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The Structure of Decision Rights in Franchising Networks: A Property Rights Perspective

Nada Mumdziev
Josef Windsperger

This paper explains the structure of decision rights in franchising networks using property rights theory. Property rights theory explains the allocation of decision rights based on the importance of intangible assets. We submit that franchisee's fraction of decision rights varies positively with the contractibility of local market assets and negatively with contractibility of system-specific assets. Further, franchisees' less contractible innovation assets impact decision rights allocations more than contractible operation assets. Hypotheses tested on data from German franchisors are largely supportive. We extend the franchise literature by arguing that the contractibility of local market assets impacts the allocation of decision rights, and that decision rights allocations change for decisions involving different areas of the value chain.

The governance structure of franchise relationships consists of two major components: residual income rights and residual decision rights. Residual income rights refer to the royalties and initial fees that are used as incentives in the franchise relationship. In recent decades, a dominant research stream in franchising has focused on explaining royalties and initial fees (Bhattacharyya & Lafontaine, 1995; Brickley & Dark, 1987; Dnes, 1996; Lafontaine, 1992; Lafontaine & Slade, 2001; Mathewson & Winter, 1985; Norton, 1988; Rubin, 1978; Sen, 1993; Vazquez, 2004; Windsperger, 2002). On the other hand, few studies have investigated the allocation of decision rights between the franchisor and franchisees (e.g., Arrunada, Garicano, & Vazquez, 2001; Azevedo, 2009; Windsperger, 2004). Franchisors use contracts to transfer decision rights across firm's boundaries (Baker, Gibbons, & Murphy, 2006, 2008). For instance, they transfer authority to the franchisees to make local advertising and training decisions. In this paper, we use property rights theory to investigate the factors that influence the allocation of residual decision rights between the franchisor and franchisees.

In organizational economics, the concept of decision rights refers to the authority to deploy and use the firm's assets (Grossman & Hart, 1986; Hansmann, 1996; Simon, [2] [3]

Please send correspondence to: Josef Windsperger, tel.: 00431-4277-38180; e-mail: josef.windsperger@univie.ac.at and to Nada Mumdziev at nada.mumdziev@gmail.com. [1]

1 1951). Property rights theory differentiates between nonresidual (or specific) decision
2 rights and residual decision rights. Nonresidual decision rights are explicitly specified in
3 contracts (Demsetz, 1998) and refer to the use of contractible (explicit) knowledge, which
4 can be easily codified and transferred. Residual decision rights refer to the authority to
5 influence the use of intangible (tacit) knowledge, which cannot be easily codified and
6 specified in contracts. In franchising, residual decision rights refer to the authority to
7 influence the use of the franchisor's system-specific assets and the franchisee's local
8 market assets, which are intangible and hence difficult to specify in contracts.

9 This study presents a property rights explanation for the allocation of decision rights
10 in franchising networks. We argue that the structure of decision rights depends on the
11 contractibility of the franchisor's system-specific assets and the contractibility of franchi-
12 sees' local market assets. We test the following hypotheses: First, franchisee's fraction of
13 decision rights varies positively with intangibility of local market assets and negatively
14 with intangibility of system-specific assets. Second, we differentiate between more and
15 less contractible local market assets. The impact of less contractible local market assets
16 (innovation assets) on the franchisees' fraction of decision rights is higher than of more
17 contractible local market assets (operation assets). Empirical results from the German
18 franchise sector are largely supportive of these hypotheses. Furthermore, we supplement
19 our central hypotheses tests by disaggregating decision rights according to the different
20 areas of the value chain, such as product, advertising, price, human resource management,
21 investment, and accounting system decisions. Our purpose is to identify which specific
22 decision rights are delegated in the presence of different combinations of franchisor and
23 franchisee intangible assets.

24 Our main contribution is to extend the franchise literature (Arrunada et al., 2001,
25 2005; Azevedo, 2009; Windsperger, 2004) by arguing that system-specific and local
26 market assets are only relevant for the structure of residual decision rights if they are
27 noncontractible. Specifically, we differentiate between more and less contractible local
28 market assets and show that only less contractible assets influence the allocation of
29 decision rights. In addition, we attempt to improve and provide a finer cut to the mea-
30 surement of the franchisee's local market assets (Windsperger). That is, we disaggregate
31 decision rights according to value chain activity (Porter, 1985) and investigate the impact
32 of the property rights variables (i.e., system-specific assets and local market assets) on
33 disaggregated decision rights.

34 **Decision Rights in Franchising**

35
36
37 In organizational economics, the question of how to allocate decision rights has been
38 investigated in several different organizational settings. Lerner and Merges (1998),
39 Arrunada et al. (2001, 2005), Elfenbein and Lerner (2003), Brickley, Linck, and Smith
40 (2003), Windsperger (2004), Higgins (2006) and Hu and Hendrikse (2009/2010) all
41 examine the allocation of decision rights in interorganizational networks. Elfenbein and
42 Lerner study the allocation of decision rights in contracts between internet portal opera-
43 tors and content suppliers, arguing that the allocation of decision rights depends on the
44 bargaining power of the parties. Higgins finds that bargaining power also matters in
45 the allocation of decision rights between pharmaceutical and biotechnology firms. Incent-
46 tives also matter. Brickley et al., for example, argue that among commercial banks, local
47 managers of independent small rural banks have a higher proportion of decision rights
48 compared with branch managers of large banks because they have higher incentives to use
49 the local knowledge regarding their customers.

