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Dynamic Co-Existence of Company-Owned and Franchised Outlets Within a Company: A Framework of the Franchisor's Perspective

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DYNAMIC CO-EXISTENCE OF COMPANY-OWNED AND FRANCHISED OUTLETS WITHIN A COMPANY: A FRAMEWORK OF THE FRANCHISOR'S PERSPECTIVE

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Why and how do company-owned and franchised outlets simultaneously exist within the same organization? The purpose of this article is to integrate a variety of theories on this interesting retail phenomenon into a broader theoretical framework based on the political-economy paradigm. This paper attempts to integrate the perspectives of several theories that previously have been considered competing models of a single reality—the access-to-capital viewpoint, transaction cost analysis, the population ecology perspective, and power-dependence-conflict arguments—into a broader perspective that utilizes intra-firm factors and the internal and external economies and polities of the political-economy paradigm. A model depicting this integration is set forth and nineteen research propositions stemming from this model are proposed.

INTRODUCTION

Franchise systems are an important channel form, accounting for about 40 percent of all retail sales in the United States (International Franchise Association, 2002). Scholars have been curious about why firms choose franchising versus company-owned outlets and why, in many cases, a dual system of operation (i.e., both franchised and company-owned outlets) has evolved. The presence of both market-like and hierarchy-like features in franchise organizations has attracted significant attention from researchers (Anderson 1984, Bradach and Eccles 1989, Brickley and Dark 1987, Brickley, Dark and Weisbach 1991, Carney and Gedajlovic 1991, Dant, Kaufmann, Paswan 1992, Martin 1988, Norton 1988a, 1988b, Osborn and Hagedoorn 1997, Thompson 1992, Williamson 1991).

Market-like transactions take place between franchisors and franchisees—two independent entities—in capital, labor, and product markets. For example, the franchisor develops a product or service to sell to franchisees. The hierarchy-like features stem from the quasi-vertical integration found between these two entities. For example, a franchisor provides substantial operational support to the franchisee and the franchisee conforms to the franchisor's provisions. Thus, franchise organizations are neither totally independent operations (market) nor completely vertically integrated ones (hierarchy). While transaction cost analysis (TCA) theory posits an intermediate point (i.e., hybrids) between markets and hierarchies (Williamson 1985, 1991), Bradach and Eccles (1989) maintain that franchise systems operate in plural forms using both market and hierarchy governance structures simultaneously to perform the same function. They argue that this provides unique synergistic benefits and, thus, should be distinguished from the TCA typology of market and hierarchy governance structures.

Among the theoretical reasons for firms' selections of franchising are: (1) the ease of raising capital (Caves and Murphy 1976, Hunt 1973, Oxenfeldt and Kelly 1969); (2) risk-sharing with franchisors, as well as

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information advantages explained by agency theory (Brickley and Dark 1987, Brickley, Combs and Ketchen 1999, Dark and Weisbach 1991, Carney and Gedajlovic 1991, Jensen and Meckling 1976, LaFontaine 1992, Mathewson and Winter 1985, Norton 1988a, 1988b, Thompson 1992); (3) economizing on transaction and governance costs (Dahlstrom and Nygaad 1999, Klein 1980, Williamson 1985, 1991); (4) different level of responsiveness to competition and environmental changes as interpreted by the population ecology viewpoint (Pilling, Henson and Yoo 1995, Yoo, Donthu and Pilling 1998); and (5) power and conflict dynamics as found in socio-psychological theories.

We argue that, given the complexity of the franchising phenomenon, no one perspective is superior to the others because the perspectives do not compete with each other to provide exclusive and exhaustive alternative explanations. By investigating different aspects of the same reality through different variables, each of the theories contributes to an overall understanding of the factors that allow the co-existence of (as well as shifts between) company-owned outlets and franchisees within the same organization. The purpose of this article is to integrate these five theories into a framework of broadened perspective based on the political-economy taxonomy (cf. Zald 1970, Stern and Reve 1980, Arndt 1983). In particular, this paper attempts to describe and explain the internal/external economy/polity of why and how company-owned and franchised outlets co-exist simultaneously within the same organization.

The developed conceptual framework is based on the political-economy paradigm, which proposes a balanced presentation of internal and external factors on the inter-organizational relations of a channel dyad (see Achrol, Reve and Stern 1983, Arndt 1983, Dahlstrom and Dwyer 1992, Dwyer and Oh 1987, Dwyer and Welsh 1985, Reve and Stern 1985, Stern and Reve 1980, Zald 1970). The political-economy framework for comparative analysis of marketing channels insists that internal and external economic and sociopolitical forces should not be analyzed. Stern (1988) recommends political-economy analysis not as a theory itself, but as a foundation for theory building in marketing channels and as the proper aid for charting-out a demonstration of the complex interrelations of relevant theories. He writes:

> First, while I firmly believe that viewing marketing channels as political economies is appropriate and helpful, the political-economy perspective merely provides a framework. It is not a theory, and makes no pretense to being one. Its primary message is that, in order to understand and map channel interactions, economic and behavioral variables must be webbed in some holistic manner. To advance knowledge in this area, theories must be brought to the framework, and the most fertile ground for those theories is probably in the basic disciplines (Stern 1988, p.2).

