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

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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, 1997).
Property rights theory differentiates between nonresidual (or specific) decision rights and residual decision rights. Nonresidual decision rights are explicitly specified in contracts (Demsetz, 1998) and refer to the use of contractible (explicit) knowledge, which can be easily codified and transferred. Residual decision rights refer to the authority to influence the use of intangible (tacit) knowledge, which cannot be easily codified and specified in contracts. In franchising, residual decision rights refer to the authority to influence the use of the franchisor’s system-specific assets and the franchisee’s local market assets, which are intangible and hence difficult to specify in contracts.

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

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

Decision Rights in Franchising

In organizational economics, the question of how to allocate decision rights has been investigated in several different organizational settings. Lerner and Merges (1998), Arrunada et al. (2001, 2005), Elfenbein and Lerner (2003), Brickley, Linck, and Smith (2003), Windsperger (2004), Higgins (2006) and Hu and Hendrikse (2009/2010) all examine the allocation of decision rights in interorganizational networks. Elfenbein and Lerner study the allocation of decision rights in contracts between internet portal operators and content suppliers, arguing that the allocation of decision rights depends on the bargaining power of the parties. Higgins finds that bargaining power also matters in the allocation of decision rights between pharmaceutical and biotechnology firms. Incentives also matter. Brickley et al., for example, argue that among commercial banks, local managers of independent small rural banks have a higher proportion of decision rights compared with branch managers of large banks because they have higher incentives to use the local knowledge regarding their customers.
Although franchising has been treated extensively in organization economics, management, and marketing, the allocation of decision rights between the franchisor and franchisees remains, with three important exceptions, largely unexplored (i.e., Arrunada et al., 2001, 2005; Azevedo, 2009; Windsperger, 2004). Arrunada, et al. (2001, 2005) investigate the allocation of specific decision rights in contracts between car manufacturers and their dealers, such as completion rights, monitoring, and enforcement rights. Azevedo investigates the impact of brand name value on the allocation of authority in franchising networks. These studies, however, do not explicitly differentiate between decision rights and residual income (or ownership) rights, and they focus only on certain formal rights without examining the range of decision rights involved in local outlets’ value chains.

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

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

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

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

**Decision Rights and Asset Contractibility**

According to property rights theory, the structure of decision rights depends on the distribution of residual-income-generating intangible (noncontractible) assets between the franchisor and franchisee (Barzel, 1989; Windsperger, 2004). Generally, we can differentiate decision rights regarding strategic and operational decisions. Strategic decisions are primarily made by the franchisor, and operational decisions are divided between the franchisor and the franchisee. Operational decisions include marketing decisions (price, product, and promotion), human resources decisions (training and recruiting),
investment, and procurement decisions. According to Jensen and Meckling (1992), two ways for allocating decision rights exist: Either knowledge must be transferred to those with the right to make decisions or decision rights must be transferred to those who have the knowledge. This means that decision rights tend to be centralized in franchising networks when the costs of transferring local knowledge to the franchisor are relatively low. This is the case when the franchisor’s portion of intangible assets is relatively high compared with franchisees’ intangible local market assets. The franchisor has strong bargaining power and can easily acquire local market knowledge because of its relatively lower degree of intangibility. On the other hand, residual decision rights have to be delegated to franchisee when their local market know-how is very specific, and consequently, knowledge-transfer costs are very high. In this case, the bargaining power of the franchisees is relatively strong because of their noncontractible local market assets. Consequently, if it is important to take advantage of franchisees’ intangible local market assets in order to generate a high-residual income stream, the franchisor must transfer residual decision rights to local partners. In sum, we formulate the following property rights proposition: The more important the franchisor’s intangible assets for the generation of the residual income relative to franchisees’ local market assets, the more decision rights are allocated to the franchisor and the less decision rights are allocated to the franchisee.

Hypotheses

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

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

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

**Franchisee’s Intangible Local Market Assets.** These assets are the outlet-specific know-how involved in innovation and operations. Innovation assets are more explorative in nature, and operation assets are more exploitative (Levinthal & March, 1993; March, 1991). Innovation assets refer to local market knowledge (in the sense of Kirzner, 1973) and innovation (in the sense of Schumpeter, 1911), and operation assets refer to quality control, human resource management, and administration (Wicking, 1995). Because innovation assets are characterized by a higher explorative component than operation assets, innovation assets are expected to show a lower degree of contractibility than...
operation assets. Consequently, by applying property rights reasoning, we expect that innovation assets have a stronger impact on the allocation of decision rights than operation assets. We summarize this expectation in the following hypothesis:

