Franchising: Limited opportunism and cooperation

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Abstract

“Traditional” principal agent theory interprets franchising as a solution to the agency problems associated with incentives and observability. Franchising has been viewed as an institution that aligns the right to make decisions with the residual claims deriving from these decisions. One problem associated with this explanation, is that in institutions like franchise systems or firms, the relevant players or partners interact quite often. Therefore reciprocity plays an important role. The success of those institutions substantially hinges on their ability to strengthen the cooperative behavior of “insiders” and to keep out opportunistic “outsiders”, that destroy cooperation. While “traditional” principal agent theory has developed powerful models to explain theoretically various provisions of franchise contracts, there is a problem in explaining the non-use of opportunities for behaving opportunistically. This paper reviews some relevant empirical findings on the “underprovision” of opportunistic behavior in franchising, that are not compatible with a principal-agent explanation of this organizational form. These findings relate to rent leaving to franchisees, the stability of contractual provisions over time, reliance on royalties from sales and the parallel use of company owned outlets and franchises in one system (the so-called plural form).

To explain these discrepancies between the cooperative reality of a good franchise system and the design of franchise contracts (which is used to prevent opportunistic behavior), a “cooperative” interpretation of franchising as an organizational system is given. It is illustrated that the careful selection of franchisees enables a cooperative semiclosed entity in an opportunistic environment. Here cooperative behavior is enhanced by repeated interaction, reciprocity and the “right” incentives for investment in implicit knowledge.
Franchising: Limited opportunism and cooperation

A. Introduction

The organizational form of franchising has received much attention as a hybrid governance arrangement (see Rajan, R./Zingales, L. (2000)). “Traditional” principal agent theory interprets franchising as a solution to the agency problems associated with incentives and observability (see Posselt, T. (1999)). Franchising has been viewed as an institution that aligns the right to make decisions with the residual claims deriving from these decisions. Thus “traditional” principal agent theory maintains that hard incentives are needed to overcome agency problems in a world full of opportunists.

One problem associated with this explanation, is that in institutions like franchise systems or firms, the relevant players or partners interact quite often. Therefore reciprocity plays an important role (see Fehr, E./Klein, A./Schmidt, K.M. (2001); Frey, B.S./Frost, J./Osterloh, M. (1999)). The success of those institutions substantially hinges on their ability to strengthen the cooperative behavior of “insiders” and to keep out opportunistic “outsiders”, that destroy cooperation (Frey, B.S./Frost, J./Osterloh, M. (1999) and Gächter, S./Falk, A. (2000)).

While “traditional” principal agent theory has developed powerful models to explain theoretically various provisions of franchise contracts, there is a problem in explaining the non-use of opportunities for behaving opportunistically. Firstly this paper reviews some relevant empirical findings on the “underprovision” of opportunistic behavior in franchising, that are not compatible with a principal-agent explanation of this organizational form. These findings relate to rent leaving to franchisees, the stability of contractual provisions over time, reliance on royalties from sales and the parallel use of company owned outlets and franchises in one system (the so-called plural form).

Secondly, some dynamic aspects/questions of the management of both franchises and company-owned outlets, that can not be adequately treated in a static contractual analysis, are analysed in this paper. Lastly, some aspects of explaining the incongruence between contractual design and empirical findings, are discussed. By the same token, there is an explanation as to why
theses previously mentioned empirical findings can only be fully understood when the ideal of unlimited opportunism, especially on the agent’s side, is dropped and franchising is interpreted in the light of cooperation. The paper is organized as follows. The next section briefly describes an advanced principal-agent explanation of franchising using double-sided hazard. The second section describes the empirical findings that are not fully compatible with a traditional principal agent approach. The final section provides some theoretical explanations of the empirical findings and some conclusions are drawn.

