The royalty rate and the trade-off between risk and incentives;

Determinants and performance outcomes in franchising networks

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ABSTRACT:

This article deals with a main monetary provision in franchise contracts, the royalty rate, which influences the profit sharing between the franchisor and the franchisee. The principal-agent model highlights a trade-off between risk and incentives motivations. Contrary to this view, we show that under low risk aversion of the franchisee, the relationship between risk and incentives is positive which implies that the royalty rate decreases with the risk of business failure. We address empirically this issue and the performance outcomes at the network level. Our unique panel dataset combines French franchising and financial data. Using a random effect model, in addition with the two-stage Murphy and Topel estimator, we provide evidence that when the royalty rate is determined regarding risk and incentives issues, the network financial performance is higher.

Keywords: Franchising, Agency theory, Network performance, Applied econometrics, Panel data.