THE FRAMEWORK

Previous research on franchising phenomena within the fields of marketing, economics, finance, law, organization and socio-psychology literature, has guided us in constructing this comprehensive conceptualization of franchising versus ownership choice. The framework defines the channel dyad of a franchisor and its franchisee as the fundamental unit of analysis because transactions between the two actors are very important to the inter-organizational study of marketing channels. However, our model is primarily focused on the franchisor's perspective since it is franchisors that determine whether a company's retail outlets will be company-owned, franchised, or both.

Focusing on inter-firm relations, the classic political-economy framework omits intra-firm phenomena that are antecedents of and ongoing influences on inter-firm relations. Our model attempts to capture intra-firm characteristics and dynamics. Thus, the intra-firm factors of both franchisors and franchisees and the internal and external forces in economic and sociopolitical areas that all affect the dyad are unified in one model.

The political-economy approach perceives an organization to be sets of important economic and sociopolitical factors that interact to influence collective behavior and performance (Stern and Reve 1980). Economy/polity and internal/external dimensions are considered central in a political-economy framework (Arndt 1983, Stern and Reve 1980, Zald 1970). Polity refers to "the power-and-control systems of a social unit (e.g., an organization), a network of social units or a society." Economy is "the productive exchange system of a social unit or society transforming inputs to outputs." The internal/external dimension consists of "the external (environmental) versus internal (organizational) polity and economy" (Arndt 1983, p. 48). Consequently, this study's framework has four categories: (1) the internal economy, i.e., "the internal economic structure and processes," (2) the internal polity, i.e., "the internal sociopolitical structure and processes," (3) the external economy, i.e., "the nature of its vertical (input and output) and horizontal markets," and (4) the external polity, i.e., "the distribution and use of power resources among external actors." These four categories interact and influence each other, and it is these interactions that this study will explore.

INTRA-FIRM CHARACTERISTICS AND DYNAMICS

Intra-firm factors deal with production, transaction, and agency costs for each member of the dyad. Major intra-factors of the franchisor are the franchisor's capital needs and agency costs. Major intra-factors of the franchisee are the franchisee's relative performance and the relative salvage value of a franchise.

As mentioned above, due to its emphasis on inter-organizational relations, the traditional political-economy paradigm allows no room for intra-firm factors which play a critical role in inter-firm relations, as marketing scholars have long contended (see Arndt 1983, Stern and Reve 1980). Ignoring intra-firm factors can make it difficult to apply the political-economy framework to research on determinants of economic structure (e.g., what determines a company's preference of vertical integration or makes the company decide to terminate relations with its partner). Basically, the political-economy approach assumes an on-going relationship between two parties in perpetuity even though the content of the relationship differs due to internal and external forces. Therefore, we need to look at intra-firm factors to more comprehensively understand the interactions between two parties.

The analysis of intra-firm characteristics and dynamics which impact on inter-firm relations of the dyad is drawn largely from TCA (Williamson 1985) and agency theory (Fama and Jensen 1983). TCA posits that the efficacy of channel arrangements is achieved by economizing or minimizing transaction costs, that is, "the costs of running the economic system" (Arrow 1969, p. 48), which are determined by such transactional attributes as transactional frequency, asset specificity and uncertainty (Williamson 1985). However, transaction costs should be weighted against corresponding production costs at a given form of organization since transaction cost economizing should not underestimate "first-order economizing--effective adaptation and elimination of waste" (Williamson 1991). In other words, transaction costs should be considered together with production costs to minimize total cost.

TCA maintains that "transactions, which differ in their attributes, are aligned with governance structures, which differ in their cost and competencies" (Williamson 1991, p. 277). Here, human aspects cannot be ignored, and it has been postulated that "human agents are given to opportunism, which is a condition of self-interest seeking with guile" (Williamson 1985, p. 30). For example, in a transaction with high specific investments, vertical integration is less costly than an arms-length market transaction (Bradach and Eccles 1989).

Like TCA, agency theory concentrates on the principal-agent relationship (i.e., in this context, franchisor-franchisee or franchisor as an employer of employee-managers) and considers characteristics and behaviors of both a principal and its agent (Bergen, Dutta and Walker 1992, Fama and Jensen 1983). Agency theory considers the pertinent agency costs as a major determinant of organizational form. As Fama and Jensen (1983) maintain, "An organizational form survives in an activity when the costs and benefits of its residual claims and approaches it provides in controlling agency problems combine with available production technology to allow the organization to deliver products at lower prices than other organizational forms" (p. 333).

