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TRANSACTION COSTS AND THE INTERNATIONALIZATION OF BUSINESS FRANCHISING

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Abstract

The assumption in the theory of international production is that direct foreign investment offers the best alternative for exercising effective control over foreign operations. This is based on the belief that, by externalising company-specific advantages, firms will be unable to efficiently constrain the behaviour of the other parties, and will therefore incur high transaction costs. This paper argues that the costs of overseas operation may be higher in direct foreign investment than in franchising and that the latter is a form of organisation in which arms-length associates can be effectively monitored and controlled without the need for substantial direct investment.

I. Introduction

In his seminal paper, ‘The Nature of the Firm’, Ronald Coase (1937), raised the following question: In the light of the efficiencies of the competitive market mechanism emphasized in economic theory, why does so much economic activity take place outside the price system, that is within firms in which market transactions are replaced by centralised direction? His conclusion was that there must be costs which are incurred by using the market that can be eliminated by internalizing certain activities and having a centralised direction. These costs are known as transaction costs. The concept of transaction is now frequently used as a key determinant in the choice of methods for servicing foreign markets. Williamson (1979) notes that the new institutional economics is pre-occupied with the origins, incidence, and ramifications of transaction costs.

Transaction costs include the time and expense of negotiating, writing, and policing the implementation of agreements. These costs would also include the adverse consequences of opportunistic behaviour as well as the costs of trying to prevent it. It can be substantial and vary from one industry to another. Where it is too high, the scope for internalization increases. Proponents of transaction costs thesis argue that these costs may be too high in forms of foreign operation other than direct foreign investment (DFI) as to absorb all potential gains from trade (Buckley and Casson, 1976, 1985; Rugman, 1986; Hennart, 1986). Indeed, Hennart (1989) suggests that the new forms of international investment will be unable to efficiently constrain the behaviour of the other parties, and will therefore incur high transaction costs. Clearly, the sale of company-specific advantages falls under the generic group of new forms of international investment.

One of the key distinctions between the sale of company-specific advantages and DFI derives presumably from the need to exercise effective *control* over foreign operations. On the one hand, it is suggested that the sale of company-specific advantages attracts considerable risks insofar as the possibility of loss of control of foreign operations exists. It is also possible to eliminate or at least minimize these risks with an effective policing strategy - although, at some considerable cost. It is argued that effective control offers investors not just motivation but also, some measure of confidence in and safeguard for such investments. Thus, by implication, no other method of foreign market entry, such as franchising or licensing, will offer the same degree of investment protection as DFI, and as such, alternative methods should be considered only where foreign direct investment is not possible or profitable.

The recent surge of interest in franchising as a strategy for international expansion (though more widespread in some industries than others) defies these assumptions in the neo-classical theories of international production. This paper argues that franchising is a form of organization in which effective control can be exercised over the activities of unrelated franchisees operating in foreign markets by the franchisor. Although there are numerous definitions of the term franchising, it is defined in this paper, as an all inclusive contractual arrangement that enables the franchisee (receiver of the privileges) to use a proven and successful business formula in the production and marketing of goods and services. In return, the franchisor receives payment for the use of the trademark or brand name, training, and for merchandise supplied (Monye, 1996). Although this definition may not be exhaustive of all subtleties and nuances, the essential elements of franchising are covered.

In a typical franchise agreement, the franchisee has the right to use the trademark and operating procedures of the company at an agreed location and has various decision rights for hiring personnel, advertising, etc. The franchisor maintains the rights to monitor the franchisee for quality and has other rights related to the maintenance of the value of the trademark (Brickley, Dark and Weisbach, 1991). Of particular interest in this paper is the nature of modern franchising and the factors responsible for its increasing attraction to the big multinational companies such as McDonald's Corporation, ITT, Sears, Coca-Cola, Pepsico, Burger King, Kentucky Fried Chicken, etc., as a foreign market entry and operating strategy rather than DFI even where the latter is possible, safe and profitable. The rest of the paper is organized as follows. Section II examines the nature of franchising and the theoretical underpinning. Section III describes international franchising in practice. Section IV contains some observations on policy and strategy issues.