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

**Method**

**Data and Sample**

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

**Dependent Variable**

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

**Independent Variables**

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

**Franchisees’ Intangible Local Market Assets.** Franchisees’ intangible local market assets refer to innovation assets and operation assets. In the questionnaire, franchisors were asked to rate on a 5-point scale to evaluate franchisees’ intangible assets (see Appendix). Based on Windsperger and Dant (2006), we used the following domains of indicators to measure
the local market know-how of franchisees compared with managers of company-owned outlets. The domain of **innovation assets** refers to franchisors’ perception of their franchisees’ know-how relative to company managers in two areas: innovation and local market knowledge. The domain of **operation assets** refers to franchisors’ perception of their franchisees’ know-how relative to company managers in three areas: quality control, human resource management, and administrative capabilities. Importantly, we used these scales as formative rather than reflexive latent indicators because the constructs are defined by theoretical judgment and produced by the indicators representing the multiple domains of the content. If we omitted an indicator, the content of the construct would change (Diamantopoulos & Winkelhofer, 2001). Because innovation and local market knowledge are characterized by a higher degree of tacitness compared with administrative, human resource management, and quality control capabilities, innovation assets are expected to show a lower degree of contractibility than operation assets.

**Control Variable**

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

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

**Results**

Descriptive data are presented in Table 1.

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

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

**Aggregated Decision Rights**

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

\[
\text{Decision Rights} = \alpha + \beta_1 \text{Visits} + \beta_2 \text{Training days} + \beta_3 \text{Innovation assets} + \\
\beta_4 \text{Operation assets} + \beta_5 \text{Outlet size} + \beta_6 \text{Sector}.
\]
Table 2 depicts the regression results for the hypotheses tests. The property rights hypotheses regarding the impact of franchisor’s intangible system-specific assets on the franchisees’ fraction of residual decision rights are tested using the variables training days and visits. Hypotheses 1a and 1b predict a negative relation between training days and visits and franchisees’ fraction of residual decision rights. The coefficient of visits is negative but not significant ($\beta = -0.137, p = 0.134$), providing no support for hypothesis 1a. The coefficient for training days, however, is negative and significant ($\beta = -0.24, p < 0.05$), supporting hypothesis 1b. An increase in franchisor’s system-specific know-how, as depicted in training, relates to a lower portion of residual of decision rights allocated to the franchisees.
Hypothesis 2 is tested by using the variables innovation assets and operation assets. Hypothesis 2 predicts that less contractible innovation assets have a stronger influence on franchisee’s fraction of residual decision rights than the more contractible operation assets. The coefficient for innovation assets is positive and significant ($\beta = .206, p < .05$), indicating that less contractible local market assets (innovation and local market knowledge) strongly influence the allocation of decision rights between the franchisor and franchisee. On the other hand, the coefficient for operation assets ($\beta = -.138, p = .169$) is negative and not significant, indicating no evidence that more contractible local market assets (administrative capabilities, human resource management, and quality control) increase franchisee’s fraction of residual decision rights. One explanation for this negative coefficient is that quality control, human resource management, and administrative issues can be more easily controlled by the franchisor. Overall, our results are consistent with the view that less contractible local market assets are more important for the allocation of residual decision rights than more contractible local market assets.

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

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

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

Consistent with property rights theory regarding the franchisor’s intangible assets (hypothesis 1a and 1b), training days negatively influence franchisees’ fraction of decision rights regarding decisions involving procurement ($\beta = -.179, p < .1$), human resource management ($\beta = -.279, p < .01$), and investments ($\beta = -.295, p < .01$). The number of visits has a negative and weakly significant influence on investment decisions ($\beta = -.164, p < .10$). This result indicates that the franchisor exercises more control over procurement, recruiting, and training, as well as investment and finance when system-specific know-how is strong. In addition, consistent with hypothesis 2 regarding franchisees’ local market assets, only less contractible local market assets (innovation assets) significantly influence franchisees’ fraction of decision rights, particularly in the areas of product ($\beta = .272, p < .05$) and human resource management ($\beta = .201, p < .1$). This indicates that franchisees’ local market know-how is especially important when new products or services are introduced and when employees are recruited and trained. The overall
Table 3

