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**Franchising as power-biased
organizational change**

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Franchising as Power-Biased Organizational Change*

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Abstract

Economic theories of franchising tend to emphasize the efficiency-enhancing aspects of franchise contracts. By replacing salaried store managers with independent “franchisees” who are near-residual claimants on store output, franchising aligns the incentives of retail managers with brand owners. But efficiency explanations of franchising have failed to fully address the special nature of franchisee agents: franchisees are not production workers directly producing output incentivized by residual claimancy to eschew shirking. Rather franchisees are themselves managers of production workers. Incorporating this second level into the model and analyzing data from 530 franchise contracts, this paper shows that franchising is an example of power-biased organizational change. Through residual claimancy and contract terms that disempower both franchisees and workers, franchising motivates franchisees to exert high levels of effort at the task of monitoring and extracting labor effort from wage workers. In this second level principal-agent problem, franchisor power over franchisees and workers can increase profits without raising efficiency: rather than achieve more output per unit input, franchisors squeeze extra labor effort from the labor input. Franchise contracts represent a labor market strategy, despite franchisors not formally employing production workers

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Recent groundbreaking research by Krueger and Ashenfelter (2017) has highlighted how franchise corporations like McDonald's control labor costs at independent franchised establishments through the imposition of no-poaching agreements, which prohibit franchisees from hiring each other's workers. Krueger and Ashenfelter argue that these agreements are a mechanism to facilitate franchisee monopsony power. After the publication of this research, some franchisors have started to cease including such agreements in franchise contracts (Johnson, 2018). While eliminating these agreements removes a particularly egregious mechanism for restraining wages, this paper argues that franchisor control over labor costs and working conditions at franchised establishments goes far beyond no-poaching agreements. Franchising, I argue, is a mechanism to extract effort from a low-wage workforce. It reduces expenditures on monitoring and efficiency wages, allowing the franchisor and franchisee to share the profits from extra effort. However, because franchisors are not the legal employers of production workers, franchisors escape legal responsibility for their terms and conditions of employment. The analysis of contractual provisions provided here shows that franchisors are, in a sense, co-employers who exercise *de facto* control over terms of employment. This organizational structure strengthens the bargaining power of employers over workers.

Franchising is a business form in which a firm owning a valuable brand licenses another to use its trademarks and proprietary business methods in exchange for the remittance of a royalty consisting of a percentage of gross sales. In 2012, the most recent year for which data is available, franchising firms accounted for 7.9 million jobs in the U.S., compared to 13.4 million jobs in manufacturing. Franchisors accounted for more than 450,000 establishments, 10.45 percent of all establishments. Sales of franchised chains were about 1.3 trillion dollars in 2007, or 9.2 percent of total U.S. GDP (Kosová and Lafontaine, 2012). It is also the dominant mode of industrial organization in the fast food industry: seventy-three percent of the 3.58 million fast food workers in the US are employed in franchised chains. Has this organizational form evolved because it is more efficient, or because it reduces worker bargaining power?

1 Efficiency Theories of Franchising

Under incomplete contracts with imperfect information, the principals who own franchised chains must pay the agents who manage each location a premium over their next-best alternative (their “fallback position”) to elicit their work effort. Agents paid a premium eschew shirking because if they do not exert the desired effort level they can be terminated, losing access to the premium. For this reason the premium is often called an “enforcement rent.” Efficiency and power are closely related in principal-agent models, and power can be exercised in ways that increase or decrease efficiency.

Principals offering enforcement rents have power over their agents because they have the ability to induce agents to act in ways that further their own interests, while agents lack this ability with respect to principals. By threatening to withdraw the enforcement rent, principals can induce agents to act in ways that further their own interests. This exercise of power is Pareto-improving: rather than pay the agent his or her reservation wage to work at his or her reservation effort level, the principal pays an enforcement rent, resulting in both higher profits for the principal and higher income for the agent (Bowles and Gintis, 2007).

