Available online at www.sciencedirect.com
SCIENCE DIRECT®
International Journal of Industrial Organization
24 (2006) 449–465
International Journal of Industrial Organization
www.elsevier.com/locate/econbase

Optimal franchise contracts with private cost information

Bernd Hempelmann

Universität Osnabrück, FB Wirtschaftswissenschaften, Rolandstr. 8, D-49069 Osnabrück, Germany

Received 26 July 2001; received in revised form 24 September 2002; accepted 28 July 2005
Available online 3 October 2005

Abstract

This paper considers franchise arrangements in the case where the franchisee has private information about the marginal cost of sale. It is shown that the optimal contract in general leads to different margins for the parties than with common cost information. However, in special cases the same margins than with common cost information are optimal.

JEL classification: L14; M3

Keywords: Franchising; Two-sided incentives; Private information; Revelation principle

1. Introduction

Franchising is enjoying an increasing popularity in business practice. For example already more than 40% of all retail turnover is allotted to franchising in the USA. Due to the desired increase in the number of self-employed people an increase in franchising is also expected in Germany. Franchising can now be found in most trade areas. Hotels and restaurants, food/beverages, furniture, clothes as well as the service area are prominent examples.

Franchising can be defined as the network of a contract-giving firm (franchisor) with (in principle) independent contract takers (franchisees). The grant of rights to use labels, names, trademarks, production procedures, prescriptions, etc., of the franchisor against payment by the franchisee can be regarded as constitutive features of franchising. The payment generally consists of a lump-sum fee to be paid when entering the system as well as royalties based on gross sales.

The franchise contract forms the basis for the co-operation between the franchisor and the franchisee. One focus is the declaration of obligations of the contracting parties. For example, the franchisor is responsible for the national advertising of his products, while the franchisee is

E-mail address: bhempelmann@oec.uni-osnabrueck.de.

0167-7187/$ - see front matter
doi:10.1016/j.ijindorg.2005.07.008

responsible for advertising in local media. A complete declaration of all obligations is however not possible. Franchise contracts are generally incomplete. This is particularly true for those obligations concerning marketing activities.[1] However, marketing activities of the contracting parties are influenced by the contract. This influence is to be anticipated when designing the contract.

Before conclusion of a contract the parties may or may not share the same cost information. In this paper private information of the franchisee about the marginal cost of sale is assumed.[2] As a benchmark common cost information is also considered. The marginal cost of sale consists essentially of the costs of presenting the relevant product as well as the costs of customer consultation and service. While the first are determined to a large extent by the specifications of the contract, the latter depends on local conditions (e.g., the local structure of population), which are better known to the franchisee. Hence, the franchisee might enjoy an information advantage relative to the franchisor.[3]

However, the case of common cost information might also be relevant if the franchisor has cost data from other sales areas comparable to the sales area in question. If the franchisee previously worked in another industry, the case where the franchisor is better informed about the marginal cost of sale is also conceivable. However, this case is not further examined here.

How does the franchise contract in the case of private cost information differ from the case of common cost information? Clarifying this question is the topic of the present paper.

The paper is organized as follows. Section 2 provides a review of related literature. Section 3 presents the basic assumptions of the analysis. Section 4 derives the optimal contract in the case of common cost information. This case serves as a benchmark for the case where a franchisee has private cost information, which is considered in Section 5. The paper concludes in Section 6.

2. Related literature

Contract design in franchising has already been addressed by several researchers. Important theoretical contributions include Mathewson and Winter (1985), Lal (1990), Katz and Owen (1992), and Bhattacharyya and Lafontaine (1995). These approaches analyze franchise contracts on the basis of two-sided incentive problems: the contract contains incentives for the execution of marketing activities for both the franchisor and the franchisee. The consideration of two-sided incentive problems proves to be sufficient to theoretically justify the practice of using royalty arrangements in franchising.[4] The result that contract arrangements in franchising found in practice can best be explained by a model of two-sided moral hazard is therefore no surprise.[5] This paper follows the literature mentioned above in considering two-sided incentive problems. Royalties are therefore used to coordinate marketing activities of the franchisor and the franchisees.

The approaches indicated above do not address contract design in franchising when private information is an issue. This aspect is, however, analyzed in the models of Gal-Or (1991a,b),

[1] Very frequently franchise contracts contain only vague formulations about the marketing activities of the contracting parties.

[2] Private information is opposed to common information, i.e. information, which is accessible to both parties.

[3] Minkler (1990, 1992) argues that better knowledge about local market information by the franchisee relative to the franchisor is an important reason for the choice of franchising.

[4] See, e.g., Lal (1990).

[5] For an empirical assessment of predictions about contract design in franchising from agency theory see Lafontaine (1992), Sen (1993), and Lafontaine and Slade (1997).