B. The contractual design from a principal agent perspective

Producers have several options with respect to the right distribution channels. They could use a chain of company-owned outlets or a completely franchised system. The following model assumes double-sided moral hazard in the case of a single principal-agent pair. Thus both the work effort and necessary cure by outlet managers or franchisees and of the franchisor are considered.

\[ U = g(a, A) + \varepsilon \]

It is assumed that the “production function” contains two factors, that influence the total revenue \( U \), namely the efforts of the franchisor \( A \) and those of franchisee \( a \). A random term \( \varepsilon \) with mean zero and variance … is assumed to be unobservable by the two contracting parties, also both effort levels are assumed to be unobservable. The efforts of franchisee and franchisor increase \( U \) with

\[ \frac{\partial g}{\partial a} > 0, \frac{\partial g}{\partial A} > 0 \quad \text{and} \quad \frac{\partial^2 g}{\partial a^2} < 0, \frac{\partial^2 g}{\partial A^2} < 0 \]

Maximizing franchisor’s profit leads to

\[ \Pi^{FG} = f \cdot g(a, A) + F - C^{FG}(A) \]

with \( f(F) \) representing the royalty (fixed) fee.

The restriction that the franchisee’s share is high enough to guarantee his reservation profit is given by:

\[ \Pi^{FN} = (1 - f) \cdot g(a^*, A^*) - F - C^{FN}(a^*) \geq \Pi_0^{FN} \]

The optimum is characterized by marginal cost equalling marginal revenue:
The franchisee’s participation constraint is thus just satisfied, when (4) holds as an equation (The argument contained in (Bhattcharyya, F.S./Lafontaine, F. (1995)), that rents could be allowed in such a framework, is not convincing, given that the framework explains clearly, why rent leaving would be suboptimal). In other words: the franchisor would just increase F without altering the sales efforts of the franchisee. A closer inspection of the optimal contract requires a production technology selected for this purpose.

Therefore it is further assumed that this technology of joint effort and production should have the Cobb-Douglas form:

\[
g(a, A) = K \cdot a^\gamma \cdot A^\alpha
\]

where \(\gamma\) and \(\alpha\) characterize the revenue-elasticities of the effort for the franchisee and the franchisor respectively. \(K\) represents a scale parameter of the revenue potential in the market.

The cost functions for the franchisor and the franchisee respectively are given by:

\[
C^{FG}(A) = \frac{A^n}{n} \text{ with } n \geq 1 \quad \text{and} \quad C^{FN}(a) = \frac{a^m}{m} \text{ with } m \geq 1
\]

The elasticities \(m\) and \(n\) represent the cost incurred in marginal effort by the individual for franchisee and franchisor.

Solving the above program yields to the optimal share parameters for royalty on sales:

\[
f^* = \left[1 + \frac{\gamma(n-a)}{\alpha(m-\gamma)}\right]^{-1}
\]

In other words: The optimal royalty fee is only a function of the exponents in the production function and is independent of the scale of the market asf. .

From (9) it follows that \(f^*\) should be identical for all franchisees with the same qualification and willingness to apply effort. We should expect the participatory constraint eq. (4) to be binding , i.e. no rent leaving to the
franchisees, because this would both decrease the franchisor`s profit and it wouldn’t alter the sales effort of the franchisee, when $F$ is increased.

Furthermore we should expect the franchise contracts to use the best available data, and to divide the gains between franchisor and franchisee. Given that several franchising systems freely exchange accounting data between franchisee and franchisor, the systems can be expected to use profit-and-loss data for the franchise contract (see Laffont, J.J./Tirole, J. (1993); Fehr, E./Klein, A./Schmidt, K.M. (2000)). Assuming that different franchisees exhibit both different qualifications and different attitudes to work, we would expect many customized contracts with different contractual provisions (see eq. (9)). Lastly, we should observe only one contractual solution in a chain, which – depending on the kind of moral hazard problem – could be either hierarchical (company owned outlets), market form (licences) or a hybrid form (franchising) (see Lafontaine, F./Slade, M. (1998)). The empirical findings from these propositions are presented in next section.

