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Making channel incentives work: A discriminating match framework

Stephen K. Kim[a,*], Youngsu Lee[b]

[a] College of Business, Iowa State University, 3328 Gerdin Business Building, Ames, IA, 50011, USA
[b] College of Business, California State University, Chico, Tehama Hall 301, Chico, CA 95929-0081, USA

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ABSTRACT

Suppliers using independent resellers are vulnerable to low compliance and frequent opportunistic behaviors. We expand predominant attention to monetary incentives to motivate independent resellers in two ways. First, we propose that a supplier needs to achieve alignment on two issues: Aligning reseller actions with its actions through coordination mechanisms and aligning reseller interests with its interests through monetary incentives. Second, we propose and test the logic of a discriminating match between the two facets of monetary incentives (magnitude and immediacy) and two coordination mechanisms (monitoring and improvisation). We propose that it is a discriminating match between an incentive facet and a coordination mechanism that enhances compliance and suppresses opportunistic behavior. Conversely, a mismatch between the two negatively affects reseller outcomes. Analysis results of data from 198 mobile phone resellers in South Korea support our predictions.

1. Introduction

Although close interfirm relationships have received the bulk of research attention (Geyskens, Steenkamp, & Kumar, 1999; Jap & Anderson, 2007; Palmatier, Dant, Grewal, & Evans, 2006), many channel relationships are still characterized as *conventional marketing channels*. Conventional marketing channels refer to a loose coalition of autonomous businesses that deal with one another at arm's length and negotiate aggressively over transaction terms (Pelton, Strutton, & Lumpkin, 2002). Managing a conventional channel presents an intriguing set of challenges. First, a supplier using a conventional channel needs to secure compliance from resellers while curbing their opportunistic behavior (Rindfleisch & Heide, 1997). However, the supplier lacks the usual means of governance through the legitimate authority of legal contracts (Mooi & Ghosh, 2010), structural commitment of distribution exclusivity (Dutta, Bergen, & John, 1994), or ownership rights of vertical integration (Anderson & Schmittlein, 1984). Therefore, although a supplier's need for control is still there, its capacity for control is limited. Second, suppliers in a turbulent industry, which is the context of this study, must not only ensure that its reseller operations are aligned with its channel programs but also encourage high adaptability of its resellers. Therefore, suppliers in a turbulent industry face the dual challenges of aligning its channel operations and ensuring adaptability.

Lacking the usual means of governance, suppliers managing a conventional channel often rely on monetary incentives. Although monetary incentives are powerful means to motivate resellers, they sometimes encourage dysfunctional behaviors (Baker, 2002). Furthermore, even when monetary incentives work, gaining desirable reseller outcomes requires not only aligning *interests* between a supplier and its resellers through a monetary incentive but also aligning *actions* between them through a coordination mechanism (Gulati & Singh, 1998; Gulati, Wohlgezogen, & Zhelyazkov, 2012). These considerations, together with a dearth of research on managing conventional channels, raise our research question: *Which coordination mechanism would complement monetary incentives to produce greater compliance and lower opportunism in resellers?*

This is an important question, because spending more money on incentives without knowing of a complementary coordination mechanism can be frivolous at best and financially devastating at worst. We examine two unilateral governance mechanisms to answer this question. They are *monetary incentives* (incentives hereafter) and *coordination mechanisms*.

For incentives, we draw on the concept of incentive power (Williamson, 1991) and theorize that incentive power consists of two distinct facets: Magnitude and immediacy. Incentive power refers to the extent to which an increase in reseller sales efforts has *greater* or *more immediate* effect on compensation. *Magnitude* of incentives refers to the monetary size of incentives, whereas *immediacy* of incentives refers to the speed with which a supplier pays incentives when required tasks or goals are accomplished (Gilliland, 2004; Williamson, 1991; Zenger & Marshall, 2000). For coordination mechanisms, we examine

* Corresponding author.
E-mail addresses: stevekim@iastate.edu (S.K. Kim), ylee54@csuchico.edu (Y. Lee).

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monitoring and improvisation. *Monitoring* refers to the extent to which a supplier measures compliance in terms of behavior or outcomes of the reseller (Heide, 1994). *Improvisation* refers to the extent to which a supplier promptly reworks channel programs and executes them in response to unanticipated changes (McGinn & Keros, 2002).[1] We propose that a coordination mechanism may complement or substitute the effect of an incentive facet, depending on whether that coordination mechanism is matched with that incentive facet.

The study has theoretical and practical significance. From a theoretical standpoint, our study advances the literature on channel governance on two fronts. First, we suggest that the effect of incentives is more nuanced than a simple linear effect of incentive size. We examine the effects of immediacy as well as magnitude of incentives (Williamson, 1991). For coordination mechanisms, we introduce improvisation as another coordination mechanism and theorize on its effect as well as that of monitoring.

Second, and more importantly, we propose that neither incentives nor coordination mechanisms alone shape reseller compliance or opportunistic behavior. Instead, it is the discriminating match between an incentive facet and a coordination mechanism that may improve or worsen reseller outcomes. A match between the two induces greater compliance and dampens opportunism from resellers, whereas a mismatch worsens those reseller outcomes (cf. Kashyap, Antia, & Frazier, 2012).

