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Channel Management: Structure, Governance, and Relationship Management

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INTRODUCTION

To go to market, producers of services and products create at least one channel of distribution, or path, through which they access a potential buyer, convert the prospect into a customer, and fulfill the orders the customer places. The importance of distribution channels can be seen in many industries in the US, where channel members collectively earn margins that account for 30 to 50% of the ultimate selling price. In contrast, advertising typically accounts for less than 5 to 7% of the final price (Stern & Weitz, 1997). The importance of the distribution function is not due solely to the accounting costs of the channel's activities. Marketing channels represent a substantial opportunity cost as well. Finding the *potential* buyer and converting mere potential into profitable orders from paying customers is a major part of the channel's role. The marketing channel does a great deal not only to serve the market, but also to *make* the market.

In short, the management of channel activities has great potential for developing competitive advantage, either by lowering costs or by differentiating the final product to a market developed by channel members. And the advantage accrued from good channel management is strategic, because it is often durable, difficult to put into place, and difficult to imitate (Stern & Weitz, 1997).

Much of the early work in channels, circa the 1950s and 1960s, focuses on identifying the somewhat mysterious functions of channels, and explaining when and why these functions have utility (e.g., Alderson, 1965; Bucklin, 1969, 1972). Pioneering institutional work in channels established in fact that marketing channels exist without anyone's knowledge (Cox & Goodman (1956) noted that in the 1950s, even General Electric did not know how a humble lightbulb got from the factory to a kitchen socket). In general, we now recognize that channels perform eight major functions as they interface between suppliers and markets: taking title (ownership); taking physical possession (stewardship); promotion; negotiation; financing; risk taking; ordering; and payment. Along the way, channels achieve competitive advantage by providing support services after the sale and by composing appealing assortments (assortments of products and services to offer to buyers, assortments of potential buyers to offer to suppliers). In short, channels make markets and execute transactions by bringing together potential suppliers and demanders.

Considering the range of functions involved in accessing a market, it is not surprising that the management of marketing channels is no small matter. Going to market at all is not easy. Going to the *right* market, and doing so *quickly*, in the *manner* the customer desires, with few *errors*, and at low *cost* is ... a fairly rare achievement.

This chapter focuses on a subset of managerial decisions that are crucial to the functioning of a marketing channel. These decisions concern *structure* (essentially, strategic choices that can be represented graphically, such as how many separate firms constitute a channel), *governance* (the frameworks that are meant to insure orderly pursuit of goals and resolution of conflict), and *relationship management* (the myriad actions that frame the daily environment of a marketing channel). There are many other issues in channel management, such as the physical movement of goods, logistics and number of levels in the channel, the number of intermediaries at each level, transfer prices, and so on. See Frazier (1999) for an excellent discussion of these and other issues, and Coughlan et al. (2001) for a discussion of institutional arrangements and types of intermediaries.

Channels are typically composed of multiple organizations (either separate firms or separate divisions of one firm), all of them interdependent in that their results derive from the channel's ability to create transactions. But multiple organizations performing a myriad of functions often work at cross purposes. The mediocrity of the resulting channel performance will hurt at least some of its members, leading to recrimination and conflict. To avoid this scenario, channel members attempt to influence each other to operate in a coordinated fashion, one that recognizes that their interdependence creates common interests. Structure, governance, and relationship management shape how firms actually garner and then exert influence over each other, in order to be successful against competing systems (other sets of channel members promoting different solutions to a market's needs).

Roughly, seven governance structure issues concerned with achieving coordination are prominent in the channels literature (Jap & Weitz, 1995). This classification is somewhat arbitrary, as a given research work often covers several categories. This review is organized around these issues, as follows:

1. Vertical integration or not (whether to *own* the channel)
2. Managing conventional channel relationships
 - a) Selection of channel members
 - b) Design of contracts (both explicit and implicit) governing the relationship
 - Terms of the contract
 - The use of incentives
 - The use of monitoring
 - c) Use of relational norms
 - d) Accumulation and use of power.

The ordering of this list is carefully chosen. The first decision for the organization is whether or not to vertically integrate, that is, whether to *own* the channel (as

opposed to outsourcing, or distributing through independent parties). *The decision making organization can be any player in the channel.* While it may be the manufacturer (considering integrating forward), it may also be a downstream channel member (e.g., a retailer, a logistics services provider, a distributor, or an agent) considering integrating backward into production and/or forward toward the final point of sale. If the organization chooses to vertically integrate from production down to the level of the final buyer (e.g., through direct selling), exerting influence to coordinate channel activities is relatively easy, and hence not the most interesting research problem. But this typically is not the most cost-effective or demand-enhancing solution.

When complete channel integration is unattractive, the organization must then engage in the *recruitment of channel members*. Channel members are generally selected and courted both for their superior abilities to perform specific channel functions, and for their potential interest in cooperative, coordinative behavior. The greater is this interest, the more amenable the member is to working together with the organization to achieve coordination as a channel system. Several other governance issues then come to the forefront.¹ The channel members must establish their *contract* defining at least minimal rights and responsibilities, even if they do not express their agreement as a document. Apart from the *terms* of the contract, a key understanding concerns how *incentives* can be used to directly influence action. To the extent that incentives are not effective, the organization can directly *monitor* channel members to verify their performance levels.

The contract does not fully define the parties' expectations. Norms of behavior can be cultivated, as the relational governance approach would suggest. Further, *channel power* can be brought to bear to affect behavior. Together, contracts, norms, and power drive the behavior of the channel as a system. This influences the channel's success in competing against other channel systems for delivering value to buyers. Figure 9.1 depicts these major issues involved in governing a channel system. We use this schematic as a device to organize the literature surveyed in this chapter.

As a research area, marketing channels is in a pre-paradigmatic state (Kuhn, 1969): there is little agreement about how to frame issues and what is the appropriate mode of inquiry. In pursuit of generalizability, causality, and managerial implications, channels researchers have been eclectic in theory and in method. In addition to carrying out purely descriptive field research (to find patterns of practice and performance outcomes), channels scholars have borrowed from a number of frameworks to generate new patterns and explain existing ones. A partial list of frameworks used in the field includes:

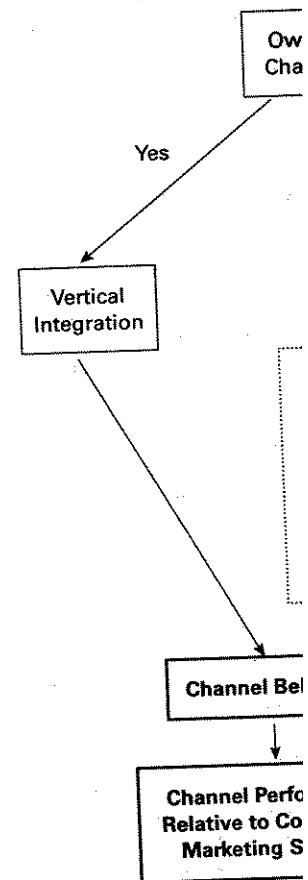


Figure 9.1 Governance Issues

1. From economics: transaction agency theory, game theory of competition and market economics
2. From sociology: theory of group processes, institutional theory
3. From psychology: the theory of interpersonal relationships
4. From marketing theory: trust, competitiveness
5. From eclectic approaches: life-cycle theories

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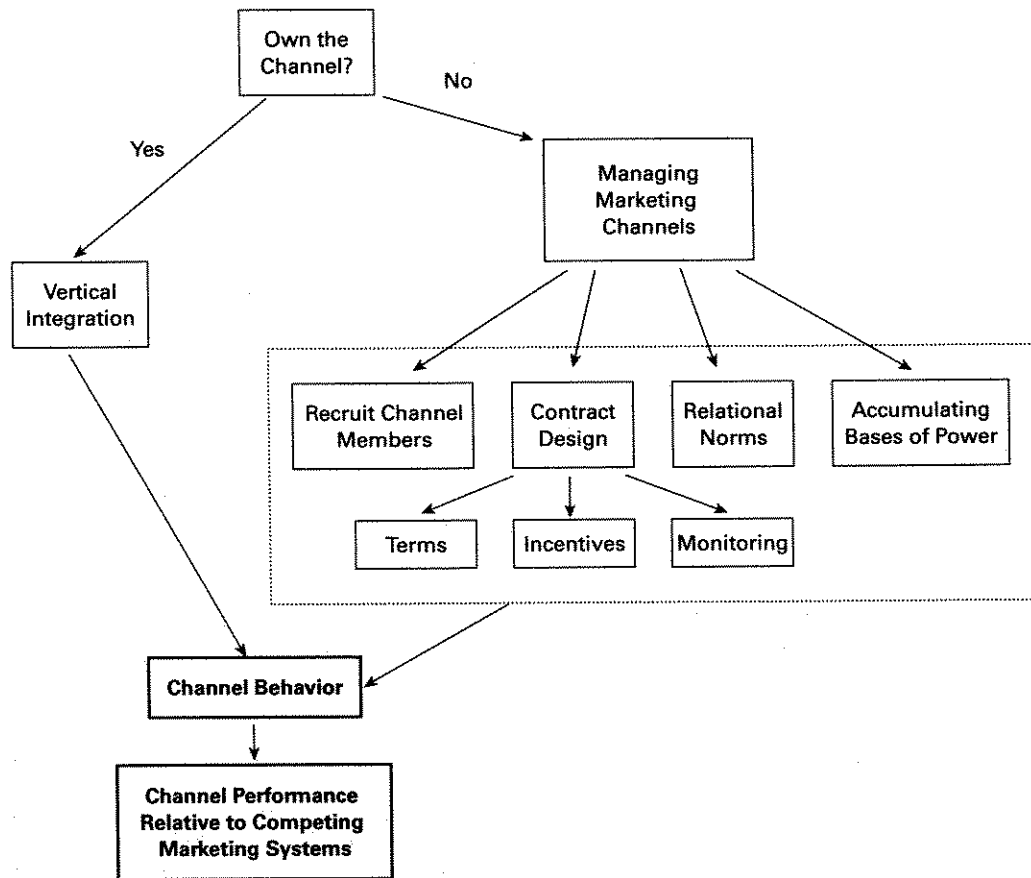


Figure 9.1 Governance Issues in Channels of Distribution

1. From economics: transaction cost analysis, agency theory, game theory, analytical models of competition and market response, evolutionary economics
2. From sociology: theories of dependence and group processes, institutional theories of legitimacy
3. From psychology: theories of social influence, interpersonal relationships, and conflict
4. From marketing theory and strategic management: trust, competitive advantage, path dependence
5. From eclectic approaches: political economy, life-cycle theories

As if channels research needed more variety, there are many points of difference about the appropriate methodology to develop and test proposed generalizations. Must there be a field test? If so, should the data be correlational (versus quasi-experimental), dyadic (versus one side – or versus the whole

network), longitudinal (versus cross-sectional), archival (versus perceptual), primary (versus secondary), single informant (versus multiple), and so forth? Given the data, how should it be modeled? Do experiments have a role? Are qualitative approaches appropriate? What is the value of inductive or exploratory (versus hypothesis testing) approaches?

The good news is that channels researchers have considerable freedom in how to proceed. The bad news is that it is difficult to achieve consensus, and thus to accumulate findings into robust generalizations. Further, many approaches compete, and their competition focuses on their differences (particularly in the causal mechanism employed, as well as in the research approach taken).

The position of this review is that results from these multiple approaches are converging, almost surprisingly so. Beneath semantic and methodological differences, there is considerable agreement in findings and in explanations for them. Further,

there is an emerging consensus about what are the issues that merit further inquiry.

This review gives center stage to the substantive conclusions that are emerging from this large and vital area of inquiry. The issues of how research gets done (i.e., differences in framework and method) will be treated, but given a low priority here.

THE CHANNEL OWNERSHIP CHOICE

Perhaps the first question in channel design and management is how many organizations should be involved in a channel: should one entity perform not only production but all channel activities (Lilien, 1979)? A vertically integrated channel is the shortest, simplest structure. But is it the most efficient, or the most effective?