II. Theoretical Underpinning

The basic tenet of the neo-classical theories of international production is based on the assumption that DFI is a better strategy for international expansion than any other method. It is suggested that the key characteristic of DFI vis-à-vis more externalization strategy is the desire to exercise effective control over foreign investments and operations, and that *effective control* can only be achieved by internalizing company-specific advantages. The inherent assumption in this line of argument is the *cost* of achieving effective control.

Dunning (1981) contends that DFI is a superior strategy when compared with the external sale of proprietary assets through licensing or franchising arrangements. He suggests that DFI is a better strategy in the internationalization process than any other method such as licensing and franchising, *ceteris paribus*. Dunning argues that the basic incentive for a firm to internalize its ownership advantages is to avoid the disadvantages, or capitalize on the imperfections of one or the other two main external mechanisms of resource allocation - the market or price system and the public authority fiat (order or decree), underlining Coase's cost hypothesis.

The foregoing arguments notwithstanding, the externalization of company-specific advantages such as intellectual property, brand names and trademarks through licensing and franchising as an international market development strategy, has witnessed a dramatic growth in recent years (Walker, B. J and Etzel, M. J, 1973; Hoffman, R. C. and Preble, J. F, 1991; Monye, 1996). This phenomenon has been described as "new form" of international operation in the literature (Oman, 1984; Cantwell, 1986; Young, 1987; Monye, 1989). Broadly, these forms of international operation include licensing, franchising, management contract, turnkey and product-in-hand contracts, production sharing contracts, and international sub-contracting. Of these, franchising has emerged as one of the most attractive and perhaps the fastest growing method for expansion into foreign market. This phenomenal development vis-à-vis international franchising raises considerable doubt over the notion that *control* is the key characteristic of DFI. For the purposes of this paper, we define DFI as ownership of foreign investment which is backed up with effective operational and managerial control.

The origin of franchising is uncertain. Hoffman and Preble (1991) suggest that it originated from the United Kingdom in the middle ages when King John of England reportedly granted franchises to tax collectors. But business franchises began in the eighteenth century with German brewers who contracted with beer halls to serve as their distributors. However widespread use of franchising started in the United States around 1860s when the Singer Sewing Machine Company utilized it in 1863 to sell products to its own sales force who in turn had to find market for them. This was followed by General Motors in 1898, and Rexall in 1902 (Walker and Etzel, 1973). Mandelson (1992) suggests that automobile distribution and drink (not alcohol) were the catalysts for franchising activity at the beginning of century, followed by a trickle of developments until the 1930s when Howard Johnson started his famous restaurant chain in the USA, and the 1940s and 1950s, which saw the birth of so many of the modern giants of the franchising community. While franchising has traditionally been in the restaurant, retail, and service industries, it has been tried in other industries such as banking (Brickley, Dark and Weisbach, 1991). The Interstate Bancorp, Golden, Colorado is recorded as the first bank to franchise in 1982. Over the last twenty years, areas not traditionally associated with franchising have been using it to extend their catchment areas. For example, the educational institutions have caught the franchising bug. A good number of universities are now offering their degrees through local and foreign franchisees.

The central feature of franchise organization is the presence of both market-like and firm-like qualities (Norton, 1988). Norton suggests that on the one hand, market-like qualities arise from the existence of trade between two entities that operate in capital, labour, and product markets. The franchisor, the parent company, develops a product or service for sale by the franchisees that market it in a particular location. On the other hand, the firm-like qualities arise from the nature of the restricted bilateral nexus between the two entities. The relationship often resembles full vertical integration - franchisors typically offer managerial assistance - for example, in site selection, training programs, standard operating procedures, design of physical layout, and advertising - to the franchisee, and the franchisee agrees to run the business according to the franchisor’s stipulations.

A major problem facing companies with valuable brand names is controlling the actions of external users or franchisees to assure the continued maintenance of their value (Brickley and Dark , 1987). It is argued that not all individuals within the firm, let alone outside, can be expected to have a strong interest in expending the effort necessary to maintain the quality and reputation of a product. Thus, the maintenance of the value of a priced-brand name requires some commitment on the part of the external users. With these known inherent risks associated with the externalization of company-specific assets such as brand names, why is franchising becoming so popular with all sorts of companies? A number of theoretical explanations have been advanced in support of franchising as an attractive growth and expansion strategy. Of these, the agency and capital-raising theories are most developed, and are reviewed in the following section.