Franchisor's Intra-Firm Factors

Franchisor's Capital Needs

The capital-raising argument views franchising as a source of capital for small business expansion. In this way, the franchisor can raise capital less expensively than using other plans (Caves and Murphy 1976). Thus, franchisees are considered an economical source of expansion capital. According to this idea, small companies with limited access to capital markets use franchising to expand their business. Later as the company matures and no longer has the same expansionary capital needs, the owners buy back the most profitable units. Thus, it is expected that successful franchise systems will tend toward perfect company ownership (Hunt 1973, Lillis, Narayana and Gilman 1976, Oxenfeldt and Kelly 1969, Zeller, Achabal and Brown 1980). Consequently:

Proposition 1. As potential franchisors require more capital they more likely choose franchising.

Proposition 2. As potential franchisors require more capital they more likely increase economic incentives (e.g., lower up-front and royalty fees) to encourage rapid investment decisions by franchisee prospects to speed up cash inflows.

Franchisor's Agency Costs

Agency costs are "the costs of aligning the incentives of principals and agents, including bonding and monitoring and related forgone output attributable to those activities" (Fama and Jensen 1983). A franchisor will compare agency costs between its two possible types of agents, employee-managers and franchisees, and will select the less-costly type. If agency costs are too expensive, the organization must change its organizational form. Agency costs are a function of agents' opportunism, which assumes that agents will act in their own best interests if given the chance (Williamson 1985). However, Bradach and Eccles (1989) maintain that, where opportunism might be reasonably anticipated, trust predominates (e.g., in franchising arrangements) because it promises reciprocal benefits to both parties to a principal-agent relationship.

LaFontaine (1992) found that, instead of the franchisor's need for capital, a more significant explanation for firms choosing to franchise is that both the agent (franchisee) and the principal (franchisor) prefer franchising because of its ability to reduce or prevent moral hazard on both sides. Under this view, there really are incentive issues for franchisors and franchisees. Within an organization the co-existence of franchisees and company-owned outlets gives the franchisor inter-firm and intra-firm control mechanisms since a franchised or company-run outlet risks ownership change whenever its agency costs become too high (Bradach and Eccles 1989, Combs and Ketchen 1999). Thus:

Proposition 3. Company ownership decreases when the cost of monitoring employee-managers increases

Proposition 4. Company ownership decreases when the level of non-repeat customers decreases

Proposition 5. Company ownership decreases when the investment needed to start a new unit decreases.

Franchisee's Intra-Firm Factors

Relative Performance of a Franchisee

A franchisee's relative performance is measured by comparing a franchisee's performance to the performance that can be achieved if the franchisee is replaced by a corresponding company-owned outlet. From the franchisor's perspective, the expected and actual performances of the franchisee greatly influence the franchisor's decision to franchise.

Here, effectiveness, efficiency, and adaptability are the measurements of performance (Ruekert, Walker and Roering 1985). Effectiveness is defined as the extent to which organizational goals are reached (Parsons 1992) and can be operationalized as market share, net income, or sales. Efficiency concerns the allocation of resources among alternative uses and often measures the degree to which the minimum possible input is used to capture a given output, or the degree to which the maximum possible output is acquired from a given input (see Donthu and Yoo 1998, Yoo, Donthu and Pilling 1998). Efficiency can be measured as the ratio of multiple inputs to multiple outputs. Adaptability or responsiveness is defined as the speed with which a company responds to changing competition and environments (Hannan and Freeman 1977, 1989), as measured by the population ecology model (see Pilling, Henson and Yoo 1995).

Research has shown franchisees are superior to company outlets mainly for two reasons. First, because franchisees have more entrepreneurial ambition to generate profits than the managers of company-owned outlets do, they often achieve better performance (Norton 1988a, 1988b, Rubin 1978, Shelton 1967, Wattel 1968). Second, a franchisee investor enters a franchise system only when there is a high probability of profitability. Research indicates that a high gross margin is a franchisee's primary consideration (Burton, Cross and Rhodes 2000, Weinrauch 1986), followed by training or know-how, greater independence, and the presence of an established trademark (Bradach and Eccles 1989, Peterson and Dant 1990). Therefore:

Proposition 6. As a franchisee outperforms an average company-owned outlet, the franchisor will open a new franchised outlet or continue the on-going relationship with the current franchisee to improve the franchisor's financing bases, capabilities, and creditworthiness.

Relative Salvage Value of a Franchisee

The franchisee's relative salvage value is the difference between the "cash-out" selling price of the franchised outlet and the franchisee's initial investment to enter that franchise system. The franchisee cannot avoid the required initial investment to enter a franchise system. As the investment increases, the relative salvage value decreases. In franchising contexts, the investment tends to be highly non-salvageable; for example, one cannot easily sell the big arch of the golden letter "M" at a McDonald's. Such unrecoverable and transaction-specific investments, termed by Williamson (1985) as specific or dedicated assets, include site specificity, physical asset specificity, human-asset specificity, brand name capital, dedicated assets, and temporal specificity (Williamson 1991). If the contract law is unfair to the franchisee, then the franchisee's non-redeployable transaction-specific assets will encounter more severe "lock-in effects, on which account autonomous trading will be commonly supplanted by unified ownership (vertical integration)" (Williamson 1985, p. 53).