Transaction Cost Analysis and Game Theory in the Channel Ownership Decision

Two useful theoretical approaches have been particularly influential in the literature on channel ownership: transaction cost economics (TCE; see, for example, Rindfleisch & Heide, 1997; Williamson, 1996) and game theory (Moorthy, 1993). Both approaches originated in the economics literature and have been adapted to the channels context by researchers in marketing. TCE's maintained hypothesis is the fundamental superiority of the market mechanism, leading to what economists call 'decentralization' (that is, composing a channel of third parties) as the default channel choice, except in cases of 'market failure.' TCE therefore informs the channel ownership choice by identifying factors leading to market failure and hence to vertical integration of the channel. The game theoretic approach, by contrast, views interaction within a channel as the choice of strategic actions by each channel 'player' that jointly affect channel profitability, and hence ultimate channel-ownership choice. Some of the key strategic factors on which the game theoretic approach focuses are wholesale and retail pricing, service decisions, the intensity of distribution, and nonprice actions such as returns policies and warranty policies. In some sense, the game theoretic approach takes as given the deviation of decentralized channel relationships from the perfectly competitive benchmark, and seeks to identify the conditions (or proactive actions of the channel captain) that nevertheless make outsourcing an optimal channel decision. Thus, TCE starts from the premise that outsourcing (the 'market') should be the default unless certain conditions hold; game theory starts from the premise that outsourcing

has inherent deficiencies relative to vertical integration. As we will see, the two approaches are much more complementary than contradictory.

Transaction Cost Economics (TCE) and Channel Ownership

In the TCE approach, the issue is whether to perform a given function (e.g., selling) or set of functions (e.g., taking title, then reselling) via the buy option (outsource, or 'decentralize') or via its polar opposite, make (vertically integrate). Outsourcing is, *a priori*, considered preferable to vertical integration on grounds of long-term efficiency. This is because the outsider, a specialist (such as a distributor or a sales agent), pools the demands of many producers for given distribution services. Thus, the outsider can achieve economies of scope and scale, which are all-important advantages in the competitive world of distribution channels.

The advantage of economies of scope, in particular, is often featured in the channels literature, where it is known as the benefit of assortment, or one-stop shopping (Coughlan et al., 2001). Channel members create economies of scope by judiciously creating a bundle of brands and products/services that appeal to a market they know well. The economies of scale phenomenon has been demonstrated in the channels literature in Coughlan (1985) and Anderson and Coughlan (1987), who show that channel choice for an incremental product in a firm's line tends to follow the pre-existing channel (whether vertically integrated or decentralized), in order to spread fixed costs of distribution across a broader volume base.

The cost advantage created by pooling the products and services of many suppliers is important; so is the discipline of the market itself. Under the assumption that a true market for the services performed by the channel member exists (that is, that other competitors offer similar services and that other buyers value these services), the independent channel intermediary with whom a manufacturer partners has every incentive to perform well. First, the manufacturer can credibly threaten termination, since alternative partners exist. Second, the existence of other potential buyers for the intermediary's services means that poor performance with this manufacturer could threaten the intermediary's future earning opportunities; other manufacturers will stay away from a channel member without a proven success record.

This assumption of the superiority of outsourcing is consistent with the broad usage of outsourcing in channels of distribution. It suggests, for example, that manufacturers' ability to sell direct over the Internet will not result in mass disintermediation, because the Internet merely narrows, but does

not eliminate, the upstream distribution efficiency. Ind using Internet technologies: management (order taking and management, complaint r others) requires specialize online commerce could be rather than lessen, the attri rization in channels (Alba et

In TCE logic, a verticall generally match the scope specialized skills (Anderson linchpin of the arguments ab of outsourcing is the assur for the channel member's this assumption is one exan 'market failure.' For exan tions, the organization can terminate the channel mem other viable organizations so-called 'small-numbers This could be true from the small economy or market, ers). But even when the channel members to choc inception of the channel, both parties in assets spec turn what was a large-n small-numbers one after th This arises when the chann as *transaction-specific ass cult to redeploy to another of substantial productive v numbers before or after a c a barrier to exit from this c ated, thereby destroying th precipitating a market fail*

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not eliminate, the upstream-downstream gap in distribution efficiency. Indeed, to the extent that using Internet technologies for channel management (order taking and fulfillment, warehouse management, complaint management, and many others) requires specialized skills, the spread of online commerce could be expected to perpetuate, rather than lessen, the attractiveness of decentralization in channels (Alba et al., 1997).

In TCE logic, a vertically integrated firm cannot generally match the scope or scale of an outsider's specialized skills (Anderson, 1988). An important linchpin of the arguments above about the superiority of outsourcing is the assumption of a true market for the channel member's skills. The violation of this assumption is one example of what TCE calls a 'market failure.' For example, for some transactions, the organization cannot credibly threaten to terminate the channel member because there are no other viable organizations to replace this one (the so-called 'small-numbers bargaining' problem). This could be true from the start (for example, in a small economy or market, there may be few players). But even when there are many potential channel members to choose from at the time of inception of the channel, investment by either or both parties in assets specific to this channel can turn what was a large-numbers situation into a small-numbers one after the channel is established. This arises when the channel builds what are known as *transaction-specific assets* – assets that are difficult to redeploy to another relationship without loss of substantial productive value. In either case (small numbers before or after a channel begins to operate), a barrier to exit from this channel relationship is created, thereby destroying the market mechanism and precipitating a market failure.

How does this happen? Opportunism is self-interest seeking in a *deceitful manner*, as opposed to the normal economic motive of self-interest seeking, but without misrepresenting one's intentions, distorting information, or renegeing on one's obligations. Transaction cost economics maintains that, given the chance, some players will practice opportunism: since it is difficult to know which players will do so, it is prudent to structure transactions so as to discourage opportunism. In normal circumstances, third parties can be discouraged by the threat of retaliation or termination. But small-numbers bargaining reduces the credibility of the threat. The 'unique' channel member can practice 'opportunistic behavior' against other channel members, with little fear of negative consequences. Thus, the motivation to contribute to the good of the whole channel diminishes or disappears. When the likelihood of opportunistic behaviors is predicted to be high, the firm is well advised to bypass the market mechanism and, instead, vertically integrate the channel. Vertical integration (e.g., by using an employee sales force instead of an independent

sales representative firm as a channel member) increases the agent's (here, salesperson's) dependence on the manufacturer (by removing all its other business), permits the exercise of an employer's legitimate authority to investigate and discipline employees, and creates an atmosphere that motivates employees to perform out of loyalty (Williamson, 1996).

In general (Rindfleisch & Heide, 1997), the transaction-cost predictions about integrating the channel under asset specificity hold up well in the field. The principal transaction-specific assets identified as having a high impact on channels are intangible, human assets that revolve around the type of product/service and the manner in which it is sold. Most of the physical assets employed in distribution can be put to another good use fairly readily: they are general purpose, rather than transaction specific. But the intangibles are considerable. Brand- and partner-specific learning, and personal relationships head the list. Where they are likely to arise and to play a major role in distribution, the firm is more likely to perform a function itself. This is particularly the case for products that are new to the world and/or technically complex. These products tend to be idiosyncratic to their producers. This requires people performing the distribution function to invest in idiosyncratic learning and to interface heavily between prospective customers and the factory. The nature of the job demands investing in personal relations and idiosyncratic (brand-specific) learning (Anderson, 1985). Both transaction cost theory and empirical evidence (Anderson & Coughlan, 1987; Rindfleisch & Heide, 1997) suggest that firms tend to 'take distribution in house' (assume ownership of the channel) for products and services of this nature.

TCE posits that another motive to vertically integrate is to gain information when it is very difficult to judge how well the agent is doing its job using only the information available when contracting with the agent. For example, the selling function is taken in house when observable measures (such as recorded sales) are not good indicators of sales performance (Anderson, 1985): this is a condition of performance ambiguity, or internal uncertainty. By integrating, the firm gains access to more and better information. This information advantage may also explain why some firms use *both* their own and an outside sales force: in situations where performance is hard to judge, each side provides information against which to benchmark the other (Dutta et al., 1995).

Taken together, extant research in the TCE tradition suggests that if cost differences between vertically integrated and decentralized channels are not too great, vertical integration in channels will occur when performance ambiguity is rife and when what is being sold demands investment in brand-specific products and relationships (Rindfleisch & Heide,

1997). These are not the most common scenarios (nor is vertical integration always a lower cost channel alternative than decentralization!); thus, TCE suggests that outsourcing in channels should be common – which indeed it is.

The Game Theoretic Approach to Channel Ownership

The game theoretic approach to channel ownership decisions, similarly to TCE, recognizes the inherent tendency of an independent *agent* (a third party, agreeing contractually to provide services) to behave in its own self-interest, rather than in the interest of the firm hiring it, the *principal*. The game theoretic approach assumes that this is the default behavior of independent members with whom the firm might partner. Although any party could be viewed as the principal, in a channels context, the agent is generally viewed as an intermediary, and the manufacturer is the principal; we will follow this convention in what follows here. Under the game-theoretic view of channel member behavior, the use of an intermediary (or, in the language of game theory, 'decentralization') may or may not bestow cost efficiencies on the channel (that is, the intermediary's ability to perform channel functions and flows at lower cost than could the manufacturer may or may not be strong). However, the independent intermediary induces a different sort of inefficiency in the channel that diminishes the attractiveness of outsourcing: an inefficiency in setting downstream prices to the market. This key transfer pricing problem in the channel is the *double marginalization* problem, written about in the economics literature by Spengler (1950) and Machlup and Taber (1960), and a key focus of Jeuland and Shugan's (1983) paper on channel coordination. When title to the product being sold changes hands as it passes through the channel, each channel member sets a new transfer price to the next downstream channel member (for example, a manufacturer sets a wholesale price to its distributor, who sets a transfer price to the retailers to whom it sells; the retailer sets the final retail price paid by the consumer). Since these transfer prices are not set at the perfectly competitive, no-rents level, but rather are set to generate an economic profit to each channel member (remember the small-numbers bargaining problem raised in TCE!), the result is a retail price that is demonstrably higher than the retail price that would prevail were the channel vertically integrated. In the absence of any other compensating factor (such as significantly lower costs to perform channel functions in the decentralized channel), the double marginalization problem suggests that vertical integration is preferable to a decentralized channel.²

Starting from this insight, analytic research in the channels area has focused on identifying conditions where, despite the double marginalization problem, and even under no cost advantage for the decentralized channel, decentralization can nevertheless be the profit-maximizing channel structure. Clearly, this is a strict test: if there are additional significant cost declines available from using specialized intermediaries, the benefit of decentralization would of course increase. The profit level achievable in a vertically integrated channel (holding the efficiency with which channel flows are performed constant) is termed the *coordinated* level of profits. The literature we review here assumes that no efficiency changes accrue to changes in the channel structure; it instead focuses on the strategic role played by vertically interacting channel members and by horizontally competing channel members and entire channels.

Jeuland and Shugan (1983) model a simple dyadic channel to highlight the double marginalization problem in channel transfer pricing. They show that double marginalization causes channel profits to be lower under decentralization (the use of the intermediary) than under vertical integration when a simple single-part transfer price is charged, holding efficiency of performance of channel flows constant. They provide an elegant solution to the problem: a jointly negotiated quantity discount schedule that causes the retailer to price so as to maximize channel profits, not just its own retail profits. Moorthy (1987) applies the economic literature on two-part tariffs³ (see, e.g., Oi, 1971) to show that a wide variety of multi-part pricing options can also coordinate the dyadic channel. These articles together have insights for the *contracting* issue (to be discussed in a later section), but also suggest that ownership of the channel is not necessary for achievement of a vertical-integration pricing and profit benchmark and a reduction of the inefficiencies of double marginalization.

