Delegation and Real Authority in Franchise Chains[1]

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Abstract

This paper investigates the level of delegation in franchise chains, distinguishing the two most relevant franchising models: Business Format Franchising and Learning Network Franchising. The two models basically differ on the level of real authority (effective control over decisions) exercised by the franchisors. Differences in business features, such as the required standardization, monitoring costs and consumer sensitivity to variations in product attributes (consumer measurement costs), explain the adoption of the different models of franchising. These variables affect the trade-off between the risk of brand name loss and the gains in knowledge sharing and learning within the network. The higher the need for standardization, the higher is the risk of brand name loss, and, consequently, the more likely the franchisor will be to adopt an organizational design that confers more control over franchisees' decisions, such as business format franchising. This paper presents two case studies with Brazilian food franchise chains that illustrate the main argument and suggest additional propositions. Moreover, an empirical analysis of 223 franchise chains provides additional support to the hypothesis of a negative effect of required standardization on the level of delegation.

Key words: *franchising, real authority, hybrid forms, delegation, Learning Network Franchising*

1. Introduction

Delegation of authority is a fundamental feature of organizational design. Although the literature generally addresses the issue of delegation within a hierarchy, it is also an essential subject for characterizing hybrid forms in general, and franchising in particular. Hybrid forms preserve the autonomy of each participant, but typically allocate several decision rights in order to promote

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cooperative behaviour and to attenuate transaction hazards (Menard, 2002; Williamson, 1996). Some of the decision rights are the primary subject of a transaction – for instance, a franchise contract allocates to franchisees the right to use the franchisor's brand name under certain restrictions –, whereas other decision rights are allocated in order to mitigate the hazards that a transaction is subject to – for example, the franchisor has the right to inspect the outlet without any notice. This is the issue of allocation of formal authority or, to use Barzel's terminology, legal property rights. Besides allocating formal rights by means of a contract, the parties choose how much effort they want to spend in monitoring and measuring information, which is relevant in determining the effectiveness of their formal rights. This is the issue of allocation of real authority (Aghion and Tirole, 1997) or economic property rights (Barzel, 1997). In this paper we will investigate the determinants of the allocation of formal and real authority in franchise chains, which is the main variable that distinguishes the two most relevant franchising models: Business Format Franchising and Learning Network Franchising.

The paper is organized as follows. Section 2 presents the basic argument to explain the allocation of formal and real authority in franchise chains – which is the main variable that defines what is commonly known as 'franchising generations'. Section 3 provides two case studies that illustrate the main argument and also suggests additional propositions. In Section 4, we test these propositions with a sample of 223 franchise chains. Section 5 then concludes with a discussion of possible extensions of the main findings.

2. Formal and real authority in franchise chains

A franchise is a contract whereby a franchisor assigns to franchisees the right to produce or sell branded products or services. In return, the franchisee pays fixed or variable fees, or contributes with other assets. In such arrangements, the parties explore the mutual benefit of sharing intangible and non-depletable assets – brand name, business practices and specific local knowledge – while preserving autonomy. As cooperative behavior is not spontaneous, the parties allocate other decision rights so as to attenuate the hazards associated with this type of transaction, particularly the potential cost of brand name misuse.

A brand name has value because it transmits reliable and relevant information that would otherwise be costly to acquire (Barzel, 1982). Insofar as a brand name's value depends on its capacity to transmit information, the experience of consuming a product with characteristics differing from those transmitted by the brand name voids the latter's capacity to inform, and therefore partially reduces its value.

In order to preserve brand name value, a franchise chain must maintain uniformity across units (Caves and Murphy, 1976; Rubin, 1978). This should be the goal not only for product offerings, but also for building design, ambience, service, and price. These features extend the role of franchisees in preserving or enhancing brand name value, sometimes leading to incentive problems in brand name use and in local marketing efforts. In other words, since local effort has strong externality on other units in the company, individual units tend to under-provide it (Bai and Tao, 2000; Lafontaine and Raynaud, 2002).

These potential hazards regarding brand name misuse affect the design of franchise contracts in several ways. For example, Lafontaine and Raynaud (2002) explore complementarities of contract features, especially between residual claims and self-enforcement mechanisms to promote better incentive alignment between franchisees and franchisors. We explore the effect of the same transaction hazard on the allocation of formal and real authority in franchise chains.