In these so-called efficiency wage models, principals not only must pay an enforcement rent, but also invest in monitoring to detect shirking. Pareto improvements are therefore still possible, since monitoring, unlike higher wages, has a social cost. Making the agents residual claimants on output solves the principal-agent problem by fully aligning their incentives with the principals, eliminating the need to monitor their effort and creating a pareto improvement over even the wage premium-plus-monitoring alternative (Bowles, 1985; Bowles and Gintis, 1988; Shapiro and Stiglitz, 1984). With royalty rates averaging only five percent of gross sales, franchise contracts in the fast food industry make franchisees virtually complete residual claimants on output.

Models of franchising emphasize these efficiency aspects of franchise contracts, focusing on how franchisor-principals incentivize franchisee-agents to provide high levels of effort (Mathewson and Winter, 1985; Rubin, 1978; Norton, 1988b). Empirical support is provided

by Lafontaine and Slade (1997), who show that the importance of the franchisee’s effort is positively related to the use of high-powered incentives in franchise contracts and that high costs of monitoring are positively related to the use of franchised outlets relative to company owned and operated outlets.

However, the existence of externalities gives franchisees some power against franchisors through their ability to affect franchisor profitability through shirking. For example, franchisees can free-ride on the franchisor’s brand name. Franchisors therefore must invest in enforcement rents and monitoring to internalize these externalities, even though franchisees are residual claimants. Kaufmann and Lafontaine (1994) show that McDonald’s does indeed pay enforcement rents to its franchisees. Rather than extract the full value of the franchise, it leaves money on the table to induce effort. Moreover, McDonald’s specifically selects wealth-constrained franchisees who must depend on their franchise for their livelihoods, and thus have the most to lose from termination of the enforcement rent. Franchisors also invest in monitoring. They send “secret shoppers” to franchised establishments, and monitor franchisee cash registers and operations through real time “point of sale” systems. Moreover, as will be shown below, franchisors also supercharge the incentives of residual claimancy through investments in bargaining power.

We can model the franchisor-franchisee relationship according to the familiar efficiency wage model. Franchisor profits are represented by the equation:

$$\pi = s[y(ne(m, w, s; h)) - n(m + w)] \quad (1)$$

Franchisors share profits with franchisees.¹ In this model, s is the franchisor’s share of profits (so $1 - s$ is therefore the share left to franchisees). Revenues, y , are a function of the number of franchisees, n , and the effort of each franchise, e . I assume identical franchisees throughout this paper. Effort is in turn a function of the level of franchisor monitoring of franchisees,

¹In practice, most franchisors charge a royalty on revenues rather than profits, because profits are considered too easy for franchisees to manipulate. For analytical convenience, I have set up a profit sharing rather than revenue-sharing model. In practice under a revenue-sharing contract franchisors and franchisees split the surplus from franchisee unit operations, so the profit-sharing model is apt.

m , operating costs (including wages), w , the franchisor's profit share, s and the franchisee's exogenous fallback position, h . $e_m > 0$ (increased monitoring increases franchisee effort), $e_w < 0$ (higher costs lower franchisee returns to effort) and $e_s < 0$ (franchisees have weaker incentives to exert effort when the franchisor's profit share is high). The cost side of the profit equation contains the number of outlets times the monitoring costs m and operating costs w .

Franchisors vary n , m , and w , and s to maximize profits. Franchisor first order conditions are given by:

$$y' = \frac{m+w}{e} \quad (2.1)$$

$$\frac{e}{m+w} = e_m = e_w \quad (2.2)$$

$$\frac{e}{sy} = e_s \quad (2.3)$$

(2.1) states that the marginal product of franchisee effort equals the unit cost of effort. (2.2) states that the marginal effect of variations in the level of monitoring and operating costs equal the average level of effort per dollar of expenditures. (2.3) states that the marginal impact on effort of varying the franchisor's profit share equals the average level of effort per dollar in revenue. Profitability is increased when monitoring costs or operating costs fall. Because franchisors and franchisees share the profits of the franchise system, franchisors benefit from low franchise-level operating costs, including low wages. Franchisor profitability's relationship to the profit share parameter is ambiguous: a higher franchisor profit share directly benefits franchisors, but at the cost of decreasing franchisee effort, which lowers the revenues available for sharing between franchisors and franchisees.