This works as a self-enforcing mechanism (Wathne and Heide 2000). However, the franchisee's vertical integration cannot be developed until the contract with its franchisor is terminated; without the franchisor's trademark, the franchisee cannot enjoy any benefits from the relationship since its performance is based on high interdependency with its franchisor. Nevertheless, a franchisor may not be willing to wait to terminate the franchise contract until the salvage value is low, which makes continuing the relationship too expensive for the franchisor. Caves and Murphy (1976) posit that a franchisor tends to repurchase its franchise if potential returns from changing company ownership exceed the costs of repurchasing the franchise. Thus:

Proposition 7. As the reacquisition cost of the franchise decreases, ownership redirection from franchisee to franchisor increases.

THE INTERNAL ECONOMY

This category is divided into two subgroups--internal economic structure and processes. The internal economic structure refers to "a type of transactional form linking channel members (e.g., vertical integration versus market)" (Stern and Reve 1980, p. 54) ranging from independent agencies to integrated hierarchies. The internal economic processes refer to "the nature of the decision mechanisms employed to determine the terms of trade among the members" (Stern and Reve 1980, p. 54). At the intra-firm level, a franchise company can select one of three transactional forms that correspond to Williamson's (1985, 1991) hierarchies, markets, and hybrids respectively: entirely company-owned outlets, entirely franchised outlets, and a mixture of both. In terms of the internal economic structure of a franchisor-franchisee channel dyad, however, a franchisor can move between continuity and termination of a franchising relationship as a strategic move between hierarchy and market.

Decision-making may be probabilistic, depending on many other inter-organizational and environmental forces, even though there are only two levels of organization in a franchising dyad. The probability of franchising leads us to predict the opening of a new location for a franchised or company-owned outlet, termination of a franchising contract with the current franchisee, or replacement of one organizational form (franchised or company-owned) with the other. At the firm level, this probability can be transformed into the proportion of franchised outlets to the total number of outlets in a franchise system.

Even though bureaucracy issues such as centralization, formalization, specialization/ differentiation or complexity, and participation in decision making have greatly affected the internal economic structure (Arndt 1983, Dwyer and Oh 1988, Ruekert, Walker and Roering 1985, Stern and Reve 1980), it is noteworthy that they show significant differences only when different forms of organization are compared. Thus, bureaucracy is important between different organizational forms, not within the same organizational form (see Dwyer and Oh 1988). From the franchisor's perspective, if a company-owned unit is compared to a franchised one, the franchised unit will show lower centralization, higher formalization, and higher participation in decision making since basically the latter is less integrated with the franchisor than the former.

Internal economic processes are driving forces in the economic exchange decisions between the members of the channel dyad. Some examples are allocation rules and incentive systems (Arndt 1983, Zald 1970). These decision mechanisms are constrained by the internal structure (Stern and Reve 1980). In the franchising context, the mechanisms are an agreement between the franchisor and franchisee on royalty fees, sales-reporting, improving the value of the trademark, and other services and obligations.

Economic Rules and Incentives for a Franchisee

The allocation rules refer to accounting and budgeting information, as well as to decision instruments developed to ensure compliance with decisions and to promote efficiency (Arndt 1983). Examples in franchising are royalty fees and sales report agreements. Incentive allocations are defined as "the distribution of rewards and sanctions to motivate role performance" (Zald 1970, p. 251). These systems contain monetary/non-monetary and contractual/non-contractual incentives to bond the target firm to the source firm and make the source firm more dependent on the target firm. A franchisor can offer various incentives such as market surveys, site selection assistance, store design and improvement, management training programs, operating manuals, equipment packages, regular operating assistance, coop-ad, and promotion (Knight 1986). In short:

Proposition 8. When a franchisee is offered more favorable economic rules and higher economic incentives, it performs better.

THE INTERNAL POLITY

Like internal economy, this category is divided into two subgroups: the internal sociopolitical structure and the internal sociopolitical processes. Internal sociopolitical structure refers to "the pattern of power-dependence relations which exist among channel members" (Stern and Reve 1980, p. 54) that "identify an individual's position in a hierarchy" (Dahlstrom and Dwyer 1992, p. 48). Internal sociopolitical processes refer to "the dominant sentiments (e.g., cooperation and/or conflict) within the channel" (Stern and Reve 1980, p. 54).

In general, polity is viewed as "the allocation and use of authority and power within the system" (Stern and Reve 1980, p. 57, also see Emerson 1962). In the framework of this research, the internal sociopolitical structure consists of: (1) a franchisor's dependence on its franchisee, (2) the franchisee's power over the franchisor, and (3) the franchisor's coercive power over the franchisee. The internal sociopolitical processes consist of: (1) the unfairness of the contractual agreement, (2) conflict, (3) cooperation, and (4) competition within the same franchise system. Williamson (1984) said, "credible commitments and credible threats...appear mainly in conjunction with irreversible, specialized investments" (p. 33). A franchisor may be tempted to be opportunistic since a franchisee invests significant unrecoverable assets that become hostages to the franchisor's orders and the franchisee's performance is one-sidedly interpreted by the franchisor. Among typical opportunistic behaviors of the franchisor are agreement renewal refusal hazards, underestimation of the franchisee's specific investment, and incomplete or maladaptive contracts which are open to contingencies during contract execution (see Williamson 1984).