We borrow from Aghion and Tirole (1997) the meaning of formal authority ('the right to decide') and real authority ('the effective control over decisions'). In their model, a principal contracts an agent to perform some task (the selection of projects that may be implemented by both). The separation of formal and real authority derives from asymmetric costs in collecting information about the quality of each project. If the principal delegates to the agent the right to choose a project, she will make more effort collecting information about the projects, thus saving on information costs that would be incurred by the principal. On the other hand, the agent is likely to choose a project that would not be the principal's choice. Based on this trade-off, the principal decides its own effort in acquiring information and, as a consequence, determines the allocation of real authority to the agent.

This basic idea is similar to the one presented in Barzel (1997) distinguishing legal and economic property rights. The former is the state or formal arrangement assigned to an economic entity. The latter is "the individual ability, in expected terms, to consume a good or the service of the asset [over which he has property rights] directly or to consume it indirectly through exchange" (Barzel, 1997, 3). The asymmetric costs of measuring information and enforcing legal property rights are the main variables that separate legal and economic rights.

The organizational design of a franchising may vary in several ways with respect to the allocation of authority. The franchisee's manual may prescribe very detailed tasks that must be performed in each outlet, formally allocating the decision rights on those tasks to the franchisor.

In addition, franchisors generally operate both franchised and company-owned outlets. The franchisor will retain more formal authority as the proportion of company-owned outlets increases, given that she will maintain full possession of legal rights in vertically integrated outlets. Moreover, the proportion of company-owned outlets is also likely to affect the level of real authority for a given level of formal authority. With the operation of its own units, the franchisor collects information and learns about the franchisees' environment, increasing her ability to have 'effective control over decisions'. Finally, monitoring intensity also varies among franchise chains, leading to different levels of real authority for a given formal allocation of rights.

The risk of brand name loss, as developed elsewhere (Azevedo et al., 2002), depends on consumer sensibility to variations in quality standards and the effect of the franchisee's actions on product attributes. We expect that the higher the brand name value and the risk of not meeting consumers' expectations (risk of brand name loss), the lower will be the allocation of authority to franchisees, both formal and real, because more control over decisions will be needed to achieve the required standardization across outlets.

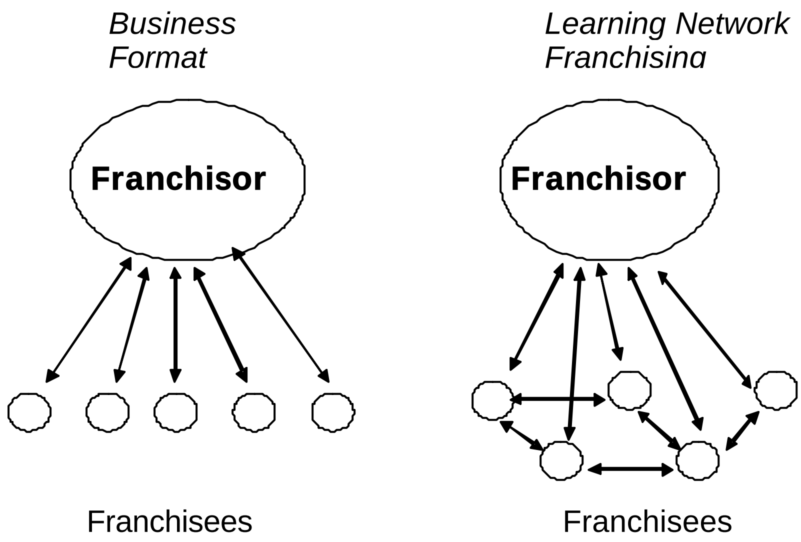
In contrast, if the franchisor retains too much authority, franchisees may lack incentives for the appropriate use of local specific knowledge. The more real authority a franchisee has, the more incentives she will have to innovate. This innovation is likely to be biased towards the franchisee's own interests, but nevertheless brings about savings in research costs that would otherwise be incurred by the franchisor. On the other hand, if innovation depends mainly on the franchisor's knowledge, too much delegation may harm its desirable dissemination throughout the chain. As a consequence, the higher the gains in knowledge sharing and learning within the network, the more likely it is that the franchise chain will allocate real authority to franchisees.

