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Centralization of franchising networks: evidence from the Austrian franchise sector

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Abstract

Based on the property rights approach, residual decision rights in franchising networks must be allocated according to the distribution of intangible knowledge assets between the franchisor and franchisee. Our analysis follows from this hypothesis: the more important the franchisor's system-specific assets for the generation of residual surplus, the more residual decision rights are assigned to the franchisor, and the higher is the degree of centralization of the franchising network. This property rights hypothesis is tested in the Austrian franchise sector. The results of the study suggest that the franchisor's intangible system-specific know-how and brand name assets have a stronger influence on the allocation of residual decision rights in the franchising network than the franchisee's intangible local market assets.

Keywords: Franchising networks; Intangible assets; Residual decision rights; Centralization/decentralization

1. Introduction

This paper explains the degree of centralization of decision making in franchising networks by applying the property rights theory. In the 1990s, the property rights theory, developed by Alchian, Demsetz, Fama, Jensen, Barzel, Grossman, Hart, and Moore (Alchian and Demsetz, 1993; Fama and Jensen, 1983; Barzel, 1997; Grossman and Hart, 1986; Hart and Moore, 1990; Hart, 1995), was used to explain the decision and incentive structure of the firm (Jensen and Meckling, 1992; Brynjolfsson, 1994; Brickley et al., 1991; Christie et al., 1995; Hitt and Brynjolfsson, 1997; Hart and Moore, 1999). According to the property rights approach, the structure of decision rights (as residual rights of control) depends on the distribution of intangible knowledge assets that generate the firm's residual surplus (Barzel, 1997; Hart, 1995). Intangible knowledge assets refer to the knowledge and skills (know-how) that cannot be easily codified and transferred to other agents, since they have an important tacit component (Polanyi, 1962; Boisot, 1998). In franchising, intangible knowledge assets refer to the brand name assets and the system-specific know-how of the franchisor and the local market know-how of the franchisee. The thesis of our paper is that the higher the franchisor's portion of intangible knowledge assets relative to the franchisee's, the more residual decision rights should be assigned to the franchisor, and the higher is the degree of centralization.

Although theoretical and empirical studies dealing with the allocation of decision rights exist in the organizational economics and accounting literature (Aghion and Tirole, 1997; Dessein, 2000; Harris and Raviv, 2002; Christie et al., 1995; Baiman et al., 1995; Nagar, 2002), no prior research—with the exception of Arrunada et al. (2001)—examines the determinants of the allocation of decision rights in franchising networks. This situation may result from the difficulty in acquiring knowledge assets and decision rights data. Compared to the agency and transaction cost theoretical view of Arrunada et al. (2001), we develop a property rights approach of the allocation of decision rights. Our main contribution to the franchising literature is in applying the property rights theory to explain the degree of centralization of franchising networks and in examining empirically the influence of intangible knowledge assets on the structure of decision rights. First, we present a property rights view of the allocation of decision rights between the franchisor and the franchisee, and second, we empirically investigate the degree of centralization of franchising networks in the Austrian franchise

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sector. Consequently, this research moves forward the theoretical aspect of decision making in franchising networks by stating that the allocation of decision rights depends on the intangibility (noncontractibility) of knowledge assets of the franchisor and franchisees.

The paper is organized as follows. Section 2 presents the property rights proposition concerning centralization versus decentralization of decision rights. Section 3 uses the property rights approach to examine the relationship between the characteristics of franchisor's and franchisee's knowledge assets and the allocation of residual decision rights in franchising networks. We develop the proposition that the degree of centralization depends on the distribution of the franchisor's and franchisee's intangible assets. In the fourth section, we apply this framework to derive testable hypotheses. The hypotheses are finally tested in the Austrian franchise sector.

2. The structure of decision rights: a property rights approach

According to von Hayek (1935, 1940), centralization of decision making is only efficient if the central planner has the knowledge that is specific in time and place. March and Simon (1958) applied similar ideas to the design of organization. Due to the CEO's limited information-processing capabilities organizations must delegate decision-making power (see also Van Zandt, 1999; Van Alstyne, 1997). Based on the property rights theory, Jensen and Meckling (1992) argued that organizational efficiency requires that those with the responsibility for decisions also have the knowledge valuable to those decisions. Colocation of decision rights with knowledge can be achieved by transferring the knowledge to the person who has the decision right or by transferring the decision rights to the person with the knowledge. Such transfers mean that knowledge transfer costs determine the degree of centralization of decision making. Decision rights tend to remain in the CEO's office when the costs of transferring knowledge to the central office is low, and decision rights tend to be delegated to lower levels of the hierarchy when the firm primarily produces knowledge that is costly to transfer to the CEO (Malone, 1997).

Which factors influence the knowledge transfer costs? According to the property rights approach (Hart and Moore, 1990; Barzel, 1997; Brickley et al., 1995) the structure of residual decision rights depends on the distribution of intangible (noncontractible) assets. The person who has intangible knowledge assets that generates the residual surplus should have the residual decision rights to maximize the residual income (Rajan and Zingales, 2000). These rights refer to the use of local knowledge as "sticky" information (Von Hippel, 1994) that cannot be easily communicated and specified in contracts due to too high transaction costs. In addition, specific or nonresidual rights are explicitly stipulated in contracts (Demsetz, 1998). For instance, "specific user rights over a computer may be rights to use it to run a particular program in a particular manner in a particular time period for some specific purpose" (Foss and Foss, 1998). Therefore, they refer to the use of general or explicit knowledge (as tangible knowledge assets) of the parties which can be more easily written down and specified in contracts. Consequently, given the distribution of intangible knowledge assets, the maximum resource value is obtained if the decision rights are assigned to those who are best able to use these assets (Aghion and Tirole, 1997; Malone, 1997; Wruck and Jensen, 1994). The relationship between knowledge assets and decision rights can be stated by the following property rights proposition:

Proposition 1: *The allocation of residual decision rights depends on the characteristics of knowledge assets: The more important a person's intangible knowledge assets for the generation of the residual income relative to another person, the more residual decision rights should be assigned to that person.*

3. Knowledge assets and the degree of centralization of franchising networks

The knowledge characteristics relevant for the allocation of decision rights are the degree of intangibility of knowledge assets. Starting from Itami (1984) and Itami and Roehl (1987) in strategic management, Hall (1989, 1993) develops the concept of intangible assets, which is partially compatible with the concept used in the property rights theory. Hall (1989, 1993) differentiates between two groups of intangible assets: intellectual property and knowledge assets. The first includes patents, trademarks, copyright, registered design, and databases, and the latter refers to the capabilities (skills and know-how) and reputation and goodwill. Intellectual property is contractible; it can be transferred by contracts (Hall, 1989, p. 56).

On the other hand, low degree of contractibility characterizes capabilities and reputation capital because they have an important tacit component (Contractor, 2000; Fernandez et al., 2000). According to Hall (1993), noncontractible assets are the source of competitive advantage because they cannot be easily transferred and imitated. Consequently, Hall's intangible assets concept partially deviates from the concept used in the property rights theory. In economics, intangible assets only refer to the assets with a low degree of contractibility (Hart and Moore, 1990; Brynjolfsson, 1994). We use the latter concept for our analysis.

Which knowledge assets are generated and used in franchising networks and how are the decision rights allocated? The franchisor faces the problem of maximizing the returns to his intangible system-specific assets when they are dependent on investments in local intangible assets of the franchisee (Caves and Murphy, 1976). Based on