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Reducing the Size of Internal Hierarchy: The Case of Multi-Unit Franchising

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Abstract

Successive layers of supervisor–subordinate relationships in organizations often distort information, increase monitoring costs, and lead to a cumulative loss of control. This paper discusses how some organizations can reduce their internal hierarchy by slicing it into two components and substituting the supervisor–subordinate relationship with an independent contract. This substitution allows the organization to shift its lower-level hierarchy to the contractors. These contractors are less likely to indulge in moral hazard, which can further reduce the size of hierarchy required. The paper examines this theory in the domain of multi-unit franchising and tests the hypotheses with a longitudinal data set.

Keywords: Franchising; Channels of distribution; Chain organizations; Inter-organizational relationships; Agency theory; Internal hierarchies

Introduction

> [In an organization,] layers slow everything down. Take decision-making. The more layers, the more people who have to thump their rubber stamp. The more PowerPoint presentations to be made to bosses and bosses' bosses before the rubber stamp. Or take communicating change. Layers make that process—hard enough as it is—like that children's whispering game, telephone. Every time a piece of information passes through a person, it morphs a little. Layers do that, too, adding spin, interpretation, and buzz with every telling.
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> —Jack Welch, ex-CEO General Electric Company (Welch and Welch 2007, p. 96)

Research has long recognized the problems that arise from multiple layers in a hierarchy, that is, a chain of supervisor–subordinate relationships. Subordinates typically satisfy only a fraction of the directives of their supervisors, so successive layers of these relationships often distort information, increase monitoring costs, slow down decision making, and lead to a cumulative loss of control (Aghion and Tirole 1997; Alchian and Demsetz 1972; Calvo and Wellisz 1978; Holmstrom and Tirole 1989; Radner 1992; Williamson 1967). In marketing organizations such as retail chains, sales forces, and franchise systems, these problems may undermine not only organizational efficiency but also the organization's efforts to achieve consistency in brand presentation and customer service. Despite the recognition of the need, most theories of the firm fail to address these problems of hierarchy (Garrouste and Saussier 2005; Gibbons 2005). This paper discusses how slicing a hierarchy into two components and substituting the supervisor–subordinate relationships at the sliced level with independent contracts can help some organizations reduce these problems. This substitution allows an organization to shift its lower-level hierarchy to multiple contractors who can manage these mini-hierarchies more effectively because of their relatively smaller sizes. Such an organization consists of two hierarchical components joined together with an independent contract. Furthermore, due to the compensation design, the contractors monitoring such mini-hierarchies are less likely to indulge in moral hazard, which further reduces the size of internal hierarchy the organization needs to monitor the monitors.

We examine this theory in the domain of franchising. Franchisees usually have incentives to free ride on joint inputs because of spillover effects (Brickley 1999). If left uncontrolled, free riding can damage the value of the brand and hurt both the franchisees and the franchisor. To deter franchisees from free riding, a franchisor can employ monitors to observe their activities. However, because these employee monitors usually draw a substantial portion of their compensation as fixed salary, they have incentives to shirk and need to be monitored as well (Alchian and Demsetz 1972; Arrow 1985). Rather than controlling free riding among franchisees, such multiple layers of monitors disseminate moral hazard across the entire hierarchy

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of the organization, leading to distortion of information, slower decision making, and a cumulative loss of control. Hence, franchising provides an appropriate setting to study ways to reduce the size of internal hierarchies.

Using data on 3,436 observations from 713 franchisors between 1995 and 2005, we show that one way franchisors can reduce the size of their hierarchies is by adopting multi-unit franchising, that is, allocating multiple outlets to their franchisees. Specifically, we show that the franchisors are more likely to adopt multi-unit franchising when the conditions that require a large monitoring hierarchy escalate. By using multi-unit franchising a franchisor slices its monitoring hierarchy and substitutes lower-level employee monitors such as district managers with independent entities known as multi-unit franchisees. Multi-unit franchisees' compensation depends entirely on outlet performance, which makes them more motivated monitors compared with employee-monitors. Because of their stronger motivation they need relatively less monitoring than employee-monitors, which further reduces the hierarchy the franchisor needs.