Franchising generations

Some franchising experts characterize four modes of franchising, which they call ‘generations’. Silva (2002) describes the four modes of organization as follows. 1) The 1st generation is a simple form of vertical restriction, in which the franchisor commits to supply products to distribution channels and transfers only the right to sell its products. 2) In the 2nd generation the franchisor also shares its brand name. 3) The 3rd generation (Business Format Franchising) is characterized not only by the right to use a brand name, but also a whole business concept, including routines and the provision of collective goods, such as training, promotion and research and development of new products and processes. 4) The 4th generation, besides transferring to franchisees the right to use the whole business format, also shares the rights and obligations to innovate among all participants in the franchise chain, hence the name Learning Network Franchising. Each ‘franchising generation’ is an ideal type, in Weberian terms, representing abstract features of real world arrangements.

The first two modes of organization may be better characterized as exclusive dealing and brand name licensing. Insofar as the contract assigns to franchisees only the right to use part of the business concept (brand name), it is not necessary for the franchisor to maintain control over tasks not directly related to this transaction. In contrast, in the last two modes of organization – Business Format Franchising and Learning Network Franchising – it is necessary to exert control over several tasks that are related to the business concept. The allocation of authority within the chain is the main variable that distinguishes the two latest ‘franchising generations’. Figure 1 represents both modes of organization, emphasizing how franchisors allocate real authority to franchisees, who may even have discretion to communicate and act directly with each other.

Figure 1: Delegation in Franchising Generations



In Business Format Franchising the franchisor holds a clear responsibility to provide a whole package (business format) to franchisees and, in order to preserve this intangible asset, maintain some decision rights over tasks performed by franchisees. In Learning Network Franchising the responsibility to innovate and, as a consequence, enhance the value of the business concept is shared among the participants of the chain. In order to provide incentives for the use of local knowledge, franchisors tend to allocate more authority, both formal and real, to franchisees. Next, we present two cases of fast food franchising that illustrate the two main 'franchising generations'.

3. Two representative cases: Vivenda do Camarão and China in Box

3.1. Vivenda do Camarão

Vivenda do Camarão, a Brazilian restaurant specialized in meals based on shrimps and other sea food in cream sauces, began its activities in 1984, with one unit in Moema, a fancy neighborhood in São Paulo. 7 years later it had three outlets in up-market areas and had just launched a fast food version of its restaurant in a high-class shopping center. The fast food operations required increasing formatting of its business practices, which created room for the franchising that started in 1991. In 2006 the chain had 37 company-owned and 18 franchised outlets, maintaining consistently in the late 6 years a proportion of 70% of company-owned outlets. The high proportion of vertically integrated outlets denotes a deep concern with control on outlets. In addition, company-owned outlets tend to be located near the headquarters, which is coherent with agency reasoning that firms use franchising in order to save monitoring costs (Rubin, 1978; Lafontaine & Shaw, 2001).

The company operates in high-income Brazilian regions (South and Southeast), as well as in Portugal. Consistent with its geographic distribution, Vivenda do Camarão explores manly the high-end market segment, vertically differentiating its products. Consumers tend to be highly sensitive to quality variations, implying higher required standardization. Moreover, consumers generally do not restrict themselves to the same outlet (network consumer), which increases the required standardization among outlets.

The franchisor retains formal and real authority over franchisees. The Franchisee's manual is highly detailed and the company centralizes several tasks of food processing, leaving only simple tasks to franchisees, such as heating a pre-cooked meal. The franchisor is solely responsible for product or process innovation, and there is no mechanism to disseminate know-how developed by franchisees. Finally, the company exercises real authority by making use of intense monitoring and of the information gathered in its own outlets.

The supply chain coordination is also designed to provide greater control over the standard of the final products, particularly those directly related to the brand name (Azevedo & Silva, 2003). The company vertically integrates shrimp production and has long-term contracts for the supply of skimmed milk, cheese, desserts and beverages. Inasmuch as shrimp supply is highly unstable, particularly at quality standards, Vivenda chose to raise them artificially in a farm located on the Northeastern seashore, thus saving on measurement costs. The problems foreseen in terms of learning how to raise shrimps and monitor this task were attenuated by means of a joint venture with a local producer.

Vegetables, in virtue of being highly perishable and not directly related to the brand name, are purchased in regional spot markets, though the franchisor prescribes the use of specific varieties subject to a lower variance in quality. Due to all these features, Vivenda do Camarão can be characterized as a straightforward Business Format Franchising.