Regression Results for Disaggregated Decision Rights

<table>
<thead>
<tr>
<th></th>
<th>Advertising</th>
<th>Price</th>
<th>Product</th>
<th>Procurement</th>
<th>HRM</th>
<th>Investment</th>
<th>Accounting system</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(standard error)</td>
<td>(standard error)</td>
<td>(standard error)</td>
<td>(standard error)</td>
<td>(standard error)</td>
<td>(standard error)</td>
<td>(standard error)</td>
</tr>
<tr>
<td>Intercept</td>
<td>+9.393 (1.684)***</td>
<td>+2.313 (2.291)***</td>
<td>+7.167 (2.033)***</td>
<td>+8.875 (2.089)***</td>
<td>+7.718 (1.047)***</td>
<td>+7.044 (1.798)***</td>
<td>+7.260 (2.375)***</td>
</tr>
<tr>
<td>Annual number of</td>
<td>+0.024 (0.026)</td>
<td>-0.043 (0.032)</td>
<td>-0.036 (0.028)</td>
<td>-0.019 (0.029)</td>
<td>+0.011 (0.015)</td>
<td>-0.045 (0.025)</td>
<td>* -0.051 (0.033)</td>
</tr>
<tr>
<td>outlet visits</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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</tr>
<tr>
<td>Annual number of</td>
<td>-0.023 (0.022)</td>
<td>+0.015 (0.027)</td>
<td>-0.014 (0.024)</td>
<td>-0.047 (0.025)</td>
<td>-0.036 (0.012)***</td>
<td>-0.068 (0.021)***</td>
<td>-0.010 (0.028)</td>
</tr>
<tr>
<td>training days</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Innovation assets</td>
<td>+0.003 (0.177)</td>
<td>-0.014 (0.215)</td>
<td>+0.497 (0.191)**</td>
<td>+0.017 (0.196)</td>
<td>+0.186 (0.074)*</td>
<td>+0.227 (0.168)</td>
<td>+0.293 (0.223)</td>
</tr>
<tr>
<td>Operation assets</td>
<td>+0.046 (0.189)</td>
<td>+0.081 (0.229)</td>
<td>-0.175 (0.204)</td>
<td>-0.138 (0.209)</td>
<td>-0.160 (0.105)</td>
<td>-0.290 (0.179)</td>
<td>-0.274 (0.238)</td>
</tr>
<tr>
<td>Outlet size</td>
<td>-0.284 (0.133)**</td>
<td>-0.253 (0.162)</td>
<td>-0.238 (0.144)*</td>
<td>-0.261 (0.147)*</td>
<td>-0.105 (0.074)</td>
<td>-0.018 (0.126)</td>
<td>-0.150 (0.168)</td>
</tr>
<tr>
<td>Sector (service</td>
<td>-0.444 (0.333)</td>
<td>-0.485 (0.405)</td>
<td>-0.408 (0.359)</td>
<td>-0.949 (0.369)**</td>
<td>+0.168 (0.185)</td>
<td>-0.593* (0.185)</td>
<td>-0.504 (0.420)</td>
</tr>
<tr>
<td>= 0, product = 1)</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>R²</td>
<td>F = 1.201</td>
<td>F = 0.999</td>
<td>F = 2.854</td>
<td>F = 2.696</td>
<td>F = 1.889</td>
<td>F = 3.944</td>
<td>F = 1.721</td>
</tr>
<tr>
<td></td>
<td>R² = 0.061</td>
<td>R² = 0.046</td>
<td>R² = 0.133</td>
<td>R² = 0.126</td>
<td>R² = 0.092</td>
<td>R² = 0.174</td>
<td>R² = 0.084</td>
</tr>
</tbody>
</table>

Two-tailed significance values indicate: *** p < 0.01; ** p < 0.05; * p < 0.1; + p < 0.11
n = 118

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

Discussion

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

Implications for Research

This study has important implications for both researchers and franchisors. We find
empirical support that contractibility of assets determines the structure of decision rights
in franchising networks. Complementary to the agency-theoretical view (Arrunada et al.,
2001, 2005; Azevedo, 2009), we develop and extend the property rights explanation of the
allocation of decision rights in franchising networks (Windsperger, 2004). First, we argue
that local market assets are only relevant for the allocation of residual decision rights in
franchising if they are noncontractible. To test this hypothesis, we differentiate between
more and less contractible local market assets and, by differentiating between operation
and innovation assets, provide a finer-cut measurement of franchisees’ local market assets.
Second, by applying Porter’s value chain concept (Porter, 1985), we disaggregate decision
rights according to the major value chain activities in outlets (product, procurement,
advertising, price, human resource management, investment, and accounting system deci-
sions) and test the influence of property rights variables on each of them separately. This
analysis provides new insight into the structure of residual decision rights in franchising.
Specifically, intangible system-specific assets have a negative influence on franchisees’
residual decision rights regarding procurement, human resource management, and
investment decisions, and intangible local market assets have a positive influence on
franchisees’ decision rights regarding human resource and product decisions. Evidently, the franchisor tends to increase control over decisions regarding core elements of system know-how, such as procurement and investments. Simultaneously, the franchisor transfers more control over decisions to franchisees in areas where the local market know-how is critical to the success of the system.