II.1. The Agency Theory

The agency theory suggests that there is a cost/benefit trade-off between company ownership and franchising, and that the weight of the benefits favours franchising. Brickley, Dark and Weisbach (1991) contend that whereas managers of units owned by the central franchisor do not bear the full costs and benefits of their decisions, owner-managers of franchised units are compensated by residual claims from their particular units. Thus, the vested financial interest of owner-managers in a franchised unit is a powerful tool for controlling the conduct and behaviour of agents. Since the agents bear most of the financial consequences of their behaviour, the franchisee has as much interest and commitment to maintain the quality and reputation of the product as the franchisor. Moreover, an investor is likely to be more motivated to perform to the best of his ability than a salaried manager.

Fama and Jensen (1983) suggest that further effective control of agents could be achieved by (a) applying a number of control devices such as elaborate monitoring systems that limit the discretion of the decision agents and (b) the use of residual ownership. Ownership of residual claims can be restricted to the decision agents. Brickley and Dark (1987) observe that although franchisees purchase a residual claim for their unit, they do not have significant decision rights. For example, their right to sell the claim is frequently restricted as franchisors may have to approve the sale of the unit to another party. This enables the franchisor to exercise very effective and sometimes, 'suffocating' control over the franchisee. Rubin (1978) argues that reliance upon clauses that permit unilateral termination by the franchisor as well as strict performance criteria make the relationship resemble an employer-employee contract.

Furthermore, Caves and Murphy II (1976) contend that the potential franchisee, often with no previous experience in the franchised activity, would be committing the bulk of his portfolio in a lump-sum bid for a franchise. Franchisees who reduce the quality of the goods or service they offer for a given price might increase their profits in the short-term, yet by disappointing buyers' expectations they could reduce by a greater amount, the net returns to the common intangible goodwill asset - maintained by the franchisor and used jointly by the other franchisees.

Other factors which favour franchising over owning of outlets include (a) low incentive for free-riding (quality substitution) by both the franchisee and the franchisor - the penalty for cheating is severe and can reduce the incentive to cheat, and (b) low investment in firm-specific assets (Brickley and Dark, 1987).

II.2. Capital-Raising Theory

The central argument in the capital-raising theory of franchising is that small firms with limited access to capital markets often sell franchise contracts in order to generate the required capital for business expansion. Oxenfeldt and Thompson (1969) contend that franchisors create systems because they have too little capital to consider a wholly-owned chain, at least at the early stages of the operation. Using the life cycle analogy, Oxenfeldt and Kelly (1969) note that as the capabilities and resources of franchisors change over time, their capital position and ability to raise additional funds improve with the success of the system. Therefore, as the business matures, the franchisor is able to circumvent the initial capital shortage by repurchasing the franchised units and subsequently, operating them as wholly-owned units. This dimension of franchising cycle is particularly significant in strategic terms. In their study, Brickley, Dark and Weisback (1991) observe that the market value of firms announcing franchise buy-backs rose by up to 3 per cent. It is suggested that such announcements transmitted positive information to the market about the associated effect on profits.

For the franchisees, they are a number of important considerations. First, they are attracted to the franchising option in part because they have insufficient capital for an independent operation. Thus, both find a solution in pooling of resources and in the availability of funds to members of the franchise system which are not available to the same individuals outside the system. Second, available research evidence suggest that it offers low risk investment opportunity for investors (Oxenfeldt and Thompson, 1969; Ayling, 1988). Failures are reportedly substantially lower among comparable independent businesses. Figures of between 10 and 20 per cent for failure rate are commonly cited in the literature.

In a survey of British franchisees by the National Westminster Bank/British Franchise Association (March, 1996), the proportion of franchisees reporting profitable results increased from 87 per cent in 1994 to 90 per cent in 1995. Not surprisingly, of the franchisees with less than three years of their agreement to run, only 8 per cent did not wish to renew.