3.2. China in Box

China in Box, as its name suggests, is a Brazilian franchise chain specialized in Chinese food delivery. Founded in 1992, the company began franchising in 1994. By 2006, the chain had 11 company-owned outlets and 104 franchised outlets. In comparison to Vivenda do Camarão, what stands out is the faster growth of China in Box and its more intense reliance on franchising, with a proportion of just 10% of company-owned outlets. It is noteworthy that this low proportion of company-owned outlets is stable and has been reached since the first year of China in Box in franchising.

The rapid growth is geographically spread, with outlets in all Brazilian regions and plans to expand to other Latin American countries. Apart from São Paulo state and the Mid-Western region, which are managed directly by the company, China in Box has master-franchisees in all other regions, which have several decision rights, such as the rights to select other franchisees and to decide monitoring intensity. With this type of arrangement, the franchisor delegates formal authority to master franchisees, which, in turn, decide monitoring intensity and, as a consequence, the distribution of real authority throughout the franchise chain.

When the chain reached more than 100 outlets, the board of franchisees decided to restrict the incorporation of new franchisees, committing themselves to opening any new outlets in Brazil where expansion opportunities were detected. Arguably, the greater the number of franchisees, the greater are the costs of coordinating franchisees that retain a considerable level of real authority.

Inasmuch as 95% of the outlets' revenue derives from delivery services, customers tend to be outlet specific, i.e., they only use the outlet in their neighborhood. As a consequence, the franchise chain is not subject to the same externality problem first observed by Rubin (1978). As quality standards mainly affect future clients of the same outlet, there is no incentive to under-provide quality. Moreover, quality standards may vary among outlets without risking brand name value. Since customers consume from the same outlet, their expectations about quality standards must be met in their neighborhood outlet alone.

This feature allows for the delegation of the rights to develop new products and services. Any innovation at outlet level is firstly tested in the neighborhood market and then submitted to the franchisor for validation and diffusion throughout the chain. Franchisees hold tacit and local specific knowledge about consumer behavior, which plays a complementary role to the knowledge of delivery services and packing centralized by the franchisor. Delegation of R&D decision rights provides the appropriate incentives for the use of dispersed and local specific knowledge held by franchisees. Moreover, as the franchisor maintains the decision rights to validate and disseminate innovations by local franchisees, the company ensures a minimum level of standardization and enlarges the gains from learning and innovation.

Consumers are medially sensitive to variation in product attributes, making innovation less costly in comparison to a highly sensitive consumer, as in the case of Vivenda. Consistently, China in Box explores more intensely the medium and low-income markets, with competitive prices.

Among the inputs for meal processing, meat is the one that requires great care, as there is huge quality variability in the spot market. In order to achieve minimum quality standards, the company contracts regular suppliers and distributes standardized packages of cut meat. Franchisees acquire other inputs for meal processing – such as pasta and vegetables – from a set of credited suppliers. A logistic unit, controlled by a franchisee's board, stores and distributes these inputs to each outlet. Products not directly related to brand name, such as rice and beverages, are bought directly by franchisees, who may count on the franchisor's technical support. Lastly, the input mainly related to the brand name – the delivery box – is directly controlled by the franchisor, which has an idiosyncratic contract with its sole supplier. In short, the company does not intensely control input quality standards, delegating quality control related tasks to franchisees. The noteworthy exception is the delivery box, which corroborates the argument that franchise chains are likely to exert greater control only in the supply of inputs directly related to the brand name (Azevedo and Silva, 2003). In addition, innovation in packing is probably less subject to gains from the aggregation of the franchisees' local knowledge.

China in Box clearly delegates more formal authority to franchisees than does Vivenda do Camarão. Nevertheless, the company exerts intense effort in measuring consumer satisfaction and the quality of its franchisees' services. It is noteworthy that the franchisor tries to measure information regarding the overall performance of franchisees as opposed to stipulating the observance of business practices established in the franchisee manual. Arguably this effort to gather information serves more to evaluate innovations that are locally tested (a horizontal coordination problem) than to increase the franchisor's real authority over the actions of franchisees. The delegation of key decision rights to franchisees, such as innovation, and the efforts to disseminate local innovations throughout the chain characterizes China in Box as a 4th generation franchising (Learning Network Franchising).

The differences between Vivenda do Camarão and China in Box are substantial. Table 1 summarizes the main features of each case, which, in broad figures, allows for the illustration of the two models of franchising: business format franchising and learning network franchising. Should Vivenda do Camarão delegate more decision rights to franchisees and, as a consequence, explore more deeply the locally specific knowledge? Or is China in Box risking its brand name value too much when it deliberately relinquishes some control over the actions of its franchisees?

