

ESNIE Post-doctoral Workshop

# **The Role of Decision Rights in Incomplete Contracts: Lessons from Automobile Franchising**

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# 1. Introduction

- Incomplete contracts allocate decision rights
  - Hadfield SLR '90; Lerner & Merges JIE '98; Arruñada *et al.* JLEO '01; Elfenbein & Lerner RJE '03; Zanarone JLE '09
- Why?
- Case study on automobile franchising:  
decision rights help manufacturers to complete contracts *ex post*

## 2. Classic theory: decision rights as “bargaining chips”

- Spot: More decision rights → greater share of surplus bargained ex post → more investments ex ante
  - Grossman & Hart JPE '86; Aghion & Tirole QJE '94
- Relational: Less decision rights
  - less temptation to bargain ex post
  - efficient distribution of surplus → efficient investments ex ante

– Baker *et al.* QJE '02

# Implications

- Decisions contracted ex post
- Ex post contracts court-enforceable
- Decision rights → more favorable contract terms ex post

### 3. Data & results

- Current dealership contracts of 19 car manufacturers
  - How decision rights are assigned ex ante
- Contract annexes & interviews
  - How decisions are made ex post

## 3.2 Decision rights shared

<i>Type of decision</i>	<i>Allocation of decision right</i>		
	Manufacturer	Dealer	Negotiation
Sales target	0%	0%	100%
List price	100%	0%	0%
Showroom design	73%	27%	0%
Advertising contribution	52%	48%	0%
Advertising quality	52%	48%	0%
Advertising budget	15%	85%	0%
Size of personnel	47%	53%	0%

<i>Type of decision</i>	<i>Allocation of decision right</i>		
	Manufacturer	Dealer	Negotiation
Qualification of personnel	36%	64%	0%
Training of personnel	73%	27%	0%
Operating capital	36%	64%	0%
Customer satisfaction programs	47%	53%	0%
Customer satisfaction target	52%	48%	0%
Working hours	15%	85%	0%
Standards in general	63%	37%	0%

### 3.3. Manufacturer completes contract

<i>Party who has decision right ex ante</i>	<i>Party who makes decisions ex post</i>		<i>Party favored by ex post contract terms</i>		<i>Nature of dealer's ex post compensation</i>	
	Theory	Data	Theory	Data	Theory	Data
Manufacturer	Both, by agreement	Manufacturer	Manufacturer	Dealer (discount)	Obligatory	Discretionary (discount = % list price)
Dealer	Both, by agreement	Manufacturer	Dealer	Dealer (discount)	Obligatory	Discretionary (discount = % list price)

## 3.4. Dealers get paid

<i>Party who has decision right ex ante</i>	<i>Party who makes decisions ex post</i>	<i>Party favored by ex post contract terms</i>		<i>Nature of dealer's ex post compensation</i>		
	Theory	Data	Theory	Data	Theory	Data
Manufacturer	Both, by agreement	Manufacturer	Manufacturer	Dealer (discount)	Obligatory	Discretionary (discount = % list price)
Dealer	Both, by agreement	Manufacturer	Dealer	Dealer (discount)	Obligatory	Discretionary (discount = % list price)

## 3.5. Pay is discretionary

<i>Party who has decision right ex ante</i>	<i>Party who makes decisions ex post</i>	<i>Party favored by ex post contract terms</i>		<i>Nature of dealer's ex post compensation</i>		
	Theory	Data	Theory	Data	Theory	Data
Manufacturer	Both, by agreement	Manufacturer	Manufacturer	Dealer (discount)	Obligatory	Discretionary (discount = % list price)
Dealer	Both, by agreement	Manufacturer	Dealer	Dealer (discount)	Obligatory	Discretionary (discount = % list price)

## 4. Interpretation

- Unilateral decisions
  - Only manufacturers have skills & info to elaborate standards
- Bonus tied to sales instead of termination
  - Allows selective standards, saving money to small dealers
    - Circumvent “no discrimination” rule in EU law
- Discretionary bonus
  - Allows manufacturer to adjust it to sales shocks

## 4.2. The role of decision rights

- Manufacturers informally delegated to set standards and split surplus
- Formal decision rights reduce dealers' renegeing temptation
  - Consistent w/ "hard" decision rights being assigned to manufacturer
  - Consistent w/ previous evidence on contracts
    - Arruñada *et al.* JLEO '01, Zanarone JLE '09

## 5. Conclusions

- Dealers' standards not negotiated, *ex ante* & *ex post*
- Manufacturers informally delegated to set standards & split surplus *ex post*
- Decision rights may facilitate “relational adaptation”
  - Klein EI '96, REI '00; Baker *et al.* '09

Thanks