C. Contractual design and empirical findings

C.I. Rents

A principal pays rent to an agent when he pays him or her an amount larger than the minimum necessary to keep the agent in the contract. Assuming a competitive market for employees, neoclassical considerations would suggest that employees should receive a payment equal to the value of their marginal product. Thus, also assuming that the market for franchisees is competitive, their income should be approximately as high as the income of a store manager plus the compensation for capital used. In a competitive environment, a franchisor should have no incentive to increase the residual profit of the franchisee by deviating from this payment which would satisfy the participation constraint of the franchisee (see eq. (4)). This condition should hold, because this increase would not alter the sales effort of the franchisees. So in effect, we should expect and find an incentive for franchisors to extract the maximum economic rent from their franchisees.
It is quite remarkable that one of the obviously best managed franchise systems in the world, leaves both ex post and ex ante rents for its franchisee. *Ex ante* rents are defined as rents that franchisees can expect to realize (under certain assumptions about the distribution of sales etc.) before they sign the franchise contract (*Kaufman, P.J./Lafontaine, F.* (1994a)). This rent stream can, for example, be measured as the difference in net present value between the expected income within and outside a chain (see *Kaufman, P.J./Lafontaine, F.* (1994a), S. 419ff). By contrast, ex post rents can or could be obtained by franchisees, that are already operating one or more outlets actively.

Ex post rents that reflect the same difference, can take the form (in the case of Mc Donald’s) of the difference between high market prices and the (a low) subsidized purchase prices of another Mc Donald’s restaurant franchise. The evidence of rent leaving in well managed franchise systems is overwhelming (see *Michael, S.C./Moore, H.J.* (1995), *Lafontaine, F., Kaufman, P.J.* (1994)).

One suggested explanation for rent leaving for franchisees, is that it improves the selection process of the franchise systems (*Posselt, T.* (1999), S. 353). But the above-used definitions of ex ante and ex post rents seem to exclude the interpretation, that more rent can be earned, the better the applicants who become franchisees. Au contraire: When there are large lists of applicants who wish to become, say a Mc Donald’s franchisee (acceptance rate is only around 2 %), then we should expect a lower rent to be offered officially, the better the applicants. Or, in other words: when the going gets tough, the tough get going. For franchising in particular, this argument should hold (see C.II.) because of the royalties on sales that constitute the variable payments of franchisees to franchisors. It is this provision that enables better franchisees to extract more rent from the operation of an outlet, than not-so-good franchisees, via higher operational efficiency (cost reduction), which in effect, enables them to achieve higher economic rent. One empirical illustration in this respect (see *Lafontaine/Kaufman (1994)*), is the bias of franchise systems such as Mc Donald’s, in favor of accepting individuals with the right qualification and mindset, even if they face capital constraints. Many wealthy individuals are often rejected, because they are unwilling to stick to the principle of being an owner-operator.
By posting a high bond or paying a large fixed fee, this class of wealthy individual, would allow Mc Donald’s and other franchisors to extract economic rent from the franchisee.

By deliberately foregoing this rent extraction and offering both ex ante and ex post rents to franchisee chains like MC Donald’s, franchisors commit credibly to developing the entire system in cooperation with the franchisee. In effect, this particular empirical finding, seems to convey two messages: Firstly for the system the selection process functions as a social filter that attracts highly motivated franchisees.

Secondly, the system offers ex post rents at least to above-average franchisees, that by definition, have acted cooperatively for some years (Kaufman, P.J./Lafontaine, F. (1994a)).

C.II. Royalties on sales

In return for the periodic services such as marketing, inspection, providing access to the trademark provided by the franchisor, the franchisee pays a royalty on sales (typically between 1% and 10%). This fee generally characterizes this organizational form. Traditional arguments for using sales instead of profit as a measure for this fee, include differential problems of observability. The idea is that sales are measured more easily than profits, because the latter can be diminished by cost padding etc. (see Lafontaine, F./Slade, M. (1998), S. 36ff). Contrary to this hypothetical observation problem, several franchise systems do in fact freely exchange accounting data between franchisee and franchisor. Also, the franchisor is generally well informed in detail about the franchisee’s cost structure. This information relates to the sales of products manufactured for the franchisee, monitoring sales processes and the operation of company owned outlets. All in all: most relevant economic variables are completely known to the franchisor.

