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The Quasi-Judicial Role of Large Retailers:

An Efficiency Hypothesis of their Relation with Suppliers**

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Abstract

The paper explores an efficiency hypothesis regarding the contractual process between large retailers, such as Wal-Mart and Carrefour, and their suppliers. The empirical evidence presented supports the idea that large retailers play a quasi-judicial role, acting as "courts of first instance" in their relationships with suppliers. In this role, large retailers adjust the terms of trade to on-going changes and sanction performance failures, sometimes delaying payments. A potential abuse of their position is limited by the need for re-contracting and preserving their reputations. Suppliers renew their confidence in their retailers on a yearly basis, through writing new contracts. This renovation contradicts the alternative hypothesis that suppliers are expropriated by large retailers as a consequence of specific investments.

JEL codes: L14, L22, L81, K12, M31.

Keywords: Retailing. Distribution. Contracts. Transaction Costs. Self-enforcement.

1. Introduction

The problem

In recent years, public discussion concerning large retailers and their suppliers has been growing in intensity. It is often claimed that large retailers are endowed with overwhelming bargaining power and that they abuse this power in their relations with suppliers. New regulations have already been introduced and new regulatory initiatives are proposed frequently.[1] This work sketches and tests an alternative hypothesis, according to which large retailers efficiently perform a function similar to that of a court of first instance, that is, they act as second-party enforcers in their relationships with suppliers.

The empirical analysis is consistent with the argument that in order to perform this function, large retailers exercise a set of implicit and explicit rights to "complete" or fill the gaps in the contract, to evaluate their own and the other party's performance and to impose due sanctions. Safeguards against opportunistic behavior in the performance of these quasi-judicial functions follow directly from the retailers' own interest in maintaining their reputation and the relationship with the suppliers and in continuing to perform the double role of judge and interested party. It is rarely optimal, however, to eliminate opportunism completely. In retailing, failures in safeguards arise especially when the retailer's time horizon is

[1] See, for example, the French 1996 "Galland" Act (*Loi* 96-588), modifying the 1986 *Ordonnance* (86-1243) on freedom of pricing and competition, and the Spanish Retailing Act of 1996 (*Ley* 7/1996). More recent examples of this regulatory trend are the initiative taken by the French Government on January 2000 to modify the Galland Act (*Les Echos*, January 14-15, 2000: 24), the project for a Code of Good Commercial Practice prepared by the Spanish Ministry of Finance in 1998, the proposals to strengthen the protection of suppliers in the Spanish Retailing Act (extracted in Arruñada, 1999c: 68-84), and the recurrent proposal for a

unexpectedly shortened or his decentralized decisions are imperfectly controlled. Regarding these residual and potentially efficient distortions, it is claimed that regulation could hardly provide better incentives than market competition.

The article pays special attention to the most problematical aspects of the relationship between suppliers and retailers: the duration of the payment period, payment delays and the revision of the clauses before the end of the contract term. Quantitative empirical evidence aiming to explain these phenomena in terms of efficiency is presented. On the one hand, payment periods vary according to an industry-wide pattern that is coherent with an incentive-based logic. On the other hand, statistical analysis of the average payment period and payment delay per country shows that administrative difficulties of the firms are the cause of both the longer payment period and the delay. This is coherent with the view of these two phenomena, payment period and payment delay, as being efficient contractual instruments. Finally, some empirical data concerning revisions before the end of the contract term are analyzed. It seems, firstly, that these revisions are related to phenomena that increase the total surplus of the relationship. Secondly, the possibility of suppliers being exploited is rejected on several grounds, such as the lack of specific investments because of the nature of the activity, the low concentration of the retail sector in Spain, the use of short term contracts and, above all, the annual renovation of contracts.

The article has the following structure. The logic of the contracting process is examined in the second part of the Introduction where the theoretical background of the analysis is presented. Both the explicit (section 2) and the implicit contracting (3) between the two economic agents are studied, including the initial contracts, their revision, and the form and contents of the contracts. Special attention is paid to the payment period and payment

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European Union Directive on late payments (*OJEC*, December 3, 1998).

conditions. The main sources of conflict are studied at length (section 4), and possible discipline mechanisms used by the retailer in his parajudicial role are analyzed (0). Finally, the safeguards assuring that these discipline mechanisms would not be abused are presented (6). The article ends with a summary of its basic conclusions.

Asymmetric contracting

Three main branches have been distinguished in the analysis of contracts (Masten, 1999). Firstly, in the economic theory of contracts, parties reach agreements on the content of the exchange and an external judge enforces these agreements perfectly. Secondly, law and economics comes closer to reality, by supposing that the judge also completes the contract, contributing to defining the terms of exchange. Different approaches within this perspective use more or less restrictive concepts. Sometimes the judge is believed to behave efficiently, trying to discover the hypothetical will of the parties. Alternatively, judges are assumed to take into account other considerations, such as equity, and sometimes their decisions are viewed as affected by the rent-seeking activities of the parties. Finally, the theories that consider contracts as relationships offer a more complex perspective, considering also the possibility that judicial intervention can be relatively inefficient. As a consequence, the main function of contracts is not to define the terms of exchange, but to frame the process by which these terms are decided (Macaulay; 1963, 1985). Thus contracts define a variety of organs and decision rules, helping to create a framework, constitution or governance structure for the corresponding economic relationship.