Contractual Agreement Unfairness

The primary reason that franchise systems are not somewhere on the continuum of the market and hierarchy dichotomy is that they operate under a distinctive type of contract law (Williamson 1985, 1991). A franchisee has greater autonomy than in a hierarchy but must follow more rules and undergo more surveillance than a market. The franchisor exercises significantly more power over the franchisee through one-sided contract termination and performance supervision (Klein 1980, Preble and Hoffman 1999, Williamson 1984). The ability of the franchisor to unilaterally terminate a franchise is essential to the franchise ownership choice (Dant, Kaufmann and Paswan 1992). In general, the franchisor always has a greater initiative of contract termination since it can arbitrarily evaluate the performance and behavior of its franchisee. In this study, the franchise relationship resembles an employer-employee contract--the implicit contract law of internal organization (Norton 1988a, 1988b, Williamson 1985). An unfair contract between a franchisor and its franchisee can be measured in comparison to the contract among the company-owned outlets on the same issues (Bradach and Eccles 1989). The two contracts can be compared because a franchisor utilizes two different control mechanisms to accomplish the same function. Unfair and incomplete franchise laws favorable to franchisors are conventional since franchisors tend to apply the forbearance doctrine (Hadfield 1990). However, Williamson (1985) suggests relational contracting or bilateral governance where a contractual market relationship remains steady since the transactions in franchising are frequent and dictated by transaction-specific investments.

Heide (1992) also predicts bilateral governance for franchise-like relationships, where "the parties jointly develop policies directed toward the achievement of common goals" (p. 10). Both parties benefit from maintaining the relationship because they can avoid the loss of investments and jeopardy to the reputation of the trademark. The norms of obligation and cooperation suggest shared values exist between the two parties (Bradach and Eccles 1989, Heide and John 1992, Kaufmann and Stern 1988). In the franchising context, these norms include decreased risk of free-riding, increased goal congruence, and the development of common beliefs and values. In summary:

Proposition 9. An unbalanced or unfair power scheme allows the franchisor to exercise coercive power over the franchisee, leading to a lower degree of cooperation.

Cooperation

Some researchers have conceptualized cooperation as inversely related to conflict, that is, as one of the two ends of the cooperation-conflict continuum; others have thought of cooperation and conflict as different concepts (e.g., Anderson and Narus 1990, Gaski 1984). In this framework, cooperation is treated separately from conflict since it is postulated that lower levels of cooperation precede conflict. Anderson and Narus (1990) define cooperation as "similar or complementary coordinated actions taken by firms in interdependent relationships to achieve mutual outcomes or singular outcomes with expected reciprocation over time" (p. 45). They found that cooperation is positively affected by communication and outcomes in comparison with alternatives, and favorably affects both trust and evaluations of recent efforts to solve disagreements (Anderson and Narus 1990). Consequently:

Proposition 10. An increase in the cooperative behavior of a franchisee leads to a decrease in conflict with its franchisor.

Franchisor's Dependence on the Franchisee

Frazier (1984) maintains, "the performance of the source's firm on elements of its channel role or its role performance, its perceived ability to carry out inherent responsibilities, will largely determine the target's need to maintain their exchange relationship" (p. 70). Thus, when the franchisor favorably perceives the franchisee's role performance, its dependence on the franchisee will increase. Keith, Jackson and Crosby (1990) found that coercive influence strategies (e.g., punishments) are more effective than non-coercive ones (e.g., reward, expert, referent, and legitimate strategies) since they can be targeted to both an individual channel member and to an individual behavior or performance (Etgar 1978). The more dependent channel member tends to obey its partner's request and such obedience is contradictory to the use of coercive power. Thus:

Proposition 11. A franchisor that is more dependent on its franchisee will be less likely to use coercive influence strategies against that franchisee.

Competition within the Same Franchise System

If the number of franchisees in a specific geographic area within the same franchise system is large, then inter-franchise rivalry increases (Dant and Gundlach 1999, Ghosh and Craig 1991, Kaufmann and Rangan 1990, Zeller, Achabal and Brown 1980). The rivalry becomes severe if the available resources (e.g., potential buyers) are not sufficient for the members of the franchise system to meet their growth targets (Schmidt and Kochan 1972). Pfeffer and Salancik (1978) postulate three types of rivalry: (1) a competitive rivalry (essentially a zero sum game; the outcome of one party can be higher only if the outcome for the other is lower); (2) a symbiotic rivalry (where both parties become worse off or better off at the same time); and (3) an asymmetric rivalry (that is, a mixture of competitive and symbiotic rivalries) (p. 41).

