiar, but is not unique.

The relative ubiquity of stores in Japan is not limited to stores of a particular type. It is characteristic both of stores selling daily necessities like food and toiletries, and of stores selling durable goods like furniture or apparel. The relative ubiquity of retail stores in Japan is pervasive with one glaring exception: department stores. Though Japan has more than four times as many food stores per thousand persons as does the United States, it has only one-fifth as many department stores. This may come as a surprise to anyone who has patronized and admired the upscale, opulent, and seemingly omnipresent Japanese department stores in Osaka, Tokyo, or other major cities of

Table 15.1. Numbers of stores per thousand persons in Japan and selected other nations

Country	Retail stores per 1,000 persons	
	Around 1985 ^a	1990
Japan	14.3 (1982)	13.2
USA	6.1 (1987)	7.9
UK	6.2 (1982)	8.1
France	10.3 (1982)	9.7
Germany	6.6 (1984-5)	8.5
Greece	16.2 (1978)	18.4

^a Excluding eating and drinking establishments.

Sources: 1985 figures: David Flath and Tatsuhiko Nariu, "Is Japan's Retail Sector Truly Distinctive?" *Journal of Comparative Economics*, vol. 23 (1996), pp. 181-91 (primary source: Censuses of commerce of the respective nations); 1990 figures: Dirk Pilat, "Regulation and Performance of the Distribution Sector," *OECD Working Papers*, vol. 5 (1997), table 2.3, p. 19.

Japan. But "department stores" also include the low-end discount stores (any large stores selling a wide array of merchandise are classified as department stores), and these are far less numerous in Japan than in the USA. The reason is regulation.

The Large Store Law

A succession of Japanese laws over the last half-century have imposed bureaucratic obstacles to the establishment of large stores. The Department Store Act of 1937, which was suspended in 1947 and then reinstated in 1956, required approval of the national government (Ministry of Commerce and Industry, prewar/Ministry of International Trade and Industry, post-war) for the opening of a new department store anywhere in Japan. In 1973 the Large Scale Retail Store Law replaced the Department Store Act and made the extent of floor space of proposed stores, rather than the nature of the stores, the criterion for necessitating MITI approval. The cutoffs were 3,000m² in the largest cities and 1,500m² everywhere else; in fact, almost all stores having larger floor space than these had been department stores. In 1978 this law was completely revamped so as to broaden its coverage to include all proposed new stores with floor space above 500m². In May 1998, the Diet replaced the old law with a new one that

places all details of the regulation of large stores under the control of the prefectural governments. Some prefectures may enact more severe restraints on the opening of large stores, and others may remove the restraints altogether.

Prior to 1998, the process of securing MITI approval to open a large store was torturous and, if successful, typically required two years or more to obtain. The process involved hearings before local panels that included owners of existing stores whose businesses would suffer if the particular proposed large store was established. These panels tended either to recommend against MITI approval or else propose restrictions on the hours or days of the week that a new large store could operate. In many cases they proposed onerous requirements, such as the requirement that the large store offer classes in cultural activities such as calligraphy or floral arrangement, at prices that would fail to cover costs. MITI tended to adopt these recommendations and proposals. Consequently, following the adoption of the 1978 amendments to the Large Store Act, the number of applications to open new stores with floor space in excess of 500m² dropped in 1984 to less than 500 applications in all of Japan, a nation of 120 million persons.¹

In 1989, the US government identified the Large Store Law as a "structural impediment" to the sale of US-made consumer products in Japan, and argued in trade negotiations with the government of Japan for a repeal or relaxation of the law. Whatever the merits of the claim that expansion of the number of large stores in Japan would expand commercial opportunities for US businesses, the government of Japan did agree to expedite the process of approving the opening of large stores. But the law remained in force, and the actual numbers of large stores showed little signs of increase. It is too early to know whether the shift from national government control to prefectural government control of the regulation of large stores, enacted in

¹ McCraw and O'Brien offer this fact as evidence of the profound effects of the Large Store Law: Thomas K. McCraw and Patricia A. O'Brien, "Production and Distribution: Competition Policy and Industrial Structure," in Thomas K. McCraw (ed.), *American Versus Japan: A Comparative Study*, Boston: Harvard Business School Press, 1986, ch. 3, pp. 77-116.

Marketing

1998, will matter. At least for now, the Large Store Law remains the essential reason why Japan has far fewer department stores per person than the USA when at the same time it has far more of most other kinds of stores per person.

We will shortly examine the political economy of the Large Store Law, but first we need to understand the basic economics of retail structure and how it applies to Japan.

Economics of retail density

Those who leap to the unwarranted conclusion that a marketing system like Japan's with a ubiquity of stores must be burdened with unnecessary costs—the added costs of maintaining and restocking a multiplicity of small stores as opposed to a few large ones—perhaps overlook the benefits of a proliferation of stores. These benefits reside in the economies on household transport and storage of goods that result from shortening the distance between the representative household and nearest store.

For nondurable daily necessities like groceries and toiletries, lowering the costs of shopping trips induces households to shop more frequently and buy smaller quantities of the goods each time, so they can maintain smaller household inventories and economize on storage space. This describes the basic logic of the *economic order quantity model*, first developed by William Baumol. The model is relatively simple and, because of its wide applicability in economics, is worth learning independently of its application to the present issue. (For example, Baumol applied it to the demand for money.)

Economic order quantity model

Let us presume that a household consumes some good at a continuous rate of q units per week, shopping when its holdings are just exhausted. The household's maximal inventory equals the amount it obtains each time m , and it makes q/m shopping trips per week. Let the household's reorder costs be r per shopping trip, and let its storage costs be k per maximal inventory. Then the household's combined storage and reorder costs are

$$r(q/m) + km.$$

Now the household chooses its reorder quantity m , and by implication its frequency of shopping q/m , so as to minimize its combined storage and reorder costs. That is, it chooses m so that the derivative with respect to m of combined storage and reorder costs equals zero. This leads immediately to the so-called square root rule:

$$m^* = (qr/k)^{1/2}.$$

The optimal reorder quantity is proportionate to the square root of the costs of a single shopping trip and is inversely proportionate to the square root of storage cost per unit of inventory. As storage costs k rise or the costs of a shopping trip r fall, the household reduces the quantity m it obtains on each shopping trip, shopping more frequently and reducing its maximal inventory.

The economic order quantity model is depicted diagrammatically in Figures 15.1(a) and 15.1(b). This model reveals why Japanese households shop more frequently than American households do. Because retail stores are so numerous in Japan, the cost of a single shopping trip is less. And because Japanese households tend to live in small dwellings, household storage space commands a premium, and so a greater frequency of shopping trips is necessary. Furthermore, the economic order quantity model reveals that where household storage costs are high, as in Japan, households derive a greater benefit from a proliferation of stores and are willing to pay a bit more for the added convenience of next-door shopping than if their storage costs were lower.

The household consumes continually at the rate of q units per week, shopping only when its holdings are just exhausted. Maximum holdings exactly equal the amount obtained on each shopping trip. More frequent shopping trips mean that less is obtained on each shopping trip.

