1. Introduction

Many of the ideas as well as the approach presented below are as applicable to the wholesale sector as they are to the retail sector. In order to emphasize this applicability the more general term 'distribution sector' is often used in what follows whenever the issues or arguments are essentially the same in the context of retail or wholesale. Nevertheless, the analysis here focuses explicitly on the retail sector and this is stressed by the choice of title for many of the chapters.¹

Defining and understanding a distribution system is a difficult task for at least three reasons. First, the distribution activity encompasses any mechanism for making available goods and services to consumers. Hence, it includes the activities of the department store, the supermarket and auction companies on the Internet as well as those of the travel agent, the telephone company and the local branch of a bank. An important difference between the first three activities and the last three activities is that in the first three what are being distributed to consumers are usually outputs of the manufacturing and agricultural sectors and in the last three what are being distributed are outputs of the service sector. Output measurement in the service sector is notoriously difficult and the distribution activity itself is part of the service sector.

Measurement difficulties in the case of services have begun to attract the attention of economists. Initial steps in addressing this issue, especially at the conceptual level, can be found in a conference volume edited by Griliches (1992). Since measuring the output of distribution activities is a major task in any analysis of services, it is not surprising that one of the chapters in this conference volume is devoted to the distributive trades (Oi, 1992). Along the same lines earlier empirical work on the role of services in the economy, Syrquin and Chenery (1989), has been recently disaggregated to focus on the distribution sector, Anderson and Betancourt (2002). The latter authors find different patterns of evolution with respect to income for the distribution sector than had been found by the former authors for services: namely, it follows an inverted-U pattern rather than a rising pattern.

Second, since the retailing activity provides a link between consumers and producers or wholesalers, it is going to be affected by the characteristics of both the consumers and the producers or wholesalers. Thus, long-term demographic and technological changes that affect consumers and producers will have an indirect impact on retailers. For instance when refrigeration becomes

widely available to households at low cost, the range of products that the retail system can make available to them is different from when no such refrigeration is available. Similarly when a society is populated increasingly by households with two income earners, the demands of consumers for some retail services, extended hours for example, become very different from when a society has an insignificant fraction of such households. Understanding the indirect impact of long-term demographic and technological processes is not an easy task.

Third, since distribution is an economic activity it will be directly affected by all the factors that affect any economic activity. For instance technological change will also have a direct impact on the retail or wholesale system. The by now ubiquitous presence of optical scanners in supermarkets and the rapid spread of retailing and wholesaling through the Internet are two well-known examples. Similarly, the regulatory environment that prevails in a society will have a direct impact on the distribution system. For example, restrictive zoning laws in France during the 1950s (Loi Royer) provided powerful incentives for the development of hypermarkets there before they were introduced elsewhere. In general, variations in the prices of major inputs and outputs of this sector, for example rents and interest rates, would be expected to generate significant adjustments in the variables controlled by economic agents operating in this sector.

Substantial variations in so many different possible characteristics create difficulties for understanding the distribution system. They come to the fore when one attempts to make international comparisons. To illustrate, in the early 1990s the OECD commissioned a study of the distribution systems in seven advanced countries to seven different researchers (Japan: Maruyama, 1993; UK: Dawson, 1993; France: Messerlin, 1993, Germany: Lachner, Tager and Weitzel, 1993; Sweden: Wibe, 1993; Italy: Pellegrini and Cardani, 1993; and the US: Betancourt, 1993). Each study was carried out in a different manner and no attempt was made to synthesize the results.

The rest of the introduction is devoted to two tasks. Despite its difficulty, it is important to understand the distribution system from a variety of perspectives and in the next section arguments are put forth that justify this assertion. In the subsequent section, the approach taken here to this difficult and important topic is presented together with an overview of the progress made in the chapters that follow.

1.1 IMPORTANCE OF THE TOPIC

One reason for the importance of the topic is the economic size of this sector and, consequently, the substantial amount of resources devoted to it in any

economy. A good measure of the economic importance of this sector in terms of size is its contribution to GDP relative to other sectors. For the US, for example, the wholesale and retail trade accounted for 16.5 per cent of GDP in 1996, measured in constant dollars (1992).² The magnitude of this percentage is not unique to the US. For instance, Anderson and Betancourt (2002) find that the average contribution to GDP of the retail and wholesale trade for a group of 74 countries during the period 1950–1983 is 13.5 per cent.³ The wholesale and retail trade together rank second only to manufacturing in their contribution to GDP in the US, and the retail trade constitutes between 50 and 60 per cent of the distribution sector's contribution to GDP in any one year.