Therefore, in effect, it can be concluded that switching from sales to profit data should not pose much of a problem.
This change would be very much in line with the informativeness principle of principal agent theory, which states that all verifiable information should be used in contracts (see Laffont, J.J./Tirole, J. (1993)).

A cooperative interpretation of the royalty on sales provision, seems to be more helpful, given that is the effort of the franchisee to increase local demand, Their costs can also be changed according to the franchisee’s effort. So in that respect, it could make economic sense to allow the franchisee to be the residual claimant of its own cost reductions. In return franchisors acquire their share of the economic measures they themselves influence, by maintaining the value of the trademark, advertising etc.. Being dependent on sales is equivalent to enforcing an interest of the franchisor in maintaining a strong brand. The interpretation corresponds to a share of the royalty fee, according to the efforts of both franchisor and franchisee. In that respect, cooperative aspects of the fee structure seem to outweigh the aspect of solving or eliminating the moral hazard problem.

C.III. Contractual provisions and contract terms

In chapter B it was explained, that homogenous local markets with equally qualified franchisees, imply the same share parameter for royalty on sales. However, when talking about different franchisees which have different qualifications and abilities, we should expect lots of different contracts with a high degree of customization. Also, during the life cycle of a franchise system, we should expect contract terms (royalty rates, fixed fees, advertising fees asf.) to adjust optimally to according to the model presented in B. Lastly, we should expect to see the fixed fee and the royalty to be negatively correlated, so as to extract the rent from the franchisee (see C.I.). This negative correlation should manifest itself over time.

Contrary to the notions of principal agent theory of customized contracts, the empirical literature finds enormous stability in contract terms (see Lafontaine, F. (1992), S. 268; Lafontaine, F./Slade, M. (1998), S. 35). This stability holds both for the evolution of contracts within the lifecycle of a franchise system
and for different franchisees (see Lafontaine, F./Slade, M. (1998), S. 30). These findings are remarkable in the age of steadily improving IT-Systems, which at the same time decrease the costs of customization and reduce observation problems. When CRM is used in mass markets and – as has been mentioned before - accounting data is exchanged freely between franchisee and franchisor, it is the lack of customized franchise contracts that is surprising (Holmström, B./Milgrom, P. and Holmström, B./Milgrom, P. (1987); Lafontaine, F. (1992b); Lafontaine, F./Slade, M. (1998), S. 35).

A cooperative interpretation hinges on a “cost-benefit” analysis of the uniformity and stability of contract terms. Opportunistic behavior by franchisor, becomes very high when he changes contract terms frequently and drastically. These changes, that may occur because franchisors try to extract rent from franchisees post contractually, could easily be observed by interested outsiders, e.g. potential new franchisees. On the negative side a credible commitment by the franchisor to behave cooperatively, can involve high costs of foregone flexibility. But overall, such a behavior helps franchisors to attract cooperative franchisees, by signalling credibly, their own cooperative behavior.

C.IV. company-owned outlets and franchises in one franchise system

The simultaneous use of company-owned outlets and franchises in one franchise system, contradicts the expectation expressed in principal agent theory, of one optimal contractual form. That is, one solution to the specific problems posed is used throughout the system. If it were the other way round, we would see diverse solutions for a multitude of problems. This would lead to an “anything goes” approach, because we would be tempted to think that every institutional form we observe, should be an efficient organizational solution to (ex post) a clearly defined problem. But this does need not to be the case, given that there are many institutions that, because of their inefficiency are superseded by others. What we would not expect at all, is the simultaneous use of two organisational forms, that have to be managed by a central unit (see Lafontaine, F./Slade, M. (1998)). Given that this central unit has to manage the complexity of two entirely different organisational forms, it cannot achieve the cost savings from “organizational” economies of scale, that principal agent
theory proposes. Following principal-agent-theory, the ratio of franchises to company owned outlets should rise continually during the life cycle of a franchise system (Lafontaine, F./Kaufman, P.J. (1994)), because the franchise contract provides more effective incentives than conventional employment contracts and the franchisor becomes better and better in managing the franchisees.