Franchisees, meanwhile, determine their effort levels by maximizing the objective function U ,

$$U = (1 - t(e))v(e) + t(e)h(a, \bar{y}, \lambda) \quad (3)$$

In this equation, $t(e)$ represents the termination function, capturing the effect of effort on the probability of the franchisee being terminated and reverting to his or her fallback position.

Greater effort reduces the likelihood of termination, so $t' < 0$. The function $v(e)$ describes the value of the franchise to the franchisee.²

$v(e)$ is increasing and concave, $v' > 0, v'' < 0$, for two reasons. First, franchisee income (and, cumulatively, assets) are increasing in effort, but the franchisee experiences a declining marginal utility of income and wealth. Second, effort carries a disutility, and disutility increases at an accelerating rate at higher levels of effort. Note that unlike standard efficiency wage models, franchisee income is not a flat wage but varies with effort. Finally, $h(a, \bar{y}, \lambda)$ represents the franchisee's fallback position, which is a function of the value of the franchisee's assets outside the franchise relationship a , the franchisee's expected income outside the franchise relationship \bar{y} , and the probability of finding income-generating activity outside the franchise relationship, λ . Franchisees vary effort to maximize utility, taking their fallback position as exogenous, giving the following first order condition:

$$v_e = t_e \frac{h-v}{1-t} \quad (5)$$

That is, starting at a high level of effort, franchisees decrease effort until the marginal utility of effort (reflecting both increased income from effort and disutility of effort) just equals the marginal effect of decreasing effort on the expected value of the fallback position as weighted by the probability of termination. At this stage, the model shows that by internalizing externalities through monitoring and enforcement rents, and aligning incentives with franchisors through residual claimancy, franchise contracts raise franchisor profits through improvements in efficiency.

²An more explicit function for v is:

$$v = v\left(\frac{1-s}{n}\pi(e, m, w, s), d(e)\right) \quad (4)$$

Franchisee income, $\frac{1-s}{n}\pi$ is the franchisee's share of profits, and d is the franchisee's disutility of effort.

2 Franchising, Labor Discipline and Efficiency

Franchisors go beyond the efficiency-enhancing exercises of power described in the first section, however. They also make investments in bargaining power to reduce the fallback position of franchisees. By reducing the franchisee's fallback position, franchisors can induce franchisees to work harder, raising output and franchisor profits. The extra output is not a genuine productivity increase, because output has not increased per unit input. Rather, one input has been squeezed into producing additional output.

From equations (3) - (5) above, we see that franchisors can increase franchisee effort by decreasing the (exogenous to franchisees) franchisee fallback position, $h(a, \bar{y}, \lambda)$. By a reasonable assumption, the franchisee fallback position is increasing in franchisee assets a and expected income \bar{y} outside the franchise relationship, and also increasing in the probability of finding income-generating economy activity outside the franchise relationship λ . Interventions that reduce the fallback position shift the franchisee's effort function inward, which through the franchisor's first order conditions (2.1) - (2.3) increases franchisor profits. I discuss some of these interventions in detail in the next section.

Even if franchising resulted in efficient contracts between franchisors and franchisees, moreover, franchisees are a special kind of agent. They are not potentially shirking production workers who directly produce the output, as envisioned in classic efficiency wage-type principal-agent models. Rather, *they are the monitors*. As Norton (1988a, p. 202) points out, this aspect of franchising makes labor intensity a key variable explaining which industries deploy franchise contracts. Since workers, not machines, have a propensity to shirk, franchise contracts only make sense in labor-intensive industries like fast food. Franchising thus solves principal-agent problems between owners and management only to face them again one level lower, between management and labor. Furthermore, franchisors have a direct stake in labor costs. Since franchisors and franchisees share the profits from franchised outlets, franchisors benefit from lower labor costs.