Table 1

Vivenda do Camarão and China in Box: a comparative analysis

Variables	Vivenda do Camarão	China in Box
Required standardization	High consumer sensitivity Network consumer	Medium consumer sensitivity Outlet consumer
Upstream coordination	Vertical integration (shrimps) Contracting	Contracting and spot market (local suppliers) Long term contract (package)
Downstream coordination	Detailed franchisee's manual Centralized R&D Pre-cooked meals Intense monitoring	Less detailed franchisee's manual Dispersed R&D Monitoring: consumers' feedback
Proportion of Company-Owned Outlets	70%	10%
Mode of franchising	Business Format Franchising	Learning Network Franchising

We submit that both organizational designs are suitable to their particular business features and transaction attributes. Vivenda do Camarão faces higher risk of brand name loss because consumers are highly sensitive to variations in product attributes and may be clients of virtually any chain outlet. As a consequence, upholding brand name value requires keen standardization both in each outlet and among outlets. Several strategies employed by Vivenda are designed to deal with this difficult task: a) pre-cooked meals reduce the effect of franchisee behavior on the quality standards of final products (and hence decrease the risk of not meeting consumer expectations); b) all franchisees receive standardized inputs, particularly shrimps, which are artificially raised in its own farm; c) the chain makes use of an exceptionally high proportion of company-owned outlets given its franchising experience[3], making it less vulnerable to the incentives franchisees have to under-provide quality.

In contrast, China in Box may provide different products in each outlet without risking brand name value, insofar as customers tend to be outlet specific. In addition, consumers are not so sensitive to variation in quality standards. Actually, China in Box makes use of this feature to deeply explore its franchisees' local knowledge and to submit innovations to market tests before disseminating them to the whole chain.

It is noteworthy that China in Box, after reaching a certain size, interrupted the selection of new franchisees, giving new outlets to incumbent franchisees. There are two possible complementary explanations for this strategy. Firstly, the costs of coordinating agents who hold a relatively high level of decision rights is likely to increase with the number of agents, and the marginal benefit of exploring the local knowledge of an additional franchisee probably decreases as the chain gets larger. Secondly, granting incumbent franchisees the right to open new outlets increases the ongoing rent they expect to appropriate in their relationship with the franchisor. As this ongoing rent may be lost if the contract is terminated, it provides incentives for the franchisee to behave in accordance with the franchisor's interests (Klein, 1995). In the next section we will empirically examine some of the propositions illustrated in the experiences of Vivenda do Camarão and China in Box.

[3] Lafontaine and Shaw (2001) observed that in the U.S. and Canada franchise chains with more than 8 years of franchising experience tend to have a lower proportion of company-owned outlets. Pénard et al. (2003) and Azevedo & Silva (2002) found similar results for France and Brazil.

4. An empirical analysis: determinants of real authority in franchising

4.1 Data and procedures

The dataset contains information from an extensive survey on Brazilian franchising carried out by Editora Globo in 2004, covering 223 franchise chains. These dataset, although a cross-section, contains richer information in comparison to other available sources, thus allowing for an investigation into the level of delegation and real authority in franchising.

The dataset provides information about (a) the franchise chain as a whole, such as the number of company-owned and franchised outlets, geographic distribution, experience before franchising, years of franchising experience, and R&D expenditures; (b) franchisor characteristics, such as business sector and location of headquarters; (c) characteristics of franchised units, such as estimated revenue, number of employees, investments in installations, etc., and (d) contract features, such as franchise fees, royalties and other payments, support services offered, franchisee manual prescriptions, and monitoring intensity.

Although it seemed theoretically appealing, we decided not to include explanatory variables in the estimation that were part of current company strategies, such as contract length and franchisee fee. Such variables result from company decisions and, as a consequence, may be endogenous, causing problems for parameter estimation (Greene, 1997: 763). Since alternatives to correct for endogeneity generally make use of instrumental variables, which were not available in our sample, we used a reduced form of estimation, including only exogenous or pre-determined variables.