Furthermore, it is suggested that franchised businesses are usually promoted more actively than their independent counterparts. This issue is particularly relevant because of the superior experience, resources and administrative back-up available from the franchisor organisation. Moreover, the wider network of franchised outlets ensures that franchise systems enjoy higher visibility than their independent counterpart. Third, franchisees are better prepared for the responsibility of managing businesses than their independent counterparts. Franchisees usually receive mandatory training on various aspects of business management from the franchisors before they commence trading. Often, the training arrangements continue throughout the duration of the franchise contract. Thus, it could be argued that franchisees are generally better qualified business owners and managers at the initial stages of operation than the independent operators.

III. International Franchising in Practice

International franchising has blossomed from a modest beginning in the 1940s into a major international expansion strategy. A number of favourable trends are creating an environment conducive to franchising. These trends include movement toward world economic integration, improvements in communications and transportation, rising disposable income, broader acceptance of capitalism, and the reduction in barriers to trade and investment in a number of countries (US International Trade Commission, 1995). Nonetheless, internationalization of franchising on a meaningful scale did not start until the late 1960s in the United States when the signs of saturation in the market became noticeable. Finding prime locations to site businesses, increased competition, and an unsettled legal environment became operational difficulties that were frequently encountered by franchisors (Hackett, 1976). These conditions may be described as the catalysts that made companies to begin to look for opportunities in foreign environments. Hackett notes that in a 1969 survey of its members, the International Franchising Association found that only 14 per cent had franchisees outside the United States, and many of these were limited to Canada. By 1973, the US Department of Commerce reported that over 208 American firms operated over 9500 franchise establishments abroad.

In his study of 353 US franchisors, Hackett identified the principal motivation for internationalization as intermediate and long-run market potential rather than by immediate financial gain. Other motivational statements from cross-border franchisors are presented in table 1. Notably, this study also showed that six of the nine franchise classifications are dominated by the use of the 100 per cent franchisee ownership form, with 54 per cent of the respondents expressing preference for franchisee ownership of outlets - the driving force being the desire to penetrate markets while avoiding the risks of ownership and financing in the local markets. This is supported by the confidence that effective control over foreign franchisees can be exercised.

Table 1. Rank Order of Motivations Underlying International Entry by Franchise Firms

Motivational Statement	Rank
Desire to take advantage of market with great potential	1
Establish company name in markets that will be important in the future	2
Proposal from prospective or existing franchisee	3
Initial interest shown by senior executive	4
Desire to be known as an international firm	5
Greater ROI than available on domestic investment	6
Overseas expansion of other franchising firms	7
Saturated US market	8
Encouragement of US government agencies	9
Desire to lessen US tax liability	10

Source: Hackett, D. W. (1976) The International Expansion of US Franchise Systems: Status and Strategies. Journal of International Business Studies, Spring, p. 69.

*The ranks were determined by assigning weights of importance to the individual rankings. The criterion receiving the highest weighted ranking was assigned the rank of "1", the next highest "2", and so on.

Other studies have exhibited similar results. For example, in his study of the process of internationalization by Australian franchisors, Welch (1990) observes that the three factors that stood out in the process were (i) *an expansion ethos* - Expansion seen as a statement of business virility. In other words, 'to say that one had a franchised operation with just three outlets in one city would be tantamount to an admission of failure... Thus, the number and spread of outlets is often used heavily in advertising'. (ii) *Network spread* - Widespread network is treated as a signpost of the market attractiveness of the concept, and by implication, increases the likelihood of an approach by foreigners. This observation reinforces a similar finding by Walker and Etzel (1973) and Hackett (1976). (iii) *Learning process* - The likelihood and nature of international expansion is preceded by developing internationally relevant skills, knowledge and experience.

