Why Do Entrepreneurs Enter Franchising and Other Share Relationships?[1]

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ABSTRACT. Many entrepreneurs enter long-term relationships such as franchising, an important area of entrepreneurship research. However, franchising is but one version of an underlying organizational form—long-term share relationships—in which both principals and agents receive variable returns. Using two major streams of research that have long remained largely separate from one another—franchising and sharecropping—we build an integrative model of the determinants of share relationships, apply an evolutionary perspective to show how incentives may change, develop explanations for longstanding theoretical conflicts, and generate a fresh set of research propositions.

RÉSUMÉ. Un bon nombre d'entrepreneurs entrent dans des relations d'affaires à long terme tel que le franchisage, un important domaine de la recherche en entrepreneuriat. Par contre, le franchisage n'est qu'une version d'une forme organisationnelle sous-jacente, soit les relations de partage à long terme dans lesquelles les partenaires de cette relation, les franchiseurs et les franchisés, ont des rendements qui varient. C'est à l'aide de deux volets de recherche, le franchisage et le métayage, lesquels sont longtemps demeurés séparés, que les auteurs ont développé un modèle d'intégration des déterminants des relations de partage, appliqué une perspective évolutionnaire pour montrer la façon dont les motivations peuvent évoluer, élaboré des explications quant à des conflits théoriques de longue date, et élaboré de nouvelles hypothèses de recherche.

Introduction

North America makes substantial use of franchising. In the United States, franchising employs roughly 11 million people and produces $880 billion of output (International Franchise Assocation, 2007). In Canada, franchising directly employs more than one million people and accounts for 10 percent of the country's gross domestic product (Canadian Franchise Association, 2010).

Many entrepreneurs embark on business ownership by becoming franchisees, while others commercialize business ideas by becoming franchisors. Franchising itself is an important area of entrepreneurship research (e.g., Kaufmann and Dant, 1999). Significant work has been done to develop various models of franchising (e.g., Castrogiovanni, Combs, and Justis, 2006; Combs and Ketchen, 2003; Tracey and Jarvis, 2007). The principal (franchisor) grants an agent (franchisee) the right to produce, distribute or sell goods or services using the principal's trademark and business format in exchange for a sales royalty (Hunt and Nevin, 1976). It has been used since at least the late 19th century, when the Singer Company sold the right to market its sewing machines. Business format franchising grew dramatically starting in the 1950s and now is found in many industries (Lafontaine and Shaw, 1998).

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However, most franchising research has overlooked the idea that franchising is but one version of an underlying organizational form—long-term entrepreneurial share relationships, in which the contract parties receive variable returns. (Share relationship and share contract are used interchangeably throughout the paper.) To develop an integrative, evolutionary view of entrepreneurial share relationships, we mesh and extend two major streams of research that have for decades remained largely separate from one another—franchising and sharecropping. We build an integrative model of share relationships, apply an evolutionary perspective to show how incentives may change, develop explanations for longstanding theoretical conflicts, and generate a fresh set of research propositions.

The international spread of franchising (Preble and Hoffman, 1995) echoes the global use of another share relationship—the ancient practice of agricultural sharecropping. As in franchising, participants range from individual entrepreneurs to extended families to large corporations.

Surprisingly, entrepreneurship research has largely ignored sharecropping. However, not only do sharecropping and franchising share the same basic form, they also have remarkably similar explanations of form, incentives, and managerial issues. In sharecropping, until now studied mostly by economists, the principal (landlord) grants the agent (tenant) the use of land in exchange for part of the output. It has also been found in extraction industries such as mining and logging.

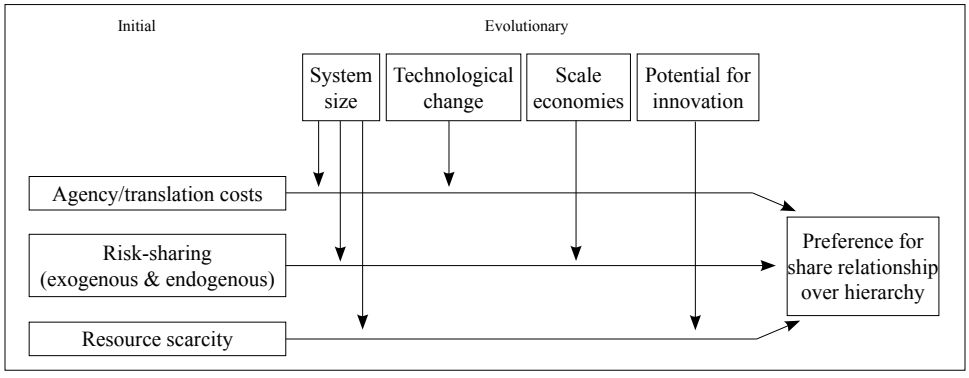
In North America, the use of farm tenancy is substantial. In the U.S., in 2007, tenants farmed 81.8 million acres (8.9%) of all U.S. farmland, the average tenant farm was more than twice as large as the average owner-operated farm (582 acres versus 226), and tenants operated more than 10% (6,079) of the 57,292 farms with crop values over $1 million (U.S. Department of Agriculture, Census 2007, Volume 1, Chapter 1, Table 65). In Canada, in 2006, 5.7 million acres (3.4% of all Canadian farmland) were identified specifically as being in crop-share tenancy, and another 34 million acres (20%) were identified as being in tenancy without share details being provided (Statistics Canada, Census of Agriculture, 2006, Table 1.6).

We disaggregate the three traditional explanations for share relationships—agency, risk, and resource explanations—to identify and resolve a variety of conflicts and gaps in existing work. First, we extend the traditional agency view by incorporating the agent's monitoring costs, the relative importance of agency costs, and the competitiveness of partner markets. The second argument, risk sharing, usually includes external price and productivity risks. We extend this explanation by integrating the complex internal risks in share relationships. Third, the inefficient resource markets argument suggests that share contracts create access to resources.