McGuire and Staelin (1983) and Coughlan (1985) examine the channel ownership problem from a different point of view. They restrict their attention to single-part transfer pricing (i.e., a constant wholesale price), but investigate the effect of *competition* on the channel structure, profitability, and coordination problem. Coughlan's model generalizes the linear demand system of McGuire and Staelin to allow for nonlinearities in demand. They model a channel consisting of two competing manufacturers, each of whom can choose to sell through a vertically integrated retail channel or through an exclusive decentralized retailer. The overall market can therefore be completely vertically integrated; completely decentralized (with exclusive retailers); or mixed, with one manufacturer vertically integrating and one decentralizing. They show that the degree of substitutability between the products being sold is a determining factor in optimal ownership choices of

the manufacturers. A market substitutability is optimally socially integrated channels, where product substitutability generates complete decentralization, and integration. The result is attrition in very competitive markets. It permits the manufacturers to compete on price competition. In effect, the integration 'problem' becomes a competitive market. Coughlan's empirical test to show support for this in the context of the inter-
tor industry.

Coughlan and Wernerfelt (1985) threads of the double-margin problem. Jeuland and Shugan (1983) and Staelin (1983) and Coughlan (1985) the implications for optimal channel structure in a competitive channel whose performance is restricted to one-part pricing. If possible, manufacturers can integrate the level of channel performance to the actual decentralization (or, decentralization becomes a benefit of being able to coordinate Stackelberg leadership) to the channel. However, if these contracts are not observable and credible in a competitive channel, and cannot be enforced, there is an incentive to 'cheat' on the pricing level for individual manufacturers. If possible, the rational expectation system to devolve back to the channel's profitable levels. This approach emphasizes the importance of contract observability to commit to contracts as a determining factor in the profitability of the channel.

Later papers in this vein of these concepts. Coughlan (1985) choice problem in a market with goods; Coughlan and Lal (1985) the channel can and should be vertically integrated in the market. Coughlan's model generalizes the linear demand system of McGuire and Staelin to allow for nonlinearities in demand. They model a channel consisting of two competing manufacturers, each of whom can choose to sell through a vertically integrated retail channel or through an exclusive decentralized retailer. The overall market can therefore be completely vertically integrated; completely decentralized (with exclusive retailers); or mixed, with one manufacturer vertically integrating and one decentralizing. They show that the degree of substitutability between the products being sold is a determining factor in optimal ownership choices of

analytic research in the identifying conditions of decentralization problem, the stage for the decentralization can nevertheless be a channel structure. Clearly, an additional significant finding using specialized inter-integration would be a level achievable in a vertical holding the efficiency (as performed constant) level of profits. The literature notes that no efficiency in the channel structure; a strategic role played by channel members and by channel members and entire

1983) model a simple the double marginalization-transfer pricing. They show that causes channel profits decentralization (the use of the vertical integration when a price is charged, holding of channel flows a channel solution to the channel quantity discount retailer to price so as to not just its own retail price but also the economic literature, e.g., Oi, 1971) to the use of multi-part pricing in the dyadic channel. The insights for the channel in a later section), but the use of the channel is not a vertical-integration channel and a reduction of the double marginalization.

1983) and Coughlan (1985) ship problem from a different perspective: they restrict their attention to i.e., a constant wholesale price effect of competition on the channel, and coordination of channel members generalizes the linear model and Staelin to allow for a channel model a channel with two manufacturers, each of which sells through a vertically integrated channel through an exclusive decentralization market can therefore be a channel; completely decentralized (retailers); or mixed, with both vertically integrating and one channel that the degree of substitution products being sold is a channel ownership choices of

the manufacturers. A market with little product substitutability is optimally served through vertically integrated channels, while sufficiently high product substitutability generates two equilibria: complete decentralization, and complete vertical integration. The result is attributed to the fact that in very competitive markets, decentralizing permits the manufacturers to commit to less intense price competition. In effect, the double marginalization 'problem' becomes a benefit in very competitive markets. Coughlan (1985) adds an empirical test to show support for the model's findings in the context of the international semiconductor industry.

Coughlan and Wernerfelt (1989) tie together the threads of the double-marginalization approach of Jeuland and Shugan (1983) with those in the competition-between-channels approach of McGuire and Staelin (1983) and Coughlan (1985), to examine the implications for optimal channel structure in a competitive channel whose manufacturers are not restricted to one-part pricing. When two-part pricing is possible, manufacturers can replicate the vertically integrated level of channel coordination, despite the actual decentralization of the channel. Thus, decentralization becomes optimal because of the benefits of being able to commit (in the sense of Stackelberg leadership) to a coordinated price.⁴ However, if these contracts within the channel are not observable and credible to members of the competing channel, and cannot be truly committed to, there is an incentive to 'cheat' on the coordinated pricing level for individual gain. When this is possible, the rational expectation of cheating causes the system to devolve back to more competitive, less profitable levels. This approach thus highlights the importance of contract observability and the ability to commit to contracts as a mechanism for preserving the profitability of the decentralized channel.

Later papers in this vein of the literature expand on these concepts. Coughlan (1987) models the channel-choice problem in a market with complementary goods; Coughlan and Lal (1992) consider how long the channel can and should be as a function of product substitutability in the market; Choi (1991) considers a different channel structure where two manufacturers sell through a common retailer; and Ingene and Parry (1995a, 1995b) model a manufacturer selling through two non-identical retailers. All of these compare the non-integrated channel structure's profitability to a vertically integrated benchmark, under the assumption that the channel intermediary is equally efficient at performing channel functions as would be the vertically integrated manufacturer. The underlying theme is that, in general, a decentralized channel structure can be less attractive than a vertically integrated channel, both because of the double marginalization problem and because of the intermediary's divergent goals from those of the manufacturer. For example, in Choi's channel structure, the retailer seeks to

maximize profit across the two competing product lines, which is not the incentive of the individual manufacturer. Further inefficiencies within the channel system are induced when intermediaries are not identical (as in Ingene and Parry); then the antitrust requirement of equal treatment of intermediaries prevents the manufacturer from using effective price discrimination with each of them to coordinate the channel. The underlying thread in this literature is that despite these inefficiencies, there are certainly situations where the manufacturer does not have the choice to vertically integrate, or the fixed cost of doing so is simply prohibitive; thus, the manufacturer needs to appropriately structure the decentralized channel to maximize its profitability.

The game-theoretic approach to the channel ownership problem thus focuses on factors such as transfer pricing inefficiencies; sophisticated transfer pricing mechanisms to get rid of inefficiencies; the impact of competition at various levels of the channel; channel length; and the nature and observability of channel contracts, to see their effects on the value of ownership versus decentralization. The common theme in these results is that decentralization induces strategic inefficiencies in the channel, and that the channel manager's (typically, the manufacturer's) problem is therefore to structure contracts and incentives to do the best job of restoring a coordinated outcome to the channel.

Future Research Directions

This discussion suggests some interesting and provocative avenues for future research in the channel-ownership area. Currently, research on vertical integration in the TCE vein is turning to examining the causal effect of opportunism on channel choice. This mechanism is controversial, and distinguishes TCE from competing approaches. Wathne and Heide (2000) offers an excellent review that traces the second-order effects (such as providing a signal to customers) that can accompany efforts to forestall opportunism. On these lines, Ghosh and John (1999) offer an interesting marriage of TCE and marketing strategy.

Two research issues are particularly promising. First, TCE makes no allowance for the logic of simultaneously making and buying the same function (dual distribution), nor for the possibility of making some channel functions and buying others (hybrid channels). (TCE concerns making or buying a given set of functions, but is silent about how to bundle the functions in the first place.) Both of these non-pure options are increasingly common in channels (some analytic approaches to the dual distribution problem are discussed below in the section on selection of channel members). In particular, the Internet opens new routes to market, both vertically

integrated and decentralized, as well as offering the possibility of allocating some (but not necessarily all) specific functions to the online channel presence. This is obviously an issue deserving of considerable research attention.

A second issue concerns the role of external uncertainty, or the inability to forecast frequent environmental changes (volatility) on the choice to vertically integrate or decentralize. TCE theorists differ in their interpretation of what impact volatility should have, and the empirical findings are contradictory and inconclusive (Rindfleisch & Heide, 1997). A new conceptualization is needed, perhaps from another framework such as real-options theory (Kogut & Kulatilaka, 1994).

THE RECRUITMENT OF CHANNEL MEMBERS

If the decision has been made to abandon vertical integration in favor of a decentralized channel, it is necessary to choose what type of channel intermediaries to recruit, and which particular ones to (attempt to) partner with.⁵ The marketing literature has looked at the first issue through investigations of the choice of one versus another *form* of channel intermediary. The second question – which specific retailer to recruit, for example, given the choice to sell via retailers at all – has been attacked through *signaling* and *screening* models, which were first used in the economics literature.

Choice of the Form of Intermediary

The question of which type of intermediary to recruit has been approached in several different substantive channels contexts. One is the automobile market channel. A set of three articles looks at different aspects of this problem. Purohit and Staelin (1994) and Purohit (1997) examine the tradeoffs among rentals, sales, and buybacks in the automotive channel, finding that the manufacturer's sales increase with the use of a rental channel that sells off old cars originally sold to rental fleets. However, dealer profitability varies under the different regimes, as these rental agency sales compete with the dealer's used car lots. This is consistent with recent moves by automobile manufacturers to switch from an overlapping system to a buyback system, in which the automakers buy back their used cars from the rental agencies and resell them to dealers. The use of rentals and buybacks changes the dynamics of working with the standard dealer channel. Desai and Purohit (1999) extend this analysis to consider the more general choice between leasing and selling as modes of revenue generation in the channel. They show that the

optimal proportion of leasing in the lease/sell mix falls as manufacturers' products become more competitive with each other. This is because products leased today are returned to the manufacturer in the future and then sold on the used car market, competing with future new cars in the market. This extra competition from used leased cars is more problematic, the greater is the degree of competition between the manufacturers.

In the retailing context, the question of which type of intermediary to use has been investigated by Balasubramanian (1998) in a paper examining the nature of competition between direct marketers (such as catalog houses) and conventional retailers. While this paper does not model the whole channel interface between manufacturer and retailer, it does show that the competitive incursion of a direct marketer fundamentally changes the nature of competition in the retail marketplace. The direct marketer has the advantage of 'location-less' competition, but the disadvantage of an inability to let consumers 'touch and feel' products before buying. The tension between these factors makes some consumers prefer bricks-and-mortar stores to direct buying, while others are comfortable with the direct channel. Balasubramanian also considers the importance of *information* about the direct seller's offering: catalog retailers, for example, do not send catalogs to every household, and therefore competition between the cataloguer and the conventional retailer is incomplete. He shows that the optimal coverage level for the direct marketer, interestingly, may not be complete. This suggests the need for a manufacturer seeking to sell through retail channels to take into account the coverage choices of its retailers.

Another treatment of the retailing choice is given in Coughlan and Soberman (2000). Here, the question is whether competing manufacturers of branded retail goods, such as apparel, should open their own vertically integrated outlet stores in addition to selling through their standard primary retail outlets. The authors show that the answer depends on the nature of segmentation in the market. The more different consumers are in their price sensitivity (holding service sensitivity differences constant), the more likely selling through outlet stores as well as primary retailers is to be profitable. Conversely, the more different consumers are in their service sensitivity (holding price sensitivity differences constant), the more likely manufacturers are to choose *not* to sell through outlet stores. Standard segmentation and price discrimination arguments suggest the former insight, but the latter insight is counterintuitive and explained by the usefulness of price-sensitive consumers in limiting the amount of costly service competition by the primary retail channel. Thus, here the choice of what types of retail formats to use depends not just on the fact of segmentation, but how consumers are segmented.

Therefore, the issue of intermediaries to partner with varies on demand and supply nature and degree of competition or differences between competitors in the marketplace.

An ambitious effort in this area was made by Balasubramanian (1992). This work offers a conceptual support approach to the selection of intermediaries for new products.

Which Specific Channel Member to Recruit

The second question, of which channel member to work with, comes from the conventional issue of channel member selection. New approaches to this problem involve the use of screening and signaling to help decide which member will do business with each other. The term *screening* refers to an action taken by a manufacturer (for example to uncover the nature or potential candidate really refers to an action taken to reveal its quality or type) before considering partnering with it.