Household reorder costs are proportionate to the frequency of shopping trips, which becomes less and less as the amount obtained on each trip is allowed to rise. Household storage costs are proportionate to maximal holdings, which grow *pari passu* with the amount obtained on each shopping trip. The optimal reorder quantity balances the marginal increase in shopping costs and the marginal reduction in storage costs. If the costs of a single shopping trip become less, the optimal

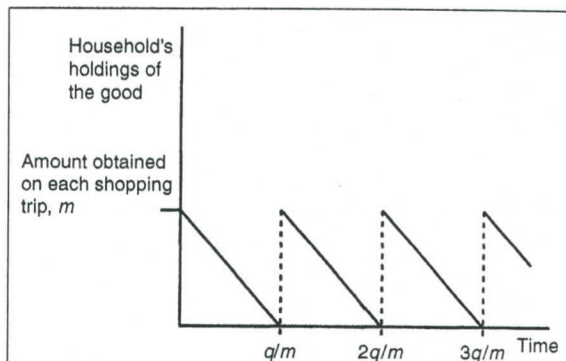


Figure 15.1(a). Economic order quantity model

The household consumes continually at the rate of q units per week, shopping only when its holdings are just exhausted. Maximum holdings exactly equal the amount obtained on each shopping trip. More frequent shopping trips mean that less is obtained on each shopping trip.

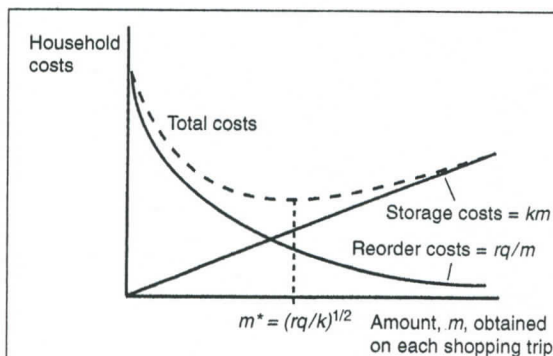


Figure 15.1(b). Economic order quantity model, continued

Household reorder costs are proportionate to the frequency of shopping trips, which becomes less and less as the amount obtained on each trip is allowed to rise. Household storage costs are proportionate to maximal holdings, which grow *pari passu* with the amount obtained on each shopping trip. The optimal reorder quantity balances the marginal increase in shopping costs and the marginal reduction in storage costs. If the costs of a single shopping trip become less, the optimal reorder quantity also becomes less—the household shops more frequently, thereby economizing on storage costs.

reorder quantity also becomes less—the household shops more frequently, thereby economizing on storage costs.

The above paragraph gives us one reason for Japan's ubiquity of stores, but it is not the only

reason. For instance, Japan has not only more stores per person selling daily necessities like groceries, but also relatively more stores selling durables like furniture, appliances, and apparel. Why might that be? To complete the picture we need to look at retail density not only from the point of view of households, but also from that of the distribution sector.

Why are there so many retail stores in Japan?

The proliferation of retail stores benefits households but at the same time raises the logistical costs of the distribution sector itself. It is more costly to restock numerous small stores than a few large ones. To put it a slightly different way, as stores proliferate, some of the burden of transporting goods from point of production to point of consumption are shifted away from households and on to the distribution sector. Just how far such shifting will go, that is just how dense retail outlets will become, depends upon the households' and distribution sector's relative efficiencies at storing and transporting goods. This is because new stores can be profitable only if the added benefits that their presence confers are greater than their costs. As already mentioned, factors like scarcity of living space that raise all households' costs of storing goods lead households to offer higher price premia to retailers who locate closer to their dwellings, which makes a greater profusion of stores profitable. Similarly, factors that lower retailers' costs render it more profitable for them to accommodate households' preferences for shorter shopping trips and increase the profitability of a profusion of stores.

The vast majority of Japan's population resides in the coastal plains of Kanto, Chubu, and Kansai that encompass Tokyo, Nagoya, and Osaka, respectively. Accordingly, the geographic distance between point of production and point of final consumption is typically much less in Japan than in most other developed nations. For this reason, the costs of restocking a multiplicity of retail stores are less in geographically compact Japan than in the vast United States or the expanses of western Europe. Over the decades, Japan has developed a system of roads and rail lines that further lower the costs of maintaining its proliferation of stores. By the 1980s Japan had more commercial vehicles

Marketing

per person than any other nation besides the United States.

Other factors influence retail density in the same basic way as does scarcity of living space and efficiency of distribution sector logistics. For example, if owning and operating a personal vehicle is more expensive, then households will place more value on the convenience of nearby shopping, and proliferation of stores will become more profitable and more likely. Also, population density itself affects the relative profitability of retailer proliferation, independently of any effects it may have on the scarcity value of household (or retailer!) storage space. For if population density is great, any given number of retail stores per person corresponds to a shorter average distance between each household and the nearest store, and the marginal reductions in that average distance caused by the entry of a new store is also correspondingly less. In regions of greater population density, therefore, the benefits to households of store proliferation are smaller and proliferation of stores becomes less profitable and less likely. Japan is more densely inhabited than America or the nations of Western Europe, and on this ground we might expect it to have fewer stores per person rather than more. Sorting out the various influences on Japan's density of retail stores, including the Large Store Law, scarcity of household storage space, geographic centrism, costs of maintaining personal vehicles, and population density, requires careful statistical investigation. Up to now there have been only a few such studies, but their findings support the tentative conclusion that regulation matters less than the other factors just mentioned.

A couple of studies have explored the prefecture-by-prefecture variation within Japan itself in numbers of stores of different kinds. Here population density matters a great deal and in the way we would expect, with Tokyo, the most densely inhabited prefecture, having the least number of stores per person. A similar pattern is evident within the United States, with New York City exhibiting fewer stores per person than most any other city. The author² and Jeroen Potjes³ report statistical regressions in which not only population density, but also household floor space per person and extent of ownership of personal vehicles, significantly influence the number of stores

per person in each prefecture. I also included as an explanatory variable the number of department stores per person in each prefecture. If department stores are relatively less numerous, then the Large Store Law may be presumed to impose more severe constraints on the opening of large stores (almost all of which in Japan are "department stores"). Based on this investigation, prefectures with fewer department stores seem also to have rather more of other stores of various types, including food, liquor, and apparel, all of which are items that Japanese department stores sell in great quantities.

However, the sensitivity of numbers of other stores to prefectural differences in numbers of department stores is far smaller than would need to be the case if Japan's Large Store Law were the main reason for its ubiquity of stores compared with other nations. For instance, the regression equation predicts that, if Japan's number of department stores were to quintuple, its number of food stores would fall by one-fourth. But then Japan would still have more than twice as many food stores as the USA. An international study of retail density bears out the point.

In a recent paper by the author and Nariu Tatsuhiko,⁴ numbers of retail stores per person in each of seventeen nations including Japan and the USA are statistically related to each nation's population density, household floor space per person, the "length" of the country (defined as the square root of its land area), cars per person, and trucks per person—all of which in some way reflect factors that bear on the economic advantages of a retail system that exhibits a ubiquity of stores. And all these factors significantly influence retail density across the nations in the way we would expect. Nor is this all. Japan is not a regression outlier. Rather, its relative ubiquity of stores is correctly predicted on the basis of its small length, relative paucity of household floor space, and

² David Flath, "Why Are There So Many Retail Stores in Japan?" *Japan and the World Economy*, vol. 2 (1991), pp. 365–86.

³ Jeroen C. A. Potjes (1993), *Empirical Studies in Japanese Retailing*, Tinbergen Institute Research Series no. 41, Amsterdam: Thesis Publishers.

⁴ David Flath and Tatsuhiko Nariu, "Is Japan's Retail Sector Truly Distinctive?" *Journal of Comparative Economics*, vol. 23 (1996), pp. 181–91.

superabundance of trucks, controlling for population density, all as suggested at various points in the preceding discussion.

