

Todorova, Tamara; Iliev, Ivan

Conference Paper — Manuscript Version (Preprint)

The Role of Wholesalers in International Distribution: Transaction Cost Effects

Suggested Citation: Todorova, Tamara; Iliev, Ivan (1999) : The Role of Wholesalers in International Distribution: Transaction Cost Effects, In: Dimitrov, Pavel (Ed.): Logistics in the Transition Economy. Papers from the Second International Conference "Logistics in the Changing World" (Theory, Practice, Education), Varna, July 12-13, 1999, University of National and World Economy, Sofia

This Version is available at:

<http://hdl.handle.net/10419/157660>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

The Role of Wholesalers in International Distribution: Transaction Cost Effects

Tamara Todorova, Assistant Professor

Ivan Iliev, Associate Professor, Dr.

Varna University of Economics

The paper focuses on the role of wholesaling in the establishment of international distribution channels with respect to the transaction costs associated with the sale of goods on the international market. The first part of the paper is devoted to the peculiarities and conditions of the domestic market and the participation in it of domestic wholesalers. The main idea is that of the necessity of wholesaling in terms of transaction cost reduction. A model is presented revealing a distribution channel with and without an intermediary as a link between the producers and the retailers. The paper argues that wholesalers have a vital role in bringing down the costs of transacting as well as in the proper and efficient functioning of the very distribution channel. The second part of the paper discusses the international market in its complexity and size compared to local markets. This is done in the context of the transaction costs faced by large international corporations. The focus is again on these costs which turn out to be the reason for firms to internalize their market operations expanding thus their size.

Key words: transaction costs, international distribution, wholesaling

JEL classification: D23, F18, M21, M31

The choice of the producer (or the retailer) when it comes to the wholesaler as a partner in a transaction inevitably necessitates the analysis and evaluation of possible advantages and

disadvantages which arise out of this partnership. Much of the economics and marketing literature stresses the role, which wholesaling plays with respect to the emergence and functioning of the international distribution channels. There are different opinions about the efficiency of wholesalers in terms of the logistics, price and value of their activities in international business. It is believed that international intermediaries have not only advantages for the producer and the final consumer. Karakasheva and Boeva (1994), for instance, recognize the professionalism, promptness, and loyalty of the intermediary but emphasize that, given his specific functions, he increases the distance between the producer and his market and deprives him of the most precise and up-to-date information when it comes to consumer reaction to the product, the strengths and characteristics of the competition, etc. It is also believed that the rewards to the wholesaler do not always correspond with the quality and efficiency of his service, which elevates the price of the commodity and reduces both producer competitiveness and consumer surplus.

This paper aims to illustrate the essential role that wholesalers play in international commodity distribution from the perspective of transaction cost theory. We maintain that wholesalers are an indispensable part of the distribution chain. Using the competitive market pricing mechanism and being part of the market, wholesalers help save on transaction costs.

Let us first analyze the domestic market which involves wholesalers adding value within the distribution channel. We assume a model of a channel comprising producers, a wholesaler and retailers (as in Fig. 1). There are three producers of a commodity who presumably negotiate with a wholesaler acting as a link between them and three retailers. Another assumption is that with the help of the wholesaler the retailers buy the commodity in bulk.

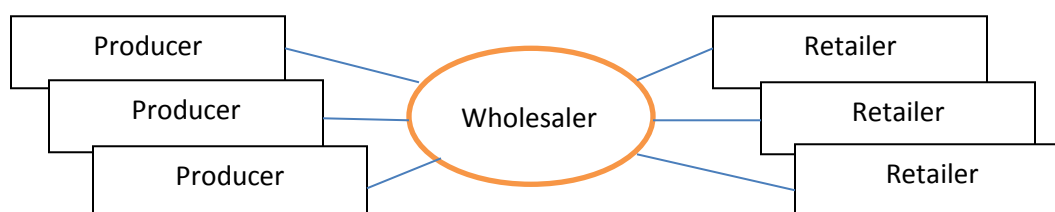


Figure 1. A distribution channel using a wholesaler

Every producer establishes contact with the wholesaler in search of a market for his product. To deliver the final product to the market the retailers also contact the wholesaler. Thus, the total number of transactions within the distribution channel or channels is six. The wholesaler aims to reach a volume of sales which minimizes the costs of their organization. Whether the wholesaler would invest capital in the commercial operations depends on the rate of return. Likewise, economic considerations drive the retailer's choice of partner (producer or wholesaler). This determines the general level of contractual expenses, the magnitude of wholesaler's transactions, etc.

