Franchising

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Franchising, in which independent businesses operate under a shared trademark using a common production process, is used primarily by service businesses. It is an enduring and pervasive organisational form. As an organisational form, franchising has a large and visible presence in consumer industries such as restaurants, lodging, auto repair, real estate, hair styling, and specialty retailing, where it has captured typically thirty to forty percent of sales. Business services in which franchising is prominent include temporary employment, commercial cleaning, printing and copying, tax preparation, and accounting services. Recent areas of growth include home health care, business signage, and child development and education.

Historically, franchising was introduced in the United States in the early 20th century by manufacturers in order to secure local distribution of their product (Dicke 1992). Franchise chains formed at that time still dominate automobile and gasoline retailing, and soft drink and beer distribution. This type of franchising is called product franchising. A second type, business format franchising, arose in the 1950s by entrepreneurs in services industries, and is the subject of this article. When sales from product franchises such as gas stations and soda bottlers are combined with business format franchises such as restaurants and dry cleaners, franchise chains represent for over forty percent of retail sales in the United States (International Franchise Association 2004). Further, franchising has become a key mode of expansion for US and European firms in foreign markets; there are over one million franchisees worldwide (Michael 2003).

The mechanics of business format franchising are as follows. A franchise is a legal contract between the owner of a production process and a trademark (the franchisor, such as McDonald's) and a local businessman (franchisee) to sell products or services under the franchisor's trademark employing a production process developed by the franchisor. When a franchise contract is signed, the franchisee pays a lump sum, a franchise fee. After signing the contract, the franchisor gives the franchisee services needed to open the unit, including training and blueprints for the production process, and in some cases support for site selection or construction management. The franchisee typically makes all necessary investments in land, building, and equipment to open the particular site.

After opening, the franchisor provides periodic inspection of the franchise (to insure operating standards are being followed), access to trademarks, and marketing services (such as advertising and new product development). In return for these services, the franchisee pays a royalty on sales (typically ranging between one and ten percent) and a royalty for marketing expenses (from zero to six percent), commonly called the advertising fee. Generally franchisees do not sell products of the franchisor (although important exceptions exist); the franchisor is compensated for the trademark and its management. The franchise chain is composed of units franchised to local operators and units owned by the franchisor. Both types operate the same production process and sell under the same trademark, but most franchise chains are primarily composed of franchised units.

Research contribution

Franchising has two characteristics that distinguish it from other inter-organisational forms such as equity joint ventures and strategic alliances. First, franchising typically occurs in businesses where there is a notable service component that must be performed near customers. The result is that service-providing outlets must be replicated and dispersed geographically. The second key characteristic is that franchise contracts typically reflect a unique allocation of responsibilities, decision rights, and profits between a centralised principal (the franchisor) and decentralised agents (franchisees). Franchising furnishes a visible contract embodying much of this allocation that facilitates testing important organisational hypotheses. And franchise chains exist in numbers large enough for statistical analysis.

Franchising has been a subject of interest for students of the economics of organisations for many years. Initial and still-insightful works are Caves and Murphy (1976) and Rubin (1978). Lafontaine and Slade (1997) reviewed much of the empirical literature from economics and highlighted agency theory as a motivation for franchising; further amplification and analysis can be found in Blair and Lafontaine (2005). A perspective combining economics and organisation theory can be found in the review by Combs et al. (2004).

Most relevant to this collection, Professor Williamson has discussed franchising inter alia in several of his works (found in Williamson 1985, 1996). Franchising has not been analysed explicitly but it has instead been cited as an example of hybrid governance. Here is a typical reference:

> The distribution of branded product from retail outlets by market, hierarchy, and hybrid, where franchising is an example of this last, illustrates the argument… Forward integration out of manufacturing into distribution would be implied by hierarchy. That would sacrifice incentive intensity but would (better) assure that the parts do not operate at cross-purposes with one another. The market solution would be to sell the good or service outright. Incentive intensity is thereby harnessed, but suboptimization (free riding on promotional efforts, dissipation of the brand name, etc.) may also result. Franchising awards greater autonomy than hierarchy but places franchisees under added rules and surveillance as compared with markets. Costs control and local adaptations are stronger under franchising than hierarchy, and suboptimisation is reduced under franchising as compared with the market. The added autonomy (as compared with hierarchy) and the added restraints (as compared with the market) under which franchisees operate nevertheless come at a cost. If, for example, quality assurance is realized by constraining the franchisee to use materials supplied by the franchisor, and if exceptions to that practice are not permitted because of the potential for abuse that would result, then local opportunities to make 'apparently' cost-effective procurements will be prohibited. Similarly, the added local autonomy enjoyed by franchisees may get in the way of some global adjustments. (Williamson 1996, p. 107.) [1]

Broadly speaking, these insights have been demonstrated to be correct. The purpose of this paper is to briefly review empirical and theoretical amplifications. It is important to note, however, that the insight that franchising gives a larger share of high powered incentives (relative to corporate ownership) is redolent of the key arguments of agency theory, and indeed the language of agency has been more commonly employed than that of transaction cost economics (e.g., residual claims and ownership rather than 'high powered' incentives). Similarly, the problem of 'suboptimisation' that Williamson describes has usually been described as 'free riding.' Nonetheless, the analysis is the same.

