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The effect of organizational form on quality: the case of franchising

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Abstract

The organizational form of franchising has been shown to yield higher profits and faster growth through reducing agency costs. Why then does anyone *not* franchise? In this paper I argue that the diffuse residual claims of the franchise system reduce overall system quality, and that this problem is inherent in the nature of franchising. The theory is tested by examining evidence from both the restaurant and the hotel industries, including chains that franchise and ones that own all of their units. In both industries, quality is negatively related to the percent franchising in the chain, controlling for size, growth in units, monitoring costs, market segment, ownership structure, multi-chain operation, and price. The results suggest that the franchise contract increases free-riding and decreases quality in decentralized service chains, and that quality is not contractible in this setting. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

Franchising is an organizational form chosen by management in order to compete in industries in the retail trade and services sectors that require highly decentralized operations at a chain of multiple sites. Unlike employees, franchisees invest their own capital and receive residual claims from a specific site rather than a salary. Existing research has explained franchising as a solution to the agency problem; franchising overcomes the moral hazard problem of site managers operating within a chain of dispersed units. Making site managers residual claimants reduces agency costs relative to using corporate employees.

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These conclusions present a puzzle for scholars of organizational form. Despite its beneficial effects, franchising does not have a monopoly on retail trade and services: as an organizational form, franchise chains have between a third and a half of industry sales where they compete, as Michael (1996) reports. Given that competition in organizational form is a well documented phenomenon (e.g. Armour and Teece, 1978; Michael, 1994), and that franchising in its present form has existed for almost 50 years, why has competition in organizational form not eliminated nonfranchising chains?

It is the contention in this paper that the franchise system, whatever its other advantages, cannot deliver the same high quality as a totally owned organization, and that this is inherent in the nature of franchising. Both theory and empirical evidence from two industries will be offered to support this conclusion. Section 2 reviews the literature on explanations of franchising, and its expected effect on quality. Section 3 presents the research design for the empirical estimation. Section 4 presents evidence from the restaurant industry. Section 5 presents evidence from the hotel industry. Section 6 concludes.

2. Explanation for franchising

Chains in industries that require highly decentralized operations at a chain of multiple sites require the services of site managers who are responsible for supervising the operation of the site. The chain can choose to use as site manager an *employee*, who is paid a salary and perhaps a bonus. Alternatively, the chain can use a *franchisee*, who is granted through a contract for a particular site the stream of profits after all expenses have been paid, including a royalty to the franchisor. The franchisee site manager also invests his own funds in items necessary to open the site, including buildings and equipment. In return, the franchisor typically gives the franchisee services needed to open the unit, including training in a production process. After opening, the franchisor provides periodic inspection of the franchisee, access to trademarks, and marketing services. [1]

2.1. Franchising as a static solution to the agency problem

Rubin (1978) argued that the franchise relationship is superior to the employment relationship as a solution to the agency problem of motivating site managers because franchising makes the franchisee-manager the residual claimant of operations at the site. Standard theory suggests that residual claimant status of an agent will induce greater effort and, in some cases, full effort in supervising. Rubin (1978) notes that the franchise contract divides tasks and associated residual claims to create incentives that promote efficiency for both franchisor and franchisee. Subsequently, different authors have stressed different aspects of these incentives, such as the division of revenue through royalties, the right to sell the unit, or the payment of quasi-rents. Lafontaine (1992) analyzes a large sample of franchise contracts and observes that the division of revenue between franchisee and franchisor (specifically royalty and franchise fee) adjusts to reflect the effort required of each. Lutz (1995) argues

[1] The seminal papers identifying the economic issues are Caves and Murphy (1976) and Rubin (1978). A recent review of the franchising literature is in Dnes (1996).