From this latter point of view, a basic option in contractual design consists of choosing whether to facilitate or to avoid the use of self-completion and self-enforcement mechanisms. By "self-completion" we mean the parties defining by themselves the conditions or contents of the exchange, that is, the set of duties that the parties are obliged to perform for each other in

any possible contingency. In general, the contents of these obligations can be specified through mechanisms that are internal or external to the parties. Internal solutions are implemented through organs and decision rules, but also through asymmetric authority, as in the case in hand. Alternatively, external institutional solutions may be used, consisting mainly of the law, for achieving ex ante completion, and of litigation and arbitration, for ex post completion. There is also a wide range of possibilities for enforcing the obligations resulting from the contractual relationship. They are also either internal to the parties, based on repetition and reputation, or external, using mainly the coercive power of the State.[2]

Participants in economic transactions enjoy considerable information advantages with respect to third parties, including judges. For this reason, if one of the parties reaches a position of impartiality (either because of his reputation or because he contracts in a repetitive way), it is in the interest of all contracting parties to agree that this party possessing better information and incentives should be in charge of completing and enforcing the contract. This party thus performs tasks of a judicial nature. These include defining ex post any obligations that have not been agreed on ex ante, by adjusting the terms of trade to the latest changes and distributing unexpected gains or losses; evaluating whether each party has fulfilled its obligations or not; and imposing sanctions for poor performance.[3] In order to facilitate the exercise of these functions, it is necessary for the parties to choose contract solutions which strengthen the enforcing capacity of the internal judge (or which prevent opportunistic recourse to an external judge, as analyzed in Masten and Snyder, 1993). The clearest of the examples studied in this article is the payment period between retailers and suppliers, which plays a much more important role than just exploiting comparative advantages of a strictly financial nature.

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[2] See Arruñada (1998, Ch. 3).

The resulting organizational structure therefore constitutes a hybrid between the two extremes that, following Williamson's typology (1975, 1985), represent the ideal types of market and hierarchy. Williamson views these hybrids as corresponding to neoclassical contract law subject to the 'excuse doctrine', which is also an intermediate form between classical contract law and the principle of *forbearance* that governs the legal treatment of hierarchical relations (Williamson, 1991; 1996: 93-119).

The degree of judicial intervention places these intermediate solutions closer to one of the two extremes. In this case and with respect to the dimensions analyzed, we will see that the solution adopted in practice will be closer to the *forbearance* that is typical of the judicial treatment of hierarchical organization. This closeness, however, is not a consequence of active judicial abstention. In fact, judges are not given the opportunity of passing judgment on these matters because they are not litigated. Furthermore, if judges were given such an opportunity, precedents in other fields suggest that they would be likely to act in a way that would obstruct the performance of quasi-judicial functions by the retailer. This judicial inclination would motivate opportunistic litigation by suppliers. For this reason, this solution could only work when the relationship provides a large self-enforcement range or when this range can be enlarged by contractual means (Klein, 1992 y 1996; Masten and Snyder, 1993; Klein and Murphy, 1997).

These contractual mechanisms designed to avoid judicial intervention seem to be unnecessary between suppliers and retailers. Suppliers do not usually object to retailers' decisions, mostly because of the repetitive nature of the transactions. Interestingly, this happens even in cases of statutory rules which, because of their mandatory nature, can not be overruled

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[3] For an empirical test of this theory in the car distribution sector see Arruñada, Garicano y Vázquez (1999).

contractually and which aim to establish a legal basis for litigation. An example of such a rule is the one giving creditors an irrevocable right to be paid interest and a penalty in the case of late payment by a retailer.

2. Explicit contracting

Typically, explicit contracting between suppliers and large retailers begins with the retailer making a thorough examination of the potential supplier. When the supplier passes the examination, a written contract is signed defining the terms of exchange, even if they remain open to systematic renegotiation and annual revisions.[4]

Contractual conditions

First negotiation. Large retailers usually examine their suppliers before signing the first contract to ensure that the quality of the product corresponds to the retailer's market position, thus effectively performing their quality assurance role. They usually inspect the supplier's financial solvency, probably with the intention of estimating the potential duration of the relationship, and its incentives to maintain quality. Finally, they also evaluate the administrative organization of the supplier, as this is often a source of future conflicts .

Selling through a large retailer is valuable for small suppliers. If the retailer is an industry leader, suppliers even use this fact as a signaling device in their relations with other clients.

