Research in Economics (2002) **56**, 157–186
doi:10.1006/reec.2001.0275
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Co-ordination costs and vertical integration in production franchise networks: a common agency model

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(*Received 19 January 2000, accepted 12 March 2001*)

Summary

A common agency model describes the production franchise in the carbonated soft drink industry as a contractual device between an upstream agent (the franchisor) and downstream principals in a duopoly (potential franchised firms). Process and product innovations are formalized as the subject matter of the contract, which is observable at no cost by downstream firms, together with local conditions. The latter are unknown by the upstream firm. Anti-complementarities in network co-ordination costs are demonstrated to be necessary and sufficient for the franchisor to obtain strictly positive profits. Upstream profitability is found to decline in favour of franchised firms when the content of the contract is decreasingly proprietary, when local cost or demand conditions harmonize and when co-ordination costs fall. Implications for the explanation of vertical integration are discussed. © 2002 Published by Elsevier Science Ltd on behalf of University of Venice

J.E.L. Classification: F23, L10.
Keywords: franchising, production, innovation, integration, common agency.

* The hospitality of the CRIEFF (Centre for Research into Industry, Enterprise, Finance and the Firm), University of St Andrews, in which this paper has been partly written, is gratefully acknowledged. This version benefited from comments or help in various forms by Michèle Breton, Etienne Billette de Villemeur, Guillaume Hollard, Louis Phlips, Gavin Reid, Bauke Visser, the Associate Editor, the Editorial Assistant and two anonymous referees. Discussions with session participants in Lyon (RENT '98) and Naples (ICSB '99) were useful. Special thanks are due to Steve Thompson who gave me the idea to work on this topic a long time ago. All remaining errors are mine.

1090–9443/02/020157 + 30 $35.00/0 © 2002 Published by Elsevier Science Ltd on behalf of University of Venice

1. Introduction

This paper presents a common agency model in which a franchisor diffuses innovations of the process and/or product kinds to manufacturing franchisees. The objective is to investigate from a new angle some possible determinants of observed shifts from production franchising to vertical integration.

Real-world situations under which an (upstream) innovator controls a set of (downstream) adopters can take organizational forms that fall between two discrete alternatives: a price-determining market exchange (the no-control case) and centrally managed activities (the complete-control case). Franchising, as a contractual device midway between independent operations on the marketplace and vertical integration within a firm, is one of them. This agreement combines the decentralized ownership of assets among a set of franchised firms with the centralized provision of an operational know-how and/or the centralized advertising of a(n) (inter)national brand name. Franchise agreements have been applied to a nearly endless variety of activities. They are usually classified into three categories: the "distribution" franchise, the "service" franchise and the "production" franchise. Well-known examples of the two former types are Benetton and McDonald's, respectively.† In franchise agreements of the production type, the franchisor grants to distant franchisees a manufacturing licence based upon technical know-how combined with a trade mark licence. This description follows the definition offered by the European Commission in the Regulation No. 4087/88 of November 1988 on the application of Article 85(3) of the treaty to categories of franchise agreements (paragraph 4 of the preamble). On a given territory (say, a country), the franchisor generally authorizes several firms (say, one for each region) to implement a particular process in order to produce a specified product and distribute it. In most contractual agreements, franchisees are compelled to purchase their entire requirement of some inputs from the franchisor. Locally, a final good is then obtained at lower variable costs and/or differentiated from other substitute products. This is made in accordance with some instructions contained in standard operation manuals and/or thanks to the goodwill associated with some trade marks supplied by the franchisor. The difficulty in

† In most contributions to the economic literature on franchising, references to the production type are simply omitted. This absence echoes the European Commission regulation of franchise practices, as reproduced in Frazer and Waterson (1994): "[s]uch agreements, which usually govern relationships between producers, present different characteristics than the other types of franchise" (p. 234). An exception can be found in a very complete survey by Lafontaine and Slade (1997). The authors refer to Muris *et al*. (1992) and do not point to anything systematically different about production franchises, as compared with other types of franchises.

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