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Rules on Retailer- Supplier Relationships in the Competition Policy of the Russian Federation: How and Why Misunderstanding Economics Threatens the Competitiveness of the Sector

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Rules on Retailer-Supplier Relationships in the Competition Policy of the Russian Federation: How and Why Misunderstanding Economics Threatens the Competitiveness of the Sector

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*If it seems to you that life becomes better
It means something hasn't been counted*

I. INTRODUCTION

The Law ‘On Trade,’ adopted in the Russian Federation at the end of 2009, introduced a set of rules that regulate the terms of contracts between food suppliers and retail chains. The legal requirements are very different to any regulations employed in other countries (including the Grocery Supply Code of Practice (“GSCOP”) in the United Kingdom) but, at the same time, they use many concepts developed by economics and expressed both in competition policy and antitrust legislation. The new rules are being actively enforced by the Russian competition agency and provide a significant impact on contracting practices in retailing. At the same time results of many surveys as well as expert estimates show that the proclaimed goal of the law—that is, the redistribution of surplus in the supplier-retailer relationship in favor of the supplier—has not been achieved.

Without discussing in detail the possibility of achieving the desired state of affairs in the contractual relationships in retailing we concentrate on one of the possible explanations for market participants’ dissatisfaction with the results of the law’s implementation. The law’s requirements are based on assuming that terms and conditions common in retailer-supplier contracts, such as discounts, slotting allowances, and marketing fees, as well as variations in contract terms between suppliers, represent an abuse of bargaining power by retail chains that should be illegal. We develop a theoretical framework to show how restrictions on contract terms not only generate an excessive administrative burden on market participants but also undermine a successful cooperation between suppliers and retailers.

II. LEGAL REQUIREMENTS FOR CONTRACTS BETWEEN SUPPLIERS AND RETAILERS IN RUSSIA

Since 2006 terms of contracts in the Russian Federation between grocery chains and their suppliers have been considered as an area where specific regulation should be introduced in order to support manufacturers vis-à-vis food retail chains. Discussions in the Russian

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government interpreted payments made by suppliers as pure deductions from their revenue. Efficiency reasons for using different types of slotting allowances, including strong promotion effects, were completely ignored.² These efforts were finalized in the Federal law “On Main Provisions for State Regulation of Trading Activity” (“law ‘On Trade’”) that passed the Parliament RF in 2009 and came into force at the beginning of 2010. These legal requirements cover all grocery retail chains in Russia.

The law envisages two important types of provisions: the first one is intended to adjust the market structure and the second establishes terms for contractual arrangements between food suppliers and food retail chains. As an example of the first type, the law prohibits further expansion of a food retail chain if its share in the geographical market has reached 25 percent. As an example of the second type, the law prohibits specific terms of contractual arrangements between food suppliers and food retail chains.

Comparing this group of provisions with those imposed by the GSCOP shows that instead of an emphasis on allocating bargaining power and prohibitions against abusing bargaining powers *ex post*, rules imposed by the law ‘On Trade’ emphasize prohibiting certain contract terms *ex ante*. Along with similar (as compared with GSCOP) provisions (no delay in payments, no obligations of suppliers to contribute to marketing costs, no payment of supplier for shrinkages, no compensation by suppliers of retailer’s forecasting errors) law ‘On Trade’ also contains unique ones. It is prohibited to require any slotting allowance (either up-front or follow-up) as a part of delivery contract. It is prohibited to request and receive from a supplier a quantity discount exceeding 10 percent of the wholesale price. It is also prohibited to require any most-favored nation clause in the supply contract.

Two general provisions are a prohibition on the conditions under which a supplier can be discriminated against by a food retail chain and vice versa, and any imposition of unfavorable contract terms to the counterparty. On the other hand, law ‘On Trade’ does not impose the list of requirements that the GSCOP does—for instance, a requirement against changes of supply procedures or any retrospective variation of contract terms.

Both types of provisions are known in the Russian legal system as “anti-monopoly” rules in spite of the fact that they actually represent sector-specific regulations. There are two explanations for such a classification. The first one is that, for public rhetoric, the most important goal of adopting the law is to protect domestic manufacturers by reducing entry barriers into the market and promoting competition. The second is the fact that compliance with the law is supervised by the Russian competition authority, the Federal Antitrust Service (“FAS”), and its regional offices.