In light of all this, we return attention to Japan's Large Store Law.

Political economy of the Large Store Law

The Large Store Law of Japan and its antecedents have protected small stores there from competition with larger ones. Government regulations in the USA have tended to favor large stores. Local zoning in almost every city in the United States has had the effect of separating residential and commercial activities, which promotes car ownership and favors large stores over smaller ones. Many scholars and others have correctly deplored Japan's Large Store Law as imposing unnecessary constraints on the marketing of goods in Japan, but they may have both exaggerated the extent to which Japan's marketing system reflects the heavy hand of government regulation, and overlooked the extent to which the US marketing system and those of other nations are also influenced by government regulations.

Government policies that transfer income encounter less strenuous political opposition if the deadweight losses they impose are small in relation to the net subsidy.⁵ Given that small stores are ubiquitous in Japan anyway for the reasons mentioned in the previous section, regulations that protect small stores from competition by large stores imply only small economic distortions and encounter little effective resistance. If small stores had not been predominant already, the Large Store Law could not have survived in Japan's political marketplace. Geographic factors in the USA have favored large chain stores, and slanted the political marketplace in favor of regulations that benefit them instead. Government limitations on large stores can survive the give-and-take of political competition in Japan but not in the United States. For local zoning that favors large stores over small ones, the reverse is true. In each case, regulation ends up exaggerating the inherent tendencies rather than fundamentally influencing them.

Given that Japan's ubiquity of stores fundamentally reflects the country's geography, other aspects of Japan's marketing system also appear

logical. In particular, Japan's convoluted marketing channels, which exhibit multiple wholesale steps, are corollaries of its multiplicity of retail stores.

The complexity of wholesale marketing channels in Japan

Wholesalers are middlemen who purchase only to resell, and whose customers are often not final demanders but instead retailers or other wholesalers. Any sensible analysis of wholesaling needs to begin by recognizing that middlemen of all sorts lower the costs of trading rather than adding to them; otherwise they could not charge prices that their customers willingly pay and that cover their own costs. The costs of middlemen are transactions costs by definition; they are costs of activities that are either essential to trade or that facilitate trade. These include the costs of assuring ownership rights, detecting the quality of traded goods, discovering valuable trading opportunities, negotiating mutually agreeable terms, and so on. Those who can perform these services at costs that are lower than the middleman's price spread do so; many cannot. Competition among middlemen forces their price spread (difference between bid price and asking price) to the lowest level that just covers their own costs. In all these respects, wholesaling in Japan surely resembles wholesaling in other nations; but there is one thing about wholesaling in Japan that stands out.

The peculiar thing about wholesaling in Japan is the often large number of separate wholesalers through whose hands goods pass before reaching their ultimate destinations on the shelves of retail stores. One indication of this fact is the large percentage of merchant wholesalers' sales that are to other wholesalers: 41.9 percent for Japan versus 24.8 percent for the United States and 16.2 percent for West Germany (all in 1985-6).⁶ A more precise indication of the numbers of wholesale steps in

⁵ So argues Gary Becker, "A Theory of Competition among Pressure Groups for Political Influence," *Quarterly Journal of Economics*, vol. 98, no. 3 (August 1983), pp. 371-400.

⁶ Takatoshi Ito and M. Maruyama, "Is the Japanese Distribution System Really Inefficient?" in Paul Krugman (ed.), *Trade With Japan: Has the Door Opened Wider?*, University of Chicago Press/NBER, 1991, pp. 149-74.

Marketing

Japan can be constructed from data on the gross markup of retailers' prices over manufacturers' prices and from the average price spreads of all wholesalers. Dividing the total price markup in a wholesale chain by the average price spread of all wholesalers gives an estimate of the number of wholesalers in the chain. The average total price markup in wholesale chains is in fact less in Japan than in the United States: 24 percent of manufacturers' price in Japan versus 35 percent in the USA (again based on 1985 data).⁷ But the average price markup of each wholesaler is also less in Japan than in the USA, so we infer that on average Japanese marketing channels have a greater number of wholesale steps, 1.8 in Japan versus 1.4 in the USA.⁸ If we round these to the nearest integers, we could say that the typical or average marketing channel in Japan includes two wholesalers in sequence while that in the United States includes only one. The commonly held view that wholesale marketing channels are longer or have more steps in Japan than in the USA is thus supported. What are the reasons for this peculiarity?

Japan's multiplicity of wholesale steps reflects its proliferation of retail outlets. Retail businesses like food, liquor, and toiletries that have vastly more outlets per person in Japan than in the USA also tend to have more wholesale steps in Japan.⁹ In thinking about the reasons for this, reflect for a moment on the human circulatory system. The arteries that have many branches before reaching the finest capillaries are far more efficient at delivering oxygen to the body's numerous small cells than would be a system of arteries with few branches leading more directly from heart to each cell. In the same fashion, the simple logistics of transporting goods to multiple destinations dictates the shipment of goods to intermediate collection points in order to exploit the cost savings that arise from consolidating shipments. The post office exploits the same principle in delivering mail. And although, as the post office example indicates, there is no necessity that titular ownership changes hands at the point where goods are delivered to logistical collection points, it is quite natural that goods often do pass from one wholesaler to another at precisely such a point.

One further fact about wholesale marketing channels in Japan is worth iterating. Marketing

channels that have particularly many wholesale steps in Japan are likely also to have relatively many wholesale steps in the United States.¹⁰ For instance, fresh fish, meat, and vegetables all have more wholesale steps than most other kinds of business in both nations. Shoes and apparel have relatively few wholesale steps in both countries. Common forces appear to be operative in the economies of both Japan and America. Marketing channels in Japan and elsewhere reflect the calculated attempts of profit-seeking entrepreneurs to economize on transport costs, to avert spoilage, and to collect and act on information about the local demands for goods. The same is true of other aspects of Japanese marketing channels, including that which we next address, the contractual arrangements among channel members.

Vertical restraints

Manufacturers, wholesalers, and retailers linked to one another by contracts stipulating maximum or minimum resale prices, exclusive dealing, customer assignments, and so on are referred to in Japan as *distribution keiretsu*. Typical examples include the well-known manufacturers of home electronics (Matsushita, Toshiba), cameras (Nikon), cosmetics (Shiseido), and the members of their respective marketing channels. In Japan, as in the United States, antitrust laws proscribe contractual stipulations of the sort just mentioned, which in antitrust law are referred to generically as "vertical restraints." For instance, Japanese anti-monopoly laws explicitly proscribe "unjust" customer restrictions and exclusive dealing stipulations. But there are significant exemptions from Japan's anti-monopoly laws. For instance, in Japan contracts stipulating minimum resale prices for copyrighted works are legal, while in the United States such

⁷ Ibid.

⁸ See table 6-1, p. 86, in Tatsuhiko Nariu and David Flath, "The Complexity of Wholesale Distribution Channels in Japan," in M. Kotabe and M. Czinkota (eds.), *The Japanese Distribution System*, Chicago, Ill.: Probus, 1991, pp. 83-98.

⁹ Ibid., table 6-3, p. 94.

¹⁰ Ibid. Estimates of average numbers of wholesale steps in Japan (and in the USA) are fresh fish, 2.56 (2.27); meat and poultry, 1.68 (1.67); vegetables and fruit, 1.86 (1.73); men's apparel, 1.22 (1.12); shoes, 1.14 (1.31).

contracts have been illegal since 1976. And in any case, the penalties for violating anti-monopoly laws in Japan are largely inconsequential, and the resources devoted to investigating and prosecuting anti-monopoly cases are also small. All this has contributed to the view that vertical restraints remain prevalent in Japan.