1 Although franchising has been treated extensively in organization economics, man-
2 agement, and marketing, the allocation of decision rights between the franchisor and
3 franchisees remains, with three important exceptions, largely unexplored (i.e., Arrunada
4 et al., 2001, 2005; Azevedo, 2009; Windsperger, 2004). Arrunada, et al. (2001, 2005) 4 5
5 investigate the allocation of specific decision rights in contracts between car manufactur-
6 ers and their dealers, such as completion rights, monitoring, and enforcement rights.
7 Azevedo investigates the impact of brand name value on the allocation of authority in
8 franchising networks. These studies, however, do not explicitly differentiate between
9 decision rights and residual income (or ownership) rights, and they focus only on certain
10 formal rights without examining the range of decision rights involved in local outlets'
11 value chains.

12 In a third study, Windsperger (2004) examines the allocation of decision rights in
13 franchising networks in Austria and shows that centralization of decision making power
14 in franchise networks depends on the intangibility of franchisor's system-specific assets
15 and franchisee's local market assets. We extend the property rights explanation developed
16 by Windsperger in two ways. First, we argue that local market assets are only relevant for
17 the structure of residual decision rights if they are noncontractible. Specifically, we
18 differentiate between more and less contractible local market assets and show that only
19 less contractible assets influence the allocation of decision rights. In doing so, we also
20 improve the measurement of local market assets by differentiating between more con-
21 tractible assets (operation assets) and less contractible assets (innovation assets). Second,
22 by applying Porter's value chain concept (Porter, 1985), we disaggregate decision rights
23 according to major value chain activities in outlets (i.e., decisions involving product,
24 procurement, advertising, price, human resources, investments, and the accounting
25 system) and test the influence of the property rights variables on each of them.

26 This provides new insight in the structure of residual decision rights in the franchise
27 relationship. For instance, we found a significant influence of franchisors' intangible
28 system-specific assets on procurement, human resource management, and investment
29 decisions. Franchisee's noncontractible (or intangible) local market know-how, in con-
30 trast, influences product and human resource management decisions.

31 Finally, our study also contributes to the empirical literature in organizational eco-
32 nomics and management that applies the concept of decision rights in inter and intraor-
33 ganizational settings. Empirical studies have mainly relied on measures of formal
34 authority, such as organizational charts, job characteristics (titles and responsibilities), and
35 contract clauses (e.g., Aggarwal & Samwick, 2003; Campbell, Datar, & Sandino, 2009;
36 Colombo & Delmastro, 2004; Higgins, 2006; Hu & Hendrikse, 2009/2010; Lerner &
37 Merges, 1998; Ortega, 2009; Vazquez, 2006; Wulf, 2007, 2010). Our study provides a first 6
38 step to operationalize decision rights as real authority (Aghion & Tirole, 1997).

39 **A Property Rights View of Decision Rights Allocation**

40 **Decision Rights and Asset Contractibility**

41
42 According to property rights theory, the structure of decision rights depends on the
43 distribution of residual-income-generating intangible (noncontractible) assets between
44 the franchisor and franchisee (Barzel, 1989; Windsperger, 2004). Generally, we can
45 differentiate decision rights regarding strategic and operational decisions. Strategic deci-
46 sions are primarily made by the franchisor, and operational decisions are divided between
47 the franchisor and the franchisee. Operational decisions include marketing decisions
48 (price, product, and promotion), human resources decisions (training and recruiting),
49

1 investment, and procurement decisions. According to Jensen and Meckling (1992), two
2 ways for allocating decision rights exist: Either knowledge must be transferred to those
3 with the right to make decisions or decision rights must be transferred to those who have
4 the knowledge. This means that decision rights tend to be centralized in franchising
5 networks when the costs of transferring local knowledge to the franchisor are relatively
6 low. This is the case when the franchisor's portion of intangible assets is relatively high
7 compared with franchisees' intangible local market assets. The franchisor has strong
8 bargaining power and can easily acquire local market knowledge because of its relatively
9 lower degree of intangibility. On the other hand, residual decision rights have to be
10 delegated to franchisee when their local market know-how is very specific, and conse-
11 quently, knowledge-transfer costs are very high. In this case, the bargaining power of the
12 franchisees is relatively strong because of their noncontractible local market assets.
13 Consequently, if it is important to take advantage of franchisees' intangible local market
14 assets in order to generate a high-residual income stream, the franchisor must transfer
15 residual decision rights to local partners. In sum, we formulate the following property
16 rights proposition: The more important the franchisor's intangible assets for the genera-
17 tion of the residual income relative to franchisees' local market assets, the more decision
18 rights are allocated to the franchisor and the less decision rights are allocated to the
19 franchisee.

21 Hypotheses

22
23 **Franchisor's Intangible Assets.** Franchisors' intangible assets refer to system-specific
24 know-how (Hall, 1993; Klein & Leffler, 1981) that is characterized by a low degree of
25 contractibility. System-specific know-how includes knowledge and skills in site selection,
26 store layout, product development, and procurement (Kacker, 1988). The transfer of
27 intangible knowledge requires personal and face-to-face contact between the franchisor
28 and franchisees (Teece, 1981; von Hippel, 1994). Based on previous studies (Darr, Argote,
29 & Epple, 1995; Fladmoe-Lindquist & Jacque, 1995; Simonin, 1999), we use annual ⁷
30 training days and the number of outlet visits as indicators of franchisors' intangible
31 system-specific assets. An increase in franchisors' intangible system-specific assets
32 requires higher number of face-to-face interactions (annual training days and local visits).
33 By applying property rights theory, we expect that the franchisor's intangible system-
34 specific assets are negatively related with franchisees' fraction of residual decision rights.
35 Thus, we formulate two hypotheses:

36 **Hypothesis 1a:** Franchisees' fraction of residual decision rights is negatively related
37 with the number of franchisor visits at the local outlet.

38 **Hypothesis 1b:** Franchisees' fraction of residual decision rights is negatively related
39 with the number of training days.

40
41 **Franchisee's Intangible Local Market Assets.** These assets are the outlet-specific know-
42 how involved in innovation and operations. Innovation assets are more explorative in
43 nature, and operation assets are more exploitative (Levinthal & March, 1993; March,
44 1991). Innovation assets refer to local market knowledge (in the sense of Kirzner, 1973)
45 and innovation (in the sense of Schumpeter, 1911), and operation assets refer to quality
46 control, human resource management, and administration (Wicking, 1995). Because
47 innovation assets are characterized by a higher explorative component than operation
48 assets, innovation assets are expected to show a lower degree of contractibility than

1 operation assets. Consequently, by applying property rights reasoning, we expect that
2 innovation assets have a stronger impact on the allocation of decision rights than operation
3 assets. We summarize this expectation in the following hypothesis:

4 **Hypothesis 2:** The influence of the less-contractible local market assets (innovation
5 assets) on franchisee's fraction of decision rights is higher than the influence of more
6 contractible local market assets (operation assets).

8 Method

10 Data and Sample

11 The empirical analysis is based on a sample of 153 German franchise systems. The
12 data were collected via self-administered questionnaire that was developed in several
13 steps. After several preliminary refinements, we conducted in-depth interviews with
14 franchise consultants and with professionals from the Austrian and German Franchise
15 Association. We also performed a pretest with 10 franchisors. The questionnaire was
16 mailed to 485 franchise systems in Germany. The response rate was 31%, providing a
17 sample of 153 franchise systems. Nonresponse bias was estimated by comparing early
18 versus late respondents (Armstrong & Overton, 1977), where late respondents serve as
19 proxies for nonrespondents. No significant differences emerged between the two groups
20 of respondents. In addition, we checked for common method bias. Based on Podsakoff,
21 Mackenzie, Podsakoff, and Lee (2003), we used Harman's single-factor test to examine
22 whether a significant amount of common method variance exists in the data. Common
23 method bias could not be corroborated. Given that our independent variables are fairly
24 objective (e.g., training days, visits, and initial investments), it is less likely that method
25 is biasing the results.

27 Dependent Variable

28
29 **Decision Rights.** Residual decision rights were measured by asking franchisors to assess
30 the influence of franchisees on decisions in the following areas: procurement, price,
31 product, advertising, recruitment, training, investment, finance decisions, and accounting
32 system. These were assessed on a 7-point scale (1 = no influence and 7 = very high
33 influence). By averaging the scale values, we constructed a decision index as a formative
34 construct varying between 1 and 7. The higher the index, the higher is franchisees'
35 influence on residual decision making—i.e., their fraction of decision rights.

37 Independent Variables

38
39 **Franchisor's System-Specific Assets.** We use annual training days and the annual
40 number of outlet visits as a proxy for the franchisor's intangible system-specific assets
41 (e.g., Darr et al., 1995; Fladmoe-Lindquist & Jacque, 1995; Simonin, 1999).

42
43 **Franchisees' Intangible Local Market Assets.** Franchisee's intangible local market assets
44 refer to *innovation assets* and *operation assets*. In the questionnaire, franchisors were asked
45 to rate on a 5-point scale to evaluate franchisees' intangible assets (see Appendix). Based
46 on Windsperger and Dant (2006), we used the following domains of indicators to measure

1 the local market know-how of franchisees compared with managers of company-owned
2 outlets. The domain of *innovation assets* refers to franchisors' perception of their franchi-
3 sees' know-how relative to company managers in two areas: innovation and local market
4 knowledge. The domain of *operation assets* refers to franchisors' perception of their
5 franchisees' know-how relative to company managers in three areas: quality control, human
6 resource management, and administrative capabilities. Importantly, we used these scales as
7 formative rather than reflexive latent indicators because the constructs are defined by
8 theoretical judgment and produced by the indicators representing the multiple domains of
9 the content. If we omitted an indicator, the content of the construct would change
10 (Diamantopoulos & Winkelhofer, 2001). Because innovation and local market knowledge
11 are characterized by a higher degree of tacitness compared with administrative, human
12 resource management, and quality control capabilities, innovation assets are expected to
13 show a lower degree of contractibility than operation assets.

14 Control Variable

15
16
17 **Outlet Size.** We controlled for outlet size using the natural log of the sum of franchisees'
18 initial investments and initial fees. Franchise systems with larger outlets tend to be highly
19 standardized and realize greater economies of scale in monitoring (Lafontaine, 1992).
20 Thus, they should delegate fewer decisions to franchisees.

21
22 **Sector.** We coded 0 for service and 1 to product franchising. Know-how intensity varies
23 between product franchising and service firms (e.g., Blomstermo, Sharma, & Sallis, 2006;
24 Zeithaml, Parasuraman, & Berry, 1985). Because service franchises are characterized by
25 a higher fraction of franchisees' intangible local market assets and product franchises are
26 characterized by a higher fraction of franchisors' intangible system-specific assets, a
27 higher proportion of residual decision rights should be transferred to franchisees in the
28 service sector.

29 Results

30
31
32 Descriptive data are presented in Table 1.

33 To test the decision rights hypotheses, we conduct a multiple regression analysis with
34 franchisees' fraction of decision rights as the dependent variable. Explanatory variables
35 are the number of annual training days, number of annual visits, franchisees' innovation
36 assets, franchisees' operation assets, outlet size, and sector. In addition, the variance
37 inflation factors are well below the rule-of-thumb cutoff of 10 (Neter, Wasserman, &
38 Kutner, 1985). Therefore, we do not find any collinearity indication.

39 We proceed in two steps: First, we use an index of nine operational decisions (decision
40 rights) (see Appendix) as the dependent variable. Second, based on Porter's value chain
41 (Porter, 1985), we disaggregate decision rights according to the main value chain activities
42 at the outlet: product, procurement, human resources (training and recruiting), price,
43 advertising, investments (finance and investment), and accounting systems.

44 Aggregated Decision Rights

45
46 To test the property rights hypotheses, we estimate the following regression equation:

47
$$\text{Decision Rights} = \alpha + \beta_1 \text{Visits} + \beta_2 \text{Training days} + \beta_3 \text{Innovation assets} +$$

48
$$\beta_4 \text{Operation assets} + \beta_5 \text{Outlet size} + \beta_6 \text{Sector.}$$

1 Table 1

2
3 **20** Descriptive Statistics

4

5 Variable	6 Mean	7 Standard deviation	8 1	9 2	10 3	11 4	12 5	13 6	14 7
15 1. Decision rights	5.43	0.98	1						
16 2. Number of annual visits	5.68	5.67	-.219**	1					
17 3. Number of annual training days	7.63	7.13	-.082	.110	1				
18 4. Innovation assets	3.66	1.07	.139	-.007	.185*	1			
19 5. Operation assets	3.15	.95	-.017	.085	-.147	.388**	1		
20 6. Outlet size [†]	1.74	7.57	.065	.157	-.017	.007	-.020	1	
21 7. Sector (service = 0, product = 1)	0.31	0.46	-.153	.123	-.128	-.171*	.105	.073	1

22 ** $p < 0.01$; * $p < 0.05$ (two-tailed tests)

23 [†] (00, 000)

24 Table 2

25 Regression Results for Aggregated Decision Rights

26

27 —	28 Model 1 DR index (standard error)	29 Model 2 DR index (standard error)
30 Intercept	+4.979 (0.587)***	+7.349 (0.994)***
31 Annual number of outlet visits	—	-0.021 (0.014)
32 Annual number of training days	—	-0.031 (0.012)**
33 Innovation assets	—	+0.190 (0.045)**
34 Operation assets	—	-0.138 (0.100)
35 Outlet size	+0.041 (0.044)	-0.124 (0.070)*
36 Sector (service = 0, product = 1)	-0.329 (0.176)*	-0.369 (0.176)**
37 F-statistic	2.065	4.209***
38 R ²	0.028	0.184

39 Two-tailed significance values indicate: *** $p < 0.01$; ** $p < 0.05$; * $p < 0.1$

40 $n = 146$ (Model 1); $n = 118$ (Model 2)

41 DR, decision rights.

42 Table 2 depicts the regression results for the hypotheses tests. The property rights
43 hypotheses regarding the impact of franchisor's intangible system-specific assets on the
44 franchisees' fraction of residual decision rights are tested using the variables training days
45 and visits. Hypotheses 1a and 1b predict a negative relation between training days and
46 visits and franchisees' fraction of residual decision rights. The coefficient of visits is
47 negative but not significant ($\beta = -.137, p = .134$), providing no support for hypothesis 1a.
48 The coefficient for training days, however, is negative and significant ($\beta = -.24, p < .05$),
49 supporting hypothesis 1b. An increase in franchisor's system-specific know-how, as
50 depicted in training, relates to a lower portion of residual of decision rights allocated to the
51 franchisees.

1 Hypothesis 2 is tested by using the variables innovation assets and operation assets.
2 Hypothesis 2 predicts that less contractible innovation assets have a stronger influence on
3 franchisee's fraction of residual decision rights than the more contractible operation
4 assets. The coefficient for innovation assets is positive and significant ($\beta = .206, p < .05$),
5 indicating that less contractible local market assets (innovation and local market know-
6 ledge) strongly influence the allocation of decision rights between the franchisor and
7 franchisee. On the other hand, the coefficient for operation assets ($\beta = -.138, p = .169$) is
8 negative and not significant, indicating no evidence that more contractible local market
9 assets (administrative capabilities, human resource management, and quality control)
10 increase franchisee's fraction of residual decision rights. One explanation for this negative
11 coefficient is that quality control, human resource management, and administrative issues
12 can be more easily controlled by the franchisor. Overall, our results are consistent with the
13 view that less contractible local market assets are more important for the allocation of
14 residual decision rights than more contractible local market assets.

15 Regarding the control variables, the sign of the coefficient of outlet size is negative
16 and weakly significant ($\beta = -.157, p < .10$), which implies that franchise systems with
17 larger outlets tend to be highly standardized and thus delegate fewer decisions to fran-
18 chisees. For sector, the sign of the coefficient is significant ($\beta = -.19, p < .05$), indicating
19 that more decision rights are transferred to franchisees among service sector franchisors.
20 This can be explained by the nature of business in the service sector, which is character-
21 ized by higher outlet-specific know-how intensity than in the product-franchising sector
22 (Blomstermo et al., 2006).

23 In Table 2, we report unstandardized beta coefficients, but to evaluate the theoretical
24 relevance of the empirical results, we need to compare the standardized regression coef-
25 ficients from Model 2 (Combs, 2010; Eden, 2002). The standardized betas have the
26 following values: number of visits ($-.137, ns$), number of training days ($-.24, p < .05$),
27 operation assets ($-.138, ns$), and innovation assets ($-.206, p < .01$). Thus, the standardized
28 coefficients also indicate that noncontractible system-specific assets and noncontractible
29 local market assets are important determinants of the allocation of decision rights in
30 franchising networks.

31
32 ***Disaggregated Decision Rights.*** In the second step, we investigate the structure of
33 decision rights by disaggregating decision rights according to the major value chain
34 activities in outlets (see Appendix): advertising, price, product, procurement, human
35 resources management, investment, and accounting system decisions. We examine the
36 importance of the property rights determinants of disaggregated decision rights structure
37 by comparing their impact across decisions (see Table 3).

38 Consistent with property rights theory regarding the franchisor's intangible assets
39 (hypothesis 1a and 1b), training days negatively influences franchisees' fraction of deci-
40 sion rights regarding decisions involving procurement ($\beta = -.179, p < .1$), human resource
41 management ($\beta = -.279, p < .01$), and investments ($\beta = -.295, p < .01$). The number of
42 visits has a negative and weakly significant influence on investment decisions ($\beta = -.164,$
43 $p < .10$). This result indicates that the franchisor exercises more control over procurement,
44 recruiting, and training, as well as investment and finance when system-specific know-
45 how is strong. In addition, consistent with hypothesis 2 regarding franchisees' local
46 market assets, only less contractible local market assets (innovation assets) significantly
47 influence franchisees' fraction of decision rights, particularly in the areas of product
48 ($\beta = .272, p < .05$) and human resource management ($\beta = .201, p < .1$). This indicates
49 that franchisees' local market know-how is especially important when new products or
50 services are introduced and when employees are recruited and trained. The overall

Table 3

Regression Results for Disaggregated Decision Rights

	Advertising (standard error)	Price (standard error)	Product (standard error)	Procurement (standard error)	HRM (standard error)	Investment (standard error)	Accounting system (standard error)
Intercept	+9.393 (1.684)***	+2.313 (2.291)***	+7.167 (2.033)***	+8.875 (2.089)***	+7.718 (1.047)***	+7.044 (1.798)***	+7.260 (2.375)***
Annual number of outlet visits	+0.024 (0.026)	-0.043 (0.032)	-0.036 (0.028)	-0.019 (0.029)	+0.011 (0.015)	-0.045 (0.025) *	-0.051 (0.033)
Annual number of training days	-0.023 (0.022)	+0.015 (0.027)	-0.014 (0.024)	-0.047 (0.025)*	-0.036 (0.012)***	-0.068 (0.021)***	-0.010 (0.028)
Innovation assets	+0.003 (0.177)	-0.014 (0.215)	+0.497 (0.191)**	+0.017 (0.196)	+0.186 (0.074)*	+0.227 (0.168)	+0.293 (0.223)
Operation assets	+0.046 (0.189)	+0.081 (0.229)	-0.175 (0.204)	-0.138 (0.209)	-0.160 (0.105)	-0.290 (0.179)	-0.274 (0.238)
Outlet size	-0.284 (0.133)**	-0.253 (0.162)	-0.238 (0.144)*	-0.261 (0.147)*	-0.105 (0.074)	-0.018 (0.126)	-0.150 (0.168)
Sector (service = 0, product = 1)	-0.444 (0.333)	-0.485 (0.405)	-0.408 (0.359)	-0.949 (0.369)**	+0.168 (0.185)	-0.593* (0.185)	-0.504 (0.420)
—	F = 1.201 R ² = 0.061	F = 0.899 R ² = 0.046	F = 2.854 R ² = 0.133	F = 2.696 R ² = 0.126	F = 1.889 R ² = 0.092	F = 3.944 R ² = 0.174	F = 1.721 R ² = 0.084

Two-tailed significance values indicate: *** $p < 0.01$; ** $p < 0.05$; * $p < 0.1$; + $p < 0.11$.

n = 118
HRM, **.

1 comparison of results in Table 3 reveals stronger effects on the decision rights related to
2 investment, procurement, and human resources decisions. Decision rights related
3 to investment and procurement decisions are typically held by the franchisor, and decision
4 rights related to product and human resources decisions are influenced by both the
5 franchisor and franchisee.

6 7 **Discussion**

8
9 This paper aims to explain the structure of residual decision rights in franchising
10 networks by developing hypotheses from property rights theory. Property rights theory
11 emphasizes the importance of the franchisor's and franchisees' intangible assets (system-
12 specific assets and local market assets) for the generation of the network's residual income
13 and hence for the structure of decision rights. The partner with more intangible assets
14 should have a higher fraction of residual decision rights. The results obtained from the
15 survey provide support to the property rights hypotheses. First, we find empirical support
16 that franchisor's intangible system-specific assets negatively influence franchisees' frac-
17 tion of decision rights. This reflects franchisors' need to gain control when the complexity
18 and specificity of system know-how is high. Second, results show that less contractible
19 local market assets (innovation assets) have a stronger impact on franchisees' fraction of
20 decision rights than more contractible local market assets (operation assets). This implies
21 that operation assets can be more easily controlled by the franchisor and specified in
22 franchise contracts, thus requiring less transfer of residual decision rights to network
23 partners (Hendrikse & Windsperger, 2011). These results are also consistent with Jensen
24 and Meckling's view that residual decision rights tend to remain centralized when fran-
25 chisees have less intangible (more contractible) local market knowledge that is not costly
26 to transfer. Conversely, residual decision rights tend to be delegated to franchisees when
27 franchisees have more intangible (less contractible) local market knowledge that is costly
28 to transfer to the franchisor.

29 30 **Implications for Research**

31 This study has important implications for both researchers and franchisors. We find
32 empirical support that contractibility of assets determines the structure of decision rights
33 in franchising networks. Complementary to the agency-theoretical view (Arrunada et al.,
34 2001, 2005; Azevedo, 2009), we develop and extend the property rights explanation of the
35 allocation of decision rights in franchising networks (Windsperger, 2004). First, we argue
36 that local market assets are only relevant for the allocation of residual decision rights in
37 franchising if they are noncontractible. To test this hypothesis, we differentiate between
38 more and less contractible local market assets and, by differentiating between operation
39 and innovation assets, provide a finer-cut measurement of franchisees' local market assets.
40 Second, by applying Porter's value chain concept (Porter, 1985), we disaggregate decision
41 rights according to the major value chain activities in outlets (product, procurement,
42 advertising, price, human resource management, investment, and accounting system deci-
43 sions) and test the influence of property rights variables on each of them separately. This
44 analysis provides new insight into the structure of residual decision rights in franchising.
45 Specifically, intangible system-specific assets have a negative influence on franchisees'
46 residual decision rights regarding procurement, human resource management, and
47 investment decisions, and intangible local market assets have a positive influence on

1 franchisees' decision rights regarding human resource and product decisions. Evidently,
2 the franchisor tends to increase control over decisions regarding core elements of system
3 know-how, such as procurement and investments. Simultaneously, the franchisor transfers
4 more control over decisions to franchisees in areas where the local market know-how is
5 critical to the success of the system.

6 Our study also contributes to the empirical literature in organizational economics and
7 management that applies the concept of decision rights in inter and intraorganizational
8 settings (Aggarwal & Samwick, 2003; Campbell et al., 2009; Colombo & Delmastro,
9 2004; Higgins, 2006; Hu & Hendrikse, 2009/2010; Lerner & Merges, 1998; Vazquez,
10 2006; Wulf, 2007/2010; Ortega, 2009). First, it takes a step toward operationalizing
11 residual decision rights as real authority (Aghion & Tirole, 1997).

12 Second, our property rights view is similar to the bargaining power theory of alloca-
13 tion of control in international joint ventures and strategic alliances (Blodgetts, 1991;
14 Child, Yan, & Ku, 1997; Harrigan & Newman, 1990; Higgins, 2006; Lecraw, 1984; Mjoen
15 & Tallmann, 1997; Yan & Gray, 1994). According to the bargaining power theory, the 10
16 allocation of decision-making authority is a function of the specific knowledge contribu-
17 tions of the partners. For instance, joint-venture partners tend to exercise dominant control
18 over those value chain activities where they have firm-specific advantages (Choi &
19 Beamish, 2004). Firm-specific advantages are related to intangible knowledge assets.
20 However, compared with property rights theory, bargaining power theory does not explic-
21 itly differentiate between more and less contractible knowledge assets.

22 Third, our property right reasoning is consistent with the "critical" assets view of
23 control of Rajan and Zingales (1998, 2000). They argue that access to critical assets (e.g.,
24 franchisor's system-specific know-how and franchisee's intangible market assets)
25 increases control by network partners. Finally, our study is also related to the literature on
26 vertical integration. Under given ownership, the allocation of decision rights determines
27 the degree of vertical integration (Baker et al., 2006, 2008). For instance, the franchisor
28 might increase vertical integration by acquiring a higher fraction of residual decision
29 rights. In this case, the franchisor uses contracts to exercise control by transferring
30 decision rights across firm boundaries. Hence, the degree of vertical integration under
31 given ownership is related to the allocation of residual decision rights between the
32 partners.

33 34 **Implications for Practice**

35 The results of our study also yield practical implications. First, based on the property
36 rights model, franchisors should allocate decision rights according to the importance of
37 franchisor's intangible system-specific assets relative to franchisees' intangible local
38 market assets. Second, based on property rights reasoning, franchisors have to be aware of
39 the fact that less intangible and hence more contractible local market assets appear less
40 important for allocating residual decision rights. Hence, the use of more contractible local
41 market assets should be fully specified in franchise contracts.

