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Manufacturer-provided services vs. Retailer-provided services: Effect on product quality, channel profits and consumer welfare

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ABSTRACT

Demand-enhancing services like automated help desks, toll-free technical support hotlines or delivery and installation services are routinely offered to consumers by manufacturers or retailers or both. This paper examines how the identity of the channel member (manufacturer or retailer) providing the demand-enhancing services can have a different impact on the manufacturer's product quality decisions and resultant channel and consumer welfare. We show that when a manufacturer wishing to sell its entire product line through a retailer provides demand-enhancing services to consumers, then it chooses higher product quality levels and channel member profits and consumer welfare are higher. However, when the retailer selling the manufacturer's product line is the one who provides the demand-enhancing services, then the manufacturer may choose a *lower* product quality level and retailer profit and consumer welfare may be *lower*. Our results therefore indicate that a manufacturer should not simply look at cost savings arising from shifting service responsibilities from itself to the retailer. Similarly, a retailer should not expect to always benefit from situations where it has secured the ability to choose its own desired levels of services to be provided to consumers.

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1. Introduction

It is well-documented in both academic literature and industry trade publications that firms provide a significant amount of demand-enhancing services to consumers for their products. Such services include automated help desks, toll-free technical support hotlines, maintenance or repair services, image advertising, detailed instructions on installation and recommended use, delivery and return services. In channel settings where the manufacturer sells to consumers through a retailer, such services are offered by either the manufacturer, the retailer or both. For example, computer manufacturers like Dell or Gateway offer consumers technical support even though the products may be purchased at retail stores like Best Buy. Similarly, wireless phone manufacturers like Research in Motion (which manufactures the Blackberry line of phones) or Motorola provide substantial over-the phone and online technical support for consumers who mostly purchase their phones through the various wireless carriers like Verizon Wireless or AT&T. At the same time, retailers like Macy's or Sears often provide the bulk of the demand-enhancing services like financing, customer service, in-store events and demonstrations and delivery services.

This paper examines how the *identity* of the provider of demand-enhancing services in the channel affects product quality, channel profits and consumer welfare. Several demand-enhancing services may be provided by either the manufacturer or the retailer, for example, advertising campaigns (Verizon Wireless advertising the Samsung Galaxy 4 smartphone versus Samsung advertising the Galaxy 4 smartphone by itself) or technical support (Best Buy's Geek Squad providing technical support versus the manufacturer providing the technical support for its product). In practice, a channel member may be better suited to provide a particular service than the other. Which channel member does provide the bulk of such services may be a function of logistics (for example, a large domestic retailer like Target or Walmart providing services for products manufactured by a small company located outside the US) or relative expertise (for example, a manufacturer of a high-tech product may be better equipped to provide technical support than a retailer selling the product). In this paper, we take the choice of who provides services in the channel — the retailer or the manufacturer — as exogeneously given (for example, due to above-mentioned reasons such as whether the manufacturer is located in this country or outside, or decided through prior negotiations) and study the strategic implications of manufacturer-provided services where the manufacturer alone provides services versus retailer-provided services where the retailer alone provides services, on consumers and channel members. While there may be many instances where both channel members provide services simultaneously, we focus on these polar opposite cases to highlight differential economic effects that may occur when each channel member takes on a relatively more significant role in service provision in the channel. These implications are useful not only when the channel members have to take as given this service-provider choice (for reasons given above), but also when one could endogenize this choice of who

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provides this service; in the latter case, our insights enable one to compare the profitability of the retailer/manufacturer when it provides the service to the case where the other party provides this service.

We consider a framework where a manufacturer designs a product line and wishes to sell the entire product line to consumers through a retailer. In this setting, we examine how the provision of services, especially, the identity of the service provider, interacts with the incentives the manufacturer must provide to the retailer to induce it to carry the entire product line to have interesting implications on channel outcomes like product quality levels and channel member profits. As in Villas-Boas (1998), our intention is to highlight the following challenge faced by the manufacturer with a product line: since the retailer cares about its own interests while making decisions about retail prices and products purchased from the manufacturer, there is a potential source of conflict in the channel where the retailer may prefer to carry a subset of the manufacturer's product line while the manufacturer would prefer to sell its entire product line to the consumers through the retailer. There are many real world scenarios where such a conflict of interest between manufacturers and retailers is likely to arise, for instance, in markets where a manufacturer with a stable of products must deal with a single or a dominant retailer to make all its products available to end consumers. In the model section, we describe certain characteristics of a market in terms of the degree of heterogeneity among different consumer segments and proportion of different consumer types under which the manufacturer prefers offering the product line (in spite of the challenges in dealing with the retailer) to selling fewer items through the retailer.