Although studies on the process of international franchising are limited, they are nonetheless, very useful for the interpretation of the data in table 2 below. The data show that relatively, only a small number of franchisors in all countries accounted for the huge number of outlets. For example, 714 franchisors account for 139,788 outlets in Japan. Similarly, 85 franchisors account for 1600 outlets in Singapore. Because there is no information on the nationalities or even a list of the franchisors in these countries, it is not possible to show the key franchisors with the bulk of the outlets. However, data from the US would seem to suggest that the majority of these outlets are franchised by a very small number of franchisors. Of the 250,000 franchised units in the U.S., 95,666 outlets are either owned or franchised by only 20 firms. In other words, 20 franchisors account for 38 per cent of the franchised outlets in the U.S. One expects the pattern to be consistent and replicated across the world, reinforcing the assertion in Walker and Etzel (1973), Hackett (1976) and Welch, (1990) that successful domestic operation with widespread network indicates the market attractiveness of the concept, and thus, increases the likelihood of an approach by foreigners. This perhaps, explains why McDonald's alone has over 1000 restaurants in Japan (see Rensi, 1995).

Furthermore, the very small percentage of international franchisors in all countries (except Columbia, Singapore, Finland, Austria, UK, Mexico, and France) suggests that push a strategy (i.e. franchisors being proactive in seeking international franchisees) for international expansion by franchisors may not be suitable or effective. In other words, the successful domestic operators with high visibility are more likely to approached by foreign investors. Therefore, as the bulk of the reputable businesses are owned by few franchisors, the less visible domestic firms are less likely to have international breakthrough.

A pattern that can be delineated in the development of international franchising as shown in table 2, is that where franchising is well developed, size of the domestic market is normally a critical motivating factor encouraging internationalization. Therefore, franchisors from countries with limited domestic market are likely to be more active in international franchising than those from countries with large domestic markets. This is underlined by the evidence from Columbia, Singapore, Finland, Austria and France where between 30 and 63 per cent of the franchisors in these countries are involved in cross-border franchising. It is particularly outstanding, in relative terms, that Columbia and Singapore (two countries with very small domestic markets) have the highest proportion of cross-border franchisors than the other countries. Of all the countries in this category, only France can be described as having large domestic market. But then, franchising is most developed in France than in any other European country. So it is not accidental that France boasts most number of international franchisors in Europe.

This is in marked contrast with the United States, Brazil, Australia/New Zealand, Mexico and Britain with less than 25 per cent of their franchisors engaged in international franchising. The case of the United States is particularly noteworthy. Of the 3000 registered franchisors, only 400 (13%) are involved in cross-border franchising. The most plausible explanation for this seeming lack of interest in international franchising by the bulk of the franchisors is perhaps, the huge size of the domestic market, and the lack of need for and/or relevance of the type of businesses engaged by most of these franchisors in international markets. The second point is very relevant because international expansion by franchisors is usually pull-driven rather than by any meaningful push strategy. In other words, successful domestic franchisors with famous and franchiseable businesses would attract the attention of foreign investors, and are normally approached by these prospective franchisees.

Table 2. Global Franchising in Perspective (as of November 1995)

Country	Number of Franchisors	No. of Domestic Franchisees	No. of International Franchisors	% of Franchisors with International Franchisees
Israel	18	15	0	0%
Czech Republic	35	100	0	0%
Chile	45	25	5	11%
Yugoslavia	45	620	0	0%
Columbia	48	300	30	63%
Philippines	56	61	4	7%
Denmark	68	1,210	7	10%
Finland	70	900	22	31%
Portugal	70	-**	4	6%
Hong Kong	84	-**	4	5%
Singapore	85	1,600	40	47%
Argentina	100	3,500	3	3%
Indonesia*	105	-**	-	-
Malaysia	125	800	5	4%
Belgium*	150	3,083	-	-
Switzerland*	170	-**	-	-
South Africa*	180	-**	-	-
Norway	185	3,500	20	11%
Sweden	200	9,000	4	2%
Hungary	200	10,000	3	2%
Austria	200	3,000	57	29%
Spain	286	18,500	5	2%
Netherlands	341	11,975	15	4%
Mexico	375	18,724	75	20%
Italy	400	18,500	40	10%
Britain	414	26,400	99	24%
Germany*	500	18,000	-	-
France	520	30,000	150	30%
Australia/NZ	600	26,000	40	7%
Japan*	714	139,788	-	-
Brazil	932	60,000	19	2%
Canada*	1,000	65,000	-	-
United States	3,000	250,000	400	13%