In the second case the wholesaler is excluded from the distribution channel. Figure 2 illustrates three producers of a given good and three retailers selling it.

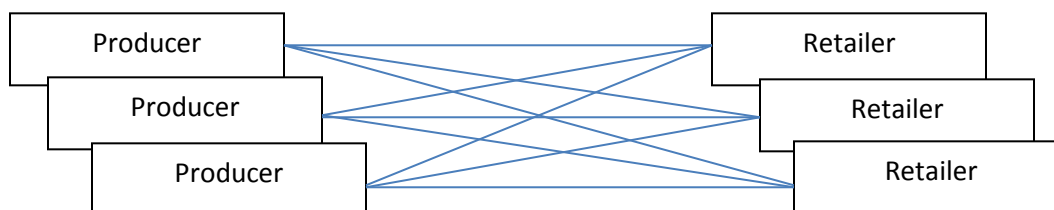


Figure 2. A distribution channel without a wholesaler

In the absence of the wholesaler as a linkage in the distribution channel every retailer needs to directly and personally connect with the producers on the market. Every retailer should establish three contacts in order to connect to the three producers. This results in a total of nine contacts necessary to relate the three retailers with the three producers. This increase in the number of transactions results merely from the elimination of the wholesaler from the distribution channel. This bigger number of transactions determines higher transaction costs.

In the context of transaction cost theory these costs are defined as costs encountered in the process of market exchange, operations known also as transactions (from lat. *Transactio* – agreement, contract under mutual concessions). The transaction is, in effect, a deal on the simultaneous sale and purchase of a good. The firms and households, executing deals daily, need money to carry out each deal. Commodity exchange, i.e. the selling and buying of goods, requires a number of support activities which assist the movement of goods from the place of their production to the place of their consumption. This process involves a number of market

institutions which arise out of market exchange and proliferate with its evolution. Such support institutions aiding the market and thereof the wholesalers are the credit institutions, insurance companies, information agencies, etc. Using their services in relation to the market dealings of the wholesaler is invariably related to expenses, i.e., transaction costs. They turn out to be the price of using the market mechanism (the marketing costs of negotiation). These are unavoidable expenses incurred by anyone who wishes to conclude a commercial deal, to determine and choose, based on the analysis of the information gathered, who it is that he wishes to trade with, under what terms to trade, to lead negotiations, to carry out business talks, to sign a contract with the respective partner, to monitor the contract's observance and so on. With commodity exchange transaction costs can be reduced but cannot be eliminated completely.

It is worth mentioning that the presence of wholesalers in the market saves on transaction costs. Wholesalers do not just add value to the distribution channel with their intermediary role. As the tie between supply and demand wholesalers reduce transaction costs, which otherwise would have to be incurred by the other market participants. Wholesaling optimizes financially a number of operations which bring the product from the producer to the ultimate consumer. These could be transportation, insurance, storage, customs or other operations. More specifically, cost economies result from reducing the number of contracts along the product distribution chain. Specialization, at the same time, increases efficiency bringing higher returns while lowering costs. It is not convincing to state that the presence of wholesalers along the channel increases the price of the final product. Without an intermediary products, which appear to be cheap would, in effect, become costly to deliver. The higher transaction costs incurred by retailers would have to be transferred onto the final customer. This is because, using the market mechanism, retailers have to ability to incorporate these higher costs of transacting into the final price.

Producers, on their part, also react to the absence of intermediaries in the market. Under such circumstances they are forced to search for clients among retailers or, worse, among final individual or institutional consumers. Each producer would have to contact retailers individually, while each retailer would buy smaller volumes of the good compared to a wholesaler. This would dedicate producer resources (capital, labor, or time) to commercial functions. An ultimate individual consumer, on his part, will buy minimal amounts compared to other buyers.