An excellent example of screening is a double-blind test in which a manufacturer can a channel member create a product that it provides high quality and that is hard to verify; and 2) how to induce its employee to invest in décor and solving the first problem, work on skills, building a service and tying pay to customer satisfaction.

Other uses of the signaling model in the channels literature are:

- The use of *signaling* to convince the channel (and the product's high quality) of *screening* new products by offering allowances from which they are shown to prefer screening; in general, slotting allowances by profit and social welfare.
- The manufacturer's choice of force its reputation quality. Manufacturers choose to distribute products through retailers, while manufacturers distribute products through reputation (e.g., distribution) (1994).

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Therefore, the issue of what type of channel intermediaries to partner with is shown to depend variously on demand and segmentation issues; the nature and degree of competition; and the similarity or differences between competitive products in the marketplace.

An ambitious effort in this area is Rangan et al. (1992). This work offers a comprehensive decision-support approach to the selection of a channel structure for new products.

Which Specific Channel Member to Recruit?

The second question, of which *specific* channel members to work with, corresponds to the institutional issue of channel member selection criteria. New approaches to this problem are using the logic of screening and signaling to examine which players will do business with each other to form a channel. The term *screening* refers to the process by which a manufacturer (for example) takes actions designed to uncover the nature or type of intermediary a potential candidate really is. The term *signaling* refers to an action taken by the candidate itself to reveal its quality or type to the manufacturer considering partnering with it.

An excellent example is Mishra et al. (1998), which examines a double channel problem: 1) how can a channel member credibly promise consumers that it provides high quality in cases where quality is hard to verify; and 2) how can that channel member then induce its employees to live up to the quality promise? This paper shows that premium pricing and investing in décor serve as a signal to help to solve the first problem, while screening employees on skills, building a service culture, paying well, and tying pay to customer satisfaction help to solve the second problem.

Other uses of the signaling and screening concept in the channels literature include:

- The use of *signaling* by a *manufacturer* to convince the channel (and consumers) of its new product's high quality, versus the *retailer's* use of *screening* new products via demanding slotting allowances from suppliers. Manufacturers are shown to prefer signaling, while retailers prefer screening; in general, screening through slotting allowances yields higher total channel profit and social welfare (Chu, 1992).
- The manufacturer's choice of a retailer to reinforce its reputation and *signal* its product quality. Manufacturers of higher-quality products choose to distribute through more reputable retailers, while manufacturers of lower-quality products distribute through retailers with no reputation (e.g., discounters) (Chu & Chu, 1994).

THE DESIGN OF CONTRACTS WITH CHANNEL MEMBERS

The channel relationship is extremely complex, and therefore lends itself to formal contract design (clauses and their wording), or informal contracting (relational governance), over many aspects. In this section we touch on both formal and informal contracting applied to

- (a) the form of transfer pricing used;
- (b) non-price aspects of the channel relationship;
- (c) non-formal, bureaucratic structuring of the channel relationship;
- (d) the form of strategic leadership in the channel;
- (e) vertical restraints and channel exclusivity;
- (f) franchising; and
- (g) gray marketing.

The Form of Transfer Pricing in the Channel

The manufacturer is typically the agent choosing the form of transfer pricing applicable to the channel intermediary. As discussed above in the section on channel ownership, the form of transfer price used significantly affects the profitability of the channel. In the simplest channel relationship, like that modeled by Jeuland and Shugan (1983), the manufacturer using a single-part price – a constant wholesale price per unit – is really trying to accomplish two tasks with just one decision variable. The manufacturer seeks both to create an incentive for appropriate retail pricing, and to appropriately split the total channel profit pie, through its choice of wholesale price. Just as in the problem of insufficient degrees of freedom in statistics, here too, the double-marginalization problem really arises because of the manufacturer's inability to manage these two tasks with just one instrument – the wholesale price. This is why Jeuland and Shugan's (1983) solution, as well as the insights of Moorthy (1987) and Coughlan and Wernerfelt (1989), involve a multi-part transfer pricing scheme.

Ingenue and Parry (1995a, 1995b, 1998) investigate closely the effects of transfer pricing form on a manufacturer's profits in a channel. They focus on a channel structure where the manufacturer sells through multiple retailers, who may or may not compete directly with one another. One of their contributions is to point out the divergence between transfer pricing contracts that *coordinate the channel* (that is, maximize *total channel profit*) and those that *maximize manufacturer profit* alone. They show that even if the manufacturer's retailers do not compete with each other, the channel-coordinating two-part tariff contract generally does not maximize manufacturer profits (1995b). When the

retailers are heterogeneous, they show that there does not exist a single two-part tariff of the sort devised by Jeuland and Shugan (1983) that replicates the channel coordination outcome, but an appropriately devised quantity discount schedule will do so. However, under many conditions, the manufacturer would actually make more profit by offering a two-part tariff than by offering the channel-coordinating quantity discount scheme (1995a). Further, although there does exist a menu of two-part tariffs that mimics the coordinated channel, proper separation of the retailers does not always occur (that is, each retailer does not always choose the 'right' tariff for it). There are therefore many situations where a second-best two-part tariff generates manufacturer profits superior to those available under a channel-profit-maximizing menu of tariffs. Finally, they show the importance of truly jointly choosing both the fixed fee and the per-unit fee in the optimal two-part tariff, and that both of these are a function of the divergence in fixed-cost positions of the two retailers used (1998). In short, these articles show that (a) channel coordination, which has been held up as a goal for pricing models in the channels literature, is not likely to be chosen by a profit-maximizing manufacturer under various circumstances, and (b) while a multi-part pricing scheme dominates the simple single-part pricing structures assumed in many articles, often the manufacturer prefers a second-best version of such a contract to the supposed first-best, channel-coordinating solution.

Non-Price Aspects of the Channel Relationship

Manufacturers and their intermediaries must decide not only how the product is priced, but how it is marketed in non-price ways as well. Several non-price aspects of the channel relationship have been investigated, including manufacturers' returns policies, and product information or after-sales service. While a complete inventory of non-price channel contracting mechanisms is impossible to provide here, this subset serves to illustrate the principles involved.

In some product markets, product returns are routinely accepted by manufacturers. The book market is a good example. A returns policy may be viewed by the retailer as an insurance against unsold inventory; manufacturers may view it as a costly inducement to retailers to carry their products. Padmanabhan and Png (1997) provide another, more strategic rationale for offering a returns policy in the channel contract. By offering returns, competitive manufacturers transform retail competition from *quantity-based competition*, or so-called Cournot competition, to *price-based competition*, or so-called Bertrand competition. In effect, by

allowing unlimited product returns, the manufacturers induce the retailers to order *at least* as many units (e.g., books) as they think they will sell; price competition between the retailers then clears the market. In contrast, without a returns policy, retailers will seek to order *no more than* the number of units they think they will sell, and in this situation, the quantity ordered is often sufficiently low to make quantities the market-clearing mechanism. It has been long-known that price-based competition results in lower retail prices and higher quantities sold than quantity-based competition. Thus, by inducing price-based competition in the channel, the manufacturers cause the retailers to compete more fiercely on retail prices and drive down retail margins – effectively reducing the double-marginalization problem mentioned earlier. Of course, the viability of using a returns policy can be limited by its costliness, but if it is not too costly, the strategic competitive benefits outweigh the costs of running such a program.

A general approach to channel contracting in the presence of non-price sales-enhancing activities is given by Iyer (1998). He considers how the channel contract should be structured when consumers are segmented into relatively more service-sensitive and less service-sensitive groups, and shows how the channel contract can be explicitly designed to induce retail differentiation, even if the retailers are, *ex ante*, identical to each other. Such retail differentiation is optimal when retailers' locational differentiation is small enough relative to differences among consumers in willingness to pay for products. Iyer finds that a menu of contracts from which the retailers can choose can be structured to induce the correct level of retail differentiation in service provision and pricing.

These examples show that, in general, the channel-contracting mechanism should be chosen carefully to induce channel intermediaries to do the tasks that need to be done, as well as to effectively manage intra- and inter-channel competition. A good example of the complex ways in which the contract structure influences channel member behavior is Dwyer and Oh (1988).

Bureaucratic Structuring of the Channel

A literature on bureaucratic structuring examines the way that suppliers deal with downstream channel members. The means by which they do so are often (though not always) embedded in contract clauses. Bureaucratization (see Paswan et al., 1998 for a review) in channels comprises multiple constructs, of which two dominate this literature: formalization (decision-making via explicit rules and procedures), and centralization (decision-making by a handful of people, typically at the supplier level).⁶ In general,

centralization is negatively norms, meaning that positive to arise without the broad i people. One reason is that c making threats, in accord w possession of power encoura et al., 1999).

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centralization is negatively related to relational norms, meaning that positive norms are less likely to arise without the broad involvement of many people. One reason is that centralization is tied to making threats, in accord with the idea that the possession of power encourages its use (Geyskens et al., 1999).

The effects of formalization are mixed. It is widely considered a negative in interfirm relationships – a heavy-handed imposition of one-sided bureaucracy that discourages initiative, erodes trust, and encourages the target of influence to behave opportunistically (John, 1984). However, recent evidence suggests that in some situations, formalization may function, as a way to achieve role clarity. By reducing confusion over who does what, formalization may actually decrease opportunism and increase inter-firm cooperation – at least in one-sided relationships, such as franchising, where it is understood from the beginning that one party is dominant (Dahlstrom & Nygaard, 1999). Further, formalization is connected to using noncoercive influence strategies, which boosts channel member satisfaction (Geyskens et al., 1999).

A different approach comes from Celly and Frazier (1996), which examine how suppliers apportion their efforts to influence downstream channel members. Suppliers have only so much influence: do they focus it primarily on the channel member's outputs (results, without regard for how they are obtained), primarily on their inputs (competences and activities, regardless of results), or a combination? This has implications for the way a contract is written; some of these tradeoffs are consented to in a contract.

The Form of Strategic Leadership in the Channel

On a completely different level, some recent work on the economics-based modeling side of the channels literature has considered the benefits and costs of 'channel leadership.' In institutional parlance, a 'channel leader' is a channel member who plays a key role in bringing channel members together and has a strong voice in managing channel activities and behaviors. The channel leader's will is usually expected to prevail. This description begs how such leadership is in fact exercised. One way it is dealt with in the game-theoretic literature is by describing the 'leader' (generally known as the Stackelberg leader) as that member who can pre-commit to an action in the channel, which must be taken as given by the other channel member(s) as they take their actions. The classic example is the manufacturer, acting as a Stackelberg leader, who pre-commits to a wholesale pricing rule, which is therefore taken as given by the retailer (who in this case is known as the Stackelberg follower). Those who are interested

in the nuts and bolts of Stackelberg game models are referred to sources such as Fudenberg and Tirole (1993).

It has been generally believed that Stackelberg leadership confers benefits, and this has in fact been shown in many models (see, for example, Coughlan & Wernerfelt, 1989). Choi (1991) explicitly addresses this problem in his analysis of a channel with two manufacturers and one retailer. He examines both a linear demand system and a Cobb-Douglas non-linear demand system, and finds the standard result for linear demand: the manufacturer makes the most profit when manufacturers are Stackelberg leaders in the channel, while the retailer makes the most profit when it is the Stackelberg leader in the channel. However, curiously, the results change under the Cobb-Douglas demand function: here, each manufacturer's profit is largest when the retailer is the Stackelberg leader, while the retailer's profit is largest if the manufacturers are the Stackelberg leaders in the channel. Apparently the form of the demand function affects whether the manufacturer would rather be the leader or the follower in the channel!