Franchising yields higher incentives and effort

Strategically, franchising is an organisational form chosen by entrepreneurs in order to compete in certain industries. Services entrepreneurs choose franchising in order to solve the incentive problem. When operating a chain of dispersed service outlets, each outlet typically requires intensive on-site supervision. Franchising makes the local supervisor the owner of the local business, granting to the supervisor-franchisee the profits after all expenses have been paid. Requiring site managers to invest their own capital and giving them profits after costs induces the franchisee-manager to put forth more effort in supervision than would a corporate employee-manager (Rubin 1978). Franchisees do not shirk (i.e., reduce effort) because their income is tied to their effort. Through franchising, higher-powered incentives are offered (compared to corporate), greater operational efficiency is obtained, and the agency problem is mitigated.

In franchising, however, the potential for shirking is two-sided (a double sided moral hazard). The franchisor can fail to invest in the trademark or inadequately screen prospective franchisees, for example. Given that both parties can shirk, one stream of research has focused on how franchise contracts divide tasks and residual claims to create incentives that promote efficiency and minimise shirking. Lafontaine (1992) analysed royalties and franchise fees and observed that the division of revenue between franchisee and franchisor reflects the effort required of each. Klein (1995) argued that chains' brand name reputations create pricing power that allows franchisors to pay franchisees quasi-rents – amounts greater the franchisee's opportunity cost in alternative employment. Hence franchisees suffer if they leave the franchise chain. By paying quasi-rents, coupled with ongoing monitoring and the threat of contract termination, the franchisor motivates the franchisee.

For termination to have an economic effect on the franchisee, the franchisee must receive quasi-rents, an amount exceeding the franchisee's opportunity cost in other employment. Michael and Moore (1995) compared franchisees' total returns to an estimated return on franchisee labour plus return on invested capital and found that franchisees earn considerably more than either independent entrepreneurs in similar businesses or employee-managers in company-owned outlets.

Franchising yields more free riding

As theory predicts, free riding is indeed a significant problem in the hybrid organisational form of franchising. Because all outlets operate under a shared trademark and customers transfer goodwill associated with one outlet to others with the same trademark, certain investments franchisees make have spillover benefits to other franchisees. For example, the cleanliness of one outlet affects customers' perception of all outlets under the trademark. Because the benefits are shared, franchisees prefer to free ride on others rather than to invest their own effort. These individual actions potentially lead to chain-wide under investment. This argument applies to all local investments that strengthen the brand and that cannot be contractually specified by the franchisor. For example, franchisee local advertising spills over by reaching distant customers in nearby markets and by reaching local customers who purchase elsewhere. Franchisees who benefit from national advertising by the franchisor and spillover advertising by nearby franchisees might therefore under invest in advertising. Franchisors attempt to limit free riding through monitoring (Brickley et al., 1991), with practices such as periodic inspections, mystery shoppers, and advertising audits.

Free-riding has been shown to occur in franchising. Using chain-level hotel and restaurant data, Michael (1999) found that chains that rely heavily on franchising advertise less (as a percentage of sales). In addition, Michael (2000a) found that franchised chains offered lower quality in both the restaurant and hotel industries. These two studies uniquely compared franchised chains and chains that do not franchise. In addition, Lafontaine (1999) showed that prices are higher at franchised outlets than company-owned outlets in restaurant chains. Thus, while franchising appears to solve shirking, the consequences of using franchising also include higher prices, lower quality, and less advertising. This suggests that gains from the control of shirking may be offset by costs of free riding.

The possibility that ‘local autonomy’ can hamper ‘global adjustment’ has also been demonstrated. Research has shown that franchisors also appear less able than firm-owned chains to coordinate elements of the marketing mix of price, quality, and advertising. Michael (2002) observed that price and quality were positively related and price and advertising were negatively related (presumably the chain is advertising lower prices) among firm-owned chains as recommended by marketing practice. Among franchised chains, however, price and quality were inversely related, and price and advertising had no relation, suggesting an inability to coordinate the marketing mix. Thus a further conclusion from this line of research is that franchise chains are less able to present a consistent product positioning with their marketing mix of price, quality, and advertising to customers.

Thus, franchising is truly a hybrid organisational form; high-powered incentives do yield predictable results of superior operating efficiency – an improvement over hierarchy – but inferior investment in chain-wide public goods such as quality and advertising – a disadvantage versus hierarchy.