In this framework, we show some interesting results. For example, when the manufacturer provides demand-enhancing services in the channel, product quality levels, channel member profits and consumer welfare are higher compared to levels under no service provision. However, when the retailer selling the manufacturer's product line provides the demand-enhancing services, then product quality level, retailer profit and consumer welfare may be *lower* than under no service provision. Similarly, we find that while all channel members benefit from manufacturer services, retail services may not always be preferred by all channel members. We also find that while the manufacturer always prefers to provide services itself rather than to delegate the responsibilities to the retailer, the retailer may prefer manufacturer services over its own service provision. Additionally, we present conditions under which retail services may be preferred by both channel members, yet makes the consumers worse off. This suggests that overprovision of services, from consumer perspective, is possible under some circumstances. Thus, one of our contributions is to show that these kinds of asymmetric service arrangements have substantive strategic implications beyond just additional costs borne by the service provider. For example, the manufacturer should not simply look at cost savings arising from shifting service responsibilities from itself to the retailer. Similarly, while a retailer may expect that possessing the ability to choose its own desired service levels should be profitable, we highlight circumstances where such a strategy may actually lead to lower profits for the retailer compared to yielding that decision power to the manufacturer and even to a situation where no services are provided at all.

The intuition behind our results is as follows. As we described above, the manufacturer wishing to sell its entire product line through the retailer must provide the retailer with the proper economic incentive to do so, rather than carry only a subset of the product line. The magnitude of that incentive will be a function of the level of profit the retailer can make from choosing to carry fewer items than that desired by the manufacturer. When the retailer provides demand-enhancing services, it chooses the level of services optimally depending on the number of products it carries and as a result, succeeds in optimizing its profit in *every* situation — i.e., when it carries the entire product line or when it carries a subset of the product line. This potential for the retailer to raise its profit in scenarios where it carries only the partial product line is absent in the case of no service provision. As a result, when the retailer provides the demand-enhancing services in the channel, the manufacturer must leave a higher surplus with the retailer to induce it to carry the product line. Since the retailer's profit under the scenarios where it carries the partial product line will be higher with higher product quality, the manufacturer then takes into account this potential for higher retailer opportunism when making its own decisions regarding its product qualities and wholesale prices. This results in a dampening force on the product quality decision by the manufacturer. At the same time, the higher consumer valuations caused by the demand-enhancing services at all quality levels yield a positive force on the product quality decision by the manufacturer. The net effect on the quality level therefore depends on which force dominates the other, and we show circumstances where the net effect is a lower product quality. Furthermore, this drop in product quality leads to lower consumer welfare and lower retailer profit in this scenario.

In terms of managerial implications, this paper sheds some light on the nature of discrepancy in channel outcomes that a manufacturer or a retailer may expect to occur when the bulk of service provision is carried out by the retailer rather than the manufacturer itself. This is particularly salient in situations where the retailer commits to take on several service responsibilities like installation and delivery services and in-store presentations that the manufacturer, given its remoteness from end consumers, cannot fulfill in an adequate manner. This paper shows how once the retailer takes into consideration that this may have a feedback effect on the manufacturer's product line decisions (product quality and prices), it should realize that its overall profit can be adversely affected. In such a case, the retailer would do well to engage in additional negotiation or compensation from the manufacturer. As mentioned above, we also highlight strategic implications for the manufacturer in its delegation of services, viz. it should not simply look at cost savings arising from shifting service responsibilities from itself to the retailer.

1.1. Relationship to literature

Our paper is related to three main streams of prior literature: (i) the effect of demand-enhancing services by retailers on channel coordination and other channel-related decisions made by the manufacturer, (ii) the effect of demand-enhancing instruments like advertising by manufacturers on channel outcomes, and (iii) effect of channel structure on product qualities chosen by a manufacturer.

A number of papers have studied the issue of channel coordination when retailers provide demand-enhancing services to consumers. For example, Taylor (2002) examines how target rebates and returns policies under demand uncertainty are effective in achieving channel coordination. Raju and Zhang (2005) examine the relative effectiveness of quantity discounts and menu of two-part tariffs to obtain channel coordination in the presence of a dominant retailer providing demand-enhancing services. Blair and Lewis (1994) and Desiraju and Moorthy (1997) consider a market where the retailer has better information on demand conditions than the manufacturer, and examine the effectiveness of various vertical restraints such as resale price maintenance to achieve channel coordination. Similarly, Perry and Porter (1990), Winter (1993) and Iyer (1998) consider the effect of retailer competition in price and service on channel coordination. Coughlan and Soberman (2005) study manufacturers' decisions regarding whether to sell through single distribution channels with primary retailers or through dual distribution channels with primary retailers and their own outlet stores in a framework where consumers are both price-sensitive and service-sensitive and where only primary retailers provide service. In contrast, our paper highlights the differences in the impact of retailer-provided services versus manufacturer-provided services on a manufacturer's product quality decisions and the resultant channel and consumer welfare.

A number of papers have highlighted a manufacturer's role in providing demand-enhancing services in the channel in the form of

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