The franchisee's role as labor monitor has efficiency and fairness implications that have

been overlooked by the franchising literature, which tends to examine the efficiency implications of franchise contracts for the owner-manager principal-agent problem, without looking further into the manager-worker relationship. Franchise contracts maximize franchisee effort *toward maximizing worker effort*.³ But workers are not residual claimants in franchising systems and the efficiency (and fairness) claims made for franchising do not extend to them and their non-contractible effort. Rather than being motivated by residual claimancy, franchisors motivate workers through a combination of monitoring and the offer of enforcement rents. The organizational innovation of franchising, by improving the ability of franchisors to monitor workers through the effort of franchisees, is designed to decrease the power of production workers in franchised chains in order to extract extra effort. This biases franchisees toward intense monitoring and effort extraction strategies over high-wage efficiency wage or employee skilling strategies.

Skott and Guy (2007) argue that because the size of the enforcement rent depends on the employee's ability to affect profitability by varying his or her own effort, workers have power over employers to the extent that they can control their effort and effect outcomes important to employers. Technological changes that increase managers' ability to monitor workers decrease worker power. In a formal model, they show how such "power-biased technical change" can increase profitability by increasing effort extraction from workers, even if the new technology is less technically efficient than existing technologies. The negative effect on profits of lower technical efficiency in such cases is more than made up for by the decrease in workers' power and the accompanying changes in effort and wages.

We can think of franchising as an example of power-biased *organizational* change within Guy and Skott's framework. The organizational innovation of franchising, by solving the principal-agent problem between owners and managers, influences the principal-agent problem one level down between managers and production workers. By highly incentivizing franchisee-managers to monitor production workers, franchising as an organizational innova-

³Felstead (1993) also emphasizes the effort extraction over the efficiency aspects of franchise contracts, but dismisses the relevance of the type of economic models used here for analyzing the issue.

tion increases employer power in Guy and Skott's model just as surely as a new surveillance technology. The use of franchising, even if it has no effect on technical efficiency, can increase franchisor profits by extracting additional effort from production workers.

3 Investments in Bargaining Power Over Franchisees

The initial source of the franchisor's bargaining power over franchisees is its product market power, derived from its trademark and trade name. These give the franchisor a type of power known as "short-side" power: the power to control access to scarce resources of which quantities are limited (Bowles and Gintis, 2007). In markets characterized by short-side power the market does not clear, and there are queues on the short side of the market consisting of those who would like to transact on terms being offered to others but are unable to do so. The franchisor's ability to restrict access to its brand name gives it the ability to confer a rent on the franchisees with whom it does transact, since the fallback position for the franchisee is exclusion from the brand. Exclusion means competing with the franchisor's established chain, with years of consumer recognition behind it, as an independent business. Franchisees have attested to the power of the brand name, noting that they experience difficulty persuading customers, banks, or real estate owners to do business with them as an independent firms in competition with established brands. When the fallback position is operating without a brand name and competing with McDonald's or Burger King, affiliation with an established brand confers a rent on the independent businessperson-cum-franchisee, a rent that franchisors can threaten to withdraw. As Richard Riggs, a Dunkin' Donuts franchisee testified before Congress in April 1976, explaining why he signed such a restrictive franchise contract, "We had counsel at the time but we had not very much choice. We had limited funds. I had the choice of going with a franchisor or opening up Riggs Donut Shop on the corner and competing with the franchisor" (Subcommittee on Consumer Protection and Finance, 1976, p. 93).

Beyond the rents conferred by association with the brand name, franchisors also require franchisees to sign contracts that raise the value of this rent. For example, franchisees are required to make investments in relationship-specific sunk assets (oddly shaped buildings, proprietary signage and equipment, their own industry-specific human capital) that have value inside the franchise relationship, but little value outside it, raising the value of v relative to h . According to Dnes (1993), franchisors *create* most of this asset-specificity through trademarking fixtures and equipment, and through restrictive covenants in franchise contracts. Some common terms of franchise agreements increase franchisee sunk investments. As Representative Abner Mikva said in 1976,

Once the agreement is entered into, the franchisee is totally dependent on the products, services or tradename supplied by the franchisor. Loss of the right to use the franchisors tradename or distribute the franchisors product or service results in economic ruin for the franchisee. It is a relationship that more closely resembles one between a master and his indentured servant than between economically equal contracting parties (Subcommittee on Consumer Protection and Finance, 1976, pp. 53-54).

Franchisee lawyer Barry Kellman testified to Congress in 1988 that “bargaining power changes over time to the greater advantage of the franchisor” due to sunk, firm-specific investments the franchisees make over time and the costs the franchisors contractually impose for leaving the relationship, such as non-compete agreements and restrictions on sales and transfers (Subcommittee on Antitrust, Impact of Deregulation, and Privatization, 1988, p. 44). Franchisee lawyer Peter Singler testified that:

I ask one question when a new client comes into my office, and that is, if you werent already in this system, would you do it all over again? The answer, without exception, has been “Absolutely not.” And it is usually followed with a statement, “But because of non-competition covenants, because of restrictions

on sourcing, because of restrictions on transferability—on my ability to sell my business—I can't get out, and so I've got to make the best of it" (Subcommittee on Commercial and Administrative Law, 1999, p. 100).

Franchisor investments in bargaining have not gone unnoticed by franchising scholars. Michael (2000) shows that franchisor investments in bargaining power, such as covenants not to compete, reduce litigation between franchisors and franchisees. Dnes (1993) argues that the requirement that franchisees reduce their own fallback positions in franchise contracts through sunk investments is yet another sign of franchising's efficiency, as it acts as a screening and signalling device. Franchisees who have what it takes, he argues, will self-select into franchise rather than alternative contracts, their willingness to do so acting as a signal to franchisors of their high productivity.

However, Dnes's claim demands a high degree of information and foresight from franchisees. For one thing, franchisees may not be aware of the full meaning of the highly restrictive contracts they sign at the moment they sign them. And even if they are, real economic agents are loss-averse, weighing future losses more heavily than future gains from any point in time (Benartzi and Thaler, 1995). Thus, the franchisee is in effect a different economic agent before and after signing the franchise contract. Once they start making sunk investments, they overweight the cost of losing them. As franchisees accumulate sunk investments over time, the bargaining power of the franchisor increases, as the franchising lawyers quoted above testified.

An analysis of franchise contracts reveals the prevalence of these and other methods of increasing franchisor bargaining power. From the State of Wisconsin, I collected franchise contracts from all 530 franchisors operating in Wisconsin with more than 85 outlets nationwide. This set includes all the national chains plus some regional chains as well. The data discussed below all come from these contracts. Contract terms that reduce the bargaining power of franchisees include the following:

- Franchisor remote, independent access to franchisee data increases the effectiveness of

franchisor monitoring, raising the sensitivity of the termination function $t(e)$ to franchisee effort. Increases in monitoring effectiveness reduce the size of the enforcement rent necessary to induce a given level of effort. Ninety percent of fast food franchise contracts require franchisees to give franchisors independent access to their computers and data. What is more, eighty-three percent require the franchisee to give the franchisor the ability to withdraw funds directly from the franchisee's bank account.

- Virtually all franchise contracts require franchisees to sign covenants not to compete with the franchisor for a period of time after the franchise contract ends. Such covenants raise the expected duration of time before the franchise can earn income again, $\frac{1}{\lambda}$, and reduce the value of his or her human capital a by temporarily prohibiting continued employment in the industry in which her or she has developed skills. The average duration of the noncompete agreement in fast food is twenty months.
- Franchisors tend to require franchisees to give them a right of first refusal to any sale of the franchisee's business. The ability of the franchisor to swoop in at any time depresses the resale value of the franchise, and thus the franchisee's wealth should it exit the franchise relationship, a . Ninety-two percent of fast food contracts contain this clause.
- Franchisors also often give themselves a right to purchase the franchisee's assets at expiration of the contract, restricting the universe of potential buyers and similarly reducing a . Fifty-nine percent of contracts contain this clause.
- Many franchisees require that franchisees personally operate their franchised outlets. This indicates a preference for natural persons rather than incorporated enterprises as franchisees, the former having a lower wealth endowment a and thus a lower fallback position. Forty-nine percent of contracts require a personal obligation to operate.
- Franchisors frequently require franchisees to give the franchisor recourse to their per-