Dependent variable

The paper aims to investigate the determinants of allocation of formal and real authority in franchise chains, so the first step was to construct a proxy to represent the level of delegation. As anticipated in Section 2, we looked at variables that capture both the allocation of formal and real authority.

a) Tasks prescribed in the franchisee's manual. The more comprehensive are the tasks prescribed, the lower is the level of formal authority allocated to franchisees.

b) Proportion of company-owned outlets. The greater the proportion of company-owned outlets, i.e. vertical integration, the lower the formal authority allocated to franchisees in the whole chain. In addition, as vertical integration changes information structure (Riordan, 1990), the real authority, for a given formal distribution of decision rights, will be lower.

c) Monitoring intensity. The more frequently the franchisor inspects the franchised units (i.e. the more intense is the monitoring), the lower will be the real authority allocated to franchisees.

Departing from these three variables, we constructed a delegation index – with equal weight for each variable –, ranging from '0' (no delegation) to '1' (complete delegation)[4].

Explanatory variables

To identify the effects of brand name value, we used the experience before franchising, as do Lafontaine and Shaw (2001). This variable represents the learning process that constitutes a firm's capabilities and the reputation it has earned through experience. Since we expect the marginal gain from experience to be decreasing, we applied a natural log transformation for this variable.

This proxy represents just part of brand name value. It would be interesting to have other variables that measure consumer perception of each brand, but the dataset, although richer than former sources, does not contain this type of information. In order to capture the value of the business format (including product portfolio and business practices), we used franchisor investments in

[4] 'No delegation' and 'complete delegation' are imperfect expressions for the extreme values the index can reach. In fact, complete delegation means that there is no task prescribed in the franchisee's manual, no company-owned outlet and the franchisor visits the franchised units less than once every three months.

research and development. As this variable has a high correlation with chain size – another explanatory variable – we used the amount invested in R&D per outlet.

The required standardization depends not only on brand name value but also on how strong are the franchisee's incentives to under-provide quality. As illustrated in the Vivenda do Camarão and China in Box case studies, the required standardization is lower if customers tend to consume in/from the very same outlet (externality effect). In order to capture this effect, we create a dummy variable that separates activities that are typically consumed in the customer's neighborhood – such as hairdressing, house services, fitness, education and delivery services – as opposed to activities that customers may consume in virtually all chain units, such as food services, footwear, hotels, clothing etc. We expect this variable (1 for higher externality and 0 for neighborhood consumption) to decrease the level of delegation.

The externality effect also depends on the size of the company. The higher the number of units, the stronger the incentives for franchisees to under-provide quality, and hence the lower the level of delegation. This happens because in larger chains the difference between the private and the network benefit of meeting quality standards will be greater. The case studies also suggest that too many franchisees with discretion (high level of real authority) may increase coordination costs.

Companies with headquarters in Brazil probably choose a different level of observed delegation in comparison to foreign chains, which in general operate in Brazil by means of master-franchisees. As our delegation index measures the allocation of authority to outlets, we expect that franchisors with fewer decision rights (i.e., master-franchisees) will delegate less. We create a dummy variable (domestic) to capture this effect.

We also control for years of franchising experience, as older chains tend to operate a lower proportion of company-owned outlets (Lafontaine and Shaw, 2001; Penard et al., 2003). In addition, companies that have more years of experience tend to have older franchisees (information that we do not observe). As a consequence, they may develop trust and informal mechanisms of governance not captured in our delegation index. If this is true, it is another reason why franchisor experience has a positive effect on the level of delegation.

Geographic dispersion probably raises monitoring costs, and hence is likely to decrease monitoring intensity. We used information about the regions covered by the chain[5] to capture this effect.

The number of employees in each outlet may also affect the level of delegation because the franchisee may need more discretion to deal with the set of contracts within each outlet. As a result, we expect the number of employees to have a negative effect on the delegation index.

Finally, franchisee investments – measured by the amount paid to install the outlet – are likely to have a positive effect on the level of delegation. Firstly, a significant proportion of franchisee investment has no other use than in the franchising relationship, and is therefore specific.[6] As a specific investment, it plays the role of a 'hostage' (Williamson, 1983) in the transaction, credibly committing the franchisee in the contract (Klein and Leffler, 1981; Minkler and Park, 1994; Bai and Tao, 2000). Therefore, a higher level of specific investment implies a lower need for control, and hence a higher level of delegation. Secondly, a larger investment may imply a greater variety of tasks that the franchisee has to deal with[7], thus requiring more allocation of decision rights.

[5] The variable assumes three discrete values: the chain operates internationally and in either more or fewer than 4 states in Brazil.

[6] Minkler and Park (1994) consider that "the franchisor can require the franchisee to make specific investments (e.g., specific building format, fixtures and equipment), investments the franchisee will lose if he behaves opportunistically and is caught".