Franchisor-franchisee rivalry, which emerges due to the dual distribution channel of company-owned and franchised outlets in the same market, eradicates the synergies of franchising set forth by Bradach and Eccles (1989) and Jensen (1989), and requires modification of the organizational structure toward a stable dual distribution system (Dant, Kaufmann and Paswan 1992). Given the extent of goal incompatibility and resource scarcity, failure to address this type of rivalry can develop into terminal conflict (Schmidt and Kochan 1972). The rivalry might be accelerated when consumers do not differentiate between company-owned and franchised outlets (see Williamson 1984). For example, consumers do not know--or care--whether the McDonald's they patronize is franchised or company-owned. Thus, any marketing effort to regain consumers' loyalties is ineffective and the franchisee may be tempted to violate the relationship with its franchisor to secure positive profits.

Firms that share the same trademark, whether franchised or company-owned, should be considered the same organization within the same system since, in the public's perception, they compete with independent outlets, other company-owned chains, and other franchise systems rather than with each other (Pilling, Henson and Yoo 1995). Under such conditions, the franchisee will expect to be charged less for royalties. Usually, the royalty fee is fixed as a percentage of a franchisee's sales, so the franchisor's net income fluctuates directly with the franchisee performance. However, when two companies with the same trademark are located in close proximity, performance can be a product of their rivalry as they compete and interfere with each other (Dant and Gundlach 1999, Ghosh and Craig 1991, Kaufmann and Rangan 1990, Zeller, Achabal and Brown 1980). Thus:

Proposition 12. Higher levels of competition within the same franchise system reduces the franchisee's performance.

Franchisee's Power over the Franchisor

The franchisee's power can be defined as the franchisee's ability to pressure the franchisor. Decreased franchise profitability due to increased rivalry makes the franchisee dissatisfied with its relationship with the franchisor. To secure the profitability expected when the contract was written, the franchisee will likely complain and request lower royalty fees or relocation of neighboring company-owned units. Also, the franchisee will resist any attempts by the franchisor to expand the number of units in a given market (Zeller, Achabal and Brown 1980). Even though a franchisee has firm-like features, the franchisee becomes a stronger residual claimant against the franchisor than the franchisor's employee-managers since the franchisee has paid both an explicit up-front franchisee fee as ex ante bondage and on-going royalty fees as ex post bondage (Norton 1988a, 1988b). Therefore, the franchisor is responsible for the franchisee's minimal profits. However, if the franchisor perceives the franchisee's request as reflective of incompatible role demands or expectations, then the franchisor's conflict level will increase (Pondy 1967). Consequently:

Proposition 13. A franchisee's power over its franchisor increases conflict with the franchisor.

Franchisor's Coercive Power

Coercive power sources are punishments or threats such as delivery delay, charging higher royalty fees, taking legal action, and--particularly in franchising--the threat of franchise termination (see Hunt and Nevin 1974, Lusch and Brown 1982). Michie and Sibley (1985) operationalized the coercive sources of a franchisor's power as "the likelihood of the franchisor punishing the franchisee through the use of specific business activities" (p. 196). These sources are the effect of potential ex post franchisor opportunism on contract design in franchising relationships. A franchisor tends to include very opportunistic coercive powers in ex ante contracts to deal with eventualities such as uncertain demand or more attractive alternative investment opportunities (Dewatripont and Sekkat 1991). If a franchisor interferes with the franchisee's activities through coercive power, then conflict between the parties of the channel dyad will increase (Schmidt and Kochan 1972). Williamson (1984) said that credible threats appear in the context of conflict and rivalry. Research has consistently found that execution of coercive power increases conflict while the use of non-coercive power does not (Brown and Frazier 1978, Lusch 1976, Wilkinson 1981). Thus:

Proposition 14. If coercive power is exercised, then the franchisee's satisfaction decreases.

Conflict

Here, conflict refers to the franchisor's conflict, which is not necessarily equal to the franchisee's conflict (Gaski 1984). Essential to conflict resolution procedures is whether or not continuing the relationship with the partner yields benefits in excess of costs (Pondy 1967). This crucial question must be resolved in the affirmative before deciding which strategy to use (see Dant and Schul 1992). If the benefits exceed the costs, the efforts to resolve the conflict will help continue the relationship. A wise egoistic firm will collaborate if continuous transactions offer benefits that surpass the financial and non-financial costs it will incur by exiting the relationship. Otherwise, the conflict will push the parties toward termination of the relationship. At this time, the franchisor may decide to extend its monopoly power in a given market by reacquiring some or all of the franchised outlets. This decision always presents a trade-off between the costs of managing the conflict with the franchisees and the agency costs of the company-owned units' managers (see Zeller, Achabal and Brown 1980). In summary:

Proposition 15. If the benefits exceed the costs, the franchisor will continue the relationship with its franchisee despite conflict.