Lee and Staelin (1997) extensively analyze this phenomenon and show that indeed, the nature of demand in a competitive market – in particular, the way consumers view the substitutability of the products in the market – determines the optimal form of channel leadership. They extend the concept of strategic substitutes and strategic complements from economics (Bulow et al., 1985) to the channels context by defining *vertical strategic interaction*. Vertical strategic interaction is defined by the slope of the best-response functions of channel members: that is, the optimal action of an agent in the channel in response to the action of another agent in the channel. Where rm denotes the retailer's gross profit margin, and mm denotes the manufacturer's gross profit margin, Lee and Staelin define vertical strategic complementarity (VSC) as holding when one channel member's actions move in the same direction as those of the other channel member, that is,

$$\partial rm^* / \partial mm > 0 \text{ and } \partial mm^* / \partial rm > 0.$$

Vertical strategic substitutability (VSS) holds when one channel member's actions move in the opposite direction as those of the other channel member, that is,

$$\partial rm^* / \partial mm < 0 \text{ and } \partial mm^* / \partial rm < 0.$$

And *vertical strategic independence* (VSI) holds when it is optimal to respond to a move by the channel member, that is,

$$\partial rm^* / \partial mm = \partial mm^* / \partial rm = 0$$

Given this taxonomy, Choi's linear demand model is shown to be an example of VSS (but not the only possible example of it), while his Cobb-Douglas demand function exhibits VSC (but again, not the

only possible example of VSC). Lee and Staelin show that under VSS, the manufacturer's profit is highest when the manufacturer is a Stackelberg leader, but the retailer's profit is highest when the retailer is Stackelberg leader. Conversely, under VSC, manufacturer profit is highest when the retailer is the Stackelberg leader, but retail profit is highest when the manufacturer is the Stackelberg leader. Thus, the nature of demand, and in particular the way in which consumers' propensity to buy one brand depends on the price of the other brand, strongly affects the contractual and leadership structure each channel member would prefer.

Nothing in this research speaks explicitly to the issue of how to contractually agree on who will be the Stackelberg leader and who the Stackelberg follower in the channel. The *bargaining* literature in economics, which has been recently applied in a few instances in the literature in marketing, speaks to issues such as these, but not specifically to bargaining over the identity of the Stackelberg leader. The general insight one can draw, however, is that when *total channel profits* are higher under one outcome than another (e.g., if they were higher when the manufacturer(s) play the role of Stackelberg leader), the channel members have an incentive to strike a contract that creates that channel structure. The game theory literature in economics speaks to issues such as the ability to commit to such contracts, but is beyond the scope of this review (the interested reader can refer to Fudenberg & Tirole, 1993, or to Osborne & Rubinstein, 1994).

Vertical Restraints and Channel Exclusivity

The phenomenon of exclusive representation, or category exclusivity, is seldom examined. An exception is Fein and Anderson (1997), which shows that higher degrees of category selectivity (at the limit, exclusivity) are offered by retailers in return for concessions from suppliers. The principal concession is that the supplier, in turn, restricts its coverage of the channel member's market. This means selective (at the limit, exclusive) distribution. More generally, upstream channel members appear to demand (and get) the concession of selective category representation to offset (any of) their vulnerabilities, while downstream channel members appear to demand (and get) the concession of selective coverage to offset (any of) their vulnerabilities. In short, restricting one's options (market coverage for the upstream, brand representation for the downstream) is a negotiating strategy to balance dependence in a channel.

Restricting coverage in a market is a major decision for a supplier, and a significant public policy issue. Surprisingly little empirical research on this topic exists. An exception is Frazier and Lassar (1996), which shows that limiting coverage is a key

way to build effective distribution for niche brands and for brands pursuing a high-end positioning strategy. The reason is that, in return for their concession of coverage, suppliers can demand unusual cooperation. (An intriguing way to simulate selective distribution is a strategy of branded variants (Bergen et al., 1996), which merits systematic inquiry.)

Intensity of coverage (of a market, of brands in a product category) is part of a more general issue: vertical restraints. These are brute-force ways of influencing channels (e.g., restrictions on resale price, and on distribution practices in general). Such issues deserve far more study from scholars, who have been too inclined to cede the area to economists and legal scholars (Dutta et al., 1999; see also Tirole, 1994). Some research in the economics literature of interest to marketing scholars concerns resale price maintenance (O'Brien & Shaffer, 1992; Shaffer, 1991a, 1991b) and limited and/or exclusive dealing (O'Brien & Shaffer, 1993; Shaffer, 1995). One of the points made in these articles is that slotting allowances, which until recently endured no antitrust scrutiny at all, can achieve channel outcomes very similar to those under resale price maintenance, which endures significant antitrust scrutiny. Insights such as these suggest that a more comprehensive and formal analysis of all of the non-price contracting mechanisms available to coordinate the channel could help policy makers better manage their oversight of these practices.

Franchising

Perhaps the best institutional example of relational governance (to be discussed) is franchising. Yet, here, much of the relationalism actually comes from explicit, detailed contracts, which is why we cover it under contract design. Franchising should be a prime object of inquiry for channels research, and there has been a resurgence of interest. This is a large area. Notable recent contributions include:

- exploration of the purposes of contract clauses (Dnes, 1993; Klein, 1995)
- a careful examination of the subtle cost/benefit tradeoffs to a franchisor (Kaufman & Lafontaine, 1994)
- insights into the relative importance of royalties and monitoring in the franchisor/franchisee relationship (Lal, 1990)
- a review indicating that there are good economic reasons why franchisors often buy out franchisees, and that buyout is not merely cynical exploitation of those who built a franchisee's reputation (Dant et al., 1996)
- examinations of why and how franchisees relinquish autonomy to franchisors, whether or not their contracts oblige it (Anand & Stern, 1985; Dant & Schul, 1992)

- demonstration of synergistically combining franchising in the same market (1997)
- a demonstration of the benefits of gaining legitimacy (Foo, 1999).

This body of work, reviewed by Gray (2001), points to the conclusion that a prototypical form of relational governance appears to be highly politically and economically rational than many other forms.

Gray Markets

A focus on contractual issues can be merely on the presence of exclusivity clauses, but can also focus on the parties actually enforcing them. A classic example of this is the case of counterfeit products. Authentic, branded products are sold through authorized channels, but unauthorized channels also exist. It is argued to have both negative and positive effects. On the negative side, unauthorized channels disrupt a selective distribution and take away retailers' profits and their incentive to provide service (Bucklin, 1993). On the positive side, unauthorized marketing can provide an alternative offering, a competitive alternative to the authorized resellers' service alternatives, which are often higher-priced, lower-quality, lower-serviced, lower-priced, lower-serviced. This market may also expand to new consumers to buy who are unwilling to buy in the higher-priced channel (Lal). The classic concern with service-sensitive (and quality-sensitive) ones prevails: core customers may not be able to easily switch. *Profits* rise or fall as a result of the immediately observable market.

Gray markets are a common problem. In a typical market, a company sets a different price in one market than in another; for example, a lower price in an emerging market. Alternatively, quantity discounts in one market, either case, there is an incentive for a low-price buyer to overbuy units in the high-priced market. It can be argued that it is the nature of these decisions, in areas

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- demonstration of synergies when a franchisor judiciously combines vertical integration and franchising in the same operation (Bradach, 1997)
- a demonstration of the importance to franchisors of gaining legitimacy early (Shane & Foo, 1999).

This body of work, reviewed in Coughlan et al., (2001), points to the conclusion that franchising is a prototypical form of relational governance that appears to be highly political, but that has a greater economic rationale than meets the eye.

Gray Marketing

A focus on contractual issues in channels need not be merely on the presence or absence of contractual clauses, but can also focus on the degree to which the parties actually enforce them. Gray marketing is a classic example of this issue. Gray-marketed products are authentic, branded goods, sold through unauthorized channels of distribution. They are argued to have both negative and positive effects. On the negative side, unauthorized distributors or retailers disrupt a selective or exclusive channel of distribution and take away both authorized retailers' profits and their incentive to invest in customer service (Bucklin, 1993). On the positive side, gray marketing can provide an informal way of segmenting the offerings a company provides to the market: the authorized resellers provide higher-priced, high-service alternatives, while the gray market provides lower-priced, lower-service options (Cespedes et al., 1988; Coughlan & Soberman, 1998). The gray market may also expand total sales, by inducing new consumers to buy the firm's product who are unwilling to buy it through the authorized, higher-priced channel (Ahmadi & Yang, 2000). The classic concern with separation of highly service-sensitive (and less price-sensitive) consumers from less service-sensitive (and more price-sensitive) ones prevails here; authorized resellers may lose core customers to the gray market, and may not be able to easily perceive whether their *profits* rise or fall as a result (they instead focus on the immediately observable decline in *sales*).

Gray markets are a common international channel problem. In a typical situation, a multinational company sets a different transfer price in one market than in another; for example, it may charge a lower price in an emerging market than in a developed country. Alternatively, it may use all-units quantity discounts in some or all of its markets. In either case, there is an arbitrage incentive for the low-price buyer to over-buy and resell the extra units in the high-priced market. It could therefore be argued that it is the manufacturer's own contractual decisions, in areas such as pricing, that in fact

spur the gray market (Ahmadi & Yang, 2000). Indeed, segmentation arguments suggest that policing the gray market may not always be in the manufacturer's best interest. Coughlan and Soberman (1998) even show that allowing the gray market to exist can be in the authorized retailer's best interest, if it helps the authorized retailer focus more tightly on those consumers willing to pay a high price for high service levels.

Bergen, Heide, and Dutta (1998) show that suppliers often overlook a downstream channel member's gray marketing activities, even when prohibited by their own contracts. Suppliers take a pragmatic perspective, weighing the costs and benefits of enforcement. A curious factor is the channel member's willingness to offer exclusive representation (that is, carry no competing brands in the product category). Such resellers are unusually valuable, as few will agree to such a contract. Typically, they are high performers for their sole brand. Hence, suppliers hesitate to disrupt their relationship by enforcing anti-gray-market clauses: to a point, they look the other way.

Should gray marketing be banned? Some might argue this is a reasonable response to a channel-management problem that is very difficult for manufacturers to control contractually. The current legal atmosphere is mixed in different countries, but does not uniformly prohibit gray markets (Duhan & Sheffet, 1988). Bucklin's (1993) analysis suggests that banning gray marketing would be unwise. He shows that gray market competition does not deny profits to the manufacturer (who holds the international trademark for the product) in general, and that gray marketing can be mitigated by lessening the price spread between different world markets. Currency fluctuations can harm authorized resellers, but Bucklin argues that this is insufficient to merit a public policy action against gray marketers. Further, prohibiting the gray market harms consumers, and therefore Bucklin advocates active management of the channel pricing strategy, rather than a governmental solution to the problem.

INCENTIVES FOR PARTNER PERFORMANCE

Having chosen a decentralized channel, the manufacturer (or other channel captain) has given up the right to control directly the activities of its channel members. Yet the need to coordinate the activities of the channel remains. The use of incentives to motivate channel member behavior thus becomes an important tool (monitoring, an alternative to incentives, is discussed in the next section).

The need for and design of appropriate incentive systems is a core focus of the *agency theory* literature. Agency theory arose first in economics (see, e.g., Grossman & Hart, 1983; Harris & Raviv,

1979; Holmstrom, 1979; Mirrlees, 1976; Ross, 1973). In the classic agency relationship, a *principal* (e.g., a manufacturer) contracts with or hires an *agent* (e.g., a distributor or retailer) to act on its behalf. There are three aspects of the relationship that cause problems. First, the agent and the principal typically have divergent goals and objectives (for example, the manufacturer seeks to maximize its profit over its own product line, while the multi-line distributor seeks to maximize its profit over all its product lines, only one of which belongs to the manufacturer). Second, the principal typically cannot perfectly observe the agent's effort. And third, the principal cannot *infer* the agent's effort level from market outcomes (e.g., sales) because of a stochastic relationship between the agent's effort and the market outcome. This concatenation of conditions gives the agent both the incentive and the opportunity to *shirk* on the provision of effort on behalf of the principal. Agency theory seeks to uncover incentive systems that do the best job of inducing effort from the agent consistent with the principal's goals. In essence, appropriate incentive design causes the agent's behavior to mimic what it would do if it in fact had the same objectives as the principal.

