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Hostages, marginal deterrence and franchise contracts

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Abstract

In this paper, I examine the nature of hostages in long-term contracts. The definition of a hostage is improved relative to the rents attached to a contract. In addition, I show that hostages need to reflect marginal deterrence (fitting the crime) and operate similarly to the same principle in the criminal law. Some empirical observations are presented from franchise systems and support the marginal-deterrence hypothesis.

JEL classification: K0; L2
Keywords: Contracts; Hostages; Franchising

1. Introduction

This paper contributes to the understanding of hostages in long-term contracts. Two areas are of concern. First, the hostage has proved very useful in the study of long-term contracts but its definition has varied across authors and would benefit from some tightening up. Secondly, hostages are typically seen as discrete entities equal to the entire net value of the contract to the hostage poster. An implication is that such 'total' hostages should completely stabilize contracts, when in fact we observe contracting parties exerting efforts that fall short of calling in the hostage and that are aimed at suppressing opportunistic behavior. It is the thesis of this paper that such efforts reflect marginal deterrence and operate similarly to the same principle in the criminal law. Several 'mini hostages' will usually be present, with each being sufficient to control different potential hold-up problems. Observations on marginal deterrence throw some light on the debate

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(Klein, 1995, 1996) over the extent to which hostages are linked to rent flows in the contract.

The structure of the paper is as follows. I briefly outline hostage analysis in relation to the private enforcement of contracts and then move on to give some precise definitions in terms of quasi-rents and contract-specific expenditures. Next, I introduce marginal deterrence as the appropriate means to stabilize a contract. Finally, I illustrate marginal deterrence with enforcement mechanisms from case studies of franchise contracts before drawing my conclusions together.

2. Hostages in contracts, opportunism and the probability of hold up

The economic equivalent of hostages are widely used to effect credible commitments in contracts and reduce the transactions cost of doing business (Williamson 1983, 1985, p. 168). It is normal to emphasize the ex post bonding characteristics (i.e., disciplinary use) of hostages although their ex ante screening properties are also recognized (Chiu, 1998; Dnes, 2000).[1] There will be a link between the creation of a hostage and the profitability of the underlying transactions.

A hostage is placed to assure a trading partner that a contracting party will not cheat. The device is relevant to long-term contracts where a combination of asset specificity, bounded rationality, opportunism and uncertainty may make ex post 'hold up' attractive to a party (Williamson, 1985, p. 31). Opportunism in transaction-cost analysis is normally viewed as equivalent to moral hazard in agency theory, and can arise over specific investments or over the enforcement of effort levels in a contract. Williamson emphasizes asset specificity as the driving locomotive in contracting problems. Long-term contracts are problematic because of the difficulty of specifying all contingencies and the cost of enforcement.

Specific investments result in appropriable quasi-rents in the sense of Klein et al. (1978), i.e., the difference between ex ante expected returns to the investor and the amount that must be left in the contract ex post to deter the investor from abandoning the contract.[2] Such investments are, therefore, vulnerable to opportunistic behavior and may need supporting through private enforcement mechanisms. Private enforcement is normally considered to require 'hands tying' through the posting of a hostage, i.e., the creation of offsetting vulnerability affecting the party who would otherwise be tempted to

[1] See also Raub and Keren (1993) and Stephen and Gillanders (1993).

[2] The quasi-rent is the difference between ex post returns on the total investment and normal returns on the avoidable investment, and the appropriable part is governed by the next-highest valuing user of the total investment. Klein et al. (1978) give an example of a manufacturer investing in a plant with a specific use and earning a normal return by selling output to a single buyer for a net revenue (after meeting avoidable costs) of $\$x$. There may be no scrap value for the plant, implying that the entire net revenue is a quasi-rent once the investment is made. However, if there is an alternative buyer of the output who values it (net) at $\$(x-k)$, the appropriable part of the quasi-rent is only $\$k$, i.e., the original buyer can attempt to drop the price by $\$k$, after the manufacturer has made the investment, before the manufacturer will switch to the alternative buyer. I give a simple numerical example of hold up in Dnes (1995, p. 228).