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Agency and institutional influences on franchising decisions ☆

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ABSTRACT

While the franchising literature has typically relied on agency theory, efficiency considerations may not fully explain decisions to expand through franchising or company ownership. In this study, I re-examine franchising decisions using insights from institutional theory. The key tenet of institutional theory is that decisions are influenced by isomorphic pressures arising from the environment. Economic rationales such as the achievement of efficiency are thought of as less pervasive concerns. I begin by investigating whether institutional theory explains variance in franchising decisions beyond what is explained by agency theory. Then, I explore the extent to which institutional considerations moderate the relationships between agency considerations and franchising decisions. Hypotheses are tested on a unique database of 132 French franchise chains. Empirical results suggest that successful competitors' use of franchising explains variance in the focal chain's use of franchising beyond what is explained by the importance of local managerial inputs and the threat of franchisee opportunism. In addition, the threat of franchise opportunism is less strongly related to the focal chain's use of franchising when successful competitors have a high proportion of franchised outlets. Overall, findings from this study suggest that researchers should supplement agency theory with institutional theory to adequately explain franchising decisions.

1. Executive summary

The franchising literature is based almost exclusively on agency theory. According to agency theory, there is a major difference between company ownership and franchising. In company-owned outlets, the chain operator owns the facilities and operates them directly by hiring employees. In franchised outlets, the chain operator contracts with independent entrepreneurs (i.e., franchisees) who invest their own capital in the outlet. Because the profit stream from their investments depends on their performance, franchisees have stronger incentive to perform than employee–managers. Therefore, effort is self-enforced and the need to monitor them via direct observation is significantly reduced. However, franchising is no panacea as opportunistic franchisees may be tempted to increase their short-term profitability by free-riding on the brand name.

In this study, I re-examine franchising decisions using insights from institutional theory. Over the past decades, institutional theory has developed into one of the leading perspectives in organizational analysis. The key tenet of institutional theory is that decisions are influenced by isomorphic pressures arising from the environment. Economic rationales such as the achievement of efficiency are thought of as less pervasive concerns.

Hypotheses derived from agency theory and institutional theory are tested on a unique database of 132 French franchise chains. The main findings of the study can be summarized as follows. First, considerable empirical evidence has shown that franchising decisions are influenced by agency variables. Consistent with the franchising literature, the importance of local managerial inputs

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is positively related to the use of franchising, whereas the threat of franchisee opportunism is negatively related to the use of franchising. Second, successful competitors' use of franchising explains variance in a chain's use of franchising beyond what is explained by agency variables. In other words, empirical results support the view that successful chain operators serve as role models in the franchising context. The underlying rationale is the following. When successful organizations do things a certain way, other organizations tend to follow suit not necessarily for reasons for efficiency but because that particular course of action has become either taken for granted, or necessary to appear legitimate to potential resource suppliers, or both. Third, I find some evidence that institutional pressures moderate the relationships between agency variables and franchising decisions. Specifically, the negative relationship between the threat of franchisee opportunism and a chain's use of franchising is less pronounced when its successful competitors have a high proportion of franchised outlets.

Several managerial implications can be derived from the study. While imitation is generally viewed as non-rational, it can also have some rational basis. First, mimicking successful competitors helps economize on search costs when information is time consuming and costly to collect. Second, chain operators that mimic their successful competitors may appear more legitimate to potential resource suppliers such as bankers or prospective franchisees. While legitimacy-based imitation enables organizations to increase their (long term) probability of survival, it is important to note that the likelihood of survival may be obtained at the expense of (short term) performance. Therefore, chain operators should learn how to weigh and act on legitimacy and efficiency considerations.