This research contributes to marketing theory in two ways. First, it contributes to research in franchising by identifying four conditions—density of outlets, advertising fee, outlet size, and dispersion of markets—that influence a franchisor's decision to adopt multi-unit franchising. Although scholars have highlighted "the need to incorporate multi-unit franchising into franchise theory to answer the complexity surrounding modern franchising" (Kaufmann and Dant 1996, p. 356), this seemingly counterintuitive phenomenon remains a key question of interest (Blair and Lafontaine 2005). Second, this paper contributes to broader research in interorganizational relationships by demonstrating a governance structure that can help some organizations reduce the size of their internal hierarchies.

The phenomenon of multi-unit franchising

Franchising is a widely used channel for distributing goods and services when the intangibles play a critical role in delivery to the end customer.[1] Such goods and services include restaurants, food and nonfood products, lodging, automotive products and services, laundry and dry cleaning services, printing and graphics services, and maintenance services (Blair and Lafontaine 2005). A firm using own outlets to distribute such goods and services needs dedicated outlet managers to run the outlet operations and be the custodian of its brand. However, because the outlet managers are employees they usually have incentives to shirk (Arrow 1985).

To control shirking, the firm enters into a contract with a legally independent entity, a franchisee. The franchisee owns an outlet and operates it with the firm's (now franchisor) managerial and operational guidance. The franchisee typically pays a one-time franchise fee at the beginning of the contract period and royalties for the duration of the contract (Kaufmann and Dant 2001). The franchisee is the residual claimant and thus has less incentive to shirk compared with an employee outlet manager (Brickley and Dark 1987; Lafontaine 1992; Rubin 1978).[2]

Conventional wisdom suggests that to be a dedicated owner-operator, a franchisee be physically present to operate the outlet and monitor the outlet employees (Blair and Lafontaine 2005). Thus, franchisors should allocate only one outlet to each franchisee to own and operate; this phenomenon is known as single-unit franchising. Yet empirical evidence shows that more than half of the franchisors in North America allocate multiple outlets to their franchisees (Bond 2005; Johnson 2006; Wadsworth 2002); this phenomenon is known as multi-unit franchising.

Multi-unit franchising has several potential drawbacks. First, because a multi-unit franchisee cannot operate all the outlets on its own, it must hire outlet managers. Because these outlet managers are employees (of multi-unit franchisee), multi-unit franchising reintroduces the risk of shirking (Kaufmann and Dant 1996). Second, a franchisor may lose some degree of control over the outlets to multi-unit franchisees (Lowell 2007). Third, a franchisor may lose bargaining power relative to multi-unit franchisees (Kalnins and Lafontaine 2004). Fourth, ownership of multiple outlets within a market may reduce a multi-unit franchisee's incentive to behave as aggressively as single-unit franchisees might (McKee, Lovejoy, and Moran 2004).

A question thus arises: If multi-unit franchising has so many potential drawbacks, why is it still common? Economic theory suggests that only efficient organizational forms survive in a competitive environment (Anderson 1988; Hirshleifer 1985; Stigler 1958). Literature in population ecology echoes this perspective: organizations that match environmental needs are positively selected and survive, whereas others either fail or change to match those environmental needs (Aldrich 1979). What environmental needs does multi-unit franchising match, and under what conditions might multi-unit franchising be efficient? With some notable exceptions (Bercovitz 2004; Brickley 1999; Kalnins and Lafontaine 2004; Kaufmann and Dant 1996), the rationale for existence of multi-unit franchising still remains unanswered. We relate to the work done by these scholars as we develop our theory and methodology sections.

[1] Most franchising research is based on either resource constraints theory or agency theory. Resource constraints theory views franchising as a mechanism to ease financial and managerial constraints on system growth while agency theory views franchising as a mechanism to improve the incentive alignment between the firm and outlet operators. Scholars have proposed that the two theories are not necessarily contradictory—a firm needs to both attract resources and align incentives—and might work in concert to explain multi-unit franchising (Combs, Michael, and Castrogiovanni 2004; Kaufmann and Dant 1996). The theory of slicing the hierarchy proposed in this paper, however, is based on agency theory.

[2] Salaried managers may bear partial residual risk if their salary is linked to performance, but franchisees become residual claimants by paying a franchise fee and royalties. These explicit payments make franchisees residual claimants to a greater degree (Mathewson and Winter 1985). Compared with franchisees, salaried managers also are less likely to be concerned about future returns because they do not own the assets (Lutz 1995).