sonal assets in legal disputes. Some even require the franchisee's spouse to sign such a personal guarantee as well. This raises the franchisee's cost of leaving the franchise relationship early or misbehaving during the relationship, as their entire personal assets are put at risk by doing so, further reducing a . Ninety-four percent of fast food contracts contain a personal guarantee, and thirty-three percent a spousal guarantee.

- Finally, franchisors frequently require franchisees to agree to mandatory arbitration clauses, in which franchisees sign away rights they have under the law to a jury trial, class action litigation, and the like, and forum clauses, in which franchisees agree that any litigation must take place in the geographical jurisdiction of the franchisor's choosing. The former blocks the franchisee from access to the legal system to settle disputes, while the latter dramatically raises the cost of litigation to the franchisee. These clauses limit the ability of the franchisee to recover damages that could form the assets to start a new business, a . Fifty-five percent of contracts contain a mandatory arbitration clause, and ninety percent contain a forum restriction.

Table 1 contains information on the use of these contract terms, and other contract terms discussed later in the paper, in both the whole sample of 530 contracts and the 78 contracts from fast food industry franchisors.

These exercise of power through the contract terms and restrictive covenants above can result in exploitative outcomes, but also in Pareto improvements. Residual claimancy solves the principal-agent problem, reducing unproductive monitoring expenditures and enabling the creation of additional output. Because franchisees are near-residual claimants, franchising is in a sense fair: franchisees get nearly the entire benefit of the extra effort that these onerous contract terms extract from them.

However, much depends on the shape of the franchisee utility function with respect to income and disutility of effort. Efficiency wage models focus on worker shirking, with enforcement rents inducing them to provide the contracted-for level of effort. Franchisee effort, in contrast, is a continuum of effort rather than a binary shirk or do not shirk choice,

Table 1: Prevalence of Selected Contract Terms in Franchise Contracts

Contract feature	All industries	Fast food
Franchisee Effort-Inducing Contract Terms		
Avg royalty rate (pct gross sales)	5.1%	4.9%
Pct of contracts: ind data access	79%	83%
Pct of contracts: ind bank account access	81%	90%
Avg duration of non-compete (months)	19.03	20.31
Pct of contracts: right of 1st refusal	85%	92%
Pct of contracts: right to purchase at expiration	49%	59%
Pct of contracts: obligation to operate	35%	49%
Pct of contracts: personal guarantee	93%	94%
Pct of contracts: spousal guarantee	38%	33%
Pct of contracts: mandatory arbitration	58%	55%
Pct of contracts: forum clause	91%	90%
Vertical Restraints		
Avg percent of purchases from restricted sources	47%	78%
Pct of contracts that prohibit unapproved products	91%	95%
Pct of contracts: mandatory hours of operation	64%	92%
Pct of contracts that set max or min prices	45%	56%
Pct of contracts: no poaching clause	55%	69%
N	530	78

and franchise contracts have the potential to extract effort beyond the level the franchisee would have agreed to before becoming bound by the contract. For example, if franchisees are “satisficers” targeting a given level of income with only small utility gains beyond that point, investments in bargaining power can lower their fallback position such that they work harder than they would have agreed to before entering the franchise relationship. The extra output is not a genuine productivity increase, because output has not increased per unit input. Rather, one input has been squeezed into producing additional output.