Discussing the elimination of trade in general, Demostenov (1946) claims that the greatest disadvantage to such elimination is that producers now have to perform two functions, so different and complex, that the producer can hardly combine those two. By serving the final elements of the distribution channel the producer would simply take on him all wholesale functions. Similar to the retailer, he would have to calculate the costs of his additional activities into the price of the product. Finally, taking over the responsibilities of the wholesaler would reduce the productive efficiency of the producer and his ability to take advantage of the gains from specialization. The implicit logic here is that, instead of producing, the producer would burden himself with intermediary and marketing functions, while the increased transaction costs and the lower productive efficiency would result in higher prices and lower product quality.

The discussion of the aforementioned distribution channel with and without a wholesaler allows realizing the essential role of wholesalers as well as establishing exactly the effect that transaction costs have on price. The other market participants, i.e. the producers and the retailers, have the tendency to incorporate the costs of market exchange into the price of their product. The case of a wholesaler being present between the producer and the retailer does not eliminate transaction costs. These costs are inevitable with commodity exchange; however their magnitude differs with wholesalers (intermediaries) or without them.

With their functions wholesalers are detrimental to the process of distribution since they facilitate the proper and efficient functioning of the very channel. Being competent and capable of organizing large-scale logistic operations, huge wholesalers, like other types of intermediaries, maximize efficiency in transportation, insurance and marketing in the channel. Very often in his capacity of intermediary in the channel the wholesaler is able to resolve conflicts, which from the viewpoint of transaction cost theory allows reducing *ex post* transaction costs, that is, the costs of contract observance. It is again the intermediate role of the wholesaler which provides for the *ex ante* costs to be covered. Those are the costs incurred prior to concluding the deal with the purpose to prevent opportunism, risk, and uncertainty. Considering the significance of wholesalers in the internal market, it is logical to extend this issue to international distribution.

In contrast to the domestic market, the international one is characterized by invariable complexity, magnificent scale and high degree of uncertainty (risk) for the participants. The rule here is the many more unknowns, compared to the domestic environment, both for the producers

wishing to export and the retailers trying to import. This logically poses the question about the size of the transaction costs faced by large international companies operating on a global scale as well as the role played by wholesalers in international distribution. International transactions naturally require higher costs of organization due to various geographic, cultural, political or other factors. According to Root (1990) the complexity of the world market is the reason for the existence of a large number of specialized intermediaries and agencies. He gives a detailed explanation of the variety of services performed by international intermediaries:

“The merchandise must be bought and sold; transportation services must be provided by railroads, ships, trucks, airplanes, and other agencies; international shipments must be insured, financed, and paid for; customs and other government requirements must be met; exports must be stimulated through advertising and other promotion devices; and so on.”

(Root, 1990, p. 17)

Pride and Ferrell (1993) maintain that well over 60 per cent of all commodities in the world are exchanged by or with the help of wholesalers. This can partly be attributed to the diversity of professional services provided by wholesalers which in the context of transaction cost theory include the provision of market and specialized information about a particular country, the type of clientele, the potential for establishing and maintaining contacts between the direct participants, i.e., between the seller and the buyer, the organization of transportation and sale of the product through the different selling points of the wholesaler using his intense marketing efforts.

Some authors (Root, 1990; Demostenov, 1946) believe that international intermediaries are fundamental to the process of international distribution. This is especially true in view of their ability to economize on transaction costs. The large size of these costs in international conditions is the reason why firms internalize market operations which, in effect, expands the scale of their activities. The higher transaction costs drive firms to undertake vertical integration along the distribution channel. Reality shows the tendency for retailers like Walmart, Kmart, Sears, etc. to offer a moderately priced but high-quality product in large volumes. These large retailers are inclined to ignore wholesaling by negotiating directly with the producer and selling to final consumers. By buying in bulk from producers directly, they act more like wholesalers. Yet, they retain their function of retailing by selling to the ultimate consumer at low prices. The