We learn of the details of vertical restraints in Japan in the same way as we do for the United States, in the annals of antitrust cases. Economists have devised convincing explanations for many of the US antitrust cases involving vertical restraints, and often these same explanations also fit Japanese cases that exhibit similar patterns. Here, an economic explanation is a logical argument that identifies the basis of profitability of the offending practice and that also accounts for other facts of a particular case, including ones that at first may have seemed unrelated to the practice in question. In other words, the goal is to understand the rationale for practices like vertical restraints, and only secondarily to judge the merits or demerits of laws that proscribe these practices. That said, many of the convincing explanations of specific instances of vertical restraints suggest that, rather than creating and perpetuating contrived scarcities, vertical restraints more often reflect attempts by manufacturers and wholesalers to align the interests of other members of the marketing channel with their own interest, and thereby lower the costs of informing customers about products or the costs of maintaining the quality of products. To make this point, we shall take up several Japanese examples of vertical restraints drawn from anti-monopoly cases there. But first we need to lay out some fundamental considerations common to all sorts of arrangements between manufacturers and the distributors of their products.

Monopolistic manufacturer and independent distributors

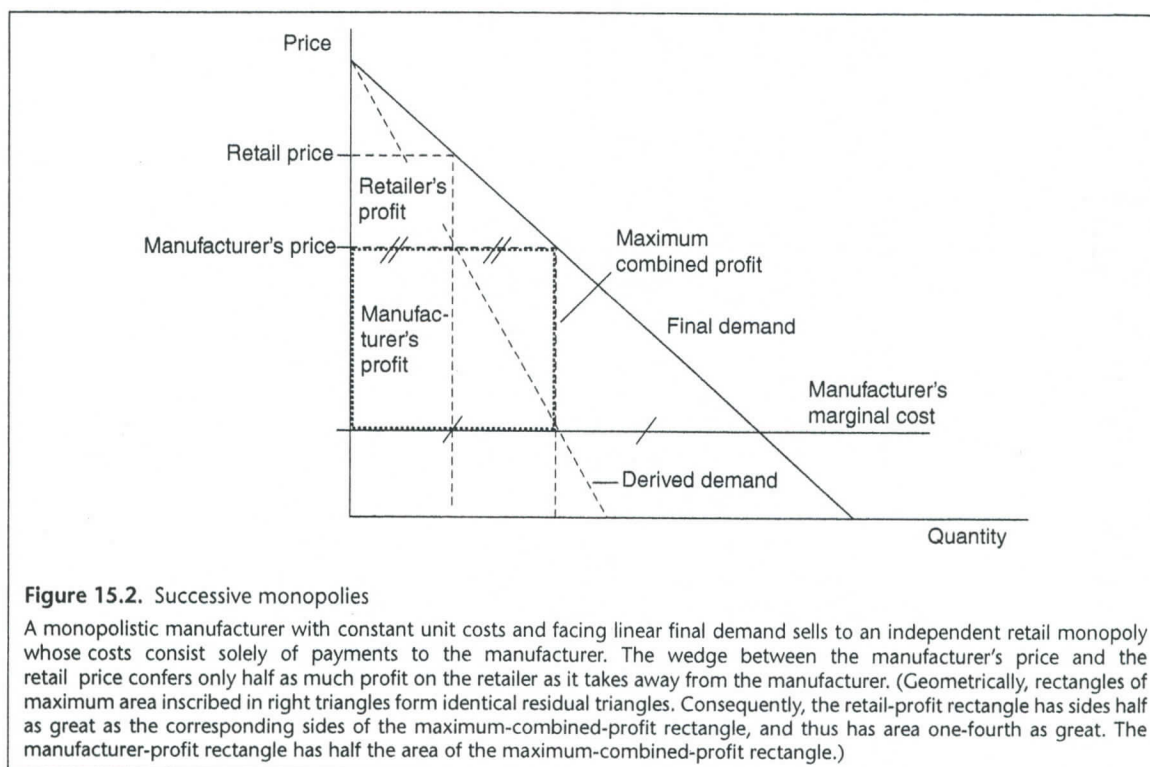
The large manufacturers of consumer goods very typically offer unique products that command a loyal following of customers. Such manufacturers face downward-sloping demand curves; they can continue to make sales even if they raise prices. In this somewhat narrow sense, they are monopolists. They can be expected to set

prices to customers that exceed their own marginal cost. And for this reason, activities such as advertising and quality assurance that push out the demand at each price add to the manufacturer's own profits.

If a monopolistic manufacturer distributes its own products itself, then it can adjust prices, promotional activities, the density of retail outlets, and so on to maximize its own profits. But more commonly, manufacturers prefer not to distribute their own products themselves but instead sell to independent wholesalers or retailers. These independent distributors in turn become responsible for many of the activities affecting the final demand for the products and the quantities ultimately sold. In this situation, the independent distributors in maximizing their own profits will not necessarily make choices that maximize the manufacturer's profit. The simplest illustration of this involves choosing the price.

Suppose that a manufacturer with constant unit costs of producing faces a downward-sloping linear final demand. To keep matters simple, suppose that the manufacturer sells to an independent retail industry whose costs consist solely of its payments to the manufacturer. The manufacturer attains maximum profit only if retail profit is zero, which it will be if competition among retailers forces the price they set all the way down to the same level as the price the manufacturer charges them. But any attenuation of competition among retailers drives a wedge between the manufacturer's price and the retail price that inevitably diminishes the manufacturer's profit by more than the amount by which it enlarges the retailers' profits. For instance, in the extreme case in which the retail industry itself is a monopoly (a perfect cartel for example), it sets a price to final demanders such that it sells exactly half the quantity that would be demanded of it if it were to set the same price as it pays the manufacturer. Recognizing this fact, the manufacturer sets a price that leaves it with profits only half as great as it could realize if it were vertically integrated, and the independent retail monopoly ends up with profits one-fourth as great as this. Figure 15.2 illustrates the geometric logic of these statements.

The conclusion to draw is more general than the geometric example: a monopolistic manufacturer



selling to an independent monopoly distributor will impose constraints on the distributor's pricing or purchases that eliminate or counteract any price wedge and preserve the manufacturer's profit. Examples of such manufacturer-imposed constraints include a resale price ceiling, minimum purchase quantity (sometimes referred to as a sales quota), and imposition of a flat fee followed by marginal cost pricing.

A Japanese example of a manufacturer imposing a maximum resale price to prevent a downstream price wedge from eroding its profit appears in the anti-monopoly case involving Takeya miso.¹¹ (Miso is soybean paste used in Japanese cuisine.) Takeya's miso "monopoly" (its national market share was never higher than about 4 percent but its nearest rival's market share was only 2 percent) was based on its distinctive flavor and reputation for quality supported by television advertising. The distribution channel for Takeya miso encountered a bottleneck at the wholesale level, with only five primary wholesalers in the Kanto area. To prevent these wholesalers from exploiting

Takeya's monopoly, Takeya imposed maximum resale prices on the wholesalers and devoted

¹¹ The legal citation to the case is as follows: KK Takeya, 25 *Shinketsushu* 32 [FTC (recommendation) no. 10, 1978], February, 13, 1979. This refers to the Fair Trade Commission of Japan's published decision (a few paragraphs setting out the basic facts and findings in the case), the tenth decision of 1978, published in vol. 25, p. 32, of *shinketsushu* (lit. "compilation of decisions"). The decision in this case was a "recommendation" decision (*kankoku shinketsu*), which means that the FTC investigated and found a violation of anti-monopoly law and the respondent agreed to take remedial action without recourse to a formal hearing. Other types of decisions include "consent" decisions (*doi shinketsu*), in which the FTC has held a formal hearing and found a violation, and the respondent agreed to take remedial action and not appeal through the courts; and "formal" decision (*sei-shiki shinketsu*), in which the FTC has held a formal hearing and has found either that no violation occurred or else that it did and has issued an order to desist which the respondent may appeal through the courts. Besides the published decision, the Takeya miso case is also discussed in a slightly more expansive manner in an article authored by a staffer of the FTC, in *Kosei torihiki*, the monthly publication of the Fair Trade Commission of Japan: M. Izumisawa, "KK Takeya no kosoku joken tsuki torihiki ni kan suru dokkin ho no mondai ten" (anti-monopoly law issues pertaining to Takeya Co.'s attachment of restrictive conditions to its transactions), *Kosei torihiki*, no. 342 (1979), pp. 54-7.

extensive effort to enforcing the stipulation, including resorting to an elaborate system of record-keeping, circuitous methods of payment, and detailed assignments of retailers to specific wholesalers, and of secondary wholesalers to specific primary wholesalers. The FTC found Takeya's price ceiling to violate anti-monopoly laws and ordered it to withdraw the stipulation. Takeya complied, and in the months following the decision in the case Takeya's production fell about 4 percent while that of the nine other largest Miso producers either rose slightly or remained the same. That is, Takeya produced more output when it was imposing price ceilings on wholesalers than when it was not imposing price ceilings, just as we would expect. The basic logic of a monopolistic manufacturer's arrangements with independent distributors, clearly evident in the Takeya case, forms an essential starting point in understanding more complicated cases, including those involving manufacturer-imposed price floors.

A monopolistic manufacturer with constant unit costs and facing linear final demand sells to an independent retail monopoly whose costs consist solely of payments to the manufacturer. The wedge between the manufacturer's price and the retail price confers only half as much profit on the retailer as it takes away from the manufacturer. (Geometrically, rectangles of maximum area inscribed in right triangles form identical residual triangles. Consequently, the retail-profit rectangle has sides half as great as the corresponding sides of the maximum-combined-profit rectangle, and thus has area one-fourth as great. The manufacturer's profit rectangle has half the area of the maximum-combined-profit rectangle.)

Resale price maintenance

Resale price maintenance (RPM) refers to retailers' agreement with a manufacturer (or wholesaler) not to resell the products of a manufacturer at prices below some stipulated level—a manufacturer-imposed price floor. Such a price floor would on first thought seem counter to the manufacturer's own self-interest. If distributors set higher prices then they face a smaller quantity demanded and, in turn, they themselves buy smaller quantities from the manufacturer, which erodes rather than

enlarges the manufacturer's profits. And in fact, the impetus for minimum retail price stipulations occasionally comes not from a manufacturer, but from retailers.¹² But such instances are rare indeed. More commonly, resale price maintenance is either part of a collusive conspiracy among two or more manufacturers (or wholesalers), or else is intended to improve retailers' incentives to promote the products.

RPM as a device for cartelization

Competing suppliers who collude with one another to raise their own prices and enlarge their joint profit face a cheating problem. Any one of them attains greater profits for itself if it secretly lowers price and expands sales; but this reduces the profits of the other conspirators by more than it adds to the profits of the chiseller. Sophisticated colluders will therefore establish mechanisms for preventing one another from secretly lowering prices, so that price discounting induces swift retaliation and is effectively discouraged. Resale price maintenance has occasionally served as such a mechanism. Retail prices are easier to monitor than wholesale prices or manufacturer prices. Collusive schemes that assign each retailer to only one supplier and stipulate minimum retail prices are likely to succeed because secret price discounts to retailers become ineffective at expanding sales when retailers are prevented either from lowering their prices or from substituting products of one supplier for that of others. (They each handle the products of only one supplier.)

Resale price maintenance has been a central component in only a few collusive schemes exposed over the years by Japan's Fair Trade Commission. These include attempts at cartelization by the Tokyo wholesalers of the products of the leading producer of stationery, by the Tokyo suppliers and wholesalers of automotive replacement glass, and by the producers of infant powdered milk. In each of these cases, competing suppliers acted in concert to stipulate minimum

¹² For instance, in California in the 1930s an association of retail druggists coerced toothpaste suppliers into enforcing retail price stipulations. Pepsident resisted and was confronted with a boycott by the association. The courts found the boycott to be illegal.

Marketing

retail prices and assigned each retailer to a single supplier.

In the case involving stationery,¹³ in September 1964 the fourteen Tokyo wholesalers of Kokuyo KK, the leading producer of stationery with a 17 percent market share, formed an association known as the Kokuyo Association (Kokuyo Kai) and agreed to assignments of each retailer to only one wholesaler and to a schedule of retail prices and wholesale prices. In October 1966 the FTC found these arrangements to violate Japan's anti-monopoly law and the Kokuyo Association agreed to desist from the offending practices. One curious feature of this case is that it represents an attempt to cartelize the Tokyo wholesale market for the products of only one producer, which demonstrates that a firm need not hold a 100 percent market share to be a monopoly in the economic sense. Also note that, had the cartel of wholesalers succeeded, it would have diminished the profits of Kokuyo, the original producer. Perhaps the swift response of the FTC reflects Kokuyo's influence in the case.

In the auto glass case,¹⁴ the ten secondary manufacturers of glass for automotive repairs acted in concert in 1965 to establish minimum prices at the fifty-eight Tokyo retail outlets for such glass, and made elaborate customer assignments which involved primary and secondary wholesalers as well as the retailers. This cartel, if successful, would have been harmful to the interests of the three primary manufacturers of automotive glass in Japan who were the suppliers of raw materials to the secondary manufacturers. Just as in the Kokuyo Kai case, the FTC acted quickly to nip the cartel in the bud.

The powdered milk cases¹⁵ are the only cases involving RPM ever to be appealed to the Supreme Court of Japan, and are generally regarded as establishing the *per se* illegality of RPM except where explicitly exempted from Japan's anti-monopoly laws. We should hasten to add that the exemptions are significant (they include all copyrighted works); and, because penalties for violating anti-monopoly laws in Japan are so small, the laws seem to be widely flouted anyway.

The facts of the powdered milk cases are as follows. Beginning in 1963 and 1964, essentially all the leading producers of infant formula acted in

concert to stipulate retail prices, assign each wholesaler to only one producer, and assign retailers to wholesalers. The producers closely monitored these arrangements and each instituted elaborate systems of rebates to wholesalers contingent on their complying with the various stipulations. The producers instigated these arrangements by acting through their sales subsidiaries, and, when this was found to violate anti-monopoly law, acted directly to perpetuate the same practices, which were again found to violate anti-monopoly law. At about the same time these practices occurred, the top executives of the same producers of infant formula conspired to form a monopsony in the purchase of raw milk, which was also found to violate anti-monopoly law.¹⁶ One curious item pertinent to this case is the much more recent unraveling of a price-fixing conspiracy involving some US producers of infant powdered milk.¹⁷ Coincidence? Or is there some

¹³ Tokyo Kokuyo Kai, 14 *Shinketsushu* 46 [FTC (recommendation) no. 14, 1966], October 27, 1966.