4 Increasing Power Over Workers

As I show elsewhere, franchisors focus franchisees on labor supervision by taking away their discretion in other areas through the imposition of vertical restraints—contractual controls that limit their choice set to a few variables (Callaci, 2018). Looking again to Table 1, in my sample of fast food franchise contracts, on average seventy-eight percent of franchisee purchases must be acquired from suppliers restricted by the franchisor. Ninety-five percent of contracts restrict franchisees to selling only franchisor-approved products. Ninety-two percent set mandatory hours of operation. And fifty-six percent even set maximum or minimum prices. Each one of these restrictions takes discretion away from the franchisee and focuses their effort on labor management and discipline. According to Lafontaine and Sivadasan (2009, p. 119), fast food industry insiders report that “labor schedule changes and flexibility in hours per week per worker are among the most important margins that managers have at their disposal to keep production costs down,” highlighting the lack of ability to alter other variables affecting profitability and the importance of labor costs to fast food profitability.

What is more, some franchisors intervene directly to hold wages down at their franchisees’ restaurants. Sixty-nine percent of fast food franchisors in my sample impose no-poaching clauses, which forbid franchisees from hiring workers away from each other. Krueger and Ashenfelter (2017) find evidence that the incidence of these clauses is associated with low-wage, high-turnover industries indicating that their purpose is to increase franchisee monopoly power over production workers.

Incentivizing franchisees through residual claimancy and effort-extracting contract terms mitigates the need to spend money on paying for monitoring *or* efficiency wages of production workers, allowing the franchisor and franchisee to share the profits from extra effort extracted from workers. Franchisors structure contracts to focus the energies of franchisees on labor effort extraction. The workplaces reflect this: rather than invest in worker skills, franchised fast food establishments are highly mechanized and designed to employ workers with a

minimum of training. Highly vigilant labor supervisors create a precarious workforce through “flexible” scheduling and extract maximum effort from them when they are on the job. Rather than invest in training or skills, franchisors incentivize franchisees to extract effort from a high-turnover, poorly trained workforce. Industry average data are consistent with such a labor market strategy: the industry-average wage in fast food is \$10.88 per hour, and 28.62 percent of workers in the industry have less than one year of tenure at their current job.

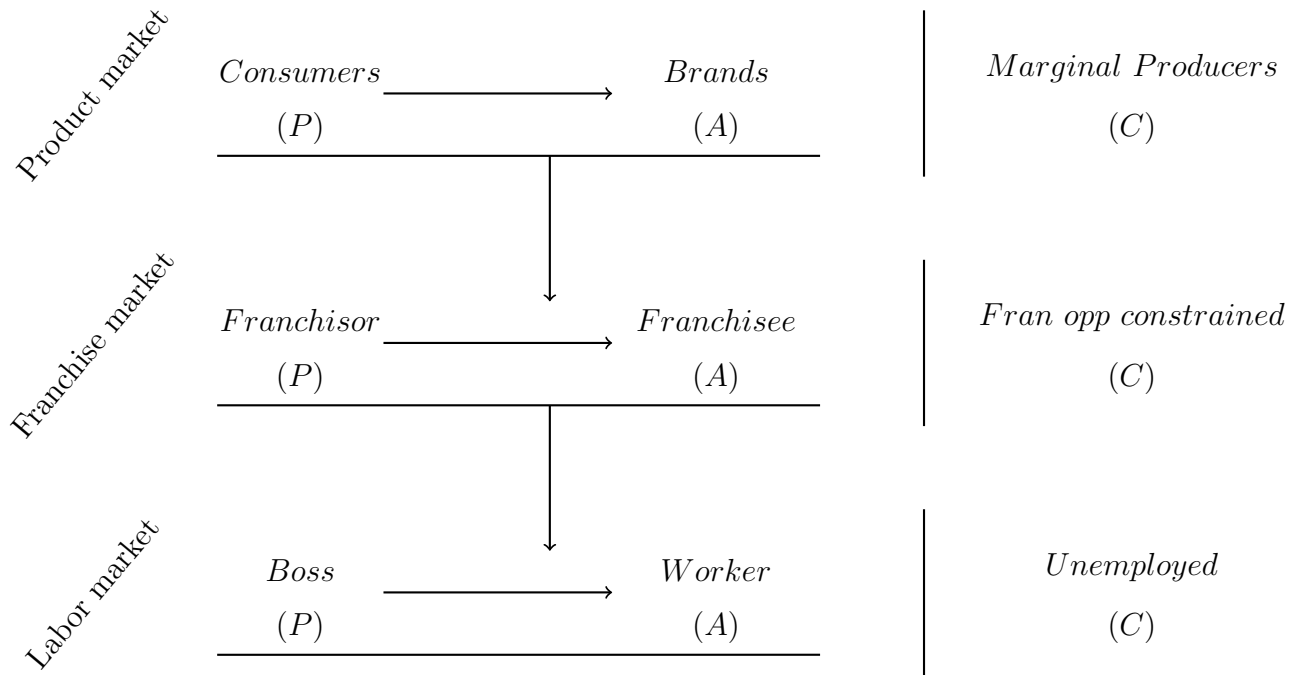
5 The Short Side of the Market and Trickle-Down Power