ENVIRONMENTAL DETERMINANTS

This category consists of external economic/ sociopolitical structure/processes. The external economy is defined as "the nature of its vertical (input and output) and horizontal markets" and the external polity is defined as "the distribution and use of power resources among external actors" (Stern and Reve 1980, p. 54). Achrol, Reve and Stern (1983) propose the environmental pluralism of channel dyads where the primary task environment (i.e., immediate suppliers and customers), the secondary task environment (i.e., suppliers to the immediate suppliers, customers to the immediate customers, regulatory agents and interest aggregators, and direct and potential competitors to the channel dyad), and the macro environment (i.e., general social, economic, political, and technological forces) are delineated (p. 57). Additionally, the two task environments are divided into the input sector (i.e., all direct and indirect suppliers to the dyad), the output sector (i.e., all direct and indirect customers of the dyad, both distributors and end users), the competitive sector (i.e., actual and potential competitors of the channel dyad), and the regulatory sector (i.e., regulatory groups) (Achrol, Reve and Stern 1983). Following Arndt (1983), this paper directly considers other related environmental forces, to wit: (1) market maturity; (2) market density; (3) competition within industry; and (4) government regulation fairness.

The environment is defined as "a phenomenon enacted by the organizational decision makers within it" (Achrol and Stern 1988, p. 47). This environment of the channel dyad affects the dyad's structure and performance. In particular, the degree of decision-making uncertainty experienced by channel members is influenced by diversity among individual consumers, dynamism, concentration, and capacity rather than diversity among organizational customers, interconnectedness via common input/output linkages, environmental conflict and interdependence (Achrol and Stern 1988).

External Economy

Market Maturity

This environmental force has been explained by a life cycle theory (Oxenfeldt and Kelly 1969). Life cycle theory views franchising as a transitory phenomenon and predicts that once a mature stage is reached, most successful franchise systems will develop into large company-owned chains. Only poor-performing, marginal sites are expected to be run by franchisees since their low profitability will make company buy-backs uneconomical. Franchising is more popular in a premature stage of the industry because a firm can grow rapidly and a significant part of the expanding firm's adjustment cost is the value of lost current production associated with selecting and training new managers (Faith, Higgins and Tollison 1984). If less capable new managers are recruited, such poor employee/task matches lead to higher production costs. Thus, according to Carney and Gredajlovic (1991), rapidly expanding firms will adopt a franchise system because the competent and motivated agents needed by these rapidly growing firms would demand franchisee status (i.e., they would demand quasi-ownership, not employee, status). In summary, franchisees are a useful means for rapidly establishing a competent presence in the market (Cavaliere and Swerdlow 1988). Thus:

Proposition 16. As the market matures, the franchisor increases the proportion of company-owned outlets.

Market Density

Market density is an industry's penetration of the target market and is measured by the number of establishments of an industry per capita in the market. Agency theory predicts that greater geographical dispersion causes more monitoring problems for the firm (Brickley and Dark 1987, Norton 1988a, 1988b). First, managers of company-owned outlets may shirk their duties because their supervisors are out of sight. Second, greater dispersion of sites implies more supervisors and higher monitoring costs since more time is lost moving between sites. Therefore, it is expected that remote locations will be serviced by franchised units and geographically concentrated locations will be served by company outlets (Norton 1988a, 1988b). Similarly, company ownership is associated with urbanization and higher population density (Thompson 1992). If brand name capital exists, a firm's physical dispersion amplifies the franchisor's vulnerability to quality debasing by a local outlet (Klein 1980). Thus, using local owner-managers, who make heavy site-specific investments and post a large bond in the form of a franchisee fee, reduces the likelihood of quality debasing, because a franchisee has much more to lose upon termination than a local employee-manager (Norton 1988a, 1988b). Consequently:

Proposition 17. When market density increases, the franchisor increases the proportion of company-owned outlets.

Competition Within Industry

Achrol, Reve and Stern (1983) posit that lateral competitive uncertainties may lead to less conflict and more cooperation within the channel dyad. Competitive threats make the channel dyad more cooperative because such threats are perceived as aggressive moves against the dyad from a common enemy. Therefore, it is expected that "the higher the uncertainty in the competitive sector of the task environment of marketing channel dyads, the higher is the level of cooperation within the dyad" (Achrol, Reve and Stern 1983, p. 64). In short:

Proposition 18. As industry competition increases, the cooperation between franchisor and franchisee increases.

External Polity

Government Regulation Fairness

The more uncertainty there is in the regulatory environment, the more opportunity there is for unfairness in the contractual agreement (Achrol, Reve and Stern 1983). Government plays an important role in preventing franchisors from taking advantage of durable, immovable investments of all kinds (Williamson 1991). Therefore:

Proposition 19. Higher levels of government regulation reduce unfairness in the franchise contractual agreement.

CONCLUSION AND IMPLICATIONS

This research suggests a framework of the franchisor's perspective on the decision to use franchised outlets, company-owned outlets, or both. Our framework harmoniously integrates within a political-economy model several paradigms--the access-to-capital viewpoint, transaction cost analysis, population ecology perspective, and power-dependence-conflict arguments.