¹⁴ KK Ishizuka tokushu gurasu seisakujo hoka shuri jidosha gurasu seizo mata wa hanbai gyosha 15-mei oyobi Tokyo-to jidosha gurasu bukai ni tai suru ken (Case against Tokyo Auto Glass Association, Ishizuka KK Specialty Glass Works, and [9] other makers of glass for automotive repairs and [6] wholesalers) KK, 14 *Shinketsushu* 79 [FTC (recommendation) no. 7, 1972], June 30, 1972.

¹⁵ There were two series of related cases involving essentially all the leading producers of infant powdered milk. The first series involved the sales subsidiaries of Morinaga, Meiji, and Sankyo and resulted in formal decisions against all of the companies which were upheld on appeal (by two of the three) to the Tokyo High Court and the Supreme Court of Japan: Meiji Shoji KK, 15 *Shinketsushu* 67 [FTC (decision) no. 1 1966], October 11, 1968, affirmed on second appeal (*jokoku*), 29 *Minshu* 951 (Sup. Ct. 2d P.B., July 11, 1975); and Wakodo KK, 15 *Shinketsushu* 84 [FTC (decision) No. 3, 1966], October 11, 1968, affirmed on second appeal (*jokoku*) 29 *minshu* 888 (Sup. Ct. 1st P.B., July 10, 1975). The second series of cases involved the continuation of the same offending practices as in the earlier cases, only by the parent companies: Yuki Jirushi Nyugyo KK, 24 *Shinketsushu* 65 [FTC (decision) no. 2, 1974], November 28, 1977. Meiji Nyugyo KK, 24 *Shinketsushu* 86 [FTC (decision) no. 3, 1974], November 24, 1977. Morinaga Nyugyo KK, 24 *Shinketsushu* 106 [FTC (decision) no. 4, 1974], November 28, 1977.

¹⁶ Yuki Jirushi KK hoka gyunyu seizo gyosha 4-mei ni tai suru ken (Case against Yuki Jirushi KK, and four other makers of drinking milk), 21 *Shinketsushu* 30 [FTC (consent) no. 18, 1974], May 22, 1974.

¹⁷ In June 1992 the FTC charged Abbott Laboratories, Mead Johnson & Co., and American Home Products with collusion and price fixing in the sale of infant formula. These and related cases filed by various state attorney generals eventually led to consent decrees involving the payment of substantial penalties by the companies.

generic property of the market for infant powdered milk that induces attempts at cartelization? For reasons of protecting public health, the governments of Japan, the United States, and other nations restrict entry in the production of infant formula. Whatever the merits of these policies, and they may be considerable, the government restrictions enlarge the reward to successful cartelization by assuring that profits will not quickly be competed away by new entrants. For this reason, the infant powdered milk industries of Japan and the United States were both more likely than other industries in the two nations to nurture price-fixing conspiracies.

Cases in which RPM occupies a central place in a cartel scheme are few in number in both Japan and elsewhere. Interesting as these cases may be, they are exceptional. There are many more instances of record in which manufacturers have stipulated minimum resale prices not as part of collusive conspiracies in concert with rivals, but individually, in attempts to encourage retailer efforts at promoting their own products. These too have run afoul of antitrust laws, and not only in the USA but in Japan as well.

RPM and retailers' incentives to provide special services

The fundamental logic of retailer provision of presale demonstrations, "special services," was first articulated in a famous article by the economist Lester Telser.¹⁸ Telser argued that manufacturers will often desire that presale demonstrations be given because some customers who would otherwise not buy the product at all will do so if they are given a presale demonstration of the product. But retailers cannot recover the costs of the demonstrations if they must compete in price with free-riding rivals who avoid giving demonstrations themselves but attract customers who have seen the demonstrations elsewhere. In this instance retailers will eventually stop providing the demonstrations. If however the manufacturer maintains a minimum retail price sufficiently above the wholesale price to compensate retailers for the costs of providing demonstrations, then retailers find that they can attract customers and be profitable only if they provide the demonstrations. (Customers will buy from the retailer who pro-

vided them with the presale demonstration if his price is not greater than that of his rivals.) Resale price maintenance can therefore induce retailers to provide presale demonstrations. This argument is most compelling for products that are somewhat complicated or unfamiliar, or for which there exist many optional features or gradations of quality and so on. Japanese examples for which the argument seems to fit well include antitrust cases involving Matsushita, Nikon, and France Bed, involving cameras, electric appliances, and furniture, respectively.

France Bed KK, a major producer of beds in Japan (40 percent market share in 1974), sold directly to 2,525 independent retailers which it organized into a formal association consisting of three hierarchical categories. The most exalted of the three categories was reserved for retailers with the largest and most diverse sales of France Bed products. Most of these sold France Bed products exclusively. Around 1965 France Bed began to insist that all of its retailers adhere to suggested retail prices which France Bed advertised to customers. Nevertheless, some retailers persisted in price discounting, and France Bed seemed to regard this as a problem. Why? The special services argument fits this case perfectly. Price discounting tended to erode the incentives of retailers to maintain showrooms with display pieces. By price discounting, retailers could attract customers who examined the beds at other outlets and could themselves avoid the considerable costs of maintaining showrooms. Unless price discounting was curbed, eventually few if any retailers would find it profitable to maintain showrooms, damaging the business prospects of the entire chain as well as eroding France Bed's own profits. It is rather clear that these arrangements can have had nothing to do with cartelization of the retailers, as this would have been counter to France Bed's own self-interest, and it was France Bed rather than the retailers that instigated the scheme. Nevertheless, the FTC found

¹⁸ Lester Telser, "Why Should Manufacturers Want Fair Trade?" *Journal of Law and Economics*, vol. 3 (1960), pp. 86-105. (Re the odd title: manufacturer-imposed minimum retail prices have sometimes been referred to as "fair trade" prices.)

Marketing

these arrangements to violate anti-monopoly laws.¹⁹

The Nikon case²⁰ resembles the France Bed case in essential respects, except that the products were cameras and camera lenses and the special services consisted not of maintaining showrooms, but rather of employing knowledgeable salesmen to demonstrate the products and answer customer's queries. In fact, Nikon had been officially authorized to practice resale price maintenance in the sale of cameras, but this authorization was withdrawn in 1966. Nikon continued its price maintenance even after 1966. Nippon Kogaku Kogyo KK (Nikon) sold its products in Japan through four designated wholesalers who in turn sold to 1,200 retailers in 1972. The retailers were designated by Nikon as belonging to one of three categories: "Nikon stores," "Nikon outlets," or "Nikon apprentices." The "stores" tended to have greater sales and in turn received more support from Nikon. Just as in the Takeya miso case, Nikon sought to prevent wholesalers from raising prices and eroding its own profits, imposing price ceilings on the wholesalers. But, as in the France Bed case, Nikon also sought to maintain retail prices to make it less profitable for retailers to refrain from sales promotion activities and attract customers who had obtained product demonstrations from other retailers. Further, Nikon prevailed on wholesalers to assist it in enforcing minimum retail price stipulations, introduced a system of rebates to retailers and wholesalers contingent on their observance of its policies, and assigned each retailer to a specific wholesaler. Nikon dispatched monitors to discover instances of retail sales of Nikon products below stipulated minimum prices. Repeated instances of price discounting were understood to result in discontinuance of shipments. Nikon can have had no desire to cartelize the wholesaling or retailing of its products, as this would have eroded its own profits. These arrangements were clearly meant to encourage more extensive efforts by retailers at promoting its products and to prevent wholesalers from introducing a price wedge. Nevertheless, in June 1974, the FTC found Nikon's practices to violate anti-monopoly laws.