III. ENFORCEMENT OF LEGAL REQUIREMENTS AND FURTHER DEVELOPMENT OF THE RULES

Law ‘On Trade’ can be enforced both privately (an injured party may file a complaint with the competition authority or directly appeal to court) and publicly. The latter means that the competition authority can inspect the compliance of a contract’s terms with the requirements of the law and make decisions and issue remedies using the results of the inspection. In 2010, just

² B. Klein & J.D. Wright, *The Economics of Slotting Contracts*, 50(3) J. L. & ECON 421-454 (2007).

after the adoption of the Law, about 25 percent of all the retail chains in Russia were inspected. In half of the cases inspections found more or less serious non-compliance with the law's requirements. In 2010 about 10,000 contracts were inspected, the year after this number grew to 15,000.³ Over time, understanding the prohibited practices has changed; after 2010 a list of written clarifications was issued by the FAS.

Decisions of arbitration courts (arbitration courts of first instance, appeal arbitration courts, and arbitration courts of Russian Federation—cassation instance) provide important and very often different explanations of contractual arrangements. The most important concepts applied to the interpretation of the law's requirements are *discrimination* and *imposition of unfair contract terms* (III.A). By interpreting the nature of the allegation we can discover important features of the 'ideal state of affairs' presumed by legal requirements (III.B). And we discuss the fact that there is no consensus on the viability of the law requirements, not only among economists, but also among lawyers in Russia and, specifically, among judges in the courts (III.C).

A. Discrimination And Imposition of Unfair Contract Terms

The decisions of the competition authority regarding discrimination have been very broad. Actions interpreted as discrimination include different levels of wholesale prices for the suppliers of the same category group, different levels of retail margins, different periods of payment delays, different quantity rebates or different schemes of quantity rebates, equal prices of promotional services for suppliers of different goods, marketing fees calculated as a percentage of the volume supplied, and different rates of marketing fees for different suppliers have all been interpreted as discrimination. In general, Russian competition authorities tend to consider discrimination as pure variation in contract terms with different suppliers. One special type of indictment in discrimination looks at the discrimination of suppliers as compared with grocery retail chains (as in inequitable terms of contract).

When grocery retail chains are accused of discrimination, their opportunity to *impose unfavorable contract terms* on a counterparty is presumed. In the special Guidelines for Entrepreneurs in the grocery sector, the competition authority clarified the meaning of *imposition* in the following way:

Imposition is an inclusion of terms unprofitable for the counterparty in a contract on conditions that these terms are challenged by counterparty, but initiator of the contract refuses or evades the approval and adoption of the proposals of the counterparty.

It is evident that prohibitions on discrimination and/or imposition of unfavorable contract terms introduce hard restrictions on contractual arrangements in the sector. Versions of discrimination and the imposition of unfavorable contractual terms are examples of Type I errors in rule-setting, which lead to over-enforcement of competition provisions in the sector.

For economists the important questions are:

³ V. RADAEV, KTO VYIGRAL OT PRINYATIYA ZAKONA O TORGOVLE (IN PRESS, 2012).

- What is the conceptual framework needed to understand contractual relationships in the sector which would justify the necessity of introducing such strict regulations; and
- How to assess the effects of regulations introduced by market participants and possibly explain these effects.

B. On The Actual and Ideal State of Affairs in Supplier-Retailer Relationships

The Law's provisions are based on the concept of an unrestricted bargaining power of food retail chains. Despite the fact that the Law does not contain any notion of "dominance," this was the most popular word used in public discussions to identify the position of grocery retail chains in Russia. The expression of dominance in the context of the manufacturers-retailers relationship significantly differs from the standard understanding of this concept. Dominance of a grocery chain is not a result of high market share and/or high entry costs. The term "dominance" just identifies the ability of grocery chains to govern the value chain in the sector⁴ by setting business standards and exerting substantial influences on the competitiveness of the supplier's product. The authors of the law said that this ability of the grocery chains is not only not useful, but also potentially dangerous for suppliers, because the grocery chains appropriate a disproportionately high share of the sector's value created thereby imposing harm on manufacturers.

A redistribution of value from the manufacturers to grocery retailers could be restrained by imposing obligations on the retailers to enter into highly standardized contracts with the suppliers. In general, enforcing the law reflects the idea that the best way to prevent abuse of bargaining power by retail chains is to limit their discretion regarding contract terms.