Franchising is an example of a multi-level principal-agent problem. It is essential to understand both levels. In the first level, franchisors have power over franchisees, as evidenced by the existence of enforcement rents. In the second level, franchisors *also* have power over production workers, which they exercise *through* their franchisees. The franchisor’s product market power (enhanced by investments in contractual power over franchisees), cascades downward into the market for franchise management opportunities, and further downward into the labor market.

There are similarities between franchising and the model of linked credit, management and labor markets in Bowles (2006, p. 359). In this model of linked non-clearing markets, demand outstrips supply, resulting in queues of “quantity constrained” individuals who would like to contract at the going price but are unable to do so. Principals on the “short side” of the market, the side where the desired number of transactions is least, have power over their agents on the “long-side” because the former can offer the latter rents, defined as payments above their fallback position. Meanwhile there are individuals who would like to have franchise contracts with a recognized brand but are unable to secure them, just as there are unemployed workers who would like jobs at the going wage but are unable to land them. These individuals are “quantity constrained,” and their presence limits the bargaining

Figure 1: Power moves across markets

P = short side principals, A = long side agents, C = quantity constrained



position of long side agents. Principals on the short side of each market can therefore confer rents on “long side” agents, and thus exercise power over them. In this way, principals with access to scarce resources exercise power over the agents with whom they contract. Figure 1 illustrates this process in the context of franchising.

In the figure, brands receive rents from the product market. Firms that do not have brand names are consigned to status as marginal producers at the fringes of the product market. Down a level, in the market for franchise opportunities, franchisors, which are the brands on the long side at the higher level, exercise power over franchisees by their ability to control access to valued brand names. Some of the franchisees in this market may even be those excluded, or “quantity constrained” from the higher market. Franchisees, in turn, are the bosses in the labor market, one level down from the market for franchise opportunities. They have power over workers in the labor market as bosses, by their ability to control access to scarce jobs. Labor law, focused narrowly on employee status, confines labor issues to the

bottom level only. The working conditions at the bottom, however, are determined several levels up, with the market power of franchise corporations.

6 Conclusion

Franchising is an example of power-biased organizational change. The structure of franchise contracts contain some features that increase profits through efficiency improvements, but others that do so through extracting additional effort from the labor input. The use of a franchised business model, in which franchisees are highly incentivized to manage, and extract effort from, low-wage, high-turnover workers, is thus a kind of labor management strategy. However, because franchisors are not the legal employers of production workers under franchising, franchisors escape legal responsibility for their working conditions.

Franchise contracts shape outcomes at franchised establishments. However, because franchisors are not the legal employers of production workers under franchising, franchisors escape legal responsibility for their working conditions. This paper also provides evidence that existing legal criteria of who is an “employer” responsible for working conditions may be in error, as franchisors, whatever their legal relationships with production workers, intimately shape their working conditions through their contracts with franchisees.

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