The Matsushita case²¹ differs from the Nikon case only in the much greater number of retailers

and wholesalers involved. Matsushita Denki KK was in 1965 the largest producer of home electronic products such as televisions, radios, vacuum cleaners, refrigerators, fans, and heaters, with a roughly 20 percent market share of each. It sold these products under the "National" brand name through a network of 180 wholesalers and 30,000 retailers. Beginning in 1964, it introduced a system of minimum retail prices which wholesalers were held responsible for enforcing. To make it easier to monitor wholesalers' compliance with these stipulations, Matsushita assigned each wholesaler an exclusive geographic territory, and to prevent a wholesale-retail price wedge from eroding its own profits, it also stipulated (maximum) wholesale prices. Matsushita's motivation for stipulating minimum retail prices was to encourage presale demonstrations by retailers, not to cartelize wholesalers and retailers. Nevertheless, the FTC found Matsushita's practices to violate Japan's antimonopoly laws.

The France Bed, Nikon, and Matsushita cases expose some features of Japan's distribution keiretsu usually hidden from public view. In spite of the FTC findings of illegality in these instances and others like them, the anti-monopoly laws of Japan pose few significant obstacles to the activities of distribution keiretsu. This is because resources devoted to enforcement of the laws are quite limited and penalties for violations are inconsequential. On the basis of the examples just discussed, to the extent that manufacturers of consumer products in Japan persist in illegally maintaining retail prices, they are likely to attain lower costs of marketing, which results in improved resource allocation. Careful consideration of instances of customer assignment and exclusive dealing stipulations support analogous conclusions.

¹⁹ France Bed KK, 22 *Shinketsushu* 127 [FTC (recommendation) no. 2, 1976], February 20, 1976. For additional facts regarding this case, see Y. Tazaki, "Beddo hanbai ni kan suru saihanbai kakaku iji oyobi senbaiten seido" (Exclusive outlets and resale price maintenance in the sale of beds), *Kosel Torihiki*, no. 305 (1976), pp. 28-31.

²⁰ Nihon Kogaku Kogyo KK, 19 *Shinketsushu* 25 [FTC (recommendation) no. 7, 1972], June 30, 1972.

²¹ Matsushita Denki Sangyo KK, 17 *Shinketsushu* 187 [FTC (consent) no. 4, 1967], March 12, 1971.

Customer assignments/exclusive territories/ exclusive agency

In both the Nikon and the Matsushita cases, the manufacturer assigned each retailer to a specific wholesaler, in effect conferring on each wholesaler a virtual monopoly in sales of the product to the retailers assigned to it. The reason in both instances was to facilitate manufacturers' monitoring of wholesalers' arrangements with retailers, not to cartelize the wholesalers. Other examples of customer assignment are motivated by the desire on the part of manufacturers to align the interests of distributors of their products with their own interests. And as in the Nikon and Matsushita cases, these customer assignments are invariably accompanied by additional stipulations such as price ceilings or sales quotas, intended to prevent distributors from exploiting their monopolies in ways that are detrimental to the manufacturer. A Japanese example is the Yakult case.²²

KK Yakuruto Honsha (Yakult) owned a valuable patent on the process for making a yoghurt drink. It produced the undiluted liquid for this drink and sold it to licensees, who diluted it, put it in bottles carrying the Yakult trademark, and sold the drink to retailers. Yakult assigned exclusive geographic territories to the bottlers and also specified their sales quantities to the retailers. The problem that Yakult sought to address with these arrangements was the following. If bottlers were permitted to sell to the same customers, then their incentives to maintain quality would be attenuated. For in that case, costly efforts by any one bottler to maintain quality would result in enhanced future sales of rival bottlers and thus would not have been undertaken for optimal investment in quality: bottlers selling in the same territory would tend to dilute the drinks, cutting their own costs but diminishing future demand facing not only themselves but rivals. Yakult assigned exclusive territories to the bottlers to prevent this problem from arising.

Further Japanese examples of customer assignment include the many instances in which foreign manufacturers have each assigned a single Japanese importer the exclusive rights to sell their products within Japan. Foreign cosmetics, foreign beer and liquor, and many other branded

consumer products have been introduced into Japan under such exclusive agency contracts, disallowing "parallel imports" by non-designated agents. Why would foreign manufacturers want to create independent, downstream, Japan-based monopolies in the distribution of their products? A sole importer, one that is a Japan-wide monopolist in the sale of a particular foreign brand of merchandise, may have a better incentive to act on private information in setting order quantities, or a better incentive to manage marketing channels appropriately so as to assure optimal promotion efforts, than would a competitive industry of importers.²³ This may account for some examples of sole agency contracts between foreign manufacturers and distributors in Japan. For instance, in spring 1995, unauthorized parallel imports of foreign cosmetics, sold through discount department stores in Japan, greatly lowered the retail prices of the products but also made it impossible for the designated Japanese importer to maintain the extensive network of point-of-sale product demonstration and promotion (special services) that it, and the manufacturers, had apparently considered to be essential to the successful marketing of the products. The end result of the parallel imports was probably to constrict sales of the products rather than expand them.

Exclusive dealing

Manufacturers occasionally stipulate that retailers of their products must not handle rivals' products. In particular, they do this when they intend to assist retailers in their selling efforts and wish to assure that the benefits redound on themselves rather than on rivals. For example, Gakken, the leading Japanese publisher of educational materials and encyclopedias, insisted that independent salesmen of its educational books and magazines deal with it exclusively, in order that the sales

²² KK Yakuruto Honsha, 13 *Shinketsushu* 72 [FTC (recommendation) no. 19, 1965], September 13, 1965.

²³ Rey and Tirole explore the incentive effects of exclusive agency stipulations: Patrick Rey and Jean Tirole, "The Logic of Vertical Restraints," *American Economic Review*, vol. 76 (1986), pp. 221-33.

Marketing

leads it provided not be used by the salesmen to benefit rivals.²⁴

The leads were generated from subscriber lists and responses to tear-out cards in Gakken's many related educational publications. In other words, Gakken had incurred significant costs in gathering leads and would have been less inclined to incur such costs if its returns from these activities had been diminished. Nevertheless, the FTC found that Gakken's exclusive dealing stipulations violated anti-monopoly laws.

Antitrust rules pertaining to exclusive dealing, not only in Japan but also in the United States, reflect a preoccupation with the possibility that exclusive dealing stipulations might foreclose entry. But in fact, foreclosure is unlikely to be the motivation for exclusive dealing stipulations. Customers would typically not agree to stipulations that conferred monopoly on an incumbent supplier unless compensated in advance for the likely future reduction in their own gains from trade that would result from monopoly pricing; but, because monopoly pricing reduces customers' gains from trade more than it adds to the monopolist's profits, the compensation required before the customers will consent to foreclosing stipulations exceeds what the incumbent supplier is willing to pay. Clever economists have constructed two exceptions to this argument. The first exception, due to Rasmusen, Ramseyer, and Wiley,²⁵ holds that, where entry is unprofitable unless some minimum efficient scale is assured, the incumbent supplier need not obtain the consent of all its customers in order to blockade entry. In this instance, exclusive dealing stipulations can be profitable for the monopolist. The second exception, due to Aghion and Bolton,²⁶ resides in the fact that, if an incumbent monopolist can join with its customers and levy fees on new entrants, they may profit from doing so, and if they do not know entrants' costs exactly they may inadvertently but unavoidably set fees that blockade efficient entry. Nobody has so far demonstrated that either qualification corresponds to actual cases of exclusive dealing. For instance, Gakken itself faced rivals; it was not an incumbent monopolist as these qualifications require.