In this framework grocery chains would provide to manufacturers a standard service of "intermediation" between suppliers and final consumers. The "justified price" of this service should be equal for all the manufacturers. The manufacturer (and the competition authority) could verify that the price of an intermediary service was, in fact, justified by calculating it as a difference between the retail and wholesale price of the good. All types of slotting allowances and marketing fees would be considered simply as an additional charge on suppliers. In essence, retailers would be put in the same position as regulated operators in the network industry, which should provide interconnection or access service at an equal price to every person that satisfies technical and safety requirements. Any deviation from standard contract terms would be considered as undoubtedly harmful and therefore illegal.

For this to work, the competition authority would need to issue a list of comments which contain the idea that any "artificial" complication of contract terms could be considered as evidence of concealed discriminatory conditions.

To conclude, the perception of reality that supports the Law On trade is significantly distorted:

⁴ Understanding "governance" as according to R Kaplinsky & M. Morris, *Handbook for Value Chain Research*, Institute of Development Studies (2012), available at: <http://oro.open.ac.uk/5861/> (accessed 12 June 2012); G. Gereffi, J. Humphrey, & T. Sturgeon, *The Governance of Global Value Chains*, 12(1) REV. INT'L POL. ECON., 78-104 (2005).

- On the one hand it reflects the changing roles of grocery chains under the developing model of retail trade, their growing impact on the standards in the sector, and the performance of the manufacturers and their growing bargaining power; but
- On the other hand it considers the new rule of grocery chains almost completely as a threat of an expropriation of the surplus created in the sector from the manufacturers and completely ignores the positive effects of contracts between retailers and manufacturers (including slotting allowances and marketing fees) on the performance of the latter.⁵

Not only is the public perception of contracting practices distorted, but this is also true for a competition authority which tries to correct contractual practices by the means of regulatory intervention. Any complications in interpreting certain case peculiarities are ignored.

In this respect the competition authority seems too self-confident; considering itself, for instance, able to make a judgment on discrimination in the very flexible and unstable environment of food retailing, in spite of the fact that even in regulated industries the meaning of discrimination is not crystal clear.⁶

Moreover, the competition authority considers it possible to develop in Russia a model of organization in retailing completely different from those models developed in the rest of the world. All the negative effects of enforcement errors are also neglected. We consider these issues to be very important, keeping in mind the large scale of enforcement.

C. Discussions on Discrimination and the Ability to Impose Contract Terms in the Courts

Fortunately, when a food retail chain accused of discrimination appeals in an arbitration court, the courts often reverse the decisions of competition authorities. Of nine cases on discrimination by food retail chains where final decisions were made during 2011, there is only one where the arbitration and/or appeal court supported the judgment of competition authority.⁷

The point expressed by the judges on issues of discrimination is much more in line with the economic understanding of the problem. In many cases court decisions emphasized that conclusions on discrimination could not be made using only the evidence of contract term variations. Differences in contract terms should be compared with the variation of the goods supplied by different manufacturers in the same product line, variation of the consumer's assessment of the good supplied, and also differences in business reputation and contract discipline of suppliers. This idea was detailed by Judge O. Boyko in the case of *Tander company*

⁵ Klein & Wright, *supra* note 2; J.D. Wright, *Slotting Contracts and Consumer Welfare*, 74(2) ANTITRUST L.J. 439-472 (2007); M. Corstjens & R. Steele R., *An international empirical analysis of the performance of manufacturers and retailers*. (15) J. RETAILING & CONSUMER SERVICES 224-236 (2008); G. Martín-Herrán & S.P. Sigué, *Prices, promotions, and channel profitability: Was the conventional wisdom mistaken?* 211(2) EUR. J. OPERATIONAL RESEARCH 415-425 (2011).

⁶ R. Pittman, *Russian railways reform and the problem of non-discriminatory access to infrastructure*, 75(2) ANNALS OF PUBLIC & COOPERATIVE ECON., 167-192 (2004).

⁷ S. Avdasheva & V. Novikov, *Lisa i Zhuravl': paradoksy diskriminatsiyi*, KONKURENTSIYA I PRAVO, 1: 22-27 (*in Russian*) (2012).