[7] E.g. compare a hotel versus an ice-cream outlet.

Regression results

Table 2 presents the results of four models with distinct specifications. As expected, three variables that measure the effect of the required standardization – experience before franchising, externality and number of outlets – have a robust and negative effect on the level of delegation. The experience before franchising is related to learning and reputation building, and, as a consequence, to brand name value. If brand name value is higher, the potential costs of delegation are greater, decreasing the allocation of authority to franchisees. Moreover, not only brand name, but also the risk of not meeting consumers' expectations (risk of brand name loss) has a negative effect on the level of delegation. The variable 'externality' is a dummy that separates franchise chains whose consumers purchase in virtually all chain outlets, and thus expresses the incentives franchisees have to under-provide quality. The same applies to the number of outlets. Nevertheless the investment in research and development per outlet does not have any effect on the level of delegation.

Table 2

Determinants of the delegation index[8]

Variables	Model 1	Model 2	Model 3	Model 4
Experience before franchising	-0,02966** ,009	-0,02898** ,009	-0,03132** ,009	-0,02943** ,009
Externalities: network consumer	-,159** ,024	-,120** ,023	-,104** ,024	-,108** ,024
Number of outlets	-0,00004** ,000	-0,00010** ,000	-0,00008** ,000	-0,00009** ,000
Domestic	,222** ,035	,238** ,032	,230** ,032	,237** ,024
Years of franchising experience		0,006168** ,002	0,004564** ,002	0,004677** ,002
Franchisee investment		-0,00512** ,001	-0,00708** ,001	-0,00706** ,001
No. of employees per outlet			0,003857** ,002	0,003751* ,002
Geographic dispersion				0,01858 ,023
R&D/outlet				0,000001 ,000
Constant	,509** ,038	,470** ,038	,473** ,038	,424** ,068
Regression information	R2 = ,324 F = 26,134	R2 = ,422 F = 26,258	R2 = ,437 F = 23,837	R2 = ,440 F = 18,559

** significant at 1%
* significant at 5%

A franchise having its headquarters in Brazil (domestic) leads to an average increase of approximately 0.2 on the delegation index. This means that Brazilian franchise chains allocate more authority to their franchisees than international companies. In our sample, what we identify as an international franchisor is, in general, a master-franchisee who has the rights to select and

[8] Weighted least square regression. The number of units in each chain provides the weight of each observation.

monitor local franchisees. It is interesting to note that they have less formal authority to delegate than a domestic franchisor, which probably constitutes the reason for this strong effect.

As expected, the years of franchising experience has a positive effect on the level of delegation. This may be due to its known effect on the proportion of company-owned outlets (Lafontaine and Shaw, 2001), which is part of our delegation index, or because trust is likely to emerge as franchisor and franchisee continue to interact (more trust, more delegation). In order to separate both effects, we also used monitoring intensity alone as a dependent variable. In this specification of the model, franchising experience was not significant, which supports the first argument.

Finally, there are two unexpected results (franchisee investment and geographic dispersion), the most intriguing being the negative and significant effect of franchisee investment, a point that certainly deserves further investigation[9].

5. Concluding remarks

Delegation of authority – a common issue in hierarchies – is also an essential component of the design of hybrid forms. In franchising, the level of delegation distinguishes the two most relevant franchising models: Business Format Franchising and Learning Network Franchising. The two models basically differ on the level of real authority (effective control over decisions) exercised by the franchisors. Differences in business features, such as the required standardization and monitoring costs and consumer sensitivity to variations in product attributes (consumer measurement costs), explain the adoption of the different modes of organization in franchising. These variables affect the trade-off between the risk of brand name loss and the gains in

[9] A possible explanation is that monitoring and codifying tasks in the franchisee manual has significant fixed costs, so as to make them more likely the larger the business franchised. As the amount of investment is a proxy for business size, it could have a positive effect on that type of control (and, as a consequence, a negative effect on

knowledge sharing and learning within the network. The higher the need for standardization, the higher is the risk of brand name loss, and, as a result, the more likely the franchisor will be to adopt an organizational design that confers less real authority on the franchisees, such as business format franchising. With a lower required standardization, the franchisor can explore the gains from knowledge sharing within the chain without risking the value of its brand name and business concept. As a consequence, designing a 'learning network' which shares intangible assets may be too costly if those assets require close coordination (e.g. required standardization), but may be profitable if local specific knowledge is the key-asset for innovation.

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