Empirical test results, using data from 198 mobile phone resellers in South Korea, support the proposed ideas. Following sections theorize on incentives and coordination mechanisms and develop the hypotheses (Section 2), describe the method and analysis results (Section 3), and discuss the contributions and implications of the study (Section 4).

2. Theoretical development and hypotheses

2.1. Desired reseller outcomes: high compliance and low opportunism

Two important outcomes of a supplier's reseller control attempts are resellers' greater compliance and lower opportunism (Kashyap et al., 2012; Payan & McFarland, 2005). *Compliance* refers to a reseller's adherence to the supplier's demands. Suppliers typically specify how resellers are to conform to the rules designed to achieve supplier goals (see Rubin, 1990 for a complete description). However, gaining reseller compliance has become more challenging recently as resellers carry greater numbers of brands and supplier-reseller relationships become strained with suppliers' increasing use of multiple channels. These challenges make gaining reseller compliance a critical reseller outcome.

Opportunism refers to the extent to which a reseller engages in self-interest seeking with guile (Crosno & Dahlstrom, 2008; John, 1984; Kashyap et al., 2012; Williamson, 1985). Gaining reseller compliance, although important, is an incomplete measure of reseller support because of the reseller's tendency to game the system, which means that reseller compliance does not equal lack of opportunism. For example, a reseller may stock and display a supplier's product exactly as the supplier specifies (compliance) and yet may steer customers toward a competing brand (opportunism) (Gilliland & Kim, 2014, pp. 361–362). Such self-serving activities are considered rational by the reseller but are opportunistic behaviors to a supplier. The supplier incurs not only the direct cost of monitoring resellers to curb opportunistic behavior but also the opportunity cost of losing potential sales to competitors because of the reseller's opportunistic behavior. Therefore, it is essential for a supplier to reduce reseller opportunistic behavior, and we propose suppression of reseller opportunism as another important reseller outcome.

2.2. Supplier incentives and their effects on reseller compliance and opportunism

Research has focused on the magnitude of incentives, with the implicit assertion that offering more money leads to better reseller outcomes (Basu, Lal, Srinivasan, & Staelin, 1985; Murry & Heide, 1998). The size of incentives certainly matters for motivating resellers. However, focusing solely on size results in an incomplete and potentially erroneous understanding of the effect of incentives. Building on Williamson (1985, 1991), we couch supplier incentives in terms of incentive power. Low incentive power means that an increase in sales efforts has little (i.e., low magnitude) or only a slow (i.e., low immediacy) effect on reseller compensation. In contrast, high incentive power means that an increase in sales efforts has a greater or more immediate effect on reseller compensation.

2.2.1. Magnitude of incentives

Most common incentives take the form of a supplier's price or margin premiums (Wathne & Heide, 2000). A supplier offers deeper wholesale price discounts or pays their resellers higher margin premiums as an incentive to induce resellers to comply with its channel policies, and/or makes extra efforts to achieve predetermined goals (Gilliland, 2004). A supplier may also give incentives in the form of a bonus when a reseller reaches a sales quota. In contrast to the research attention paid to the magnitude of incentives, relatively little attention has been paid to another important facet of incentives: Immediacy of incentives.

2.2.2. Immediacy of incentives

The less time that passes between task completion and incentive payment, the more immediate the incentive is (Dubinsky & Berkowitz, 1979). For example, receiving quantity discounts at the time of purchase is more immediate to a reseller than allowing the discounts to accrue for a quarterly payment. When a reseller calculates the expected net present value of an incentive, immediacy is represented by the extent to which the incentive is discounted to the present. Greater immediacy leads to less discount of the incentive amount.

Immediacy is an important facet of incentives because it influences the extent of cooperative behavior (Herrnstein, 1961; Jackson & Yariv, 2014; Rachlin & Jones, 2008). The immediacy of incentives takes a special significance to resellers in a turbulent environment such as mobile phone sales channels, for two reasons. First, both upstream (e.g., technology) and downstream (e.g., competition) conditions change abruptly, which makes agile operations critical for a reseller's survival. Therefore, resellers are likely to prefer high immediacy of incentives. Second, resellers, many of whom have little resource slack, need to watch their cash flow carefully to ensure their survival. The slower the incentive payment, the more a reseller must discount the incentive (Benzion, Rapoport, & Yagil, 1989), which lowers their cash flow projections and dampens the motivation to cooperate with the supplier.

2.3. Two reseller coordination mechanisms

2.3.1. Monitoring

A supplier can achieve coordination (i.e., alignment of actions) with its resellers through *monitoring*. From a supplier's standpoint, monitoring increases its ability to observe the behavior of resellers and to use the information gained to evaluate and compensate resellers (Heide, Wathne, & Rokkan, 2007; Kabadayi, 2011; Stump & Heide, 1996). Therefore, monitoring is likely to induce greater compliance. From a reseller's standpoint, monitoring is a signal that the supplier is

[1] Incentives, monitoring, and improvisation would all fall under the umbrella concept called "governance mechanisms" as theorized by Heide (1994).