42 Third, this study provides franchisors with guidance for structuring individual
43 decision rights concerning different value chain areas. Specifically, procurement and
44 investment decisions should be more controlled by the franchisor when system-specific
45 know-how is very important for the success of the system. On the other hand, human
46 resource management and product decisions should be more allocated to franchisees when
47 local market know-how is highly intangible. In sum, by applying the property rights view,
48 franchisors may be able to make better decisions regarding the structure of decision rights
49 in franchising networks.

1 **Limitations**

2 Our study has some important limitations: First, in our study, the influence of fran-
3 chisees' local market assets on the allocation of residual decision rights depends on
4 measures based on franchisors' evaluation of local market assets, and franchisors' assess-
5 ment could deviate from franchisees' assessments. To include both perspectives would
6 contribute to the reliability of the measure. Future research could make a contribution to
7 this area by developing and testing measures based on both franchisee and franchisor
8 evaluations.

9 Second, while our test of property rights theory provides interesting results, we could
10 only explain less than 20% of the variance in our decision rights measure. This indicates
11 that there are other variables, not included in this study, that impact the allocation of
12 decision rights in franchising. In addition to property rights variables, agency and trans-
13 action cost variables as well as trust and relational governance variables may influence the
14 structure of decision rights. We briefly describe how each of these might contribute to
15 knowledge about decision rights.

16 Agency theory would focus on the impact of monitoring costs and free riding on the
17 delegation of decision rights. Delegation positively influences partners' initiative and
18 hence reduces monitoring costs. Consistent with predictions on ownership in franchising
19 (Combs & Ketchen, 2003), we expect that delegation of decision rights is positively
20 related to network growth. Furthermore, when franchisor's reputation and brand name
21 value are high, the potential costs of franchisee free riding increase (Azevedo, 2009).
22 Hence, we expect that brand name value and franchisor's control over operational deci-
23 sions are positively related.

24 After taking the franchisors' and franchisees specific asset investments into account,
25 transaction cost theory might focus on the impact of environmental uncertainty on the
26 allocation of decision rights. We expect that environmental uncertainty is positively
27 related with franchisees' fraction of decision rights because higher uncertainty requires
28 more local information processing and adaptive capacity (Gulati, Lawrence, & Puranam,
29 2005; Williamson, 1991).

30 Finally, according to the relational view of governance (e.g., Dyer & Singh, 1998;
31 Gulati & Nickerson, 2008; Gulati & Sytch, 2008), trust and informal control mechanisms
32 might influence the allocation of decision rights. Trust, for example, might reduce rela-
33 tional risk and enable the franchisor to reduce formal control over operational decisions at
34 the local outlet.

35 A third limitation of this study is that we examined the impact of property rights
36 variables on the structure of decision rights without investigating the performance impli-
37 cations of the allocation of decision rights for the franchisor. Future research has to
38 investigate the relationship between the structure of residual decision rights and the
39 efficiency of the franchise systems. Our property rights view suggests higher performance
40 among franchising firms that set up a decision structure that is consistent with property
41 rights theory.

42 **Conclusion**

43 Our study offers a property rights explanation of the structure of decision rights in
44 franchising. Specifically, we show that contractibility of assets (i.e., system-specific assets
45 and local market assets) is an important determinant of the decision structure. The results
46 indicate that only less contractible assets are relevant for the allocation of residual
47 decision rights between the franchisor and franchisee. Furthermore, by applying Porter's
48
49

1 value chain concept, we were able to show how franchisor and franchisee control varies
2 among the different areas of operational decisions in outlets.

3 4 **Appendix**

5 **Measures of Variables**

6 *Franchisors' intangible system-specific assets*

7 Annual training days: Number of franchisee's training days a year

8 Annual number of visits: Number of outlet visits a year

9 *Franchisee's intangible local market assets*

- 10
11
- 12 1) **Innovation assets:** Franchisees' know-how advantage compared with the manager of
13 a company-owned outlet evaluated by the franchisor concerning
14 —Innovation
15 —Local market knowledge (no advantage 1–5 very large advantage)
 - 16 2) **Operation assets:** Franchisees' know-how advantage compared with the manager of
17 a franchisor-owned outlet evaluated by the franchisor concerning
18 —Quality control
19 —Administrative capabilities
20 —Human resource management (no advantage 1–5 very large advantage)
- 21

22 *Decision rights index (DR) (Mean of 1–9):*

23 To what extent are the following decision made by the franchisee? (no extent 1–7 to a very
24 large extent)

- 25
- 26 1 Procurement decision
 - 27 2 Product decision
 - 28 3 Accounting system decision
 - 29 4 Resale price decision
 - 30 5 Advertising decision
 - 31 6 Employees' training decision
 - 32 7 Investment decision
 - 33 8 Financing decision
 - 34 9 Recruiting decision
- 35

36 *Disaggregated decision rights*


37 Decision rights were grouped according to the value chain activities:

- 38
- 39 1 Advertising decision
 - 40 2 Price decision
 - 41 3 Product decision
 - 42 4 Procurement decision
 - 43 5 Human resources decision recruiting decision employees' training decision
 - 44 6 Investment decision investment decision financing decision
 - 45 7 Accounting system decision
- 46


47 **Outlet size:** Natural log of the sum of initial investments and initial fees (€ value)



48 **Sector:** Dummy variable, 0 = service franchising, 1 = product franchising

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42 Nada Mumdziev is a PhD candidate at the Center for Business Studies, University of Vienna.

