

Title: The Expanded Economics of Free-Riding: How Exclusive Dealing Prevents Free-Riding and Creates Undivided Loyalty

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ABSTRACT

This article presents an expanded economic analysis of the potential procompetitive purposes served by exclusive dealing. Using examples taken from important antitrust cases, exclusive dealing is shown to be an efficient element in the arrangements manufacturers adopt with their dealers to induce dealers to supply increased promotion. We describe two common circumstances where dealers have an incentive not to provide the increased promotion for which the manufacturer has compensated them. First of all, dealers may use the increased promotional efforts that have been purchased by the manufacturer to switch consumers to other products on which they can earn greater profit; and secondly, dealers may fail to supply the increased promotion paid for by the manufacturer. Exclusive dealing is shown to mitigate both of these types of dealer free-riding, which are distinct from the type of free-riding examined in the standard economic and antitrust analysis of exclusive dealing where dealers use manufacturer-provided investments to sell rival brands. Exclusive dealing is shown to prevent dealers from using their promotional efforts that have been paid for by the manufacturer to sell alternative brands even when manufacturers have not made any investments that dealers may use to sell rival products. Exclusive dealing also decreases the incentive of dealers to supply less promotion than the manufacturer has paid for by creating dealers with “undivided loyalty” who therefore have an increased independent economic incentive to more actively promote the manufacturer’s products. Although an undivided dealer loyalty rationale has been accepted by some courts as a procompetitive motivation for exclusive dealing, it has been rejected in the economics literature, and recently also rejected in *Dentsply*. Our analysis provides an economic basis for this common sense, but previously unproven, proposition that exclusive dealing increases independent dealer incentives to more actively promote a manufacturer’s product.