In the marketing and channels literature, agency theory has been applied to many problems (for an excellent review, see Bergen et al., 1992). Attention has focused on both *outcome-based contracts* and *behavior-based contracts*. Outcome-based contracts provide incentives tied to observable outcomes in the market, such as sales, market share, or profits. Behavior-based contracts reward the inputs to the production of sales, such as sales calls. Discussion of behavior-based management in channels has often been tied to the use of monitoring (discussed in the next section), the logic being that inputs must be measured and monitored to implement behavior-based management. But this does not deny the possibility that behavior-based contracts provide incentives just as do outcome-based contracts. One example of such an incentive, already discussed above, is manufacturers' payment of slotting allowances to retailers in return for access to key shelf space in the store. This payment rewards the provision of an input (shelf space) rather than an output (e.g. a bonus for selling more than a target amount).

The franchising literature (see above) focuses on the use of incentives such as royalty payments as motivators for franchisee behavior. The franchise channel is a classic agency relationship, where the franchisor recruits franchisees to execute on the marketing concept designed by the franchisor. The franchisee is a residual claimant to the profits of the franchised outlet; this makes the franchisee want to maximize the profits of the outlet. This behavior is consistent with franchisor profit maximization for at least two key reasons: first, because well-run

franchised outlets help in the recruitment of more franchisees; and second, because the typical franchise contract provides for royalty payments from the franchisee to the franchisor, typically quoted as a percentage of sales in the franchisee's outlet. One of the arguments in favor of franchising over running owned outlets with employee managers is precisely that the franchisee acts in a profit-maximizing way, while an employee, paid a salary, has no incentive to improve the profitability of a retail outlet beyond the satisficing level.

The other primary application of agency-theoretic insights into incentive design is in the sales compensation literature (see, for example, Basu et al., 1985). Although this is generally perceived to be an area distinct from channel management, there is no doubt that any real-world channel manager views part of his or her job as the motivation and compensation of the sales people making sales in the channel. Two reviews of the sales force compensation literature (Coughlan, 1993; Coughlan & Sen, 1989) summarize the agency-theoretic approach and the insights it derives into optimal use of salary versus incentive pay (e.g., commissions and bonuses) (see, for example, Table 13.7 in Coughlan (1993) for a summary of the factors affecting the optimal salary, commission rate, and ratio of salary in the total pay package). An empirical test of the agency-theoretic approach (Coughlan & Narasimhan, 1992) shows support for the agency-theoretic prescriptions for compensation.

The study of incentives in channel management is so widespread that it would be impossible to summarize every example. To give a flavor of the ubiquity of this focus, consider the following:

- Jeuland and Shugan's (1983) solution to the double-marginalization problem, discussed above, involves the use of a two-part pricing scheme. The per-unit sharing arrangement is an example of an incentive for the retailer to set retail price so as to maximize total channel profits rather than its own retail profits alone.
- Chu and Desai (1995) look at the problem of coordinating the channel for maximum customer satisfaction. In this context, they consider the use of a bonus linked to customer satisfaction index ratings.
- Gerstner and Hess (1995) examine the effect of pull promotions (promotions by manufacturers directly to final consumers) and their effect on channel coordination. The use of pull promotions creates an indirect incentive for the retailer to stock the manufacturer's product, because it enhances demand at the consumer level.
- In a more general context, Anderson et al. (1987) show that the overall economic attractiveness of one option versus another is the single largest influence on actual resource allocation by downstream channel members in

developed economies. Elements of economic one, may be cancelled considerations, suggesting t incentives on channel m difficult to disentangle.

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MONITORING OF CH.

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Another context in whi members makes sense is sale of product by one dea ritory. This phenomenon to the gray marketing p. Dutta, Bergen and John (1 to argue that monitoring of bootlegging is generall legging should be tolerat full enforceability of cc members. Bootlegging is rather than controlled v very important, when ma through bootlegging, and very committed to th Monitoring and controllin behavior is thus not alv management policy, but i market and intra-channel As one of the more channel management, m ties for future research. !

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These and many of the other examples we have already cited in other sections of this review show the prevalent use of incentives to alter channel members' behavior to better mimic a coordinated, vertically integrated channel.

MONITORING OF CHANNEL MEMBERS

The monitoring of channel members is not a highly-researched area in the channels literature. There is much more interest in the use of incentives and rewards to motivate appropriate behavior. In one area, franchising, there is a clear interest in monitoring, since the explicit monitoring of franchisees is common and there is a tradeoff between using indirect incentives (e.g. making the franchisee a residual risk-bearer of the business) and monitoring, given the possibility for free-riding in the franchise channel (see Bergen et al., 1992 for a discussion of this tradeoff). Lal (1990) explicitly considers the tradeoff between the use of royalties and monitoring in controlling franchisee behavior, and shows that both may be necessary when demand-enhancing investments are made both by franchisees (in service in the retail outlets) and the franchisor (in brand-building in the franchise business). Monitoring is also shown to be valuable in limiting the free-riding of one franchisee on the service efforts of other franchisees in the system.

Another context in which monitoring of channel members makes sense is that of bootlegging: the sale of product by one dealer in another dealer's territory. This phenomenon bears a great resemblance to the gray marketing problem discussed earlier. Dutta, Bergen and John (1994) use a TCE approach to argue that monitoring and complete prevention of bootlegging is generally not optimal. Some bootlegging should be tolerated because of the lack of full enforceability of contracts between channel members. Bootlegging is less likely to be tolerated rather than controlled when reseller services are very important, when margins are seriously eroded through bootlegging, and when the manufacturer is very committed to the channel relationship. Monitoring and controlling negative channel member behavior is thus not always the optimal channel management policy, but is valuable under particular market and intra-channel conditions.

As one of the more under-researched areas of channel management, monitoring offers opportunities for future research. Sales force and franchising

applications are clearly appropriate for research, but in any channel relationship where channel members are responsible for costly and valued channel functions and where the possibility of shirking or free-riding exists, the potential for monitoring as an alternative to incentives can be studied. An example of such work is Murray and Heide (1998), which compares the effectiveness of incentives versus monitoring as tools for manufacturers to induce retailers to participate in a supplier's promotional campaign. This work suggests that in sectors where monitoring (by such means as mystery shoppers and surprise inspections) is uncommon, channel members actively resist it, which renders incentives a much more effective means of persuasion.

RELATIONAL GOVERNANCE

Vertical integration and outsourcing may be viewed as end points on a continuum: control, responsibility, and residual profits are assigned entirely to the principal (vertical integration) or entirely to the agent (using the market, or outsourcing). Between these polar opposites lies relational governance, in which control, responsibility, and profits are *shared* according to the (often unspoken) rules of an *enduring* relationship between upstream and downstream channel members.

The roots of relational governance lie in contracting law (Kaufman & Stern, 1988; Macneil, 1980). The premise is that no contract can or does spell out the myriad understandings, processes, expectations, and norms that grow up during a channel relationship. Yet, this 'implicit contract' or 'relational contract' is what truly drives the channel (by implication, courts should – and do – examine the implicit contract and sometimes even enforce it). Channels research has focused on indexing the degree to which a channel holds 'norms,' that is, expectations of reciprocal behavior. The norms most studied are 1) flexibility (ready adaptation); 2) information exchange (free, open communication); and 3) solidarity (working for mutual benefit).

Typically, positive norms are highly correlated, leading to a research strategy of combining them into a single higher-order factor or relationalism. However measured, relationalism is associated with lower conflict and opportunism, and greater trust, satisfaction, and continued communication (Heide, 1994; Heide & John, 1992; Morgan & Hunt, 1994). However, the causal order of these outcomes has been imposed on correlational data, rather than established, and the manner in which norms come about is not well understood.

This issue – how norms arise – is critical, and several theories address it. One viewpoint is that relationships organically build norms through progressive interaction and risk taking, so that

relationships have recognizable stages of development (Dwyer et al., 1987). Increasingly candid and complete communication among an expanding number of organizational actors is a critical feature of this process (Mohr & Nevin, 1990). Others hold that that process is unpredictable, impossible to chart, and based on incidents that the players may fail to recollect (Anderson, 1995). Still others suggest that norms are constructed, but do not specify how. In general, channels research has focused on demonstrating that norms accompany positive affect (sentiment) and channel performance, but has not devoted longitudinal or experimental investigation to norm creation.

A complementary approach focuses on commitment, which is the channel member's desire for a relationship to continue indefinitely, combined with willingness to sacrifice in order to grow and maintain the relationship. This can be interpreted as the ultimate in relationalism, with the exception that commitment is conceptually one-sided, while norms are conceived as mutual states. In transaction cost economics (TCE), commitment is viewed as a hybrid governance structure, a compromise between vertical integration and outsourcing (decentralization). In this vein, commitment can be built in a semi-calculated way by altering each party's incentive structure. The logic is a somewhat curious notion of a self-enforcing contract, or of a balance of dependence (Williamson, 1996). In this view, a relationship can be secured by binding oneself to it – on condition that the channel counterpart take reciprocal action. The relationship becomes one of mutual dependence. This mutuality discourages opportunism, as each side loses if the relationship ends.

Anderson and Weitz (1992) show this logic at work in manufacturer-distributor relations. When one party makes idiosyncratic investments in the other (such as dedicated personnel and the acquisition of relationship-specific knowledge), those investments ('pledges') serve three purposes. First, they serve to bind the maker to the relationship (thereby raising the maker's commitment to the counterpart). Second, they signal to the counterpart that the maker is committed – which generates reciprocity. Third, they increase the maker's value to the counterpart – which again generates reciprocal commitment. Reciprocity of commitment (or lack thereof) is common in channels. However, asymmetric commitment does exist, for structural reasons, and has deleterious effects on relationship outcomes (Ross et al., 1997).

Much of the commitment research focuses on idiosyncratic investments as a way to forestall opportunism. However, these investments also serve a function that may be more important: they make channel members more effective in differentiating a brand and making a market for it (Wathne &

Heide, 2000). One of the few field research studies that takes a longitudinal perspective shows that when channel members make investments in each other that are difficult to redeploy, they also make more effort to coordinate. As a result, they enjoy higher channel performance *one year later* (Jap, 1999). Further, each party derives benefits from their shared value creation.

A key feature of work on relationship norms is the notion that the channel has a future, and that the players will sub-optimize now to achieve a better outcome later. This 'shadow of the future,' the key element of the theory of repeated games, is critical to achieving competitive advantage (Anderson & Weitz, 1989; Heide & Miner, 1992). The underlying notion in this literature is that channels will not stay together long enough to achieve exceptional performance unless a channel member is dependent. But one-sided dependence is exploitable: dependent parties are vulnerable, and perceive themselves to be so (Jap & Ganesan, 2000). How can the weaker party guard against this risk?

The solution is to create two-sided, or mutual, dependence, to oblige the parties to respect each other and their engagements. The dependent party enjoys 'countervailing power' when the channel counterpart is also dependent. For example, a sales agent becomes dependent on a supplier when it makes supplier-specific investments, such as brand-specific learning. To balance that dependence, some agents work to achieve leverage over suppliers by cultivating strong ties with the principal's customers, seeking ways to bind these customers to the agent (rather than to the principal). Agents that engage in such dependence balancing forestall the principal's opportunism – and generate better financial performance (Heide & John, 1988).

This notion – either eschew dependence, or craft ways to make it mutual – underlies much recent channels research on influence. This thinking is reflected in the design of incentives and structure, the subjects of earlier sections.

Much of the current research on relational governance focuses on trust, which is generally operationalized as a belief that a channel member is honest (i.e., reliable, stands by its word, sincere, fulfills obligations) and/or benevolent (concerned about the other party's welfare). A meta-analysis by Geyskens, Steenkamp, and Kumar (1998) concludes that trust, no matter how it is measured, shows a variety of relationships with variables that may be antecedent or may be consequent. On the whole, trust is most strongly tied with positive sentiments (e.g., perceived fairness, satisfaction), and with action variables such as communication and cooperation. This suggests that trust is not difficult to infer, even though it is difficult to observe.