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

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

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

**Implications for Practice**

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

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

Our study has some important limitations: First, in our study, the influence of franchisees’ local market assets on the allocation of residual decision rights depends on measures based on franchisors’ evaluation of local market assets, and franchisors’ assessment could deviate from franchisees’ assessments. To include both perspectives would contribute to the reliability of the measure. Future research could make a contribution to this area by developing and testing measures based on both franchisee and franchisor evaluations.

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

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

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

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

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

Conclusion

Our study offers a property rights explanation of the structure of decision rights in franchising. Specifically, we show that contractibility of assets (i.e., system-specific assets and local market assets) is an important determinant of the decision structure. The results indicate that only less contractible assets are relevant for the allocation of residual decision rights between the franchisor and franchisee. Furthermore, by applying Porter’s
value chain concept, we were able to show how franchisor and franchisee control varies among the different areas of operational decisions in outlets.

Appendix

Measures of Variables

Franchisors’ intangible system-specific assets
Annual training days: Number of franchisee’s training days a year
Annual number of visits: Number of outlet visits a year

Franchisee’s intangible local market assets

1) Innovation assets: Franchisees’ know-how advantage compared with the manager of a company-owned outlet evaluated by the franchisor concerning
   — Innovation
   — Local market knowledge (no advantage 1–5 very large advantage)

2) Operation assets: Franchisees’ know-how advantage compared with the manager of a franchisor-owned outlet evaluated by the franchisor concerning
   — Quality control
   — Administrative capabilities
   — Human resource management (no advantage 1–5 very large advantage)

Decision rights index (DR) (Mean of 1–9):
To what extent are the following decision made by the franchisee? (no extent 1–7 to a very large extent)

1 Procurement decision
2 Product decision
3 Accounting system decision
4 Resale price decision
5 Advertising decision
6 Employees’ training decision
7 Investment decision
8 Financing decision
9 Recruiting decision

Disaggregated decision rights
Decision rights were grouped according to the value chain activities:

1 Advertising decision
2 Price decision
3 Product decision
4 Procurement decision
5 Human resources decision recruiting decision employees’ training decision
6 Investment decision investment decision financing decision
7 Accounting system decision

Outlet size: Natural log of the sum of initial investments and initial fees (€ value)
Sector: Dummy variable, 0 = service franchising, 1 = product franchising
REFERENCES


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USING E-ANNOTATION TOOLS FOR ELECTRONIC PROOF CORRECTION

Required Software
Adobe Acrobat Professional or Acrobat Reader (version 7.0 or above) is required to e-annotate PDFs. Acrobat 8 Reader is a free download: [http://www.adobe.com/products/acrobat/readstep2.html](http://www.adobe.com/products/acrobat/readstep2.html)

Once you have Acrobat Reader 8 on your PC and open the proof, you will see the Commenting Toolbar (if it does not appear automatically go to Tools>Commenting>Commenting Toolbar). The Commenting Toolbar looks like this:

![Commenting Toolbar](image)

If you experience problems annotating files in Adobe Acrobat Reader 9 then you may need to change a preference setting in order to edit.

In the “Documents” category under “Edit – Preferences”, please select the category ‘Documents’ and change the setting “PDF/A mode:” to “Never”.

Note Tool — For making notes at specific points in the text
Marks a point on the paper where a note or question needs to be addressed.

![Note Tool](image)

**How to use it:**
1. Right click into area of either inserted text or relevance to note
2. Select Add Note and a yellow speech bubble symbol and text box will appear
3. Type comment into the text box
4. Click the X in the top right hand corner of the note box to close.

Replacement text tool — For deleting one word/section of text and replacing it
Strikes red line through text and opens up a replacement text box.

![Replacement text tool](image)

**How to use it:**
1. Select cursor from toolbar
2. Highlight word or sentence
3. Right click
4. Select Replace Text (Comment) option
5. Type replacement text in blue box
6. Click outside of the blue box to close

Cross out text tool — For deleting text when there is nothing to replace selection
Strikes through text in a red line.

![Cross out text tool](image)

**How to use it:**
1. Select cursor from toolbar
2. Highlight word or sentence
3. Right click
4. Select Cross Out Text
Approved tool — For approving a proof and that no corrections at all are required.

- **APPROVED**
- Change to small capitals
- Change to lower case
- Change italic to upright type

**How to use it:**
1. Click on the Stamp Tool in the toolbar
2. Select the Approved rubber stamp from the ‘standard business’ selection
3. Click on the text where you want to rubber stamp to appear (usually first page)

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: