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International Franchise Expansion: The Role of Institutions and Transaction Costs

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ABSTRACT

In this study, we examine how a country's institutional environment affects the international expansion activities of U.S. franchise companies. We draw on institutional and transaction cost theories to develop a model and a set of hypotheses regarding the effect of political, regulatory and infrastructural institutions, as well as economic instability, on international franchise expansion. Using a sample of U.S. franchise firms and data from a combination of secondary sources, we test these hypotheses by estimating a panel regression model. Our results demonstrate for the first time that, in addition to favorable political governance, a country's business climate, including entry regulations, taxes, and communications infrastructure, is an important predictor of foreign franchise firms' expansion into that country. Implications for practice and future research also are discussed.

1. Introduction

Consider the following examples:

- Increased political stability and more favorable regulations prompted the expansion of Anytime Fitness into Qatar.
- Papa John's expansion into Russia was driven, in part, by the country's modernization of its business infrastructure.
- Brazil ranks 120 out of 189 countries in terms of ease of doing business due to corruption and excessive regulations (World Bank, 2014a, 2014b).

In the past several decades, franchising has become an important strategy for business growth, job creation, and economic development, and has been an effective method for firms to enter foreign markets or expand internationally (e.g. Dant and Grunhagen, 2014). Indeed, some of the first companies to establish a significant presence in foreign markets have been franchise companies. As the three introductory examples demonstrate, a favorable institutional environment plays a crucial role in franchise companies' decisions regarding the location of their international expansion efforts. Countries differ widely with respect to how attractive their business environments are for new business development. As noted by the World Bank's *Doing Business* project, having the right set of business regulations has an enormous impact on business growth and development within a country, and has a profound effect on a country's overall economic development (World Bank, 2014a, 2014b). Prior research on international franchising (e.g., Baena, 2012, 2015; Hoffman et al., 2008) has focused on the impact of broad, country characteristics, such as political risk and culture, on franchise expansion. Using a theoretical framework that combines institutional theory and transaction cost theory, in this study we examine, for the first time, the effect of multiple country institutions on franchise expansion

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into host markets, including political, regulatory, and infrastructural institutions. In addition, we study the impact of the economic shock of the financial crisis of 2008–09 on international franchise expansion.

We begin by discussing the importance of franchising in the development of a country's economy. A literature review follows, in which we highlight the theories used in the extant literature on international franchising and introduce the theoretical framework we use to develop our model outlining the impact of national business climate on franchise expansion. Using institutional and transaction cost theories, we develop hypotheses regarding how franchise companies' international expansion plans may be influenced by specific elements of a country's institutions. We test these hypotheses using data collected over a seven year period on the expansion plans of U.S. franchise companies. Our results demonstrate those aspects of a country's institutional environment that are important predictors of foreign firms' expansion into that country.

1.1. International franchise expansion

Franchising has become an important driver of growth, especially in many developing economies (e.g., Michael, 2014). For example, Brazil has an active franchising sector with 2010 sales of approximately $48 billion, or just over 2% of Brazil's GDP. According to the Brazilian Franchising Association (ABF, 2015), Brazil had approximately 2942 franchise systems operating over 127,331 units. Moreover, the Russian Franchising Association reported that there were more than 595 franchise systems in 75 different lines of business and over 9000 franchisees operating in Russia (World Franchise Associates, 2012). In the past decade, franchising has become increasingly prevalent in China, where the franchise sector has 82,000 units and is growing at 49% annually, but still makes up only 3% of the country's retail sales. This growth is due in part to new franchising regulations in 2004 that made franchising a more attractive investment (International Franchise Association, 2013). In India, economic liberalization and reform stimulated similar levels of growth, at over 30% annually (Shah, 2008). Yet, franchises account for only 2% of India's retail sales (Franchise Direct, 2013), thus, there still is much potential for growth.

From these examples, it becomes clear that franchising has spread globally to become an established method of doing business in numerous countries, including many developing countries. Indeed, a recent study (Hoffman et al., forthcoming) reveals that 70% of the countries targeted by U.S. franchisors are in emerging markets. Research (e.g., Teegen, 2000) has shown that a country's institutional environment is an important driver of new business creation, for both local companies as well as inward investment by foreign companies. Because of the important role of franchise companies in the establishment and growth of new businesses in emerging economies, we need to understand how the international expansion of franchise companies is affected by the country's institutions.

2. International franchising: literature and theoretical foundations

What affects foreign market entry by firms? Much of the previous empirical research on the expansion of international franchising has been based on broad concepts from strategic management (e.g., Porter, 1990) and international business (e.g., Rugman and Doh, 2008). As a result, explanations of market entry by franchise firms are based on firm characteristics, such as resources and capabilities and/or the firm's environmental context, such as economic and socio-political forces (e.g., Alon and Martin, 1998; Dant and Grunhagen, 2014). Drawing on strategic management concepts, studies have found the following firm characteristics to be associated with international franchise expansion: size and age (Huszagh et al., 1992), growth and profit goals (Kedia et al., 1994), varied product/service offerings (Julian and Castrogiovanni, 1995), and monitoring experience and lower franchise fees (Elango, 2007). Using both strategic management and international business theory (e.g., Dunning, 1980), other studies have found the following broad environmental sectors of the host country to impact franchise expansion: cultural values (Alon et al., 2000), economic factors such as growth (Michael, 2014), wages, unemployment, and media infrastructure (Michael, 2003). In the most comprehensive study of this type Hoffman et al. (2008) found significant relationships between international franchise market penetration and five environmental sectors (geographic, cultural, economic, technological, and political). Finally, one study (Hoffman and Preble, 2001) that evaluated both firm and environmental factors found the former to have greater explanatory power.

Recently, scholars (e.g., Jell-Ojobor and Windsperger, 2014; Merrilees, 2014), have drawn on more focused theories to develop more finely grained hypotheses for examining international franchise expansion. For example, agency theory (e.g., Lafontaine, 1992), addresses the risks involved in franchising, and the need for the parent franchise organization to monitor and control its international franchise units to prevent the costs incurred by opportunism and self-interest. According to agency theory (Jensen and Meckling, 1976), an agency problem develops when the agent, or franchisee, makes decisions that are not in the best interests of the principal, or franchisor, due to goal incongruence between the franchisee and franchisor, or self-interested behavior on the part of the franchisee. As noted by franchise research based on agency theory, direct monitoring, which is often put forth as a solution to the agency problem, is quite costly (Combs and Ketchen, 1999), with a better solution being incentive alignment using a franchise business form (Carney and Gedajlovic, 1991). Indeed, franchise firms that more effectively control the costs of the agency problem through either monitoring or incentive alignment tend to perform better (Shane, 1998).

Agency theory has proven particularly useful for studying franchising as a business form in the international context, with research based on agency theory showing that franchise companies tend to increase their proportion of franchised outlets as they become more international (Castrogiovanni et al., 2006). Using agency theory, Sashi and Karuppur (2002) argue that franchisees are independent entrepreneurs who may engage in opportunistic behaviors that enhance their unit but not that of the overall franchise system. Shane (1996) noted that opportunism is greater in international markets due to uncertainty posed by economic,