The political-economy paradigm has proven useful in introducing and classifying multiple theories in an ordered way (Stern 1988). By adding intra-firm factors which act as antecedents to inter-firm relations, the current research suggests a remedy to two of the weaknesses of the political-economy model: (1) the framework has only inter-firm variables, in which the antecedents of the inter-organizational relations cannot be identified and (2) it shows no finite or foreseeable termination points to a relationship.

Despite the popular and traditional capital-raising explanation for franchise organizations, this explanation has suffered from criticisms. First, franchising is not limited to small companies with restricted access to capital markets. There are a number of large companies that have sufficient access to capital markets, yet still choose to franchise. Second, there has been no direct empirical evidence regarding the hypothesis that franchisors will increase company operation as they mature and obtain better access to capital (Caves and Murphy 1976, Martin 1988). Third, franchisors commonly supply financing to their franchisees. Thus, such franchisors do not use franchising as a source of capital. Fourth, from a portfolio view of finance, franchising is a more expensive way of capital raising compared to public equity and debt claims or selling shares of the franchisor-owned units to their employees (Rubin 1978). This is true when a risk-reluctant franchisee requires a high return on its investment because its investment in a single outlet is riskier than that in a portfolio of shares from all outlets in a chain (Rubin 1978). In summary, the capital-raising explanation is not supported in a perfect capital market, which provides cheaper capital financing than does franchising. That is why this theory is called a capital-market imperfection explanation.

Despite such criticism, redirection theory--that as a franchise becomes successful, franchisors repurchase the most profitable franchises--has been conceptually and empirically supported (Anderson 1984, Dant, Kaufmann and Paswan 1992, Hunt 1973, Lillis, Narayana and Gilman 1976, Oxenfeldt and Kelly 1968). Hunt's (1973) survey showed that, as the percentage of company-owned establishments increased, franchisors' hoped to own an even larger percentage of establishments in the future. Lillis, Narayana and Gilman's (1976) survey of fast food franchises found that the benefits of rapid market penetration promoted franchising but that fully integrated direct distribution became more popular as the franchise matured. Anderson (1984) and Dant, Kaufmann and Paswan (1992) posited that powerful franchisors expand their ownership shares by buying back the most successful franchised outlets.

On the other hand, franchising does not appear to be a transitory stage on the way to complete ownership integration, which is predicted by capital-raising and franchisor's life cycle explanations. The conflict between owners and managers over the control and use of corporate resources breaks down the wholly company-owned operation without franchising (Jensen 1989). Franchising provides remarkable benefits in operating efficiency, employee productivity, and stockholder value, and thus franchising remains a comparatively efficient source of capital over time (Jensen 1989). Bradach and Eccles (1989) view franchising as the best among Williamson's (1985, 1991) three types of organizational forms because a franchise system benefits both sides of a franchisor-franchisee relationship such as risk diversification, rapid local market penetration, flexible and quick responsiveness to changing circumstances, and economies of scale.

While previous theories tend to concentrate on a dyadic decision mechanism within the same franchise system (i.e., one franchisor and its franchisees) and ignore the influences by other competitive and environmental factors, the population ecology paradigm considers other competitors outside franchise systems (i.e., independent units) but in the same industry and environments in which the units operate (see Lambkin and Day 1989, Pilling, Henson and Yoo 1995). Therefore, population ecology makes it possible to see the dynamics of the organization from the political-economic perspective of the interactions of the channel dyad and its environment (Arndt 1983, Achrol, Reve and Stern 1983).

If the perception has been communicated that the franchisor's power is overwhelming, that perception might be misleading. A franchisee commonly has the right to sell its business to a third party before the franchisor buys it back. Actually, the sale of an existing franchise by the franchisee is common. This occurs partly because of age, economic or lifestyle considerations and partly because of actions responding to the threats and "unfair" behaviors of the franchisor. Moreover, even in the event of a buy-back, the franchisor cannot coerce the franchisee into selling at less-than-market prices. Indeed, many franchisors have paid premiums to buy back strong franchisee operations.

Both of the parties have the means, symmetric or asymmetric, to destroy each other. While in an extreme situation a franchisor has the ability to refuse to renew the franchise agreement, its franchisee can defraud it by underreporting its sales, corrupting the trademark, and neglecting required goals such as sales penetration. Heide and John (1988) hold that a firm with high transaction-specific investments offsets these investments by attempting to increase the substitutability of the assets. Therefore, we need to look at the interdependence of the dyad, which "exists whenever one actor does not entirely control all the conditions necessary for the achievement of an action or for obtaining the outcome desired from the action" (Pfeffer and Salancik 1978, p. 40).

Future research is required to (1) investigate a franchisee's perspective of franchising versus independent ownership, (2) connect the franchisor and franchisee perspectives, and (3) test and improve the conceptual frameworks through empirical research.

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