Identical transactions are sometimes treated differently

Franchising is a hybrid organisational form in a second sense: it contains units that are hierarchy (company owned units) and units that are closer to the market (franchises) within the same system. Explaining this observed fraction (proportion of outlets franchised or percent franchised) has also been a focus of research. In general, variation in transaction conditions affecting the cost of monitoring has driven the outcome. Firms use more franchising when the cost of monitoring outlets through direct observation and inspection increases. Specifically, rural (Norton 1988), distant (Brickley and Dark 1987), and foreign (Fladmoe-Lindquist and Jacque 1995) outlets are more frequently franchised because of the costs of frequent travel by monitoring personnel (Carney and Gedajlovic 1991) and the difficulty of assessing managers' efforts in unfamiliar markets (Minkler 1990). Norton (1988), for example, observed that the Waffle House relied more on franchising in the southwestern United States than near its headquarters in the southeast. Franchising is also used more often when outlet managers' local market expertise is an important competitive input (Combs and Ketchen 2003); the need for such expertise makes centralised monitoring difficult and costly (Minkler 1990). Finally, larger outlets are less frequently franchised (Combs and Ketchen 2003); large outlets give the firm greater economies of scale in monitoring (Lafontaine 1992). These results collectively support the idea that franchising is a solution to agency. Firms substitute strong incentives via franchising when outlets are costly to monitor.

A challenge to this explanation is that some firms frequently maintain both franchised and firm-owned outlets in close proximity to one another. This practice is called either dual distribution (Gallini and Lutz 1992) or the plural form (Bradach 1997). Having two identical outlets in the same market with different ownership implies that differences in monitoring costs are not exclusively driving franchising decisions.

The puzzle can be explained through application of the Williamsonian analysis of neoclassical contract law (Michael 2000b). The contract law that enables and underpins franchising is characterised as 'neoclassical' contract law (Williamson 1991). Neoclassical contract law is generally more elastic than classical contract law. Rather than specifying explicit and formal terms for all conditions, the neoclassical contract creates an 'adaptive range,' a framework and a set of boundaries, within which conflicts are resolved through negotiation between the parties. Negotiation within the adaptive range rather than literal adherence to contract terms facilitates adaptation to change and the preservation of the relationship. Such a negotiation is always carried out in the shadow of the law; when the parties cannot agree within the adaptive range, they resort to the courts.

Thus the franchisor has incentive to increase bargaining power. In the context of the ongoing negotiation between franchisees and franchisor, ownership of some units suggests to the franchisee that the franchisor has the information and the willingness to operate those units if quality declines, thus strengthening the bargaining power of the franchisor. In support of this hypothesis, research found that franchisors resorted less to litigation when they owned units (Michael 2000b).

An important extension of transaction costs is added here. Given the frequency and similarity of the franchising transaction, it is possible that the opportunity for strategic interaction affects the choice of whether to own or franchise. Hence action taken with regard to one franchisee can signal behaviour to other franchisees. Hence identical transactions are governed differently, and the set of transactions becomes worthy of analysis.

Within chains, incentives do appear to be aligned

The general logic of the economics of organisations suggests that inefficient organisational forms are eliminated through market competition. To succeed, inter-organisational forms such as franchising must align incentives of participants. Nonetheless, empirical tests of this proposition have been rare.

Investigating the alignment of incentives through contract terms was a useful by-product of a study of franchisee failure. Michael and Combs (2008) examine how terms of the franchise contract affected franchisee failure. They found that franchisor policies designed to limit adverse selection and moral hazard reduce failure by franchisees. The results are consistent with the argument of Williamson (1983) who notes that franchisees should desire many restrictive policies to be imposed by the franchisor because such policies strengthen the brand that all franchisees rely upon.

To examine the efficiency premise of organisational economics, their analysis also compared the effect of contractual terms on franchisee survival in that paper and on franchisor survival elsewhere in the literature (Combs and Ketchen 1999; Shane 1998, 2001; Shane and Foo 1999).

Such provisions as requiring industry experience, requiring active ownership, length of training, exclusive territories, and brand investments enhance survival of both franchisees and franchisors. In addition, Michael and Combs (2008) also found that franchisor performance (here ROA) positively and significantly affects franchisee survival. Thus, a strong commonality of interest exists between franchisor and franchisee, and the organisational form seems to be efficient.

Conclusion

Franchising research has largely supported the research program of the incipient science of organisation. Moreover, the use of a different theoretical language (though not a different theoretical reasoning) should not obscure the observation that franchising has provided valuable service (albeit indirectly) to transaction cost economics. In particular, franchising has amplified and elaborated what a hybrid form requires, and has introduced the possibility of strategic effects that one (seemingly identical) transaction can have on another.

Important tasks remain. It is certainly desirable to learn more of the dynamics of hybrid organisations, and how such organisations successfully innovate (or don’t). The management of such hybrid organisations remains a challenge for study by business and management scholars, if not economists (directly). More generally, franchising can and should continue to be a valuable subject for TCE research.

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Notes

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[1] Williamson also uses the term franchise in another sense: the allocation by government of the right to engage in an (exclusive) business. See, for example, Williamson (1985), chapter 13. This review does not examine this alternative usage.