It has to be noted that the above figures are a lower bound to the importance of retailing's contribution to GDP, or its economic importance, from the following perspective. Many retailing activities are attributed to sectors other than the retail sector in the national income accounts for a variety of reasons. This is especially so in the retailing of services. In the case of eating and drinking establishments, for example, difficulties in separating production activities from distribution activities have led to changes in classifications such as the ones just discussed (see note 2). A similar phenomenon manifests itself in other industries. For instance, what part of the contribution of the banking activity to GDP is due to retail banking? Similarly, what part of the contribution of communications or transportation to GDP is due to the retailing of communication services or transportation services? The arguments throughout the book are also applicable to the retailing of these services,⁴ but the explicit measurement of the retailing of these services at the level of the national income accounts is not practically feasible with current methodology.⁵ On these grounds, the national income accounts statistics substantially understate the economic importance of retail activities.

Dramatic changes in the economy have led to major changes in our measurement of economic activity and these changes will accentuate the understatement of the economic importance of retail activities when the latter are defined to correspond solely with the census definition of the distribution sector. For instance, one can access an Internet service and acquire most of the information necessary to purchase a car from a dealer, including a fixed amount to be paid above dealer cost for the specific car one wants and the name of a salesman that handles Internet sales at the dealership nearest one's home. The dealer must pay this specialized Internet service provider a fee to be part of the list of dealers to which users of the Internet service are directed. This specialized service will be classified as part of the activities of the information sector under NAICS.⁶ Before the Internet most of this information would have been provided by the auto dealer and would have been viewed as part of the activities of the retail sector. While the retailing function performed is quite similar in both cases, namely the provision of information, our

recorded measurement of the contribution to economic activity of the retail sector is different.

Notwithstanding these issues of underestimation, the contribution to output of the distribution sector as measured in the national income accounts has been, is and will remain quite large. In the past, two issues have dominated the discussion of the evolution of this sector over time: its contribution to employment and to labor productivity. For instance, two of the main findings of an early classic on the topic, Barger (1955), are: 1) the fraction of the US labor force engaged in the retail and wholesale trade increased between 1930 and 1950, whereas that in manufacturing decreased; and 2) output per man-hour in this US economic sector rose considerably less during this period than output per man-hour in manufacturing. More recent work by Oi (1992, Table 4.2) for the period 1950–87 shows that these two trends have continued.

The more recent data, however, provides two additional insights. First, it allows a split of the distribution sector between wholesale and retail. This split shows that the above two trends are more pronounced for the retail trade than for the wholesale trade. Moreover, it also shows that the retail trade share of employment in 1987 was 22 per cent, compared to 6.8 per cent in wholesale and 21.4 per cent in manufacturing. Hence, the economic importance of the retail sector measured in terms of the number of persons who earn their living in this sector is considerably larger than in terms of its contribution to output. Second, it allows a direct comparison between employment and hours, which shows for 1987 a share of hours worked in retailing equal to 19 per cent compared to 7.2 per cent in wholesale and 23.4 per cent in manufacturing. The difference between employment and hours is due to the greater use of part-time workers in retailing, which also contributes to the finding that average hourly earnings of retail workers are substantially lower than those in wholesale or manufacturing. Therefore the nature of work in the retail trade raises issues relevant for current social policy, since the availability of pensions and health benefits for part-time workers is less than for full-time ones.

One result of the imbalance in trade between the US and Japan is that the importance of the distribution sector in facilitating or hindering trade has arisen as a policy issue. Indeed, a new acronym has been added to our vocabulary, Structural Impediments Initiative or SII, and differences in the efficiency of the distribution sector across countries have become a potential culprit for the existence of structural impediments to trade. While the theoretical basis for attributing this imbalance to an inefficient distribution system is ambiguous, there is a positive empirical association between the level of trade and the level of services available to the distribution sector in terms of communication and transportation facilities.⁷

Similarly, the importance of the distribution sector in understanding macro-economic phenomena has been highlighted recently by Burstein, Neves and

Rebelo (2003). The authors find the standard model used to analyse the behavior of the real exchange rate in exchange rate based stabilization programs unable to explain, among other things, the behavior of the real exchange rate after the introduction of these programs. They introduce into the standard model a distribution sector in which tradable goods must be combined with distribution services before they can be consumed. With this feature they are able to explain variations in the real exchange rate after the introduction of the 1991 Convertibility plan in Argentina far better than the standard model. They also suggest, in their conclusion, that other puzzles in international macroeconomics might be better understood by explicitly including the distribution sector in the analysis.