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[4] Unless stated otherwise (mainly with respect to the econometric tests in sections 2 and 4, which are run over aggregate European data), the evidence on the structure and functioning of contractual relations comes from case studies and interviews conducted with a sample of representatives from all the parties in the sector in Spain. This sample contained large and small, multinational and Spanish retailers and manufacturers. While special care was taken to cover a variety of operators, it was not possible, however, to assess the statistical significance

The existence of an initial examination and this use of the condition of supplier as an informative signal indicate that large retailers effectively provide quality assurance services, which for several years has been one of their main aims.[5]

Contract terms. At the beginning of every business year, the relations between suppliers and retailers are subject to exhaustive renegotiation. The process starts with the setting of objectives and follows with the signature of a new framework contract stipulating the price and other conditions. In the majority of relationships, a tariff and series of discounts related to specific variables (such as volume) are agreed. In this way, the retailer bears the risk of, for example, unexpectedly low sales which would prevent it from benefiting from any such discounts. In other contracts, these risks are borne by the supplier because annual 'guaranteed prices' are agreed. In this second case if, at the end of the business year, after computing all the sales and promotions the resulting average price exceeds the guaranteed price, the supplier should pay the difference to the retailer. A small number of retailers try to go further, negotiating a 'net price' plus a detailed schedule of all the promotions planned for the whole year. In this way both parties have incentives to achieve common goals.

Payment period. Payment conditions such as the term and the instruments to be used are a central element of the contract. The established patterns show remarkable regularities, which can be seen most clearly in the duration of the payment periods. (a) Purchases of perishable goods are generally paid for within 30 and 45 days or on the spot. The only spot payments that

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of the sample.

[5] It should be expected that suppliers sell at a lower price and accept worse conditions from retailers that give them more additional services of this nature. For this reason, the comparisons of selling prices which are often employed in discussions on competitive conditions may lose much of their relevance, because it is only possible to observe the net price (the nominal price less the implicit discount that the supplier accepts in exchange for services that are not explicitly paid). This net price is no longer comparable across retailers of different reputation and size, because the value of the reputation services they provide to suppliers is not the same.

are really immediate, however, are those for purchases of fresh fish, the rest having a payment period of about 10 days. Payment periods are shorter for those products where a longer payment period would not facilitate supervision of the supplier by the retailer (short product life and no return policy for perishables) or where such supervision would generate more trouble than good (fresh fish). The argument can be extended to other attributes of the transactions and products that influence the parties' capacity to observe any possible defect in product quantity or quality. In this case, the problem is solved by the intervention of a third party, usually an independent transport company, that gives information about the quantity of the merchandise delivered and the date of delivery. (b) Consumer products such as packaged food and drugstore items are paid for within a period of 60-90 days, while household goods are generally paid for in 90 days. (c) Textile products, which have the longest trade cycle and as a result their quality is known with the greatest delay, are paid for in 120-180 days. (d) Finally, any merchandise that is distributed with a right to return unsold items is paid for in periods longer than the return period, thus the payment period avoids possible opportunism associated with credit balances.[6]

There is also some variation among suppliers within the same industry that is sometimes explained by differences in the suppliers' bargaining power. However, it is not clear how the retailer benefits if he exploits his hypothetically greater bargaining power over a longer payment period rather than over the buying price. In fact, international data confirms the existence of a positive correlation between the price paid by purchasers and the payment period, both in general for all kinds of purchasers, and in particular for retailers (see Table 1, in which the purchase price is proxied by the commercial margins, assuming that the selling price is unaffected).

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[6] Payment periods have been discussed in more detail in Arruñada (1999a and 1999c).

Table 1. Average profit margin as a function of credit and payment periods in EU countries

	Average net margin[a]		*Average gross margin*[b]
Constant	38,203 (5,906***)[c]	40,592 (5,375***)	1,037 (15,199***)
Ln (Contractual credit period granted to clients)	-6,796 (-3,758***)	—	—
Ln (Actual average payment period)	—	-6,838 (-3,532***)	—
Ln (Actual average payment period)	—	—	-0,222 (-3,222**)
R^2_{adj}	0,467	0,433	0,652
F	14,123**	12,473**	10,379**
N	16	16	6

Notes and sources: [a] Regressions based on country averages for the net commercial margin, obtained through a survey of manufacturers (Intrum Justitia, 1997)[7]. [b] Regression based on country averages for the gross margin of large retailers, given by Strambio (1995: 53). [c] Two-tail *t*-statistics are in brackets, with *** = significant at the 99% confidence level; ** = significant at the 95% confidence level.

Explanation of the variety observed would therefore consider the payment period as an implicit modification of the product's price. The discount implied in a longer payment period is less evident both for the negotiator himself and for an employee who negotiates for his superiors. Differences among retailers with respect to their average payment period are also difficult to explain on the basis of bargaining power. They are neither related to the respective market share, nor do these shares reach a sufficiently high level, at least in Spain, in order to

[7] This survey, carried out in 1996 by NOP Corporate for Intrum Justitia, covered 3,000 European companies and was part of a research into payment patterns supported by the

exert an influence. Given that there are also considerable variations in other dimensions of the retailers' strategies, such differences could be interpreted as an integral part of their strategic variety. In particular, retailers with longer average payment periods can be understood as developing comparative advantages in financial management.

In conclusion, the patterns in payment periods are coherent with the argument that the payment period serves not only to achieve comparative advantage of a financial nature, but also to lessen the intensity of conflict in contractual relationships. Bargaining power explanations are not satisfactory because they are unable to account for sectorial and product patterns. It is difficult to believe that bargaining power varies according to sectors and products, especially considering that sectorial and product patterns are not correlated with concentration of supply.

