Implications of Buyer Power and Private Labels on “Vertical Competition” and Innovation

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Background: Buyer power in (grocery) retailing

- High and growing concentration in many European markets (e.g., CR5 in Germany > 75%)
  - and notably also among non-discounters.

- Spread of private labels (in many markets > 30%)
  - and their changing role.
Vertical competition over functions

Changing role of retailers?

• Typically, economists have either ignored retailing or viewed it just as a bridge between manufacturers and consumers.
• This view disguises the increasing role that retailers play across all functions, such as *distribution*, *advertising*, *certification of quality* … *and innovation*.

Questions for competition policy

• Is vertical competition functioning well? Or does the exercise of retailer market/buyer power lead to inefficiencies?
• Do other enforcement policies (e.g., of RPM) distort vertical competition?
Changing role of private labels in Germany

Market shares: Brands vs. private labels
Changing role of private labels in Germany II

Market shares in organic food and beverages

![Chart showing market shares in organic food and beverages from 2007 to 2012. The chart indicates a consistent increase in private labels (orange) and a decrease in national brands (dark blue) over the years.]
A formal analysis of competition over innovation I

- Key decision variable: Investment to innovate.

- **Model 1:** One manufacturer – one retailer
  
  *I find that as the retailer’s size allows also the retailer to undertake the innovation, retailer investment can inefficiently crowd out manufacturer innovation.* Essential for this is the retailer’s **gate-keeping function**.

  Precisely:

  1. Large retailer has (relatively) too high incentives to invest ("rent appropriation motive").
  2. Manufacturer has (relatively) too low incentives to invest ("hold-up problem").

  **Note:** *Inefficiency further exacerbated by threat of retailer imitation (in case of manufacturer innovation).*
Illustration of results of Model 1:

- Joint profits from innovation $\Delta$.
- Investment costs higher if retailer undertakes innovation: $I_R > I_M$.
- If manufacturer invests, must still agree with “gatekeeping” retailer: Manufacturer’s share of the net surplus $\alpha$.

Result

\[
\begin{align*}
\alpha &= 0 & \text{Retailer invests} & \text{Manufacturer invests} & \text{Retailer invests} \\
\text{Hold - up} & & \text{Rent appropriation}
\end{align*}
\]
**Model 2:** Retailer competition. One large, several small retailers.

- **Finding 1:** Potential for inefficient duplication.
- **Finding 2:** “Innovation waterbed effect”.
  - Large retailer investment reduces manufacturer incentives to innovate.
  - Small retailers have no access to innovation.
  - Reduction of competition and further retail consolidation.

**Note:** *Large retailer incentive to strategically pre-empt manufacturer innovation.*
• Results of conceptual work:
  • Potential for inefficient shift of functions (in vertical competition) from brand manufacturers to large retailers.
  • Source 1: Gatekeeping leads to “rent appropriation” and “hold up”.
  • Source 2: “Waterbed effect”.

• Sufficient grounds to warrant interference ?
  → Possibly only additional effect in “buyer power trade-off”.

• More generally, supports creating *level playing field* for vertical competition, rather than distorting vertical competition – as accomplished by strict enforcement of RPM ?
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