2. Introduction

Franchising is an entrepreneurial activity that plays a crucial role in the creation of new jobs and economic development (Falbe et al., 1998). In the United States for instance, franchised businesses represent 11 million jobs and 8.1% of all private sector jobs (International Franchise Association, 2008). In franchising, a chain operator–entrepreneur collaborates with a franchisee–entrepreneur to create economic value. Specifically, the franchisee obtains from the chain operator the right to market goods or services under its brand name and to use its business practices. In return, the franchisee pays an up-front fee and ongoing royalties to the chain operator (Combs et al., 2004).

An important feature of most franchise chains is that they simultaneously use franchised and company-owned outlets. As the proportion of franchised and company-owned outlets varies significantly across chains, franchising decisions have been the subject of considerable empirical research. In a recent literature review and meta-analysis of forty-four franchising studies, Combs and Ketchen (2003) found strong support for hypotheses grounded in agency theory.

An agency relationship exists when one party (i.e., the principal) delegates authority to another (i.e., the agent) (Eisenhardt, 1989). A key assumption of agency theory is that the interests of agents diverge from those of principals. Therefore, agents are likely to misrepresent information regarding their skills (cf. adverse selection problem) and effort (cf. moral hazard problem) (Jensen and Meckling, 1976). According to agency theory, the adverse selection and moral hazard problems can be solved either through monitoring or residual claimancy. While monitoring aims at providing principals with information about the behavior of agents, residual claimancy aims at aligning the incentives of agents with those of principals.

In the franchising context, chain operators act as principals and delegate authority to two types of agents: employee–managers and franchisees. Unlike employee–managers, franchisees are residual claimants on the profit of their outlets. They have stronger incentives to perform and the need for chain operators to monitor them via direct observation is considerably reduced (Norton, 1988; Rubin, 1978). However, opportunistic franchisees may also be tempted to increase their short-term profitability by free-riding on the brand name (Brickley and Dark, 1987; Carney and Gedajlovic, 1991).

So far, the franchising literature has been based almost exclusively on agency theory (Combs and Ketchen, 2003; Lafontaine and Slade, 2007). However, agency theory may not provide a full account of franchising decisions because it is "under-socialized" (Granovetter, 1985). Building upon Combs et al. (2004), I introduce an institutional perspective on franchising. Over the past decades, institutional theory has developed into one of the leading perspectives in organizational analysis (Heugens and Lander, 2009). The key tenet of institutional theory is that decisions are influenced by isomorphic pressures arising from the environment (DiMaggio and Powell, 1983; Meyer and Rowan, 1977; Scott, 1995). Thus, the achievement of efficiency is thought of as a less pervasive concern than in agency theory.

Few empirical studies have adopted an institutional perspective on franchising (for an exception, see Shane and Foo, 1999). Yet, institutional theory can make an important contribution to our understanding of franchising decisions. Specifically, a direct implication of institutional theory is that decisions to expand through franchising are likely to be influenced by the extent to which franchising has become either taken for granted, or necessary to appear legitimate to potential resource suppliers, or both.

In this paper, I explore the direct and joint impact of agency and institutional considerations on franchising decisions. While both perspectives may make important explanatory contributions in their own right, neither perspective is likely to provide a fully explanatory account of franchising decisions. As pointed out above, agency theory can be criticized for providing an "under-socialized" view of organizations. Likewise, institutional theory can be reproached with providing an "over-socialized" view of organizations. By using agency theory and institutional theory into a single framework, my aim is to provide a more nuanced and complete understanding of franchising decisions. Hypotheses are tested on a unique database of 132 French business format franchise chains. Empirical results support the notion that institutional theory explains variance in franchising decisions beyond what is explained by agency theory. To some extent, institutional considerations also moderate the predictions of agency theory. Taken together, these findings suggest that researchers should supplement agency theory with institutional theory to adequately explain franchising decisions.

Most prior franchising studies have explained how chain operators arrive at a particular mix of franchised or company-owned outlets. However, purely cross-sectional analyses have two limitations. First, they cannot indicate whether chain operators are moving in the direction predicted by theory. Second, they reflect past decisions, which may have been made under different