44 Josef Windsperger is  at the Center for Business Studies, University of Vienna. 19











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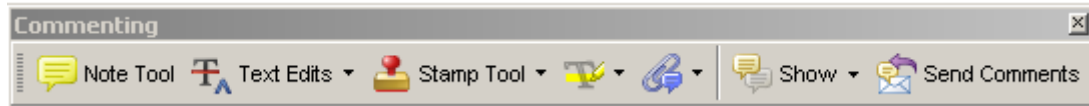
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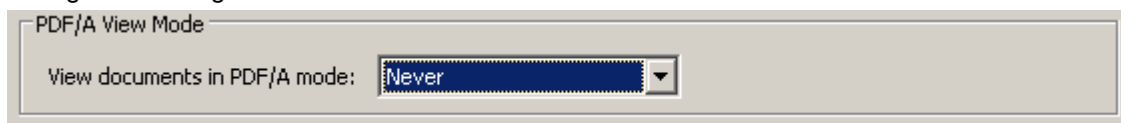
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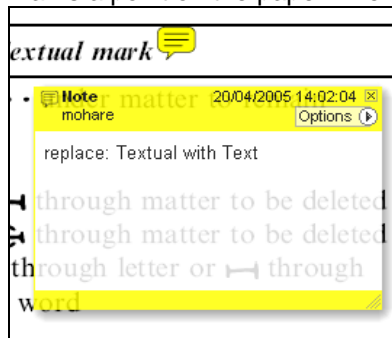
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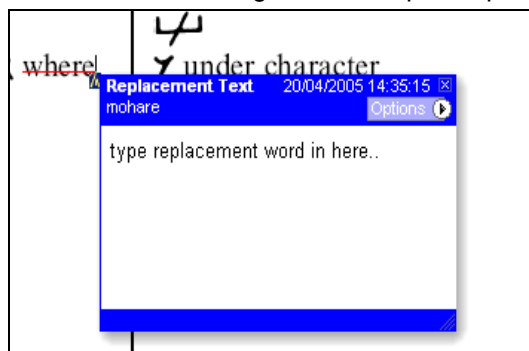


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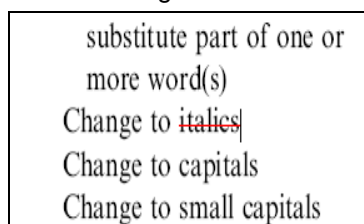


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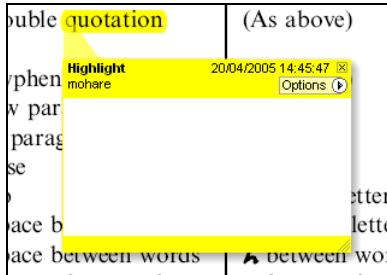


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Highlight tool — For highlighting selection that should be changed to bold or italic.

Highlights text in yellow and opens up a text box.

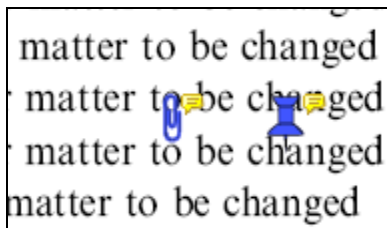


How to use it:

1. Select Highlighter Tool from the commenting toolbar
2. Highlight the desired text
3. Add a note detailing the required change

Attach File Tool — For inserting large amounts of text or replacement figures as a files.

Inserts symbol and speech bubble where a file has been inserted.

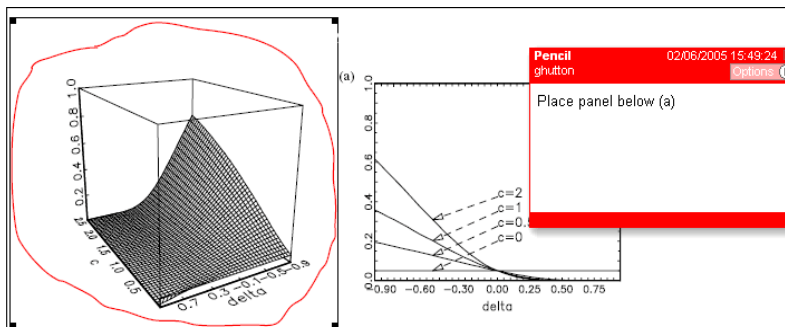


How to use it:

1. Click on paperclip icon in the commenting toolbar
2. Click where you want to insert the attachment
3. Select the saved file from your PC/network
4. Select appearance of icon (paperclip, graph, attachment or tag) and close

Pencil tool — For circling parts of figures or making freeform marks

Creates freeform shapes with a pencil tool. Particularly with graphics within the proof it may be useful to use the Drawing Markups toolbar. These tools allow you to draw circles, lines and comment on these marks.



How to use it:

1. Select Tools > Drawing Markups > Pencil Tool
2. Draw with the cursor
3. Multiple pieces of pencil annotation can be grouped together
4. Once finished, move the cursor over the shape until an arrowhead appears and right click
5. Select Open Pop-Up Note and type in a details of required change
6. Click the X in the top right hand corner of the note box to close.

Help

For further information on how to annotate proofs click on the Help button to activate a list of instructions:

