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Discussion paper

Effects of franchising on industry competition: The moderating role of the hospitality industry

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ABSTRACT

This study investigates the impact of an industry's involvement in franchising on its competitive condition. Findings show that, for services industries in general, franchising involvement (a) discourages industry instability and dynamic competition, and (b) has a non-significant impact on industry concentration. However, in the hospitality industry, the negative effects of franchising on industry instability and dynamic competition are weaker: franchising decreases industry instability and dynamic competition less in the hospitality industry than in other services industries. These findings open up a new discussion of how franchising influences the competitive environment at the industry level.

1. Introduction

Franchising is an important strategic practice in services industries; this hybrid organizational system has proven to be a successful contractual mechanism for business expansion (Marvel, 1995; Winter et al., 2012). In various research streams, scholars have investigated the hybrid nature of franchising arrangements in relation to the operational features of the system (e.g., Brickly and Dark, 1987; Combs and Ketchen, 2003; Hsu and Jang, 2009; Lafontaine, 1992; Koh et al., 2009; Roh, 2002). Researchers have defined a franchising system as an organizational form established through agreements between the owner (i.e., franchisor) of a brand and business model, and many individuals/groups (i.e., franchisees) who pay a fee to use the franchisor's brand and model to operate their own businesses. Although many scholars have investigated business outcomes of franchising at the firm level, they have paid limited attention to the association between franchising and the business environment more generally, such as that of an entire industry or a national economy. According to Jacquemin (1987), a firm's strategy and business environment are closely linked. Specifically, the business environment is always changing due to macro-economic factors as well as firms' competitive actions/reactions (D'Aveni, 1994). This implies that, as a strategic action, franchising may alter the environmental factors that firms must recognize and manage to ensure business success. To address this gap in the literature, the aim of this study is to explore the impact of franchising on business market conditions.

This research draws on two major theoretical perspectives: transaction cost economics (TCE) and the resource/knowledge-based view (RBV/KBV). Transaction cost economics (TCE) (Williamson, 1979) provides the theoretical framework for organizational boundary decisions aimed at minimizing costs associated with specific investments and opportunistic behaviors of partners when completing transactions. Arguably defined as a hybrid structure, a franchise system can help firms (franchisors) achieve efficient market coordination by deriving benefits from the financial investments made by their partners while establishing control over partners' business operations. Thus, franchisors can gain market power by using relatively little of their own capital (Michael, 2003). Second, from an RBV/KBV perspective (Barney, 1991; Kogut and Zander, 1992), a franchising system can provide franchisors with opportunities to access external resources and knowledge. Since franchisees are efficiently bundled sources of the managerial and informational capital required to ensure franchisors' business success (Stanworth et al., 2004), franchising can make it easier for firms to obtain competitive advantages in the market. Combining the arguments grounded in these two theoretical perspectives, it can be asserted that franchising increases franchisors' competitive power and advantages, which can introduce new competitive dynamics into the market. Hence, the competitive condition within an industry can be an important environmental outcome shaped by an individual firm's engagement in franchising.

In the existing literature, scholars have identified three dimensions of competition: the competition structure, changes to the competition structure, and the nature of competition (Dess and Beard, 1984; Sharfman and Dean, 1991). The competition structure is specified as

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industry concentration and represents the distribution of competitive power among market players (Shepherd, 1972). Changes to the competition structure reflect an unstable distribution of power (Caves and Porter, 1978) (i.e., industry instability). The nature of competition can be characterized as either static or dynamic; these two types of competition depend on firms either depreciating existing assets or producing new strategic assets to outperform rivals (Thomas, 1996). The aim of this research is to investigate how franchising alters these three dimensions of competition – industry concentration, industry instability, and the nature of competition – at the industry level.

Since the services industry is not homogenous, the influence of franchising on industry competition can be contingent on the industry-specific characteristics. In particular, due to the capital intensity and the nature of work performed by franchisees in the hospitality industry, the relationships between franchising and the three dimensions of competition could have different levels of importance, or even different valences in the hospitality industry compared to other services industries. In this vein, the current study aims to investigate how the influence of franchising on industry competition is different in the hospitality industry from in other services industries.

The findings of this study enrich the literature in several ways and have important implications for practitioners. First, by verifying the reverse direction of causality in the Bain/Mason structure-conduct-performance (S-C-P) paradigm, this study reveals impacts on industry-wide competitive conditions as another outcome of franchising. Second, the finding that the relationships between franchising and competitive condition are industry-specific introduces new research considerations about strategy and related environmental outcomes across industries. The noteworthy finding about the different effects of franchising in the hospitality industry compared to other services industries is likely to spark interesting discussions among hospitality scholars. Third, findings from this study could provide managers with practical guidance on which competitive conditions are shaped by franchising, which may help them make better decisions.

2. Literature review and hypotheses development

2.1. Dimensions of industrial and organizational environments

Scholars have used several approaches to conceptualize the industrial environment in industrial organizational economics and strategic management research (Sharfman and Dean, 1991). In the industrial environmental literature, researchers conceptualize business environment as either an objective reality or as a managerial perception, and describe it as having three integrated dimensions: complexity, instability and munificence (Dess and Beard, 1984; Sharfman and Dean, 1991). Complexity represents the heterogeneity of the market and captures how the market is structured (Thompson, 1967). Instability relates to the difficulty in predicting future market conditions; changes in market patterns are regarded as a central source of instability. The last dimension, munificence, concerns the extent to which a competitive market has resources that enable continued growth (Aldrich, 1979); a resourceful business environment provides organizations with growth opportunities and therefore encourages competition (Dess and Beard, 1984).

This theoretical framework provides the dimensions of the industrial environment for this study on the influence of franchising on the competitive business environment. The first dimension of the framework, complexity, is applied to competition structure because complexity indicates the diversity of market structures in which a firm operates (Dess and Beard, 1984; Zahra, 1991). The second dimension of the framework, instability, which reflects industry-level change dynamics (Dess and Beard, 1984; Zahra, 1991), is directly linked to changes to the competition structure in this research. The third dimension of the framework, munificence, reflects whether an industry encourages a type of competition that generates new business opportunities (Miller and Friesen, 1983). This feature can be represented by the nature of competition between firms (i.e., static vs. dynamic) (Bengtsson and Marell, 2006). The nature of competition within each industry determines the amount of resources in the market and represents the munificence of the industry's business environment. Rooted in this theoretical framework, this research examines the three dimensions of industry competition.

2.2. Hypotheses development

The Bain/Mason S-C-P theoretical framework is based on the notion that structure influences conduct, which in turn influences performance; however, this study is based on the reverse perspective, that a firm's strategy can influence market structure. Jacquemin (1987) suggested that causality does not move in only one direction (i.e., from markets to firms), but is characterized instead by several layers of feedback loops. The interdependence between structure and conduct may imply that an organization's strategy can influence its business environment. Specifically, a firm's strategic actions directly impact competitors' actions and reactions, and indirectly affect the strategic actions of other firms in the market (Ferrier et al., 1999). Such actions can create a business trend that must be considered before the focal firm takes additional actions in the future. The reshaped business environment thus can be considered as an outcome of strategic actions at the firm level.

2.2.1. Franchising and competition structure

The inquiry of the first hypothesis relates to how franchising strategy influences the distribution of power within the industry competition structure. In the industrial organization literature, competitive power is defined as a firm's ability to influence the actions of others in a market (Porter, 1980), and is based upon a firm's relative position within a market, normally reflected by its market share (Shervani et al., 2007). Drawing on the TCE perspective (Williamson, 1979), it is argued that a franchising strategy can influence an individual firm's (franchisor's) competitive power, and consequently influence the power distribution.

The core concept of TCE is that organizational boundary decisions about operational mode (i.e., market, hierarchical, or hybrid) are made to minimize costs related to specific investments and opportunistic behaviors when completing transactions. Arguably, a franchise system can be categorized as a hybrid operational mode because it has characteristics of both the hierarchical and market modes. Specifically, because franchisees' business outcomes are closely linked to the franchisor's business performance and contribute to the franchisor's market position, franchisors control franchisees' operations to minimize opportunistic behaviors (hierarchical mode). However, at the same time, a franchise contract defines franchisees as independent business partners in that franchisees invest their own capital to initiate and manage their businesses. The financial capital contributed by franchisees can be considered low asset-specific investments (market mode). Through this relational mechanism between hierarchies and markets, franchisors are able to improve market coordination efficiency, which increases their ability to gain competitive advantages.

In particular, a market mode of operation enables franchisors to use capital investments from franchisees to decreases the capital burden associated with entering new markets, making it possible for them to obtain better market position while using relatively little of their own capital (Gonzales-Diaz and Solis-Rodriguez, 2012; Park and Jang, 2017). By lowering barriers to entry, franchisors can efficiently build market power and obtain competitive advantages. From an industry-wide perspective, franchising attracts more firms into markets, which become crowded with competitors and thus less concentrated. Based on this argument:

H1. An industry's involvement in franchising leads to a decrease in

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