Legal formalization. The first agreement and successive annually reed ones are formalized in writing. Considering that litigation is very rare, these written contracts are mostly used to help the parties during the progress of their relationship. In this sense, the written form rationalizes the parties' behavior in at least three dimensions. Firstly, it facilitates annual revision of the contract, which starts out on a sounder and less controversial basis, reducing the cost of bargaining. Secondly, it facilitates completion, as the danger of forgetting or distorting previous mutual agreements is avoided. Finally, it provides a precise reference when judging performance, whether this judgement is made by one of the parties or by a third independent one.

Annual revision of contracts

The relationship between the large retailers and their suppliers usually lasts for a long time, although its conditions are revised by writing new contracts annually. (This is separate from the

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European Commission.

revision of the contract before the end of the contract term, which will be analyzed in section 3). This revision of the annual contract lasts from three to six months. The time and resources spent in these annual negotiations is understandable when considering that failure, which happens sporadically, would interrupt the relationship, causing substantial costs to both parties.

The duration of the negotiations is justified because it is necessary to know how the relationship functioned the previous year. In addition, retailers are overloaded with work at the end and the beginning of each year and therefore force the negotiations to start long after the beginning of the year during which the parties bargain. Furthermore, it is believed to be a disadvantage to be the first supplier to reach an agreement with a retailer, and this helps to delay the agreement further. However, signing a contract with a retailer should strengthen, rather than weaken, the bargaining position of a supplier in his negotiations with other retailers. Maybe transaction costs *within* both firms are also relevant, with both negotiating agents wanting to demonstrate to their superiors the effort they have made.

Apart from the direct costs, the long duration of the annual negotiations on revising the contracts is in itself a source of conflict and misunderstanding. During the months of negotiating, the conditions from the previous business year are still in force. However, once a new agreement is reached, the new terms are applied to all transactions during the year, including those already carried out before the agreement. Outside observers frequently misinterpret this retroactive effect of the annual price agreement, considering it as a forced discount over the previously agreed price.[8]

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[8] For example, *Expansión* (June 1, 1998: 8).

3. Implicit contracting: Dynamic adjustment of the terms of exchange

In addition to the annual formal revision, the conditions established in the annual contracts are occasionally but systematically revised during the life of the contract. The most striking revision is what the industry jargon calls ‘wedding presents’, alluding to the discounts which suppliers are asked for by retailers that have recently merged with or acquired other retailers.[9] Similar discounts are associated with promotion activities such as new center openings or anniversaries. There are two types of explanation for these revisions and discounts. One is based on the creation of efficiency incentives, and the other on the retailer’s exploitation of his improved position.

The efficiency argument. The retailer’s effort is important if the relationship with his suppliers is to result in the highest possible benefits for both parties. It is no longer true that the supplier provides all the product attributes and the retailer is a mere, passive distribution *channel*. An increasing number of attributes are now produced by retailers, not only the physical availability that is typical of passive distribution channels. Retailers are responsible for a growing part of the marketing effort and, in the case of products with insufficient reputation, for quality assurance, as was explained in section 2. For this reason, the incentives of retailers to exert effort and to invest are increasingly important. They also need to be precisely fine-tuned, which might require revision of the conditions during the course of the year.

The fact that revisions are related to investment and expenditure initiatives (openings, mergers, and promotion campaigns) which increase the total benefits of the relationship supports the above explanation. In addition, mergers create a situation in which suppliers’ costs

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[9] See two examples in *Expansión* (February 3 and June 1, 1988).

may be substantially reduced for a number of reasons: a bigger purchase volume generates bigger order and production batches; the acquiring retailer usually takes all the responsibility for logistics; the logistics of the supplier become simpler because deliveries are centralized; administrative work decreases because only one buyer is concerned; and, financial risk decreases because it is usually the more financially sound retailers that acquire the weaker ones.

The efficiency hypothesis is also supported by other data. Generally, large retailers which are better placed to affect the sales volume of the product through effort and investment are more inclined to carry out the revisions. However, both parties share the consequences of some misfortunes, which indicates once again that the distribution of the gains from trade between the parties is continuous and dynamic.[10] The fact that suppliers often accept discounts without objection is also coherent with this explanation, except for the case when the retailer's bargaining power is substantially higher in the middle of the contract period. This possibility takes us directly to the second hypothesis.

The monopoly arguments. Certainly, these occasional revisions may be due to abuse by the retailer of its bargaining power, which may be caused by an existing advantage or may be a consequence of the contract itself.

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[10] This makes the relationship between suppliers and retailers closer to the type of relationships which can be observed more and more frequently in industries in which the intensification of competition induces the use of decreasing price clauses (see an example from the automobile sector in Aláez, Bilbao, Camino and Longás [1997: 100, n. 14]). These clauses do not prevent car manufacturers from asking for and occasionally receiving additional discounts from their component suppliers. Several varieties of asymmetric contracting have been studied in different industries and the conclusion is that this kind of contracting is typical for services provided under a franchising regime, both under a strict franchise arrangement (Rubin, 1978) and under allied activities (for example, in Arruñada, Garicano and Vázquez [1999], we analyze its use in automobile distribution).

There are several arguments against the ex ante monopoly hypothesis. Mainly, it is unclear why this method should be used, when it would be enough to fix lower prices. In addition, the degree of concentration of the retail sector is low, especially in comparison with the concentration of supply in most markets.[11] The argument is not supported, either, by the relative size of the firms in the two sectors. Furthermore, it has not been found that bigger suppliers reject the revisions to a greater extent than smaller ones. Neither do smaller retailers apply this practice less often, because the quasi-integration of small retailers through purchasing organizations permits them to renegotiate and reduce their buying prices.[12]

Despite ex ante competition, suppliers could find themselves obliged to accept these revisions ex post if some of their assets are "dedicated" to the retailer (Williamson, 1985: 96). In such cases, if the retailer were to threaten to cancel or delay orders, it would be difficult for the supplier, in the short term, to find an alternative use for the assets, even if they are not physically specific to the retailer, and it would have to accept the downward revision of prices. This possibility, however, is not convincing for both theoretical and empirical reasons. From a theoretic point of view, given that these occasional revisions are applied to all suppliers, the power of a retailer to sanction recalcitrant suppliers by a cut in their orders finds a natural limit in the number of non-compliant suppliers. As the probability of rejection is greater in the case of opportunistic revisions, these will be less feasible as they carry with them the risk that the retailer would not be able to react when faced with rejection by several suppliers of the same product line. The empirical indications go in the same direction because suppliers do not break off their relations with their retailers in the short run. Furthermore, they do not seem to gradually adapt their clientele of retailers, selling more to those retailers which are known for

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[11] See Ormaza (1992) and Schwartz (1999).

[12] See, for example, Padilla (1996) for a recent case.

not revising contractual conditions in the middle of the year. This behavior by suppliers is not coherent with the possibility that their bargaining power changes substantially after signing the contract with the retailer and designing their annual production plan. The fact that they do not take other precautions against the possibility of revisions is especially revealing when considering that it is common to negotiate additional safeguards (in most cases a longer contractual period) when the contract involves investments which are dedicated to a specific retailer, as when producing goods with the retailer's own label.

4. Sources of conflict

Like all complex relationships, those established between suppliers and retailers suffer from substantial conflicts. Claims of faulty performance, either intentional or unintentional, are the main source of conflict. Other common discrepancies concern prices and deliveries. Discussion frequently arises about whether the invoiced prices are or are not in accordance with the previously agreed levels. There are also delivery delays that are punished by the retailer when they cause stockouts and losses of sales. Clarification of these arguments is difficult. Price schedules are intricate and it is hard to evaluate the cost caused by imperfect performance. Opportunism is possible on both sides. For instance, it is possible for a return of merchandise with the allegation of late delivery to be due to opportunistic behavior on the part of the retailer because sales did not go as well as planned when ordering the goods.

Errors in the administration circuits are also a main source of conflict. Examples of these are differences in the quantities and prices between the time of ordering and delivery of the merchandise, or accounting errors, where the quantity in the invoice and the delivered quantity do not correspond. Retailers claim that administrative problems are common because the administrative systems of small-size suppliers are underdeveloped. There are cases when the

supplier issues the invoice and the delivery note at the same time so, if the delivery suffers from some defect, this is only discovered when the whole invoicing process has started. This makes fixing the problem cumbersome and slow. In other cases the transportation agent may fail to return the delivery notes to the supplier, causing administrative chaos. The importance of the supplier's administration is supported by the fact that some retailers refuse to work with suppliers that lack reliable administrative systems.

How important contractual and administrative factors are becomes clear when we observe the empirical relation that exists between the average duration of the payment periods in each country and the importance attributed to the different kinds of phenomena that cause payment delays. It has been observed that the average payment period is positively correlated with the importance of debtors' financial difficulties resulting in delays and *negatively* correlated with the importance of both disagreements between creditor and debtor and administrative errors. In other words, in countries with longer payment periods, debtor insolvency is more important while disagreements and administrative errors are less important, arguably because there is more time to solve both problems before the end of the contractual credit period (Table 2). This can mean that a longer payment period worsens problems with a financial origin, while it lessens those related to contractual and administrative issues.

Table 2. Correlation coefficients between country averages of credit and payment periods and causes of late payment in domestic transactions

	Contractual credit period	*Actual average payment period*	*Days overdue*
Causes of late payment:			
Debtor in financial difficulties	54.75%**	58.72%**	39.98%
Disputes	-55.78%**	-50.02%**	-15.94%
Administrative inefficiency	-52.00%**	-64.31%***	-59.56%**

Notes: ***, ** = Correlation is statistically significant at a confidence level of 99 and 95 percent, respectively. *Source of data*: Intrum Justitia (1997)[13].

Table 3. Average payment periods, average delays and economic development

	Contractual Payment Period	*Actual Payment period*	*Delay*
Constant	390.877 (4.369)***	564.142 (6.186)***	173.265 (3.424)***
Ln (GDPpc)	-35.201 (-3.936)***	-51.065 (-5.602)***	-15.863 (-3.136)***
R^2_{adj}	0.509	0.685	0.387
F	15.494***	31.385***	9.837***
N	15	15	15

Notes: Two-tail *t*-statistics are in brackets. *** = Significant at the 99% confidence level. *Source of data*: Intrum Justitia (1997: 5) and national accounting data.

[13] See note 7 for details.

The macroeconomic data are also coherent with the argument that improved administration tends to reduce payment periods and payment delays. As shown in Table 3, in the most developed countries in which companies are supposedly better organized, both average payment period and payment delay are lower. In fact, the administrative competence of the supplier is probably as important as that of the client. On the one hand, the best-organized suppliers are the ones that meet their obligations best. On the other hand, the best-organized clients are the ones that are most capable of verifying supplier's performance in a short time.

5. Disciplinary mechanisms

In relationships between the large retailers and their suppliers, the parties themselves undertake the tasks of completing the contract and sanctioning the most usual non-fulfillments. Even when the default is claimable, the parties are unlikely to go to court, because repeated contracting provides them with a cheaper solution. The parties even find it efficient to divide the supervision and control rights—including the rights to complete the contract and to punish defaults—in an asymmetric form, assigning both rights to a greater extent to the retailer. In this quasi-judicial role, it is common for the retailer to evaluate the level of performance and to take disciplinary actions. Let us analyze now what these actions are and how they work.

Payment delay as safeguard and sanction. Payment postponement strengthens the retailer's position as a judge, enabling it to take precautionary and punitive measures for possible non-fulfillment on the part of the supplier. In this function, it can either delay the payment until the defects are rectified or discount compensation if the defects are not corrected. Obviously, on the negative side, the retailer can abuse this authority using delay or other instruments in an opportunistic manner, extracting benefits from his suppliers. However, if this opportunistic behavior is controlled (more on this in section 6), this quasi-judicial role can be a helpful and

efficient mechanism in the contracting process. This efficiency is based on the fact that both parties have an important information advantage in their role as judges, because they know the particularities of the trade and can observe the defaults and conflicts at a very low cost, as a by-product of being in the business and trading.[14]

This interpretation provides a simple explanation for a common practice found in many countries, where no supplier pretends to be paid interest in instances of payment delay.[15] It is thought that such interest is not requested because of the high litigation costs. This factor may be of importance in cases of insolvency, but not in the case of delay, especially in countries in which the party that is found guilty pays the other's party litigation expenses. The persistent remission of this interest can be better explained by the continuous nature of the relationship, which easily survives episodes of late payment. Furthermore, this continuity is coherent with the possibility that apparent late payments may not be real or may have efficient causes, stemming from previous defaults by the creditor or being related to the provision of financial slack to the debtor in times of hardship.

Explicit sanctions: discounts for inexact debits. It is also common for retailers to apply discounts for 'inexact debits', usually on the basis of differences between the prices agreed and those invoiced.[16] The existence of administrative costs, allegedly burdensome for suppliers, helps to explain why it is the retailer that resolves this issue. The retailer is the one who writes the framework contract which is equivalent in its consequences to a contract of adhesion, while

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[14] See Arruñada (1999b).

[15] For information about the situation in different European countries, see CCE (1997: 7).

[16] In some cases the impact of these discounts is substantial. For example, in the relationship between one of the biggest retailers and one of the biggest consumer-good suppliers, both multinational firms, these discounts were evaluated in 1998 at 1.67 percent of the turnover, according to the supplier. In the same year and with the same retailer the supplier recovered 13 percent of the total value of the discounts (0.2171 percent of his turnover with the retailer).

most suppliers sign a different contract for each of their distributors.[17] This variety, compounded by decentralization, means that suppliers with standard organizational capabilities do not have complete and current knowledge of the terms under which they are trading.

Quasi-judicial taxes. Most disagreements between retailers and suppliers are discussed by suppliers and "settled" through negotiation. This fact hints that retailers exercise self-restraint and do not use their self-enforcement role opportunistically. Furthermore, a process is constituted which is very similar in its characteristics to court litigation: the unsatisfied supplier 'appeals' before the decision-maker or frequently before a superior within the hierarchical structure of the retailer. This negotiation process is subject to problems similar to those affecting court litigation, including frivolous litigation. To avoid this phenomenon, some retailers have introduced a penalty payment for ungrounded claims. In a well-known case, suppliers of a chain of supermarkets who make ungrounded payment claims have to pay three percent of the sum claimed as well as a fixed fee for administrative expenses.[18] These payments raise a question similar to that of charging fees to the parties for court proceedings. Not imposing fees may motivate parties to present trivial or opportunistic claims, while imposing them may prevent parties from making justified claims. If, in our case, the retailer does not impose claim fees, treats everybody equally in its initial decisions and these decisions are subject to errors, the suppliers have an incentive to claim even in cases when it would be efficient not to claim, because of the small stakes involved or doubtful grounds. In such

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[17] The fact that retailers have a greater capacity of control does not mean that they have either perfect or homogeneous control. This issue is highlighted by the policy of some retailers who contracted specialists to detect irregularities in the contracting and accounting of their purchases. Operations over the last five years were investigated and the specialist received half of the amount recovered. The mere existence of this practice highlights the high degree of error that exists in the administrative processing of transactions.

[18] *Expansión* (1 June, 1998: 8).

circumstances, a system of fees for ungrounded claims could probably help to prevent excessive claiming.

Merchandise returns. If we ignore the wholesale phase, the most simple trading cycle is the one starting with a retailer's purchase and ending, after a storing period, with a sale to a final consumer. However, in modern economies many sales are accompanied by an explicit or implicit right to return. This prolongs the cycle by one or two phases and makes it even more unstable, because the duration of these additional phases depends on the return period the supplier and the retailer may want to introduce in their relationship, which is generally shorter than the return period for the consumer. This extension of the trade cycle may induce a corresponding extension of the payment period in order to facilitate the enforcement of the right to return. If the consumer buys with a right to return, his return decisions function as a disciplinary mechanism which helps to assure product quality. It seems logical that the retailer and the supplier should share the cost of returns to the extent to which their decisions affect the quality in question. Likewise, it seems reasonable for the retailer to be assigned an explicit or implicit right to return. An arrangement that assigns to the retailer the right to return unsold merchandise intensifies the suppliers' incentives to produce relevant information and to adjust their product to the final demand, while at the same time it reduces the retailer's incentives in these connections. For this reason, such an arrangement is more likely when suppliers are in a better position to organize productive resources according to final demand, either in the information-producing activity or in the coherent adaptation of product design and the corresponding change of the production system. This conjecture is coherent with the observation that the arrangement discussed is most commonly used with products for which

sales vary seasonally, and in which retailers are in a relatively worse position to produce information about their demand.[19]

Breaking off and cooling of relations. The long-term relationships of retailers with their suppliers may be interrupted in two ways. Final termination, which is relatively rare, is motivated by deficiency in product quality or in the services provided. A cooling-off of relations during short periods (a duration of several months, although there are cases of up to two years) may also take place as a consequence of irreconcilable disagreements over buying prices. This, however, is not common. Most retailers do not put a definite stop to their purchases, especially of branded products. Instead, they keep buying the product, although they sell it at a higher price, either because its buying price is higher or because the product in question is not included in the retailer's promotion activities, which results in a substantial decrease in the product sales.

6. Safeguards and regulation

It can be deduced from the above that the retailer is in situation to behave opportunistically with his suppliers. Moreover, some observers interpret as opportunistic many of the practices that we have rationalized by efficiency arguments. To understand some of the conflicts subsisting in these relationships, it is useful to analyze how the safeguards against opportunistic behavior function and why they occasionally fail, giving rise to conflicts.

The efficient safeguard is imperfect. The basic safeguards are the repetitive character of the exchange and the contractual reputation of the retailer.[20] The reputation affects in particular

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[19] Obviously there are more factors that influence the efficiency of contracting with or without right of return. See Kandel (1996).

the possibility of further contracting under the asymmetry conditions that have just been described. Reputation also inspires enough confidence to convince suppliers to invest in assets which are specific to the retailer. This is becoming increasingly important with the growth in sales of products under retailers' own labels.

Given that these safeguards are costly, it would not be optimal to have perfect safeguards, freeing the relationship of all opportunism. In particular, incentives to perform well lessen when the decision-makers' time horizon shortens. This is especially true for firms whose survival is in question. Some retailers that acquired other financially troubled retailers realized the importance of this issue, when observing that the acquired firm had followed dubious practices with their suppliers, usually in the form of late payments.

Similarly, on a more general level and irrespective of the type of firm, problems also appear with decentralized decision-making, because of misalignment between the optimal behavior of the decision-makers and the behavior that is optimal for the company as a whole. In large retailers this situation arises because of substantial delegation of decision-making to store and product-line managers at store level, whose time horizon is shorter than that of the company. When these division managers are subject to high-powered incentives and there are no mechanisms to control long-term effects, these managers are tempted to take decisions that boost their apparent performance at the cost of cheating the suppliers, no matter how much such cheating of suppliers damages the reputation of the retailer company.

When discussing the importance of these cases of opportunistic behavior, the long-term incentives of the parties and the inescapable nature of transaction costs have to be considered. First, given that the retailer suffers a net loss, he has an interest in resolving the conflict.

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[20] See Klein and Leffler (1981) and Shapiro (1983) for the basic formulation of the role of reputation in contracting.

Otherwise, he will be subject to worse contract conditions. Second, because of the existence of contractual costs in the relationship with the divisional managers and while decentralized decisions are needed, it is not optimal to avoid these agency costs completely. Today, even in the presence of strong differentiation among retailers, there is a powerful tendency towards centralization, which reduces the importance of these dysfunctional phenomena. In some retailers, store managers no longer have the authority to influence the payment process. These retailers have centralized the decisions that affect the whole market, with respect not only to product range and prices, but also to the physical location of products on the shelves and, for the majority of products, the selling price and promotions. The task of store managers is therefore to implement these decisions at minimum cost, and the role of in-store product-line managers is limited to incorporating specific local information and controlling, confirming or correcting the ordering decisions. Such decisions are automatically generated by the management information system, which controls the stock level and sales flows. Similar consequences result from the development of logistics platforms and centralized storehouses, which increase the distance, even physically, between suppliers and the points of sale, and also separate shop managers from the contracting process with suppliers. Obviously, the possibilities for centralization vary according to the type of product and it can be expected that decentralized decisions will be still needed for perishable products.

No clear scope for regulation. In view of all the possible failures in the system of private safeguards, a relevant question concerns the role of regulation. As is usual with regulatory matters, the answer depends on the assumptions. In this case, the important assumptions to consider are, on the one hand, the capacity of the private agents to anticipate (and also penalize through their pricing decisions) possible non-fulfillment and, on the other hand, the regulatory capacity to prevent them. As for insolvency and the deterioration of incentives that precede it, the predictive capacity of the parties is probably not very high. But regulation similar to bank

regulation, like that discussed in Spain at the beginning of the nineties, would not be effective either. Moreover, it would be costly. This is why, in the absence of systemic risk, which might justify such bank regulation, it would not be reasonable. As for payment delays, the repetitive character of the transactions inclines us to think that creditors, to a great extent, are able to anticipate delays and the problems arising from them. When delays occur, suppliers penalize the retailers that behave worst and, in consequence, the latter will strive to improve their internal control. Empirical evidence regarding the existence of these penalties are the differences in retailers' reputations concerning their internal organization capacity and their inclination to engage in this kind of conflict.

In view of the above, the analysis indicates that regulation in this field will most likely result in a reduction and distortion of competition, among both retailers and suppliers, rather than a balance of suppliers' bargaining powers with respect to retailers. To the extent that regulation in fact would oblige retailers to perform better, the ones that have been complying worst would be at a disadvantage, because they would have to include this additional cost of change in their policy, and this would lead to less decentralization and a tighter control of decentralized decisions. Obviously, these retailers would obtain a benefit because of lower prices in the agreements given the higher rate of compliance, but probably this benefit would not compensate for the cost in question, because if it had, they would have followed this policy before the change in regulation. Moreover, since regulation would oblige some retailers to adopt a policy that is not beneficial for them, it would indirectly benefit those for which the new policy was already beneficial before. The same argument can be applied to the differences that exist among suppliers, either in their capacity to foresee insolvency or in their capacity to accumulate information on the rate of compliance of their clients. As a result, regulation would probably favor suppliers with a smaller capacity for prediction.

7. Summary

Contractual practices that are typical of the relationships between large retailers and their suppliers may respond to efficiency considerations. This efficiency explanation contradicts the hypothesis of systematic abuse on the part of retailers but does not imply perfect functioning of the safeguarding mechanisms. The recurrent nature of the relationships generates incentives for compliance and makes it possible for most conflicts to be solved through negotiation between the parties without third party enforcement. The retailer is assigned and performs quasi-judicial tasks possibly because of its advantageous position regarding availability of information, which is needed to evaluate suppliers' performance. Thus, retailers act as courts of first instance, exercising a right that is implicitly assigned at the beginning of the relationship and with each annual renovation of the contract.

The main ways by which this quasi-judicial role is exercised is by delaying payments associated with defective purchases and invoices, as well as debiting discounts for inaccurate debits or incorrect invoices. Coherent with this analysis is the variability in standard payment periods across different groups of products. Payment periods vary systematically according to the types of product and the differences observed seem to correspond to the ultimate objective of reducing conflicts in the parties' financial and commercial relations rather than to their relative bargaining power. This conclusion is also supported by the fact that there are no relevant differences in payment periods, even in the special cases of exclusive suppliers and suppliers delivering products sold under the retailer's own labels.

This quasi-judicial role of retailers permits them not only to motivate suppliers' performance but also to adjust the distribution of the additional surplus produced by the efforts of each party which are too costly to contract explicitly ex ante. The mechanism used is that retailers request bonuses and discounts below the contracted buying price, these requests being

made, and mostly accepted, throughout the life of the contract. The fact these requests are triggered by retailers' initiatives—retailer mergers, openings of new stores and logistics platforms, special promotions—that benefit their suppliers supports an interpretation of these contractual revisions as being efficient. According to this interpretation, the possibility of modifying the contracted conditions allows for modification of the distribution of any gains from trade resulting in both changes in the environment and efforts and investment by the parties.

The long-term behavior of suppliers also refutes the hypothesis that delays and the revision of contract conditions constitute an abuse on the part of retailers. In the short run, suppliers might accept these delays and contract modifications because they have no other option. However, in the long run, they keep contracting repeatedly with the same retailers, in spite of such practices. This persistence would not be reasonable if such delays and adjustments were expropriatory.

A final word of caution is in order, however. The qualitative and casuistic nature of much of the evidence in this study recommends a prudent conclusion. It is hoped, however, that the arguments in the paper will hold relatively well if a similar level of circumspection is applied to alternative explanations.[21]

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[21] In fact, the studies that currently guide European legislative proposals in this field do not seem more reliable. See, in particular, the study that provided the basis for the proposed Directive on late payments (CCE, 1997) and, for a criticism, Arruñada (1999c).

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