The case of franchising

Franchising as a static solution to the agency problem

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.

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.

Effects on quality

With regard to quality, the franchisee, as the residual claimant of the business, would be expected to provide higher quality than a salaried employee if the higher costs of quality (both personal effort and other inputs) were exceeded by gains in unit profits deriving from ahigher sales price or greater quantity sold due to high quality. The presence of anexternalitysuch as a trademark's reputation for quality complicates the analysis. In the franchisechain,all units operate under a shared trademark, so individual effort to raise quality creates anexternality problem, as customers transfer the goodwill that they associate with the quality ofone outlet to others operating under the same trademark. Therefore, franchisees do not fullyappropriate the gains from their investment in quality. This externality creates incentives
for free-riding that are exacerbated by the residual claimant status of the franchisee. 5 As

Caves and Murphy (1976, p. 577) note, “A franchisee who reduced the quality of thegood or service he offers for a given price might increase his own profits, yet by disappointing buyers’expectations he could reduce by a greater amount the net returns to the common intangible goodwill asset — maintained by the franchisor and used jointly by his other franchisees”.In the absence of any controls other than residual claimant status, franchising would beexpected to yield lower quality than owned units because of this free riding. 6 Aware of the risk of free-riding, franchisors supplement residual claimant status with monitoring of franchisees to assure quality. Franchisors use an extensive network of field representatives and other means to monitor franchisees on-site. 7 Franchisees can be terminated by the franchisor if quality standards are compromised.

In summary, the proposition that franchisees may underinvest in an externality such as quality in the absence of monitoring is not controversial. But franchisors do invest considerable resources to monitoring, detection, and termination. Whether franchising, with its combination of residual claimant status and monitoring with the threat of termination, is more effective in inducing effort for quality than employment is the question the paper seeks to answer. The relationship of quality, free riding, and residual claimant status is examined in two industries after the methodology is described.