Free Rider Issues and Internet Retailing

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Introduction

The Internet allows consumers to shop a wide variety of retailers with relatively low search costs. To a first approximation, one would expect this technology to improve matches between consumers and goods, to create competition in previously uncompetitive markets, and to lower transaction costs for consumers. Allowing the sale of one's products over the Internet raises many issues for manufacturers. In this paper, I take up the issue of free-riding.

My starting point for this discussion is my view that free-riding amongst retailers is possible, and that manufacturers may have legitimate reasons for wanting to control this type of behavior. In particular, we know that free riding can occur when sales and service support for a product are efficiently done at the retail level, and when that effort cannot feasibly be sold separately from the product itself. In those circumstances, revenues from the sale of the product have to cover the sales and service effort. Retailers that do not provide such sale and service effort find themselves in a lower cost position from retailers that do provide ancillary services. Absent vertical restrictions implemented by manufacturers, low-service retailers may undercut high-service retailers. This

[1] These comments represent the views of the author, Judith A. Chevalier. They should not be construed to reflect the views of Yale University, the National Bureau of Economic Research, or Chevalier's coauthors from the research papers cited herein.

diminishes the incentives of high-service retailers to provide service, ultimately diminishing the viability of the product.

Historical Context

Manufacturers have had to grapple with these free-rider issues in many arenas prior to the advent of Internet commerce. In particular, manufacturers have had to consider whether and how to offer service-intensive products for sale at outlets such as large discount department stores or warehouse clubs, where high sales service effort is not expected. Similarly, manufacturers have long had to consider the role of retail catalogs in their supply chain. By allowing ones products to be sold through retail catalogs, a manufacturer's product can achieve wide distribution to remote locations. Futher, the catalog operator may, in some cases, have costs considerably lower than brick and mortar retail outlets, allowing lower final prices on the manufacturer's goods. Internet retailers provide a service that is extremely similar to the service provided by catalog retailers. However, as the Internet effectively greatly lowers the cost of disseminating "catalogs" to those consumers who are likely to buy particular products, the advent of Internet retailing has magnified the extent to which manufacturers are facing these issues.

Application of free rider issues to the Internet

There are many free-riding situations possible in association with the Internet. In particular, Internet retailers can free-ride off of the sales and service effort of brick and mortar retailers, and brick and mortar retailers can free-ride off of the sales and service effort of Internet retailers. For example, I can use Amazon.com to search for books on a particular topic and read Amazon customer reviews of those books. Amazon cannot prevent me from then purchasing that book at Buy.com, a competing Internet retailer, or from my local brick and mortar bookstore. In this latter circumstance, my local brick and mortar retailer is free-riding off of the sales and service effort provided by Amazon. Similarly, however, I could purchase a stereo from Amazon.com that I had listened to at a local electronics retailer. In that circumstance, Amazon.com is free-riding off of the sales and service effort provided by my local electronics retailer.

The manufacturer of these products may be concerned about both types of free-riding. If I do not make my book purchases at Amazon, and instead free-ride off of their customer reviews and search features, Amazon's incentive to produce and maintain those features diminishes. Without access to features of this sort, my overall book purchasing may decline, hurting overall sales of the manufacturer's product. Similarly, if the local stereo store's incentive to providing costly "listening" service is diminished by customer free-riding off of their promotional effort.

As pointed out in my recent research with Dennis Carlton (2001)[2], there are important differences between the two free-rider situations. Most of the sales and service effort provided by an Internet retailer takes the form of site features such as product reviews, photographs, etc. Most of the sales and service effort provided by a brick and mortar retailer will take the form of interactions between sales people and individual customers. Carlton and I note two important distinctions between this sales and service effort. First, the sales and service effort exerted by an Internet retailer largely takes the form of a fixed cost, while much of the sales effort of the brick and mortar retailer appears to be a variable cost. Second, the sales and service effort provided by an Internet

[2] J.A. Chevalier and D.C. Carlton, "Free Riding and Sales Strategies for the Internet", *Journal of Industrial Economics* 49:4, December 2001, 441-462,.

retailer is more likely to be easily verifiable by a manufacturer than the sales and service effort of a brick and mortar retailer.

In principle, then, it may be simple for a manufacturer to compensate the Internet retailer with a fixed fee for providing detailed product information features on its web site. Gertner and Stillman[3] provide some evidence that such contracting does indeed take place. However, it would be very difficult to enforce a contract in which a manufacturer compensated a brick and mortar retailer for every minute that the retailer spent demonstrating the manufacturer's product for a customer. For this reason, free-riding by Internet retailers off of the sales and service effort of brick and mortar retailers may be more of a concern for manufacturers. For retail service intensive products, manufacturers may have an interest in adopting sales strategies on the Internet that protect the margins of brick and mortar retailers.