An explanation of this apparently expensive complexity of the plural form, must firstly, consider the challenges that a franchise system faces. As Bradach, J.L. (1997): 276 ff) pointed out, there are two major challenges in a competitive environment: the system has to adapt both to new threats and opportunities and to maintain uniform standards throughout all outlets. The first challenge relates to the motivation and incentives to generate and experiment with new ideas. This implies the responsiveness of the business unit to (local) market needs. In this respect, it will be the franchisee side of the system that is confronted with this challenge. The second challenge relates to adherence to standards-control and (in a sense) bureaucracy. Thus, it will be the company-owned side of the chain, that has to tackle this challenge, even given that the franchise side cannot be managed by “force”, but by arguments and persuasion (Bradach, J.L. (1997)). In other words: while the chain provides a system perspective, the franchise units add the local market perspective. It is the balance of these two, that determines the success of a chain. How it can be accomplished is analyzed next.

D. Requirements for franchisees and the real use of opportunities for opportunistic behavior.

Thus far this paper has demonstrated the inconsistency of contractual design in relation to empirical evidence on the potential for opportunistic behavior. Some indications have been given, as to why the “ideal” of unlimited opportunism on the part of agents, must be rejected as an explanation of the empirical evidence. By the same token, franchising can only be better understood, when viewed in the light of cooperative arguments. The following
paragraphs contain some specific requirements from a good franchisor, and then an interpretation of the real use of contractual provisions by franchisors.

I. Long-term Requirements from good franchisors

In order to achieve their business objectives, franchisor must to fulfil two basic conditions:

(1) The selection of qualified and cooperative franchisee
(2) The Development and standardised systemwide application of innovations.

To attract cooperative and highly qualified franchisee, franchisors themselves, must act cooperatively (Gallini, N.T./Lutz, N.A. (1992); Michael, S.C. (2000), S. 298). Some credible signals of cooperative franchisor’s behavior are rent leaving, no opportunistic change of contractual conditions after franchisees have signed the franchise agreement and allowing franchisees to reap the benefits of cost reductions (via the royalty on sales). These empirical findings are not entirely consistent with a theoretical perspective that stresses strict usurping of utility, using all available information in contracts and the contractual solution of all problems of opportunism problems. From the perspective of potential franchisees, the offerings of the franchisor must be public knowledge and open to scrutiny. Accepting the offering requires “goodwill” on both sides. In the case of McDonald’s, there are two valuations of applicants. In the first valuation to become a franchisee, one has to fight in a tough battle to succeed in being amongst the 2% of accepted franchisees. (Being accepted implies the opportunity to obtain ex ante rents). The second valuation, which occurs while after becoming a member of the franchising system, offers the “subsidized” purchase of further franchises, implying the potential to realize expost rents. The high costs that successful franchise systems incur, demonstrate the relevance of cooperative behavior.

A complementary aspect of the cooperative aspects of franchising, lies in the use of the plural form of distribution. From the perspective of the firm or
parent organisation, it is both the development of and the standardised systemwide application of innovation that counts. To achieve these objectives, a combination of local entrepreneurial perspective which is highly responsive to market needs, and of an effective centralised administrative approach is needed (Bradach, J.L. (1997)). The cooperative component of the plural form, lies in the pilot testing of innovations in company-owned outlets alone. Only approved (and thus successful) innovations, find their way to the franchises. Also, the career paths of managers over time, strengthen the communication between the different distribution channels of the system. Last but not least, measuring franchisees success is important. Successful systems require franchisees to be only as good as, but not better than, comparable company-owned outlets with respect to the most relevant success indicators and ratios (see Böckenhold, I./Wiens, R. (2001)). Bearing in mind that franchises usually outperform their company-owned counterparts, this benchmarking provides another opportunity for franchisee to extract some economic rent (Bradach, J.L. (1997), S. 290; Kaufman, P.J./Lafontaine, F. (1994a), S. 447 and Böckenhold, I./Wiens, R. (2001)).