***Sources**: Compiled from (1) Arthur Andersen World-wide Franchising Report November 1995. (2) International Franchising Association Fact Sheet May 1995.(3) Industry and Trade Summary: Franchising - US International Trade Commission, Publication 2921 September 1995.*

* Figures for franchisors with international franchisees not provided
** Figures for the number of domestic franchisees not provided

IV. Emerging Regulatory Environment

The ‘unequalness’ in the relationship between franchisors and franchisees has, for years, been a source of considerable uneasiness within the franchising industry. Oxenfeldt and Thompson (1969) note that perhaps the main challenge facing the franchising industry, and in particular the franchisee, is the possibility of arbitrary cancellation of a franchise by the franchisor. They predicted that “a capricious cancellation policy by the franchisor will provoke comprehensive federal legislation in the coming year aimed regulating the whole franchise area”. Giving that franchising grew most rapidly in the United States, it is not surprising that the earliest attempts to provide a statutory regulatory framework for the industry came from there. In 1968, the US Senate’s Sub-Committee on Anti-trust and Monopoly produced bill S.2321, the Franchise Competitive Practice Act, while the Senate Judiciary Committee produced S.2505, the Franchise Distribution Act. Both bills require the franchisor to justify his position if he seeks to cancel a franchise contract without stated cause or refuses to negotiate in good faith on franchise renewals (Oxenfeldt and Thompsom; 1969).

With the maturity and growing international significance of franchising, the regulatory framework is now well defined. The situation in the United States is perhaps most developed. For example, in 1979, the United States’ Federal Trade Commission (FTC) promulgated a Franchise Rule which requires that a franchisor provides to the prospective franchisee the following information prior to the sale: (1) An Offering Circular, commonly called the disclosure document, or the Uniform Franchise Offering Circular. Similar to a prospectus for public offer of shares, the disclosure document provides detailed information on about 20 specific items related to the franchisor and the franchise system, and (2) A franchise agreement, which is the licensing between the franchisor and the franchisee.

These regulations are designed to ensure that potential franchisees receive reliable information in advance of their investment (Hayes, 1994). Details of the disclosure requirements are presented in table 3. It is noteworthy that as at January 1, 1996, the new format of Uniform Franchise Circular became mandatory under the FTC's Franchise Rule for all franchises sold in the United States. Consequently, it is a requirement that the disclosure document must be given to the prospective franchisee at the first serious meeting to discuss the sale of the franchise, and at least 10 business days prior to the signing of the franchise agreement, or paying the franchisor any money.

Table 3. Requirements of the FTC Disclosure Document

1	Identifying information about the franchisor.
2	Business experience of the franchisor's director and key executives.
3	The franchisor's business experience.
4	Litigation history of the franchisor and its directors and key executives.
5	Bankruptcy history of the franchisor and its directors and key executives.
6	Description of the franchise
7	Money required to be paid by the franchisee to obtain or commence the franchise operation.
8	Continuing expenses to the franchisee in operating the franchise business that are payable in whole or in part to the franchisor.
9	A list of persons, including the franchisor and any of its affiliates, with whom the franchisee is required or advised to do business.
10	Description of services that the franchisee is required to purchase, lease, or rent, and a list of any person(s) with whom such transactions must be made.
11	Description of consideration paid (such as royalties or commissions)by third parties to the franchisor or to any of its affiliates as a result of a franchise purchase from the third parties.
12	Description of any assistance offered by the franchisor in financing the purchase of a franchise.
13	Restrictions placed on a franchisee's conduct of its business.
14	Required personal participation by the franchisee.
15	Termination, cancellation, and renewal of the franchise.
16	Statistical information about the number of franchises and the rate of termination.
17	Franchisor's right to select or approve a site for the franchise.
18	Training programs for the franchisee.
19	Celebrity involvement with the franchise.
20	Financial information about the franchisor.