Ongoing work by MacGee (2002) develops a complete markets two-country multi-sector general equilibrium model that includes the provision of distribution services. In his model any traded good used for final consumption is produced by combining traded intermediate goods and distribution services specific to that good. With this modification to the standard complete markets two-country multi-sector general equilibrium model MacGee resolves one existing puzzle in this literature. That is, the data shows consumption to be correlated across countries, for example, 0.36 for the US versus the rest of the world. While the standard model without the modification predicts a correlation of 1 across countries for consumption, MacGee's modification of the standard model generates correlations of 0.37, 0.45 and 0.33 for three different assumptions on investment adjustment costs.

Is there evidence on the nature of differences in retail systems across countries, especially productivity or efficiency differences? In a widely cited study Smith and Hitchens (1985) compared the distribution sector in the US, the UK and Germany. First, they showed (Table 1.1) that in 1980 the contribution of the distribution sector to GDP was 17 per cent for the US, 12.5 per cent for the UK and 9.4 per cent for Germany. In all three countries, however, the contribution of the sector to employment was considerably larger than to output (21.5 per cent in the US, 17.3 per cent in the United Kingdom and 14.4 per cent in Germany). In the same year (Table 1.3) the share of retailing in distribution (in terms of GDP contribution) was 55 per cent for the US, 54 per cent for the UK and 52 per cent for Germany. The relative labor productivity of the US in retailing compared to the UK was 2.39 and compared to Germany it was 2.49 (Table 2.6). This comparison was based on sales per capita for the 1971–72 period for the US and the UK and for the 1972–67 period for the US and Germany.

Ito and Maruyama (1991) compared several advanced countries using value added per person engaged in retailing (Table 3.1). Value added was measured as sales times the proportionate gross margin. They find that relative to total value added per person engaged in industry, Japan's productivity in

1985 was 0.76, the US was 0.70, Germany 0.68 and the UK 0.58. On the other hand, Baily (1993) found that in general merchandise retailing US labor productivity was 2.5 times that of Japan, 1.04 times that of Germany and 1.21 that of the UK during the period 1987–88. Baily used value added per full-time equivalent employee as his measure of labor productivity.

What do we learn from these dramatically different results? In the US, UK and Germany comparisons of Baily and Smith and Hitchens there are three sources of differences. First, the measure of output of retailing in the former is value added while in the latter it is sales; second, the former study refers to a branch of retailing whereas the latter refers to the whole sector; third, the time period of the comparison in Baily is 15 to 20 years later than in Smith and Hitchens. All three sources of differences identify important issues that need to be and will be addressed in subsequent chapters: namely, the appropriate definition of retail output and the potentially different performance of different branches of retailing across space and time.

In the US–Japan comparison an important part of the explanation may be measurement problems. Part-time employment is far more prevalent in US retailing than in Japanese retailing; the Ito and Maruyama measure does not adjust for this while the Baily measure does. Hence, the former measure overstates labor productivity in Japan relative to the US. In addition, Japanese manufacturers detail workers to the retailers of their products but keep them on their own payrolls. Their contribution to output is captured in the Ito and Maruyama measure of the output of retailing but their contribution to employment is not. It is captured in the level of employment by the manufacturers. This does not affect the Baily measure. On this account the Ito and Maruyama measure also overstates labor productivity in Japanese retailing relative to the US and to other countries.

Understanding the distribution system is of direct importance to the field of industrial organization. All of the issues that arise in this field with respect to other industries arise as well with respect to the retail or wholesale sector, but they often take different forms in retailing. For instance, in evaluating the degree of concentration in an industry and what it may imply for merger policy, for example, it becomes necessary to take into account that retailing is in some sense a local or at best regional activity in a way that manufacturing is not. Furthermore retail firms are intrinsically multiproduct, offering a variety of explicit goods or services and implicit distribution services. The provision of distribution services plays a fundamental role in retailing that is not necessarily shared by other industries. For instance, variations in distribution services are a main factor generating different types of retail organizations.

Price comparisons or analyses of competition across different retail establishments that ignore these features are likely to be misleading. For instance, one of the sources of bias in the recent controversy about the CPI is explicitly

identified as outlet substitution bias (Boskin et al., 1996). The multiproduct nature of price setting at the retail level has been found to be important at the macroeconomic level as well (Lach and Tsiddon, 1996). Finally intertype competition is more important in retailing than in other industries; one can even argue that it is a unique feature, because of its intrinsically local nature and the role of distribution services in creating different types.⁸ Thus, in evaluating the competitive impact of the Staples and Office Depot merger, one of the factors that both sides tried to control for was the possibility of intertype competition. That is, they controlled for the presence in a local market of other types of stores, besides office supplies superstores, that sell office supplies such as computer superstores and warehouse clubs (Gleason and Hosken, 1998).

To conclude, understanding the retail system is also important for the study of marketing. Marketing researchers operate at lower levels of aggregation than industrial organization researchers and focus on issues that impact firm decisions in operational settings, for example heterogeneity of customers. Nevertheless, many of the economic issues addressed by marketing researchers are similar to or the same as those addressed by economists. Furthermore, in some settings the interests of researchers in both fields coincide. For instance, Wernerfelt (1994) has argued that in evaluating marketing designs it is necessary to take into account the payoff functions of all members adjacent to a channel, including the consumer. A basic feature of the approach taken to the analysis of retail systems in this work is the provision of an explicit mechanism for linking the benefits received by the consumer from the retail system to the activities of the retailers.

Ironically, many issues of interest to economists have been analysed by marketing scholars with substantial training in economics, or economists working in marketing departments, and published in marketing or business journals. Part of the reason may have been that mainstream economists often ignored the role of the distribution sector in the economic system during the 1970s and the early 1980s. Whatever the reason for this phenomenon, however, the trend of significant analyses of economic issues by marketing scholars continues unabated to this day. Indeed, perhaps one of the best illustrations of the trend can be seen in the numerous items in marketing and business journals in this book's references.

1.2 APPROACH AND SCOPE

Our approach is anchored in the following definition of the function of retail systems: the provision of goods and services to consumers together or jointly with a set of distribution services.⁹ In general it can be viewed as part of the New Institutional Economics in the sense of applying the tools of economics

to explain the workings and evolution of institutional arrangements (for example Furubotn and Richter, 1997). More specifically, it identifies distribution costs, which are transaction costs, and the distribution services into which these costs map as key determinants of the functioning of retail systems. It also pays serious attention to characteristics of retail systems that enhance the importance of the analysis of property rights, for example the bundling of distribution services with the explicit products or services sold at retail. The analysis of property rights lies at the core of the New Institutional Economics.

In the first part of the book (General considerations) I develop the main implications of adopting this view of the function of retail systems for standard models of competition in retail markets and for the empirical analysis of retail gross margins (Chapter 2), for the analysis of retail demand (Chapter 3), and for understanding the nature of retail supply (Chapter 4).

Chapter 2 contains a detailed description of the costs consumers incur in patronizing retail organizations and we map these costs into a set of five broad categories of distribution services that retailers provide. These categories are: assortment, assurance of product delivery (at the desired time or in the desired form), information, accessibility of location, and ambiance. Each one of these distribution services can be viewed as an output of any retail organization. At the same time, each of these distribution services can be viewed as a fixed input into the (household) production functions of consumers. This view of distribution services as outputs of retail firms and fixed inputs to consumers provides the mechanism for analysing an essential characteristic of retail markets: *cost shifting*. We document the implicit recognition of this issue in the economics and marketing literature of the last 30 years and illustrate the benefits of our particular formalization of the idea for the explanation of retail price dispersion and the existence of different types of retail firms in equilibrium under monopolistic competition.

A second essential characteristic of retail markets is that the distribution services implicitly provided with the goods or services explicitly provided by any part of the retail system are usually not priced independently of these explicit outputs, that is, there is *bundling* of explicit output and distribution services. We also show in Chapter 2 some of the benefits of a particular formalization of this idea in terms of a simple model with one explicit output and one distribution service. This model, which is an adaptation of the models of Bliss (1988) and Betancourt and Gautschi (1993a) put forth by Betancourt and Malanoski (1999), allows us to analyse competition and welfare issues in a straightforward fashion. Furthermore it generalizes the full-price model of services (Ehrlich and Fisher, 1982), which is used to analyse retailing under the assumption of perfect competition, and it brings out one of its limitations. The full-price model breaks down when there are increasing returns to scale in the provision of distribution services.

Since Chapter 2 introduces the approach employed throughout the book, it concludes by discussing two alternative validation processes. First, there is a thorough discussion of measurement issues and empirical evidence in the context of explaining variations in retail gross margins across retail branches. The retail gross margin has been a center of attention in this industry for many years but empirical progress in its explanation has been slow.¹⁰ We show how the emphasis on distribution services leads to an empirical framework for explaining retail gross margins that is supported by the empirical results available across branches of the retail sectors in the US, Germany, France, Holland and Spain. Second, there is a detailed discussion of a case study that illustrates how to measure and employ these concepts in a strategic setting.

Chapter 3 contains a methodological foundation for the analysis of retail demand by formally incorporating distribution services as fixed inputs into a general version of the household production model. This provides a rigorous basis for the analysis of retail demand with data on purchases rather than consumption, for example scanner data. Even without distribution services the household production model has important and little-known implications for the substitutability and complementarity that arises in retail demand as a result of price changes. This chapter derives them formally and illustrates them in practice, with a detailed analysis of two empirical studies drawn from the marketing literature.

Subsequently, the formal implications of the existence of distribution services for the substitutability and complementarity that arises in retail demand are derived. The main implications of this approach to retail demand for the nature of retail competition and for the creation of retail agglomerations are also explicitly drawn here. Finally, this analysis is related to several strands of literature on retailing. In particular I discuss in detail here two recent studies, one in agricultural economics and the other in marketing, which implement this approach to retail demand empirically.

What is the appropriate definition of retail output or supply? Simple as the question seems, it has generated a variety of answers in the literature: for instance, sales, value added, the retail or gross margin and a measure that includes the consumer! Retail firms produce two different kinds of outputs: the goods and services explicitly sold and a set of distribution services that implicitly accompany any retail exchange. In Chapter 4 modern production theory is used to show the conditions under which the latter set of outputs collapses to the value added or gross margin measures and the former to the sales measure. This formulation brings out that the existing evidence on economies of scale in retailing implies that there are economies of scale with respect to distribution services, not necessarily with respect to the explicit output of retailing. Furthermore, these tools and the accompanying econometric techniques are used to show that the role of the consumer in retail supply is incorporated by

accounting for the endogeneity of certain variables. Recognition of these issues provides a sound basis for productivity measurement in retailing and this topic concludes the text of this chapter. Since the provision of assortment, however, is a most important and distinctive characteristic of retailing, an appendix to this chapter presents a formal specification of a production function for assortment that is consistent with modern production theory.

In the second part of the book (Interactions between consumers and retailers) I apply the previous ideas to establish the multiproduct nature of retailing and its pricing implications (Chapter 5), to highlight important and neglected aspects of the packaging decision by retailers (Chapter 6), and to understand familiar institutional forms that provide the context for the interactions between retailers and consumers (Chapter 7).

What should the focus of interest be for analysis: item prices or item prices at particular points of purchase? This question becomes interesting because retailing is essentially a multiproduct activity. And, most pricing issues in retailing need to be examined taking into account this feature. In Chapter 5 I undertake this task. First, the basic result in the literature on multiproduct pricing is presented here: namely, its connection to the cross price elasticity of demand. Furthermore, its implications are illustrated with two studies from the marketing literature. Second, the main extensions of this result to a situation where distribution services are variable and subject to the choice of retailers are presented here. These services play a critical role in explaining why gross complementarity prevails among most items offered by retailers. Moreover, they are also essential in understanding pricing in the Internet and this is one of the implications of the extended analysis discussed in detail in this chapter.

Another important topic addressed in this chapter is the practice of loss leading. The strict interpretation of the latter concept (pricing below marginal cost) is meaningless in a single-product, single-period world. Furthermore, the most insightful explanation of this practice in the literature, Lal and Matutes (1994), uses the provision of a distribution service (information) as a key to the explanation. In this context, I discuss two recent empirical studies that show how the gross complementarity implied by this model (and, more importantly, by the existence of distribution services in general) is consistent with persistent empirical phenomena. This consistency is shown to be absent from alternative models. Finally, an appendix addresses a somewhat related but specialized topic in the context of multiproduct retailing: namely, the construction of cost of living indexes on the basis of scanner data.

The next chapter examines the literature on a specialized business practice in terms of the framework developed here. Namely, in Chapter 6 we consider a business practice that shifts storage costs and, thus, implies the provision of different levels of assurance of product delivery by the retailer: packaging. In economics, packaging is treated as a form of commodity bundling and the

literature emphasizes the welfare losses to consumers from this practice. Marketing scholars have followed this lead at lower levels of aggregation. By allowing for intertype competition in the provision of distribution services, however, one can explain the empirical evidence available in both types of literature and show that the welfare losses associated with the commodity bundling involved in packaging can be substantially ameliorated by intertype competition in retailing.

The last chapter in this part brings out the importance of distribution services, especially assortment, in determining the main retail forms that we actually observe in the market place. Looking at food store trends in the last century brings out the importance of expanding assortments in the development of the modern supermarket. A model of assortment based on Messinger and Narasimhan (1997) is developed and used to frame a discussion of the econometric evidence on the choice of assortment levels by supermarkets. Subsequently, the analysis is extended in the spirit of Bhatnagar and Ratchford (2000) by allowing explicitly for spatial competition in the choice of assortment and prices. Consumer heterogeneity is introduced to help differentiate between breadth and depth of assortment and identify the retail forms that stress these different dimensions. While this distinction facilitates a rudimentary classification of retail forms, it still leaves out two important retail forms: non-store retailers and shopping centers and shopping malls. I discuss both of them explicitly.

Non-store retailers are a retail form that includes, among others, two institutions providing similar distribution services – mail order catalogues and the Internet. Since the former has been around for a while, a detailed study of their evolution by Michael (1994) is used to frame and complete the discussion of the Internet as an institution started in Chapter 5. Chapter 7 concludes with a discussion of shopping centers and shopping malls. These retail forms have been expanding in the US over the last 50 years. While the demand for increasing assortments is an important feature in this expansion, especially for shopping centers, other issues acquire importance in this setting. For example, the ability to enforce contracts and internalize externalities by a single authority and the increasing demand for entertainment activities associated with regional and super-regional shopping centers.

In the third and last part of the book (Interactions between retailers and other agents) I consider the role of distribution services in the interactions between retailers and economic agents other than customers. While in the previous part of the book distribution services are viewed as an essential, indispensable factor for understanding the nature of interactions between consumers and retailers, in this part a change in perspective takes place. Distribution services remain important and the focus of our attention, but no claim is made here that all channel issues (Chapter 8) or all aspects of franchises (Chapter 9) have to be looked

at through the lenses of distribution services. The claim is merely that in some important aspects of these two topics it is useful, insightful and perhaps even necessary to do so. Finally the book concludes with an explicit discussion (Chapter 10) on the retailing of services, which is a topic where distribution services usually play a critical role.

An important economic role of distribution services lies in the ability it confers to those who control these services for affecting outcome variables of interest such as profits, prices and output in the form of turnover. In the setting of interactions between retail firms and consumers, it is automatically or implicitly assumed that retail firms rather than consumers will decide on the levels of these services. In a channel context, however, it is no longer automatically assumed that the ‘upstream’ firm has to control the distribution service and the question of what advantages follow from the power of control acquires greater importance and relevance.

Chapter 8 shows that control of a distribution service by a retailer in a bilateral monopoly setting where the manufacturer is a Stackelberg leader shifts economic power, measured in terms of the price–cost margin, towards the retailer. It also tends to increase prices and distribution services relative to the integrated solution. Control by the manufacturer, on the other hand, has no effect on the relative economic power of the two agents in the channel. This last result, however, is not robust to relaxing the assumption of a single-product distribution channel. This conceptual basis provides the framework for looking at the empirical evidence on whether economic power has shifted from manufacturers to retailers. A detailed review of the few existing studies suggests the need for incorporating distribution services more systematically into the empirical analysis. While the empirical evidence does not suggest major shifts in power between retailers and manufacturers, it does suggest that retailers have substantial economic power.¹¹

More generally, retailers have incentives to become complex organizations through backward integration, moves into new markets and the addition of new product categories or varieties. Distribution services affect these incentives. Both the evolution of Wal-Mart and the introduction of private labels are used to illustrate these processes. Finally, a somewhat selective review of the marketing and economics literature on channel issues highlights the treatment of distribution services in this context, relates some of the results to the previous analysis in the chapter and in the book, and sets the stage for the analysis of franchises in Chapter 9.

Franchises are a form of vertical contractual relations, which are reviewed in Chapter 8. Nonetheless, franchises are so pervasive as an organizational form in retailing that they deserve and get more detailed treatment in this chapter. I start by presenting as much relevant information as possible from all sources on this organizational form and its contract provisions. This leads to a

separate discussion of each of the two main examples of product trade name franchises: gas stations and automobiles. This type of franchise system is characterized by being an institutional device focused on the distribution of goods and by relying on a very limited set of provisions from the universe available in franchise contracts. By contrast business format franchises, the other type of franchise system, are primarily but not exclusively institutional devices for the distribution of services, and they tend to rely on most and sometimes on all of the distinct provisions available to a franchise contract.

A particularly interesting finding in this chapter is the variety of arrangements with respect to the role of initial investment in the franchise by the franchisee. It is the critical contract feature in automobile franchises. It plays no role in the lessee–dealer franchise arrangements of gas stations. And, it is an important feature of the contract arrangements in business format franchises. This feature is driven by, among other things, the need to provide assurance of product delivery in the desired form beyond minimum levels. The implications of endogeneity for the choice of organizational form embedded in this characteristic have been ignored by existing empirical literature.

Finally, the book concludes in Chapter 10 with an explicit consideration of the retailing of services and a brief discussion of main accomplishments. The chapter starts with a discussion of characteristics of services viewed as fundamental in the literature and it goes on to draw their main implications for the retailing of services. Some of these implications are illustrated in a detailed discussion of two applications of our approach to the financial services industry. Our main accomplishments are indicated in terms of providing foundations for further research, drawing novel results and guiding future research possibilities especially in the retailing of services.

NOTES

1. An explicit discussion of how the approach applies to the wholesale sector is available in Betancourt (1993).
2. These figures are taken from the US Statistical Abstract, 1998 (Table No 1274). With the adoption of the North American Industrial Classification System (NAICS) in 1997 by the US Census Bureau, the retail sector is redefined to exclude eating and drinking establishments. This brings US practice in line with the rest of the world and it lowers the contribution of the distribution sector to GDP in the US reported in the text by about 1 per cent. Discussion of this issue as well as other ones underlying the development of NAICS is available at <http://www.census.gov/naics>.
3. This average excludes hotels and restaurants in every country from the distribution sector. It corresponds exactly to the NAICS classification in excluding eating and drinking establishments from the distribution sector.
4. For a detailed illustration of how these arguments apply to the case of retail banking see Hanak (1992a).
5. While it is not feasible to pursue issues related to the measurement of retailing activities in

some of these service industries at this aggregate level, it is feasible to address them at lower levels of data aggregation.

6. This is a new sector created as a result of the switch from the standard industrial classification (SIC) to NAICS in 1997.
7. At the analytical level Bandyopadhyay (1998) found, using the continuum of goods model and the approach to retail systems presented here, that an increase in the efficiency of the distribution sector could raise or lower the trade balance depending on the size of distribution costs and on preferences for distribution services. On the other hand, at the empirical level (1999) one of her most robust results was that the higher the level of infrastructure variables associated with the development of the distribution sector, for example communications and transportation, the higher the level of gross bilateral trade flows among countries.
8. Industrial organization textbooks, for example Pepall, Richards and Norman (1999, p.468), associate retail competition with intrabrand competition because they take the point of view of the manufacturer implicitly. But intertype competition among retailers is consistent with both inter- and intrabrand competition from the point of view of the manufacturer, and so is intratype competition in retailing.
9. Whether one is discussing the retailing of goods or services, the basic function to be performed by the system is conceptually the same.
10. At one point one contributor to the retail literature asserted 'economic theory does not yield much that can readily be used.' (Nooteboom, 1985).
11. In addition an interesting case study by Goldsmith (2002, Chapter 3) reveals how the choice of assortment by retailers could have led to the elimination of Betamax video rentals.