economic explanation behind such trends could again be found in the existence of transaction costs (as the price of using the market mechanism). By achieving economies of scale and internalizing wholesale operations these retailers are able to deliver a much better product at a more reasonable price attractive for the consumer. These scale economies, in effect, exceed the level of transaction costs arising in the absence of a wholesaler. It is impressive that even producers are forced to contact the retailer in his role of leader of the distribution channel. A giant retailer such as Walmart is in a condition to dictate prices, product characteristics and the mode of selling of goods along the channel. Firms the size of Walmart are certainly a threat to wholesalers in domestic distribution. Through vertical integration, by internalizing wholesale trade in their operations, these firms expand their functions ensuring thus a high level of efficiency.

Still, it is hard to predict the disappearance of wholesalers in international distribution. Studying the tendency of individual consumers to create consumer unions and communities with the purpose of establishing direct contact with producers or becoming such themselves, Demostenov (1946) claims that, as far as consumers tend to unite in large self-sufficient unions, they must somehow interact with other spheres especially when it comes to encounters with the global economy. This is why consumers cannot do without merchants.

Borrowing from Demostenov (1946) we conclude that wholesaling demonstrates the connecting role played by commerce and is, therefore, an indispensable part of world trade. Giant retailers, while being efficient in the local market, could hardly be successful in global operations where the need for intermediacy is constant and apparent. The complicated global market necessitates that the process of distribution, which seems somewhat easy domestically, be facilitated by wholesalers. The costs of international transacting exceed those of domestic exchange. No wholesaler would be in a condition to cover those in the international conditions. Going global, as a result of economic rationality and profit seeking, requires information about the particular country and market, the terms of international exchange, the peculiarities of demand and conditions of selling, etc. The difficult process of negotiations in the international environment undoubtedly forces the wholesaler to reduce the number of transactions and contractual agreements with the help of advanced technologies and the means of communication. We conclude that international wholesalers are an essential part of international distribution.

Undergoing the process of transformation Bulgaria provides ample examples of the need for an intermediary, for a wholesaler. The beginning of transition saw the collapse of large structures and the appearance of small commercial units. But with the passage of time economic rationality and logic found their way in economic decision making. Private wholesalers appeared in Bulgaria, selling fruits and vegetables, foodstuffs, construction materials, etc. Alliances of producers, wholesalers and retailers began to appear. The novelty in retailing is that instead of a single store, entire store chains begin to form, i.e. large retailers open up in Bulgaria, too.

In the sphere of tourism many of the assets along the Black Sea are already privately owned. Taken alone, they are unknown in the international tourist market. Therefore, their owners are forced to search the services of famous travel agencies and other representatives. This is one reason for the creation of various types of unions, partnerships and organizational forms which supply them with the necessary information (about the market, prices, demand, etc.). It is just that the costs of all sellers of tourist services, taken separately, exceed those that would be incurred in the presence of an intermediary in the tourist sphere. In this sense, the function of the intermediary is to economize transaction costs.

References:

1. Boeva, Bistra (1996). *International Marketing*. Sofia: University of National and World Economy.
2. Cateora, Philip R. (1987). *International Marketing*. 6th edition, Homewood: IRWIN.
3. Coase, Ronald. (1937). The Nature of the Firm. *Economica*.
4. Demostenov, Simeon (1946). *Theoretical Political Economy. A Study of Exchange* (Part III). 3rd edition, reprinted by 7M Publishers and the University Publishing House, Sofia, 1991.
5. Karakasheva, Lilia and Bistra Boeva. (1994). *International Commercial Deal*. Princeps: Varna.
6. Milev, A., Y. Bratkov and B. Ivanov. (1970). *A Dictionary of Foreign Words in Bulgarian*. Sofia: Science and Arts Publishers.

7. Pride, William M. and O. C. Ferrell. (1993). *Marketing: Concepts and Strategies*. 8th edition, Houghton Mifflin Company.
8. Root, Franklin R. (1990). *International Trade and Investment*. 6th edition, Cincinnati: South-Western Publishing Company.