Source: Federal Trade Commission, Bureau of Consumer Protection: Franchise Rule

IV.1. Summary

Unlike the United States, the franchising regulations in Europe vary greatly from country to country. In all but one country, there are no specific laws governing franchising as such. It is regulated through standard commercial and international trade laws, competition, intellectual property and foreign investment laws. These are supplemented with the *Codes of Ethics* issued by the country's and European Franchise Federation (a federation of European Franchise Associations). France is the only European country where there are direct legal requirements on the franchisor similar to those of the United States. France's "Doubin Law" of December 1989 requires that a franchisor must provide a prospective franchisee with a disclosure document "setting out the circumstances in a fair and accurate manner, enabling that person to commit itself in full knowledge of all the facts" at least 20 days prior to the execution of the agreement or payment of any required sum of money.

Elsewhere, franchising is regulated by a combination of *Codes of Ethics* issued by the country's franchising association and commercial laws. But in Japan, the Code of Ethics issued by the Japan Franchise Association (JFA) has a wider scope than those found in other countries. These are provided to promote high standard of business ethics and address the perceived problems of franchisor abuses. For example, pre-contract information disclosure similar to those of the United States is obligatory under the JFA's Code of Ethics.

Global regulatory practices indicate that there is no standard on the scope or direction of franchising regulations, and whether the industry should be regulated by specific national laws or code of ethics issued by national franchising associations. However, it would seem that pre-contract disclosure as an important element of these regulations, is rapidly gaining international acceptability and may well become a standard requirement on all international franchisors in the future.

V. Policy and Strategy Issues

This paper sets out to examine the relevance of the internalization thesis of the theories of international production vis-à-vis franchising as a "new form" of international operation. In doing so, the nature of franchising and the factors responsible for its increasing attraction to the big multinational companies rather than direct foreign investment even where the latter is possible and profitable are identified and examined. A number of plicy and strategy issues emerged from the paper are particularly noteworthy.

First, the extensive use of franchising over the last twenty years has shown that it is a form of organization which is neither exclusive nor attractive to smaller firms with limited resources and restricted access to capital markets. It is a form of organisation in which effective control of arms-length international franchisees can be exercised by the franchisor. Indeed, contrary to the assumptions of the neo-classical theories of international production, franchising may be a superior strategy to DFI for international expansion because it offer the benefits of DFI without the associated costs. It provides the opportunity for rapid network spread and high visibility with very limited costs.

Second, internationalisation of operational activities through franchising is normally pull-driven by interested foreign foreign investors. This offers franchisors the opportunity to dictate the terms and conditions of any contract as the basis for securing guarantees for effective control of operational matters. However, the degree to which a firm is able to extract maximum benefits from an arrangement is dependent of the desirability of the company-specific assets such as brand names. Consequently, international franchising is predominantly controlled by a few active and well established franchisors. These firms account for the bulk of internationally franchised outlets. Furthermore, the attractiveness of a business format for international franchising is a function of the network spread of the concept in the domestic market.

Three, although proponents of transaction costs thesis argue that these are too high in forms of foreign investment other than DFI as to absorb all potential gains from trade the definition of transaction costs and their impact on contractual relationships remain unclear. Williamson (1979) suggests that the following factors seem to generate a general consensus on transaction costs: (1) opportunism is a central concept in the study of transaction costs, (2) opportunism is especially important for economic activity that involves transaction-specific investments in human and physical capital, (3) the efficient processing of information is an important and related concept, and (4) the assessment of transaction costs is a comparatively institutional undertaking. Williamson argues that beyond these general propositions, a consensus on transaction costs is lacking. Therefore their impact on contractual relations is difficult to calculate and cannot constitute the over-riding consideration in the decision whether to externalize company-specific advantages or not. Furthermore, the impact of transaction costs is situation-specific and cannot be generalised.

Four, successive studies show that franchising (domestic or otherwise) offers low risk investment opportunities for investors. Failure rate is reportedly modest (between 10 and 20 per cent).

Finally, evidence from table 2 indicate a unique pattern in the development of international franchising. It is clear from the data that where franchising is well developed, size of the domestic market is normally a critical motivating factor encouraging internationalization. Therefore, franchisors from countries with limited domestic market are likely to be more active in international franchising than those from countries with large domestic markets.

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