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Externality and organizational choice in franchising

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Abstract

In this paper, we examine some implications of externality for the organization of firms. The need to control externality explains the selection, at the level of the chain, of full integration, dealerships or franchising systems, or systems of dual distribution where company and franchised outlets operate simultaneously, in preference to unrestricted retailing. We show that there could be a trade-off between managerial motivation and effective controlling of externality. This trade-off can explain the selection of particular organizational structures within franchising. In particular, non-separable externality, where the value of the externality depends upon characteristics of both the generating and affected unit, is costly to control contractually and could encourage integration.

JEL classification: L14; L22; M21

Keywords: Externality; Franchising; Dual distribution

1. Introduction

In this paper, we examine some implications of externality for the organization of firms. In particular, we offer an explanation of franchising characteristics including the practice of dual distribution, where a franchise chain simultaneously uses both franchised and company-operated outlets. The need to control externality is cited as an explanation of the selection

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of full integration, dealerships or franchising systems in preference to unrestricted retailing (Rubin, 1978; Williamson, 1981, 1985). We show that the relative costs of inefficient effort and of controlling externality can also explain the selection of franchising in relation to dual distribution. In particular, non-separable externality, where the impact of the externality depends on characteristics of both the generating and affected satellite business, is costly to control contractually and makes it likely that integration will be selected.

We begin by examining externality issues in franchising, also giving some attention to examples of externalities based on interacting effort levels. We also consider the interaction between the encouragement of localized business efficiency and the control of externality. Our formal model is based on the trade off between managerial motivation and externality control and leads to empirical predictions.

1.1. Externality issues in franchising

Franchisors save on many day-to-day monitoring costs owing to the profit incentive for the franchisee to control local business costs (Maness, 1996). Nonetheless, the franchisor must monitor the effort of individual franchisees to prevent them from horizontally free riding on the reputations of other franchisees (Rubin, 1978). Others have seen franchise royalties as motivating the franchisor to control a vertical externality, where franchisees might try to free ride upon centralized promotional efforts (Mathewson & Winter, 1985). An externality problem potentially exists in any retail network and is likely to have organizational impact (Dnes, 1993; Williamson, 1981). The externality can in principle have positive or negative characteristics.

Franchise systems encounter problems of motivating franchisees to honor guarantees and service arrangements issued elsewhere in the system (Dnes, 1992). System-wide customer-servicing arrangements can increase sales for the chain as a whole but will impose costs on franchisees. Such an externality can have negative (effort-reducing) effects as franchisees try to free ride, and positive (demand-enhancing) effects. Franchisees try to avoid responsibilities that they believe will just cost them money, ignoring the system-wide effects of this behavior. As it is in the interest of the system as a whole to have transferable service arrangements, there are classic free-rider aspects to this problem.[1]

The problem of franchise externality is particularly severe where the impact of an externality depends upon some aspect of the satellite business it affects, i.e. where it is non-separable. An earlier literature shows that non-separable externality, where marginal

[1] For examples, see observations by Dnes (1992) and more recent follow-up work with the sample of franchises described therein. In one case, involving the overseas expansion of the Avis vehicle-rental franchise, the franchisor could not find an economic payment system that would motivate franchisees to participate willingly in a system of one way rentals (associated with business customers) or to service the vehicles of other franchisees or of company outlets. These problems became so severe that Avis changed its policy from 1992 onwards and now uses company stations in UK locations likely to generate or receive significant amounts of one-way business, which also has the advantage of increasing a reliable source of servicing. The same system operates in the USA, and there are other examples of this in many franchise chains. It is relatively well known that retail dealerships can have difficulties in suppressing externalities concerning sales or service operations (Sloan, 1964, p. 298). Customers of retail chains like Benneton often find franchisees reluctant to handle returns from other branches. Observations like these suggest that franchising may not be an ideal organizational form where there are strong systemic effects.