Prior to the late 1960s, four main branches of institutional perspective sought to be performed, by whom, and for what purpose. The institutional approach to the current state of affairs of organizations comprising a micro-analytic economic perspective sought to be primarily inductive and deductive. The micro-analytic economic perspective should look and function. Essentially an application of theory to channels, as the industry.

Beginning in the late 1960s, the industry was galvanized by the development of a conflict approach. The theory that channels can be organized into systems in a distributed manner. How power is distributed in these systems is the central question (Stern, 1972). This 'behavioral' approach, in which institutions are unarticulated motives (motives), is now commonplace. The framework was attacked by deductive for the institutional schools, and too behaviorally oriented and microeconomic.

Operationalizing the Concept

Channel power is defined as the ability of channel members to influence actions they would not otherwise take. Influence is a related concept: to influence is to change anything in its field of action as well as its field of appeal. The concept of influence is to apply. Abilities, if unused, it is difficult to know what they have done in the normal course of events.

The utility of power comes. Thus, the pitfall of the presence of power may be that ever an outcome is observed. Channel members are as powerful as they have over others. It is plausible that they don't get results they want, they in fact. This begs the questions of

CHANNEL POWER

Prior to the late 1960s, channels research comprised four main branches of inquiry (Gattorna, 1978). The institutional approach focused on describing the current state of affairs by categorizing the types of organizations comprising a channel. The functional perspective sought to identify what work was performed, by whom, under what circumstances, and for what purpose. These two approaches were primarily inductive and descriptive. In contrast, a micro-analytic economic stream focused on deducing normative generalizations about how channels should look and function. The fourth approach was essentially an application of industrial organization theory to channels, as though channels were an industry.

Beginning in the late 1960s, channels research was galvanized by the development of the power-and-conflict approach. The seminal idea here is that channels can be characterized as inter-organizational systems in which power is unevenly distributed. How power is gained and then used in these systems is the central question (El-Ansary & Stern, 1972). This 'behavioral' approach to channels, in which institutions are actors with complex, unarticulated motives (more than profit maximization), is now commonplace. Initially, however, the framework was attacked from all sides: it was too deductive for the institutional and functional schools, and too behavioral for the industrial organization and microeconomic schools.

Operationalizing and Measuring the Concept of Power

Channel power is defined as the ability to alter channel members' behavior so that they take actions they would not have taken otherwise. (Influence is a related concept but somewhat broader: to influence a channel member is to change anything in its fields of perception or goals, as well as its field of action.) While intuitively appealing, the concept of power is in itself difficult to apply. Abilities, if unused, are unobservable, and it is difficult to know what channel members would have done in the normal course of events.

The utility of power theory is to predict outcomes. Thus, the pitfall of power theory is that the presence of power may be merely inferred whenever an outcome is observed. This issue arises when channel members are asked to report how much power they have over other channel members: it is plausible that they don't know, but if they see the results they want, they infer they must have power. This begs the questions of whether 1) they have an

ability they have not exercised (thereby underestimating their power), or 2) they would have gotten the desired results anyway (thereby overestimating their power). We shall return to this issue shortly.

One way to circumvent this problem is to search for observable proxy indicators of power that are independent of any outcomes that might be attributable to the presence of power. Hence, a popular approach to measuring power is to back up one step in the causal chain by measuring not perceptions of power but the *sources* of power. Borrowing from psychology, a large research stream was sparked by making an analogy between two channel members in a commercial arrangement and two people in an interpersonal relationship. French and Raven's (1959) five bases (sources) of power is a taxonomy in which person A has more power over person B the more

1. A can offer *rewards* (positive utility) to B
2. A can *coerce* (inflict damage on) B
3. A can offer *expertise* that B can use
4. A can appeal to a *legitimate* authority (e.g., law, contract, morality, religion, social obligation) to make B feel obliged to comply
5. B views A as a positive *referent*, such that B identifies with A and wishes to be associated with A.

The translation of reward, coercive, expertise, and legitimate bases of power to channel members is straightforward. Referent power is more perplexing in a commercial setting: it is generally viewed as B's desire to share A's favorable image (e.g., to benefit by associating with a brand name or a recognized market position).

According to French and Raven, these five bases largely exhaust the ways power can be attained, and are conceptually and operationally separable. In particular, an important distinction is between reward and coercion (which are fairly demonstrable to all parties) and the other three bases. Expertise, referent, and legitimate bases are more subjective: B can more readily choose whether to acknowledge or deny their presence, so that A does not directly mediate these sources of power. For example, a franchisee may or may not acknowledge a franchisor's legitimate power to exert direction. This is why many franchisors screen prospective franchisees for a predisposition to accord legitimacy to the franchisor's intervention (some would say a compliant attitude toward authority) (Dant & Gundlach, 1998).

Field research in channels suggests it is difficult to retain this taxonomy intact, as the data often do not support it (Gaski, 1986; Hunt & Nevin, 1974). One common pairing that emerges from data reduction methods is coercion versus all-other-combined

(roughly, stick versus carrots) (e.g., Lusch & Brown, 1982). There is some indication that channel members overestimate their own autonomy when their counterparts possess considerable non-coercive power: carrots are less obtrusive than sticks.

Conceptually, the five bases could be combined into a formative indicator of the overall degree of power sources, in the same way that diverse variables (e.g. education, occupational status) are combined to index socioeconomic status. But channels research often keeps the bases separate because they are thought to create different outcomes (to be addressed in a later section).

A competitor to the five-bases approach (which comes from psychology) is the dependence approach, borrowed from sociology (Emerson, 1962). The simple premise here is that A's power over B increases with B's dependence on A. Dependence, in turn, rises with two terms: the utility that A can offer B (*benefits*), and the *scarcity* of A as a source of that utility. Party A is powerful (i.e., B is dependent) the more A is irreplaceable to B (ultimately, a monopolist) and the more A offers utility to B. Conversely, when A offers little utility, or B can find (and switch over to) many alternative suppliers, then B's dependence is low and A's power is therefore low.

A key element of dependence theory is its focus on the alternative channel members that B could realistically employ. This is absent in the five-bases approach. Dependence theory holds that benefits *per se* are irrelevant: if others could supply those benefits, party A has no leverage over B. (Conversely, scarcity is irrelevant if A doesn't provide much utility to B, since a monopoly over mediocre valuation affords little leverage.)

Dependence may be indexed directly by asking a respondent for an overall estimate of how much it needs the other party. Of course, this direct approach can be questioned: do respondents really know their level of dependence (or their channel counterpart's dependence on them), and if so, will they report it truthfully? To get around this, much channels research composes an overall dependence measure by indexing, then combining, utility and scarcity. Operationally, this means that a measure of dependence should *multiply* an index of benefits (often, these are measured as sales, profits, or an overall perceptual estimate of utility provided) by an index of scarcity (often measured as the reverse of the perceived ease of switching to a comparable channel member, or the number of comparable channel members in existence). But in practice, multiplication is seldom used. Apart from its psychometric complications, multiplication often proves unnecessary. Data reduction techniques frequently reveal that high utility and high scarcity are positively correlated, and therefore may simply be combined additively as reflective indicators of dependence (e.g., Anderson et al., 1987).

If one eschews direct elicitation, it is cumbersome to measure either the five bases or dependence. Some alternative conceptualizations of power are really proxies. In particular, *role performance* has been suggested as a useful approximation of dependence (Frazier, 1983). The premise is that competence and motivation are in limited supply. Thus, a channel member that performs its role in the channel well is distinctive. The better the channel member performs its role in an existing relationship, the more distinctive (and therefore scarce) it is. And since performing a role is useful, higher role performance makes a channel member distinctively valuable to its trading partner. Therefore, a channel member depends more on another party the higher that party's role performance in their relationship. This reasoning would explain why separate measures of utility and scarcity are often correlated, making it unnecessary to multiply utility and scarcity to create an index of dependence.

What is the best way to measure power? Which ways, if any, are invalid? This debate has generated considerable, occasionally acrimonious controversy. A comprehensive paper by Brown, Johnson, and Koenig (1995) suggests the controversy is overblown. These measurement approaches converge: all the indicators point in the right direction. Indeed, the best way to measure power appears to be the simplest way: directly ask the target of influence how much power the source possesses. Power appears to be like love: you recognize it when you see it.

The most recent branch of the power literature is the influence strategies approach. This stream treats power as manifest in the way that boundary spanners between two organizations communicate with each other. Six styles of attempting to exert influence via communication are common in channels (Frazier & Summers, 1984). Although these have been identified inductively through field observation, they map neatly onto a variation of the five bases of power. Research in this vein notes that the way influence strategies are perceived is culture-bound. In particular, influence strategies that seem heavy-handed and provoke channel resistance in Western markets may be acceptable in some cultures (e.g., Frazier et al., 1989).

Consequences of Power: Conflict

The centerpiece of power research has been the prediction that power generates conflict, in which channel members view each other as opponents. This matters because conflict is thought to damage the performance of the channel and hasten its dissolution, as well as reduce the satisfaction of channel members.

At high levels, conflict is experienced as negative emotion. Therefore, measuring conflict in a manner

separable from dissatisfaction (emotional state) is challenged in this article by Brown and D.

$$\text{Conflict} = \sum_{i=1}^N \text{Importance}_i$$

where N is the number of conflicts. By multiplying the influence of an actor rarely comes up, or that differences in the firms' power. On the other hand, a major issue over which the parties are in conflict. A large number of conflicts, which is why I ample role definitions are

The conceptual research is at odds with the empirical channels literature which can actually benefit the parties to work actively and improve their performance. Conflict spurs the change. Improves the relationship. Conflict is somewhat different. Overwhelmingly, data accompanies declining members (Geyskens et al.). Perhaps that by the time enough to be reported passed functional level that could use the spur they seldom become of the jostling that function viewed as normal behavior therefore not encoded in event, conflict and related.

Does power generate conflict? The conclusion that coercion is all other power sources that center around the dependence are related, if at all (Geyskens et al.).

Does conflict decrease performance? Curiously, this is examined. Most of the time appears to assume performance declines. The relation alone is the objection, can be subdivided (appraisal of overall performance indirect) and non-ecological of the psychosocial. Conflict is negatively related to causality, current dissatisfaction, because of channels, causes

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Power: Conflict

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separable from dissatisfaction (also a negative emotional state) is challenging. A comprehensive article by Brown and Day (1981) establishes that the level of channel conflict is best captured as:

$$\text{Conflict} = \sum_{i=1}^N \text{Importance}_i \times \text{Frequency}_i \times \text{Intensity}_i$$

where N is the number of issues (i) a channel dyad confronts. By multiplying, this formulation eliminates the influence of any issue that is minor, or that rarely comes up, or that does not involve large differences in the firms' positions on the issue. On the other hand, a major issue that comes up frequently, over which the parties are far apart, will contribute to conflict. A large number of issues also increases conflict, which is why complex relationships with ample role definitions are prone to conflict.

The conceptual research on conflict is somewhat at odds with the empirical research. In principle, the channels literature acknowledges that some conflict can actually benefit the channel, by spurring the parties to work actively to resolve their differences and improve their performance. This functional conflict spurs the channel to new heights and improves the relationship. However, functional conflict is somewhat difficult to find in the field. Overwhelmingly, data suggest that higher conflict accompanies declining satisfaction by channel members (Geyskens et al., 1999).

Perhaps that by the time conflict has increased enough to be reported by channel members, it has passed functional levels. Or perhaps relationships that could use the spur of conflict are so minor that they seldom become objects of study. Alternatively, the jostling that functional conflict creates may be viewed as normal behavior by respondents, and is therefore not encoded as being in opposition. In any event, conflict and dissatisfaction are strongly related.

Does power generate conflict? Results that center around the five-bases approach point to the conclusion that coercion generates conflict, but that all other power sources actually dampen it; results that center around the dependence approach suggest that dependence and conflict are not strongly related, if at all (Geyskens et al., 1999).