In a recent complaint, Kodak, a US manufacturer of photographic film, alleged that its leading

Japanese rival Fuji had foreclosed it from some marketing channels in Japan by entering exclusive dealing arrangements with wholesalers. The US government presented Kodak's complaint to the World Trade Organization, which ruled in December 1997 that the charges were without merit. This case awaits further study by economists before a definitive explanation may be offered.

Manufacturer acceptance of returns

Our final example of a special arrangement between the manufacturer of a product and downstream distributors of it is the practice, common in Japan, of the manufacturer accepting returns of unsold merchandise. The practice is widely noted as pertaining to books, magazines, wearing apparel, cosmetics, and electric appliances. The returned merchandise is, for the most part, not damaged or defective but merely unsold, yet after its return the manufacturers typically destroy it; they do not hold it in inventory for sale at a later time. To understand this practice, one should first note that it has the effect of placing a floor under the resale price, for no retailer will sell merchandise at a discount below the price it can receive from the manufacturer if it returns the items. Manufacturer acceptance of returns, in this way, resembles resale price maintenance and can have a similar motivation; it might simply be one way of administering RPM. But there is an additional aspect to manufacturer acceptance of returns. It can be part of an optimal price-setting policy under conditions of demand uncertainty.²⁷

²⁴ For a parallel example in the USA involving the sale of hearing aids through independent exclusive sales agents, see Howard Marvel, "Hearing Aides," in R. N. Lafferty, R. H. Lande, and J. Kirkwood (eds.), *Impact Evaluations of Federal Trade Commission Vertical Restraints Cases*, Washington, DC: Bureau of Economics, Federal Trade Commission, 1984, pp. 270-385.

²⁵ Eric Rasmusen, J. Mark Ramseyer, and John S. Wiley Jr, "Naked Exclusion," *American Economic Review* (December 1991), pp. 1137-45.

²⁶ Phillippe Aghion and Patrick Bolton, "Contracts as a Barrier to Entry," *American Economic Review* (1987), pp. 388-401.

²⁷ David Flath and T. Nariu, "Returns Policy in the Japanese Marketing System," *Journal of the Japanese and International Economies*, vol. 3 (1989), pp. 49-63.

A manufacturer that must produce before learning the true state of demand will want to disallow sales at prices below the level consistent with maximum total receipts even if it leaves some items unsold. It will generally be possible to sell the entire production run by allowing the price to fall, but it won't be worth it if the discount on merchandise that could have been sold at a higher price subtracts more from sales revenue than the larger quantity sold adds to it. By accepting returns of unsold merchandise, the manufacturer can prevent this kind of corrosive price discounting. A manufacturer-stipulated minimum resale price can, in principle, achieve the same result, but it will be difficult to enforce, for it requires that retailers fully absorb the losses attending their unsold merchandise.²⁸ The rationales for RPM discussed earlier in the chapter, including the special services argument, do not presume that retailers will order more merchandise than they can actually sell at the stipulated resale price and so do not give rise to this kind of enforcement problem.

This explanation for manufacturer acceptance of returns—that it is to forestall revenue-reducing price discounts—is most persuasive for products that are easily returnable, are subject to demand uncertainty, and have distinctive attributes. Good examples are magazines, newspapers, books, and cosmetic jewelry, and all of them are marketed with liberal return privileges, not only in Japan, but also in the USA and elsewhere. If, as often suggested, the acceptance of returns is more common in Japan than elsewhere, the reason is likely to be found in the greater uncertainty in predicting demand at each of the numerous retail outlets.²⁹

Conclusion

Japan's distribution system, though frequently labeled "inefficient," manifestly is not. Japan's frag-

mented and complex distribution sector is uniquely suited to its own particular geography. The scarcity of living space in Japan, and the inconvenience there of owning and operating a car, enhance Japanese households' willingness to pay for the added convenience of next-door shopping. And Japan's geographic centrality and highly developed transport system lower the costs of a distribution sector that accommodates this preference, a distribution sector having a proliferation of retail outlets that must be continually restocked through complex logistical arteries. These factors combine to make a proliferation of stores in Japan not only inevitable, but desirable. And, given this, regulations such as the Large Store Law that protect small stores from competition by large ones imply only minor economic distortions and encounter little effective political resistance. The Large Store Law more reflected than shaped the structure of Japan's distribution sector.

Also, manufacturers in Japan have been free to enter contractual arrangements with wholesale and retail distributors of their products little encumbered by the anti-monopoly laws which are weakly enforced. Vertical restraints, including minimum retail price stipulations, customer assignments, and exclusive dealing, have all been used by manufacturers in Japan to provide distributors with appropriate incentives or to otherwise lower the costs of marketing products. Tougher antitrust rules or penalties effectively discouraging Japanese firms from imposing vertical restraints would distort resource allocation, not improve it.

²⁸ Nevertheless, Deneckere *et al.* offer this as a possible explanation for RPM: see Raymond Deneckere, Howard P. Marvel, and James Peck, "Demand Uncertainty and Price Maintenance: Markdowns as Destructive Competition," *American Economic Review*, vol. 87, no. 4 (September 1997), pp. 619–41.

²⁹ For an elaboration of this view, see Howard P. Marvel and James Peck, "Demand Uncertainty and Returns Policies," *International Economic Review*, vol. 36, no. 3 (August 1995), pp. 691–714.

FURTHER READING

- David Flath, "Regulation, Distribution Efficiency, and Retail Density," ch. 5 in Magnus Blomström, Jennifer Corbett, Fumio Hayashi, and Anil Kashyap (eds.), *Structural Impediments to Growth in Japan*, Chicago: University of Chicago Press, 2003, pp. 129–54. Revalidates previous research and explores the effects of motorization, suburbanization, and 1998 repeal of the Large Store Law.
- David Flath, "Vertical Restraints in Japan," *Japan and the World Economy*, vol. 1 (1989), pp. 187–203. Discusses selected anti-monopoly cases of Japan including the ones described in this chapter.
- David Flath, "Why Are There So Many Retail Stores in Japan?" *Japan and the World Economy*, vol. 2 (1990), pp. 365–86. More on the ubiquity of retail stores in Japan.
- David Flath and Tatsuhiko Nariu, "Is Japan's Retail Sector Truly Distinctive?" *Journal of Comparative Economics*, vol. 23 (1996), pp. 181–91. Answers the title's question in the negative.
- Maruyama Masayoshi, Sakai Kyohei, Togawa Yoko, Sakamoto Nobuo, Yamashita Michio, Arakawa Masaharu, and Ijo Hiroyuki, "Nihon no ryūtsū shisutemu: riron to jissō" (The distribution system of Japan: theory and empirics), *Keizai bunseki*, vol. 123 (May 1991). Japanese economists analyze the nation's distribution system.
- Nariu Tatsuhiko, *Ryūtsū no keizai riron* (The economic theory of marketing), Nagoya: Nagoya Daigaku shuppankai, 1994. Theoretical and econometric analysis of Japanese marketing channels by a leading expert on the topic.