II. The real use of potential for opportunistic behavior in franchise systems: an interpretation

So far the theoretical analysis has focussed mostly on the contractual design of a franchise system. Helpful as this perspective is, it limits the analysis very much to issues solving of opportunism problems. In successful institutions, such as successful franchise systems, both contractual parties have to commit credibly to the long term guarantee of standards, quality, application of innovations etc. Therefore, a purely rational calculation of rewards and sanctions (as specified in contracts) is not particularly helpful for the day-to-day functioning of the institution. Hagstrom (1965) formulated this dilemma very clearly: ‘citizens who refrain from treason merely because it is against the law, are, by that fact, of questionable loyalty, parents, who refrain from incest merely because of fear of community reaction, are, by that fact, unfit for parenthood’.
The objectives of a franchise system defined above, are pursued in an economic environment that is characterized by economic actors who are opportunistic (see Albach, H. (1980) and Boyer, R./Orléans, A. (1992), S. 175). Thus, one basic requirement for reaching the objectives, is to select the cooperative actors from this environment. To do so, implies establishing a cooperative semiclosed entity (Boyer, R./Orléans, A. (1992)). For franchise systems, targeting cooperative and fair franchisees, is therefore a major task. After finally signing the franchise contract, the distribution of information between franchisee and franchisor becomes “symmetric”, with the potential for franchisees to achieve revenue/sales objectives.

The franchisor can use different means of selecting or screening franchisees. One of these is to use social filters to secure the compability of franchisee and franchise system. Another measure is to offer the franchisee the opportunity to earn a future rent stream that clearly exceeds the expected gain from post-contractual opportunistic behavior. After having solved the problem of selecting cooperative franchisee the opportunism problem in a franchise system should decline, as compared to a less homogenous environment.

A franchisee satisfaction analysis (Schlüter (2001)) has confirmed the relevance of a good selection process. The relevance of franchisor fairness, namely those who do not abuse their power in cases of negotiation, was observed. This also can coexist with comparatively small satisfaction values relating to the business services offered by the franchisor. It has demonstrated that the franchisee satisfaction increases with a perceived sense of partnership between franchisor and franchisee in the franchise system. It also has shown that the satisfaction with work (e.g. for the components independence, responsibility, social interaction) has a high impact on satisfaction values. High values may accompany (ultimately) smaller expected franchisee income, compared to outside employment options.

One interpretation of these results is the prominence of cooperative elements of the partnership that seem to dominate the “strict” use of all available latitude for opportunistic manouvoring. The organization type Franchising can structurally be interpreted as a combination of the incentive mechanisms
reciprocity and repeated interaction. Repeated interactions usually provide the necessary incentives for cooperative behavior, given that opportunistic behavior in a previous period can be sanctioned by the contractual partner in a subsequent period. (For franchise systems it holds that franchisors can terminate the contract in exchange for “deviant” behavior). Reciprocity, that means the positive reinforcement of cooperative behavior, in a sense serves as the environment in which repeated interaction can lead to long-term cooperative behavior.

“Classical” principal-agent-models accentuate the “hard” marginal incentives (and sanctions) of work effort, implying that shirking and cheating can be reduced. Those theoretical models can illustrate very effectively the functioning of poor franchise systems. As has been pointed out, good franchise systems ensure that the cooperative mode is self-enforcing in the long run. This also implies the need for further “soft” control mechanics like rules and norms. Facilitating rent leaving is at the heart of our analysis of franchising, because it combines hard economic incentives with intrinsically-motivated willingness to cooperate.