(trademark “Magnit,” the second largest retail chain in Russia) accused of discriminating against buckwheat suppliers:

Pure difference in terms of payment in itself is not discrimination of other suppliers. [To make a conclusion of discrimination] it is necessary to provide complex analysis of all other terms and conditions in the contract, since one term that could seem advantageous may be compensated by other conditions... One cannot speak about providing the advantage to certain supplier without careful study of other contract terms and also without the analysis of the market in order to make conclusion on the impact of certain condition of the performance of competing suppliers.⁸

So courts have maintained that a difference in contract terms may be identified as discrimination only in the case when products and manufacturers as business partners are absolutely equivalent, and, further, that contract terms should be assessed only in complex cases. However, courts cannot go as far as economists can and conclude that prohibiting contract term variations ignores the difference between manufacturers, their marketing strategies, and the impacts on *formally equal* contract terms on their performance. We return to this issue later, in section IV.C.

IV. ASSESSING THE EFFECTS OF LAW ENFORCEMENT

Evaluating the effects of law enforcement, first we turn to adaptation strategies and the assessment of law expressed in the surveys by market participants, retailers (IV.A), and manufacturers (IV.B). Then we analyze the possible negative effects from legal requirements—using the example of standardized contract terms (IV.C) and especially the model of enforcement envisaged by the law (IV.D)

A. Retailers: ‘Adaptation’ to New Regulation

Many decisions of the competition authority regarding the illegality of contract terms were declined by the arbitration courts—including the courts of first instance, appeal, and causation instance. However, in many cases the food retail chains preferred not to appeal and simply adjusted contractual terms with their suppliers in order to comply with the new requirements.

This adaptation is not without cost. Relevant costs include costs of compliance and costs of contracting under new requirements. Costs of compliance are not negligible. According to Dmitry Daugavet, who is one of most competent Russian economists in the field of competition policy in the sector, the largest grocery chains in St. Petersburg delivered hard copies of requested information on contracts to the competition authority literally by trucks.⁹ Data origination and preparation also take time.

We think, however, that the costs of contracting under the new requirements are much higher than the costs of formal compliance. Before the law, slotting allowances, marketing fees, and all the form of discounts (rebates) were completely legal in Russian retailing. The Law made

⁸ Decision on the case № A79-742/2011 by Arbitration Court of the Republic of Chuvashiya.

⁹ D. Daugavet, *Ryноchnaya vlast’ setey; chto izmenil Zakon o torgovle*, EKONOMICHESKAYA POLITIKA 4: 80-95 (in Russian) (2011).

them suspicious if not completely illegal (like quantity rebates exceeding 10 percent of wholesale price). In order to avoid administrative investigations many market participants have converted the same contract terms to an extra-legal form. Daugavet gives the example when a grocery chains says to a supplier: “To sign a supply contract please find or establish a legal person which would pay your allowances [since you cannot pay them legally].”¹⁰ This kind of arrangement is costly not only for suppliers (who are intended to be protected) but also for retailers, since it substantially increases agency costs within the company. When product line managers are supposed to perform not only legal activities but also organize “shadow” contracts it definitely increases the monitoring costs within the firm. In any case, a transition from legal to illegal forms of business activity imposes additional costs on business units.¹¹

Another source of adaptation costs for retailers are the restricted opportunities to find new suppliers of a good. In order to avoid being accused of discrimination, contracts with new suppliers are supposed to contain exactly the same terms as contracts with all other suppliers. The possible effects of this legal requirement was explicitly stressed by the 7th Arbitration Appeal Court of the Russian Federation:

[If the rules on discrimination would be applied in this way] the goal of contracting becomes not the mutually beneficial cooperation but the search of counterparty ready to conclude a contract on the same terms as all other suppliers.¹²

B. Suppliers: Apparent Dissatisfaction

It is not clear whether food suppliers have received any benefits from the enforcement of the law: preliminary evidence suggests they have not. According to the results of a survey of 512 retailers and suppliers conducted in five Russian urban areas in 2010,¹³ every fourth retailer considered that, after the law was enacted, contract requirements increased for large suppliers; every seventh agreed that this was true for even small suppliers. Assessment by manufacturers was identical: every fourth agreed that large chain stores have tightened requirements and about every seventh agreed with this statement for small chain stores.¹⁴ As far as specific contract terms (price discounts, payment delays, slotting allowances, marketing fees, and penalties) are concerned, the majority of manufacturers and retailers mentioned no change in business practice.¹⁵

In 2011, Ernst and Young issued a report on the food and beverage industry in Russia for 2010, containing the results of a survey of 31 food producers (including foreign and Russian undertakings). In this survey companies were asked whether the terms of contractual relationships with retail chains since 2010 (when the law came into force) had improved or deteriorated. More than 75 percent of respondents indicated that they remained the same and

¹⁰ *Id.*

¹¹ DE SOTO, *THE OTHER PATH; THE INVISIBLE REVOLUTION IN THE THIRD WORLD* (1989).

¹² Decision on the case № 07АП-5857/11 by 7th Arbitration Appeal Court of the Russian Federation.

¹³ Radaev, *supra* note 3.

¹⁴ V. Radaev, *Where Does the Demand for Regulation Come From? The State's Return to the Retail Trade in Russia*, HSE Basic Research Program Working Paper Series: Sociology, WP BRP 02/SOC/2011, at 19 (2011) available at: http://www.hse.ru/org/hse/wp/prepfr_SOC (accessed June 12, 2012).

¹⁵ Radaev, *Id.*

said they did not feel any improvements but only changes in the form of contractual terms. A small group (7 percent) indicated that contractual terms had even deteriorated. The same number of respondents mentioned improvements in contract terms.¹⁶

The dissatisfaction of suppliers should be explained. At first glance the introduction of rules intended to support domestic manufactures *vis-à-vis* grocery retailers should not deteriorate their performance and the suppliers should only be dissatisfied with the under-enforcement or formal enforcement of the law. This dissatisfaction with formal enforcement has taken place. According to Daugavet, enforcement has concentrated on the formal requirements and, in many cases, it has been unable to prevent the imposition of harm on suppliers when retailers formally comply with the law and, in many cases, non-compliance has not imposed any harm.¹⁷ However, in our opinion the problem is even more serious: *formally accurate* enforcement of the Law can not only provides *no positive impact for manufacturers*, it can also provide a *negative impact*. This is the “cobra effect.”

To demonstrate, we will consider the impact of the rule (using the example of the non-discrimination rule) on the performance of suppliers based on diversity of their types (IV.C) and the impact of the incentive to complain regarding the cooperation between manufacturers and retailers (IV.D).

C. Ban on Discrimination: The Fox and Crane Story

The dissatisfaction of the manufacturers may be caused by the changes in business practices inspired by a desire to comply with the requirements of law as they are interpreted by the competition agency. When the suppliers are of diverse types, non-discriminatory (that is uniform) terms of contract impose harm at least on one group. Take the example of shelf payment (slotting allowance). Under non-discriminatory requirements the competitiveness of small and, especially, new suppliers decreases since contracting with this group becomes less attractive for grocery chains as they cannot pay them less if they do not want to be accused of discrimination and, of course, they cannot pay them exactly as much as they pay to incumbent suppliers with developed brand names. As a result, compliance with law requirements restricts competition in the sector, instead of promoting it.

Paying slotting fees compensates the retailer for the shelf space that induces profitable incremental supplier sales. Klein & Wright concentrate on the advantage of slotting fees in comparison with the decrease of wholesale prices by supplier.¹⁸ At the same time, slotting fees can also compensate for different incremental profits resulting from the retail sales of different manufacturers' products that are in the same category group. Higher slotting fees can compensate for lower retail margin and/or lower demand for the given product.

Bans on slotting fees and on discrimination in slotting payments result in suppliers with lower incremental profits being unable to obtain shelf space even if they were able to do so using

¹⁶ Ernst and Young, 2011. *Obzor pishchevoy priomyshlennosti, 2010 god* [online]. Available from: [http://www.ey.com/Publication/vwLUAssets/Food-and-Beverage-survey-2010-RU/\\$FILE/Food-and-Beverage-survey-2010-RU.pdf](http://www.ey.com/Publication/vwLUAssets/Food-and-Beverage-survey-2010-RU/$FILE/Food-and-Beverage-survey-2010-RU.pdf) (accessed 12 June 2012).

¹⁷ Daugavet, *supra* note 8.

¹⁸ Klein & Wright, *supra* note 2.

slotting payments higher than those of their competitors. Competition for shelf space becomes more complicated because of the asymmetry between suppliers: for the new supplier and/or supplier of a non-branded product the retailer can underestimate consumer demand in comparison with the supplier of branded product with a good reputation. In this respect, higher slotting fees could be an important way to obtain shelf space for the new suppliers and reflect, for instance, the different assessment of demand by manufacturer and retailer.

If a ban on slotting payments (including those in the form of payments for the right to supply in new supermarket stores and/or payments for marketing services (especially popular in Russian retailing)) or a discrimination in slotting fees restrict the shelf space available for new suppliers and/or suppliers of non-branded products, they also limit profits of this sub-group of suppliers, including the expected profit of potential entrants. As a result, certain groups of suppliers leave the market, and the number of suppliers entering the market decreases.

In this context, a ban on slotting fees restricts competition among suppliers.¹⁹ As final consumers make the choice between products of a smaller number of manufacturers, demand for every product remaining on the shelf increases. A corresponding increase of incremental profit for the manufacturer from these retail sales allows the retailer to raise slotting fees for suppliers remaining on the supermarket's shelf. A decrease of the number of suppliers of the food product, an increase of the concentration of suppliers of food products, and increasing slotting fees have to be evidence of lessening competition among manufacturers. In this setting, rising fees of large and/or brand-name product suppliers don't reflect the increase of bargaining power (or market power) of retail chains but the rather weakening of competition in the wholesale market.

The conclusion that uniform contract terms may impose harm on at least one contract counter party is not new and is supported by more than just economics. Avoiding discrimination under very strict interpretation reminds us of the classic Aesop fable, *Fox and Crane*. When Fox invited Crane to dinner and served him from a flat dish, and when Crane, in turn, invited Fox to eat from a pitcher with a high neck, nobody was discriminated against under the standards of Law 'On Trade' requirements (at least how they are understood by competition authority); however, both suffered damage as they were unable to satisfy their hunger. Neglecting the difference between Fox and Crane dissatisfied both, including the one we wanted to protect.

D. Cooperation Between Retailers and Suppliers Threatened

One result of law enforcement that attracts less attention is its impact on the prospects of cooperation between suppliers and retailers. Proponents of the law proved that it could prevent conflicts between contracting parties and/or establish framework for contract resolution. But almost nobody asked whether suppliers and retailers needed any special conflict resolution rules. Surveys by Vadim Radaev²⁰ discovered that conflicts between suppliers and retailers are not so frequent as could be supposed, and when a disagreement takes place both sides are ready to make a concession, not only manufacturers but also retailers. The Law 'On trade' changed the toolkit of

¹⁹ Avdasheva S., Shastitko A. (2011). Russian Anti-trust Policy: Power of Enforcement versus Quality of Rules. *Post-Communist Economics*, 23 (4), 493-505.

²⁰ V. Radaev, *Komu prinadlezhit vlast na potrebitel'skikh rynkah*. Moskva, Izdatel'skiy Dom VSHE (2011).

conflict resolution for suppliers by vesting them with a right to complain of the harm imposed by the retailers to the competition authority.

Till now there are relatively few examples when Russian manufacturers complained of contract terms with retail chains followed by an accusatory decision from the competition authority. The most well-known are complaints of several bread manufacturers regarding the contract terms imposed by *Auchan* (obligations of manufacturer to finance special promotions). Complaints of fish producing companies against *Metro Cash and Carry* (marketing fee as percentage of volume supplied) is a second one. However, enforcement statistics reported that the number of complaints has increased.²¹ In 2011, compared to 2010, the number of complaints tripled from 74 to 209. Most of the complaints by suppliers are even less justified than the decisions of competition authorities. Two of the three inspections initiated by the competition authority detected violations, but inspection initiated by suppliers' complaints has revealed violations only in every seventh case.

For the retailers every complaint may induce additional costs of administrative investigation, and/or a legal proceeding with an unknown outcome. An increasing number of complaints signals the possible abuse of the law by suppliers and decreases the incentive for manufacturers to contract with new suppliers who don't have the reputation of being a reliable partner ready to solve business conflicts without the intermediation of competition authority and courts. For existing partners, threats of abuse of the law undermine cooperation between several groups of market participants.

The problem described so far might be presented in terms of a strategic interaction of supplier and retail chain. Simplifying the general scheme of suppliers and retailers interactions in terms of results we present a game where each player has two basic opportunities: (1) to cooperate on the creation and distribution of a quasi-rent flow based on special technologies of sales promotion (Cooperate) or (2) to exploit being a counter-agent by implementing the strategy of "pulling the blanket over" (Exploit).

Let's take the following matrix as the starting point:

| | | Retailer (R) | |
|--------------|---------------|---------------|-------------|
| | | Cooperate (C) | Exploit (E) |
| Supplier (S) | Cooperate (C) | $A_1; B_1$ | $A_2; B_2$ |
| | Exploit (E) | $A_3; B_3$ | $A_4; B_4$ |

Fig 1. Cooperation may not be established

If the payoff matrix structure has the properties: $A_3 > A_1 > A_4 > A_2$; $B_2 > B_1 > B_4 > B_3$ then the Prisoners' Dilemma arises. There are several ways to resolve the Prisoners' Dilemma but we consider only one of them: enforcement of the rule supporting cooperation and preventing exploitation.

²¹ Radaev, *supra* note 3.

In case of a non-infinite horizon for players there are grounds for the emergence of a third party (which might be the state) as an enforcer in the sense that: a) relocation to square one represents Pareto-improvement; and b) such a relocation is not feasible just by the players themselves because of the improbability of the development of evolutionally stable strategies in the context of multi-shot games with a fixed number of participants.

Is, however, the existence of the above-mentioned ratios sufficient to draw a conclusion that the state is essential for one-shot (of finite) games between certain players?

A third-party enforcer causes changes to the payoff matrix:

| | | Retailer | |
|--------------|---------------|--------------------------------------|----------------------------------------------|
| | | C | E |
| Supplier (S) | Cooperate (C) | $A_1 - 0,5T ; B_1 - 0,5T$ | $A_2 - 0,5T + Z$ $B_2 - 0,5T - Y$ |
| | Exploit (E) | $A_3 - 0,5T - Y$ $B_3 - 0,5T + Z$ | $A_4 - 0,5T - Y + Z$ $B_4 - 0,5T - Y + Z$ |

Fig 2. Cooperation be established due to sanctions and compensation of harm imposed

A violator’s backset resulting from sanctions Y and a non-breaching party’s advancement caused by compensations Z (together with decrease of the gains of the parties who are paying for services of enforcer T divided between them in equal proportions) are prerequisite for such a change of the payoff matrix structure that would relocate the Pareto-optimal Nash equilibrium to square one. Relocation of the equilibrium to square one depends on the size of the sanctions, which, according to Becker, have a deterrence effect, thus making it *unfavorable* for each actor to violate the existing rules in a situation when the counterpart abides the rules.

Both the issue of the size of the sanctions (minimum and maximum) and that of the actor applying such sanctions should be considered with due account of this important fact: a sanction is a double-edged tool, which can turn from a weapon of defense into a weapon of attack and become an example of a right to defense abuse. That is why it is important to take into account the size of compensations (which don’t necessarily have to be positive due to the risk of abuse of rights). We will have to make a specific stipulation further when discussing enforcer-entailed discrimination.

If the sanctions and compensations effects are not taken into account, the price of the services of the state, even if it means direct expenditures for the enforcer’s services, still can level the outcome of the initial game against Pareto-inefficient equilibrium. From this point of view, it is still debatable which strategy is better: ‘bellum omnium contra omnes’ or ‘Leviathan’. *Protection of rights can be efficient in terms of punishing the violator (error-free) but not*

necessarily from the point of view of the restoration of the rights violated, which have a quantitative evaluation in the form of the compensation received.²² Moreover—and this is crucial—saving on law-enforcement related costs only seems to enable a painless transition to such a combination of strategies that implies law abidance by all the participants of economic exchanges.

Till now we have assumed that the state's action of enforcing rules that prevent exploitation does not create any errors. However, introducing the probability of legal errors (especially Type I errors) substantially changes the role of the state in the game. For the sake of convenience, let's assume that Type I errors in the rules enforcement mean punishing a law-abiding player, and Type II errors mean lack of punishment for a violator, while Type I errors in the rules establishment mean falsely set prohibitions, and Type II errors mean lack thereof (in the situation when they can be set).

Assume that Type I and Type II error probabilities are greater than zero but less than one. The simplest assumption that is used here is that these probabilities are the same for all the players.

| | | Retailer (R) | |
|--------------|---------------|----------------------------------------------------------------------------------|----------------------------------------------------------------------------------|
| | | C | E |
| Supplier (S) | Cooperate (C) | $A_1 - 0,5T - \rho_1(Y - Z)$ $B_1 - 0,5T - \rho_1(Y - Z)$ | $A_2 - 0,5T + (1 - \rho_2)Z - \rho_1Y$ $B_2 - 0,5T - (1 - \rho_2)Y + \rho_1Z$ |
| | Exploit (E) | $A_3 - 0,5T - (1 - \rho_2)Y + \rho_1Z$ $B_3 - 0,5T + (1 - \rho_2)Z - \rho_1Y$ | $A_4 - 0,5T - (1 - \rho_2)(Y - Z)$ $A_4 - 0,5T - (1 - \rho_2)(Y - Z)$ |

Fig. 3. Under the positive probabilities of Type I and Type II errors cooperation may not be established even it was possible without state intervention

Intuitively speaking, the higher the probabilities of Type I and Type II errors, the more reason to claim that the “violation strategy” can become dominant for each of the players, even if *direct costs* related to the state's law enforcement services aren't too big. Detailed analysis is presented in Shastitko.²³

In case Type I and Type II probabilities are zero; threshold value of the difference between the agents' payoffs is: $(A_1 + B_1) - (A_4 + B_4) = T$. Otherwise, it is: $(A_1 + B_1) - (A_4 + B_4) = T + 2\rho_1(Y - Z)$, which is a more restricting condition for the players choosing cooperation. The results indicates that Type I errors are more important from the point of view of worsening equilibrium properties and their worsening coordination effects are due to dissipation of quasi-rent available for distribution.

²² Strictly speaking, a mediated compensation is possible if the size of the sanctions weakens a player's bargaining power and is irreversible, yet that is a different game altogether.

²³ A. Shastitko, *Errors of I and II Types in Economic Exchanges with Third Party Enforcement*. (10) J. NEW ECON. ASSOC. 125-148 (in Russian) (2011); A. Shastitko, *The rule of law economics: the cost of guarantors' services and enforcement errors*, 42(4) SOC. SCIENCES 3-19 (2011).

The framework developed illustrates one very simple but important idea. In some cases, enforcing the rules that charge the party in the contract exploiting the other party can support cooperation. However the necessary condition is the ability to identify “exploitation” in any given case. When the enforcer punishes the innocent (making a Type I error) it decreases the incentive for cooperation and, in some cases, prevents cooperation even it was possible without state intervention. That is why T in the case is only part of, and even not most interesting part, in this story.

V. CONCLUSIONS

The experience of the enforcement of the Law On Trade in Russian Federation, though short and incomplete, provides a basis for several important conclusions. First, legal rules on contracting between suppliers and food retailers are specific to the sector. Exactly for this reason they provide unique possibilities to study the opportunities and limitations of competition policy. Two years after the law came into force we can say more about limitations than about opportunities.

Second, regulations introduced to date try to apply antitrust concepts and procedures of antitrust enforcement not in order to protect competition, but in order to support a certain group of market participants. The most important concepts in the law applied in the cases against large retailers—*discrimination* and *imposition of unfavorable conditions*—are borrowed from competition law but interpreted and supported by the viewpoint of the target group (domestic manufacturers). Interpretations of *illegal* discrimination and *illegal* imposition of unfavorable condition, in general, are based on a poor understanding of the economics of supplier-retailer relationships.

Third, results of the law’s enforcement are also strongly implicative. One policy implication is that adoption of rules that are based on a misunderstanding of economics may lead both to unsuccessful enforcement and negative effects on behavior. Introducing rules that are hard to apply even as a rule of access to a [relatively] standardized service of network operator for a sector where transactions are complex represents excessive self-confidence.

Finally, there is an implication for competition policy about the danger of rules that presume that one party of the contract (in our case, the retailer) is not only able but also interested in imposing harm on the counterparty. This notion not only contradicts the reality of interdependence in any business but also induces widespread *abuse of law*. Abuse of law, in turn, increases the probability of Type I errors in enforcement and, finally, in some cases prevents legal and cooperative behavior even when it may be possible without any enforcement. In this context, if we cannot assure low probabilities of legal errors in enforcement, even the target group may be dissatisfied with the enforcement results.