Does conflict decrease the channel's performance? Curiously, this issue has seldom been examined. Most of the research in the power tradition appears to assume that if satisfaction declines, performance declines as well. Therefore, satisfaction alone is the object of study. Satisfaction, in turn, can be subdivided into economic satisfaction (appraisal of overall financial outcomes, direct and indirect) and non-economic satisfaction (appraisal of the psychosocial aspects of the relationship). Conflict is negatively associated with both. In terms of causality, current thinking holds that economic dissatisfaction, because it goes to the *raison d'être* of channels, causes conflict, which then builds

non-economic dissatisfaction (Geyskens et al., 1999). Fundamentally, the economics of the situation influence opponent-centered behavior, which influences how smoothly the relationships operate in interpersonal terms.

But is satisfaction a good proxy for performance? A host of factors suggest that it is not. Performance is what the channel (or a channel member) achieves. Satisfaction is the channel member's *evaluation* of that performance. And the evaluation is made against some unspoken baseline, which is itself difficult to assess. It could be the channel member's expectations. Or the baseline could be the channel member's sense of the rewards available from the next best use of resources (Anderson & Narus, 1984). Research using equity theory as a basis suggests that the baseline is even more complicated: it is the channel member's sense of the distributive and procedural justice of the relationship (Kumar et al., 1995).

In short, satisfaction is a complex judgment influenced by many factors, of which the absolute level of performance is only one. Therefore, satisfaction may be a poor proxy for performance. Does satisfaction, then, matter in and of itself? Yes, in that satisfaction (in both its economic and psychosocial forms) is a driver of longer-term channel behavior, such as trust and commitment (Geyskens et al., 1998, 1999). These long-term behaviors translate into extraordinary influence.

The channels literature must develop multiple ways of conceptualizing and measuring performance. This is a difficult task: performance has many facets (Kumar et al., 1992), there are complex tradeoffs among these facets, and performance exists at different levels. Each member of a dyad, the entire channel, and the end buyer all have different (and to some extent conflicting) definitions of performance.

Further, performance is difficult to assess in the absolute. It is necessary to compare an entity's realized performance to some baseline representing a reasonable expectation, given the circumstances. (This is the unspoken rationale behind satisfaction research: it is assumed that the assessor has an appropriate baseline in mind when calibrating satisfaction.) This performance expectation could be established by comparing one firm's outcomes to the results generated by similar firms. An alternative research strategy is to model raw outcomes but include covariates tapping the circumstances that have substantial impact on outcomes (e.g., intensity of competition, size of potential market).

One approach to cracking the performance measurement problem is to develop a very comprehensive index, such as Kumar, Stern, and Achrol (1992). While laudable for its ambition, this approach suffers from obvious challenges to execution. Comprehensive approaches such as this should be employed. However, in the spirit of developing

middle range theory, channel researchers should also study a single facet, or a small set of facets, at a time. For example, Anderson (1988) models the performance of a sales agent as the cost-to-sales ratio the agent realizes for the principal.

The power-and-conflict research tradition has expanded to embrace other concepts, many of them more economic and less sociological in nature. Now known as the 'political economy' approach (Stern & Reve, 1980), the behavioral stream has left an enduring mark. Power theory *per se* receives relatively little attention: so many viewpoints have proliferated that they are very difficult to separate and test (see Kumar et al., 1998 for a review). Similarly, conflict *per se* is seldom studied, although it is often invoked in one form or another as an unobserved explanatory mechanism. The channels literature has moved on to other ways to frame the problem of achieving and exercising influence. These are reviewed below: the reader will notice that many of the issues central to discussions of power also feature in these approaches to gaining influence.

A novel approach, which merits more usage, is historical analysis. Messinger and Narasimhan (1995) provide an example by reconstituting the history of the supermarket in the US. They demonstrate that power has shifted in the grocery channel, first to manufacturers, then to retailers, and finally to consumers (who have benefited substantially as a consequence of supplier/grocer rivalry).

CONCLUSION

This review has noted robust generalizations section by section. At this point, a good deal is known about how to attempt to coordinate a distribution channel, and the costs and benefits of various approaches. Going forward, it is clear that channels research needs more explanation of how to create relationships with positive relationship norms. Further demonstrations that positive affects correlate at one point in time will not add to our knowledge base. Research needs to drive to relationship antecedents that managers can observe, suggesting relationship-building strategies they can adopt, and tracing the costs, as well as the benefits, of these strategies. Research should also focus on incentives, without presuming an alliance (partnership) strategy is envisioned by either side. And, ultimately, channels research needs more contingency thinking and more precise causal reasoning to point to what works, when, and why.

Channels research has developed to the point that competing causal mechanisms are observed to lead to the same predictions. This suggests that a contribution to channels research would be to devise tests to tease out causality. This includes 1) pursuing

a theory's implications to find and test unique predictions (implications that do not follow from other theories); 2) longitudinal tests, to rule out reverse causality; and 3) experiments.

This latter is of critical importance. For reasons of implementation, quasi-experimental field designs are non-existent in channels. However, they occur in other fields, such as advertising. Why not channels? In the same vein, naturally occurring field experiments are common in channels (they often occur without management's awareness, given the chaotic nature of channels initiatives in many firms). They merit more research attention.

But the field is not the only place to test a causal mechanism. Historically, channels research has made little use of laboratory experiments, perhaps due to an informal consensus that the lack of external validity outweighs the value of internal validity. But once a phenomenon is known to occur in the field, this concern becomes minimal. Channels research needs to enlarge the currently very small place given to laboratory experiments. This may be particularly productive when seeking to test analytic models, which by force must abstract away from many factors in order to concentrate on the one of interest. Such models are difficult to test in the field environment, but in a laboratory context, the relevant factors can be isolated and tested.

A point of contention in the channels literature is the normative versus positive tradeoff. Early channels work was freely positive, describing channel actions without concern for whether they made normative sense. There has been an about-face in the literature, driven in part by the exigencies of the review process. Later and current channels research now emphasizes finding a normative rationale for prevailing practice. Some research does this by beginning with a normative theory (such as TCE or agency theory), then fitting it (sometimes forcibly) to descriptive data about actual practice. Misfits are either ignored or explained away, sometimes by a convoluted efficiency rationale. Other research begins by searching for any patterns of practice, but ends with (occasionally tortuous) efforts to justify the findings in normative terms. Both approaches (force fitting or retrofitting) pose difficulties.

A third way is suggested by Roberts and Greenwood (1997), which proposes a 'constrained-efficiency' framework, in which actors try to be rational but are limited by preconscious pressures (inability to imagine a better channel), and post-conscious pressures (inability to implement a better channel, for reasons of losing legitimacy or institutional support). A related approach is that of economic sociology (Smelser & Swedberg, 1994). This sort of balanced approach is needed in channels research, because channel actors *are* motivated to make the best normative choice, but are also limited in their ability to do so. Such an approach re-opens the door to descriptive research by removing the

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review-process penalty for finding a channel practice that no one can justify – yet.

While the field has moved beyond pure documentation of phenomena, channels research still needs description. This is particularly the case for an enormous area in which channels research has barely scratched the surface: channels operations outside of North America. The logic, methods, and institutional environments of channels in the rest of the world merit investigation; such research has a high likelihood of sparking exciting new insights and debates.

More generally, channels research (and its attendant review process) should acknowledge that, while the field has progressed considerably, it is still in a pre-paradigmatic state. This is healthy: the phenomenon is too large and important to be bounded easily. Research on influence has demonstrated that multiple competing approaches *do* make headway: it is not necessary (and is probably harmful) to force a paradigm in the name of progress. In general, channels research should be more eclectic, not less. Indeed, one paradigm can fruitfully inform another on richer ways to consider any particular channels problem.

This is not a call for an anything-goes approach. Over the decades, channels research has greatly increased in rigor, and this is to the good. In particular, there is a greater emphasis on good measurement. This is manifested in greater attention to the wording of questions, to the definition of constructs, and to the correspondence between construct and measures in empirical channels research. On the analytic side, the sophistication of channels models has increased significantly as well. There is also greater attention to the source of data. At one time, channels researchers focused on finding multiple informants to craft a single observation. It is now widely recognized that the benefits of multiple informants are offset by costs. More informants per observation (channel) can be had, but usually by asking fewer questions of each informant, and by discarding many observations where multiple informants fail to respond. Current channels research tends to qualify one best-informed source, rather than aggregate several inferior-but-available ones. It is unusual to see a channels article today that does not justify the choice of informant. This is a major advance in the standards of channels research.

At the same time, channels research risks falling into the trap of trading off validity to gain higher reliability (Kopalle & Lehmann, 1997). This is manifested in excessive deletion of variables that have face validity, and in the exercise of boosting reported reliability by failing to vary the format and nature of the information sought. This, in turn, feeds an historical weakness of much field research in channels, which is to rely solely on the very subjective perceptions and impressionistic judgments of one person. This reliance makes it easy for the informant to retrofit 'reports' of constructs to fit

his/her personal theory of how channels work. The result is a possibly spurious, albeit entirely sensible, model, with artificially high fit to the data.

One antidote is to use multiple data sources (e.g., archives, reports of other channel members, industry observers). This is particularly useful to separate the dependent variable from the independent variables. Another antidote is to oblige the informant to report more concrete observables (which are harder to distort), and then to anchor the informant's more subjective judgments in these observables. It is one thing to ask a manager how difficult it is for a new salesperson to learn a job (judgment). It is quite another to combine this estimate with the informant's report of how much the company invests in training salespeople (observable) and how long a new salesperson takes to recapture the performance of his/her predecessor in the same job (somewhat observable). Putting all this information together into one scale reduces reported reliability, because these variables tap different domains of a construct and are in different formats. But combining these variables increases validity, which is essential. In this vein, channels research relies excessively on the reflective indicators approach, built around the idea that a narrow, unitary phenomenon manifests itself in reflections that, taken together, are highly reliable. The complexity of channel phenomena suggests that formative indicators are also appropriate in many cases.

On the analytic side, the increased complexity of channels models – now commonly including multiple channel levels, horizontal competition at the manufacturing as well as downstream levels, and price as well as non-price inputs to the demand function – creates a need for numerical analysis to gain substantive insights. Earlier work, building on simpler model structures, could derive insights in a purely analytic setting, but these insights came at the price of complexity and sophistication of the models themselves. To move forward on the analytic side, the field needs to not only allow, but also encourage, numerical analysis of these increasingly realistic models.

Although the channels area has been extensively researched, using many academic paradigms and investigating a myriad of different channel institutions, there is ample room for future contribution to the field. In an ever-changing real-world marketplace, the challenges of efficient channel design for effective satisfaction of end-users' demands remain. Businesspeople have come to realize the critical importance of an effective channel effort, and this bodes well for access to fascinating problems and data, no matter what basic toolkit the channels researcher brings to the area.

Notes

1. Of course, a contracting system may be designed concurrently with the recruitment of channel members or even in advance of channel member selection. However, the

literature frequently considers optimal contract design, taking as given the identities of members of the channel, suggesting our ordering of the process.

2. Note that this is a manufacturer's view of the issue. The channels literature tends to take the manufacturer's perspective, even though any channel member's perspective (e.g., the retailer's) is equally valid. Frazier (1999) and Stern and Weitz (1997) call for research to balance this excessive emphasis on the channel as viewed from upstream.

3. A two-part tariff involves charging a fixed fee and a per-unit price for the purchase of multiple units of a product. For example, the classic franchising contract requires the franchisee to pay a fixed franchise fee at the beginning of the franchise contract, as well as an ongoing percentage royalty based on sales.

4. The Stackelberg leader chooses its action in the knowledge of the other party's reaction function (rule). For example, a manufacturer (Stackelberg leader) would set its wholesale price in the knowledge of the way in which the retailer (Stackelberg follower) will factor that wholesale price into its retail pricing decision.

5. The literature employs terms such as 'choose,' 'use,' or 'select' channel members. This implies that the supplier need only take a decision. We prefer the term 'recruit' because prospective channel members must be persuaded to join a given supplier's channel - and they frequently choose *not* to be 'selected.'

6. Note that 'centralization' in this literature is unrelated to 'decentralization,' the term economists use to denote vertical integration.

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