The focus of this paper is on the long-term survival of the cooperative semiclosed entity, which is accompanied by weaker short-term incentives, not on defences against the danger of opportunistic behavior in a franchise system. As cited, franchising has been often viewed as a solution to an agency problem, because franchisees have hard incentives to make an effort and to bear risk. Our more cooperative interpretation of franchising is, also supported empirically by experiments that have shown for different constellations, that contracts using softer mechanisms like reciprocity and repeated interactions, can outperform harder “incentive” contracts in an environment with at least some fair players (see Axelrod (1984): 21 and 28, Gächter, S./Falk, A. (2000); see also Frey, B.S./Frost, J./Osterloh, M. (1999) and Boyer, R./Orleans, A. (1992): 173ff.).

This paper has confronted the arguments of principal agent theory with empirical results on franchising. Thereby, an interpretation has been developed which views franchising as a structural combination of the two incentive
mechanisms of reciprocity and repeated interactions. This interpretation refers
mainly to the contractual framework in which real franchise systems function
in reality.
The cited empirical findings, can be viewed from outside the system by
potential franchisee and other external observers. They can, therefore, be
viewed as an intermediate phase between the contractual design and day-to-day
functioning of a franchise system. To ensure the working of the system the use
and exchange of implicit, that is, non-tradeable knowledge can be of utmost
importance. This will be the case particularly when the successful development
of a franchise system depends very much on the working of innovation
processes, relies on the maintenance of a strong (inter-)national brandname and
requires frequent and detailed exchange of information between the outlets
and the headquarters. For all cases where implicit knowledge is a relevant
requirement (a condition sine qua non) for the success of franchise systems, they
must solve the problem of the underprovision of this production factor. Bohnet,
exchange of knowledge requires motivation. Explicit knowledge, which by
definition is tradeable, will be exchanged in appropriate quantities when there
is extrinsic motivation, pecuniary rewards for instance. By contrast, the
exchange of intrinsic knowledge requires an entirely different motivational
repertoire. Given that implicit knowledge cannot be sold in markets, its
accumulation requires that a person does it for its own sake. In other words,
the accumulation of implicit knowledge, which gains economic significance
only in exchange with others, does not lead to any apparent reward beyond the
activity itself. The production and exchange of implicit knowledge can even be
hindered by extrinsic motivation. This is true, because pecuniary rewards for
example, for particular behavior restrict the opportunity set of individuals.
Therefore these individuals are then deprived from “investing” in implicit
knowledge, because of intrinsic motivation (Bohnet, I./Frey, B.S. (1997) and
Frey, B.S./Frost, J./Osterloh, M. (1999)). It is only with an unrestricted
opportunity set, that individuals feel free to engage in exchanges also of
implicit knowledge as well. By definition: the more this exchange becomes
relevant for the success and the long-term development of a franchise system,
the more important intrinsic motivation becomes. This can take the form of
team spirit, esprit de corps, a sense of mutual identity and so on (see Schlüter, H. (2000) and (2001)).

The form of cooperation described above, is embedded in an environment which can, through changing opportunity costs, necessitate the conversion of franchises into company-owned outlets. The cited costs and efficiency advantages of franchises compared with company-owned outlets, are an economic precondition for rent leaving (to achieve economic rent). Changing opportunity costs (for example better IT-systems that make the operation of own outlets more profitable) can convert the above-mentioned advantages into disadvantages. When there is no further potential for the generation of rent the conversion of the system can be accomplished marginally by new company owned outlets, either when franchise system expands or by conversion (“buy back”) of all existing franchises. The cooperative, semi-closed entity franchising will only grow when its cost advantages allow franchisees residual rents. It will shrink, decline or disappear when changing opportunity costs render own outlets more advantageous. The interpretation presented here, reflects the dialectics between opportunity costs and opportunism outside, and cooperation inside the franchise system.
References