Resale Price Maintenance

Were Resale Price Maintenance (RPM) legal, it might be an attractive mechanism for manufacturers to use to allow the sale of their products over the Internet, while protecting brick and mortar retailers from free-rider problems. For example, Carlton and Chevalier (2001) study fragrance manufacturers. It is essentially impossible for an online retailer to provide one service widely offered by brick and mortar retailers-- the opportunity to try on the product before buying it. With RPM in place, a consumer who had tried on a fragrance at a department store would have little reason to buy the fragrance online; the consumer cannot get the fragrance more cheaply online. However, a habitual user of the fragrance or a consumer living far away from a brick and mortar

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[3] R. Gertner and R. Stillman, "Vertical integration and Internet strategies in the apparel industry," *Journal of Industrial Economics* 49, December 2001, 417-440.

retailer of the fragrance might purchase the product online, even if the online retailer charges a high price and offers low service. Nonetheless, presumably, a RPM policy would hurt Internet retailers relative to brick and mortar retailers.

While explicit RPM agreements may be unenforceable, manufacturers can effectively create RPM arrangements by refusing to deal with retailers whose general business model relies on discounting products. For example, in the market for online beauty products, one could point to several retailers who appear never to discount products from the manufacturers' suggested retail prices, even in circumstances in which other online retailers discount those same products.[4] My understanding is that the manufacturer could offer its products for sale only to those retailers. This is a strategy Carlton and Chevalier (2001) identify as common for fragrance manufacturers.

Unauthorized retailers

One issue that may be of particular concern to policymakers is the question of the extent to which manufacturers are allowed recourse against "unauthorized retailers." This issue is not new to Internet retailing, but may be occurring on a larger scale with the advent of Internet commerce. For example, Amazon.com has been selling many Sony consumer electronics products for years, despite the fact that it was not an "authorized retailer" of those products until June of 2002. Many manufacturers, including Sony, claim that they are not obligated to honor their standard warranty when consumers purchase products from unauthorized retailers. The risk in this particular case is small, and indeed, my correspondence with Amazon.com in 2000 suggests that Amazon stood ready to honor Sony's warranty terms. However, in general, one might imagine many

[4] Whether and how many consumers buy high-priced products when those products are available from other Internet retailers at lower prices is a separate issue. See J. Chevalier and A. Goolsbee, "Measuring prices and price competition online: Amazon and Barnes and Noble", NBER working paper no. 9085, July 2002.

circumstances in which consumers engaged in comparison shopping are unaware that the same product at different retailers may effectively come with different warranty terms.

Exclusive sale through manufacturer websites

There is an important caution in attempts to regulate contracts between manufacturers and Internet retailers. Manufacturers are more likely to vertically integrate into distribution using online sales channels than using brick and mortar sales channels. Carlton and Chevalier (2001) show that some manufacturers that do not operate physical retail outlets sell through dedicated manufacturer sale sites. Furthermore, some manufacturers that distribute to non-dedicated brick and mortar retailers are acting as the exclusive seller of their products online. For an example not detailed in that study, consider Playmobil USA (www.playmobil.com). Playmobil is a popular brand of high-end construction/action figures for children. They are not distributed through the "mass market" discounters, but they are widely distributed through "mom and pop" toy stores. Playmobil had previously entered into a Final Judgment in which it agreed to cease using Resale Price Maintenance practices with its retailers. [5] Until September of 2002, Playmobil allowed retailers to advertise Playmobil products on their websites, but Playmobil did not allow its retailers to sell Playmobil products online. In an environment in which manufacturers cannot use exclusive territories, resale price maintenance, or other vertical restrictions to mitigate free-rider problems among retailers, eliminating online retailers altogether remains a viable option for some manufacturers. Carlton and Chevalier (2001) show that manufacturer web sites tend to have very high prices relative to both online and brick and mortar retail outlets. For example, Playmobil USA sells goods at its manufacturer website at the manufacturer's suggested retail price. After September of

[5] United States v. Playmobil USA, Inc., Civ. No. 95-0214, 1995 WL 366524 (D.D.C. May 22, 1995) 110

2002, many retailer web sites advertised Playmobil products at significant discounts from the MSRP. However, when retail prices, retail availability, and service are taken into account, it is not clear whether Playmobil will be a more vigorous competitor to other action figure brand products under the new or old Internet retailing policies.