Due to the static nature of these explanations, we explore evolutionary forces. The most salient evolutionary factor is change in size. By separating out its effects on the three traditional explanations, we explain the franchise-versus-company-ownership conflict that has been observed in growing franchise systems (e.g., Seshadri 2002). The net result is that size reinforces the incentives for being a franchisee, yet it weakens most of the franchisor's incentives. The paper explains two additional sources of conflict between franchisees and franchisors—technological scale economies and the partners' abilities to innovate.

Figure 1 summarizes our model of entrepreneurial share relationships.

Figure 1. Initial and Evolutionary Determinants of Share Relationships



Determinants of Share Relationship Entry

Extending the Agency/Transaction Cost Argument

The first determinant identified in Figure 1 is agency and transaction costs (e.g., Eisenhardt, 1989; Hennart, 1993; Williamson, 1985). There is a wealth of agency and transaction cost literature explaining that franchising reduces the cost of monitoring and enforcing a business relationship (Coase, 1937). Still, two significant elements have received insufficient attention—the relative nature of cost and the relative competitiveness of markets for partners.

At heart, there are three major agency issues: (1) avoiding adverse selection—choosing a bad partner because of incomplete information; (2) reducing moral hazard—aligning parties incentives so they do not cheat; and (3) holdup—one party exploiting another because of specific investments and/or because there are few alternative partners (Williamson, 1985).

Remarkably, the major sources of share research often have different views on which participant will behave badly. On the one hand, most of the economics-oriented literature dwells on lazy farm tenants or free-riding franchisees (e.g., Alston, 1981). On the other hand, marketing and law literatures emphasize exploitative landlords and abusive franchisors (e.g., Burke and Abel, 2003; Greco, 2001).

Share relationships may reduce the cost of monitoring labor and otherwise enforcing the contract (Alston, 1981). Selection and negotiation costs also enter the decision. A share relationship gives the agent a strong incentive to perform and mitigates the principal's problems of selecting and negotiating with employees. The share relationship may be a cheaper way to organize activity (Gallacher, Goetz, and Debertin, 1994; Fladmoe-Lindquist and Jacque, 1995) and may increase overall productivity (Brinkley, 1997) more than wage contracts (Garrett and Xu, 2003).

The relative nature of cost. Although much of the share literature centers on monitoring and contract enforcement costs, it neglects a crucial component—the value of the principal's inputs.

Monitoring of entrepreneurial agents is a central element in many models of share contracts (Ackerlof, 1976; Agrawal and Lal, 1995; Allen and Lueck, 1993; 1999; Alston, Datta, and Nugent, 1984; Baucus, Baucus, and Human, 1996; Brickley and Dark, 1987; Brown,

1998; Carney and Gedajlovic, 1991; Caves and Murphy, 1976; Chakrabarty, Chaudhuri, and Spell, 2002; Chattopadhyay and Sengupta, 2001; Chew, 1993; 1998; Curry, 1966; Hunt and Nevin, 1974; Kaufmann and Lafontaine, 1994; Krueger, 1991; Lafontaine, 1992; Lal, 1990; Mahoney, 1992; Norton, 1988a; 1988b; Ray and Sing, 2001; Reid, 1977; Reiersen, 2001; Rosenberg and Bedell, 1969; Rubin, 1978; Thompson, 1968; Walker and Etzel, 1973; Weaven and Frazer, 2003).

Minor attention has been paid to other monitoring issues such as potential abuse or degradation of the principal's assets (Dubois, 2002; Norton, 1988a; Soule, Tegene, and Wiebe, 2000) and poor choice of partners (Hallagan, 1978a; Minkler, 1990; Wattel, 1968).

The monitoring argument remains incomplete because it neglects the relative nature of cost. Comparing monitoring costs makes sense only if we explicitly consider the value of the assets to be committed. For example, consider a restaurant expanding to a distant location. The typical franchising analysis will compare the cost of direct monitoring (through travel, communication, or a salaried local employee) to the cost of a share contract. This calculation omits a key element—the value of the retailer's investment in infrastructure. A restaurant that simply hires employees will have to pay for the restaurant, but a franchisee will be expected to incur much of the cost of the new building.

Thus, the restaurant's monitoring costs have meaning only relative to its larger investment. Its monitoring costs should be specified as the ratio of the marginal cost of monitoring to the marginal value of the principal's additional input. When monitoring costs are low but the new building is expensive, the restaurant prefers to hire wage employees. When the two are the same, the restaurant is indifferent, and when the ratio is high it will prefer a franchisee to wage employees. So, when this ratio is less than 1 the principal should prefer wages, when the ratio is 1 the principal should prefer neither, and when it is greater than 1 the principal should prefer a share contract. Thus:

Proposition 1: *The ratio of the marginal cost of monitoring to the marginal value of the principal's inputs is positively related to the principal's preference for sharing over hierarchy.*

The relative competitiveness of partner markets. Literature neglects the relative competitiveness of the markets for partners. Williamson's (1985) argument about small numbers bargaining should apply—the number of potential partners will decrease from the beginning of the relationship due to selection costs and relationship-specific learning or investments that occur over time. In support of this argument, there is evidence of long-term share relationships—the average term of initial franchise agreements is more than ten years and the median turnover rate for agents is five percent (International Franchise Association, 2000: 7).

There is ample evidence that the parties in share contracts often disagree on goals and approaches (Bush, Tathum, and Hair, 1976; Caves and Murphy, 1976; Du Toit, 2003; Kaufman and Rangan, 1990; Zeller, Achable, and Brown, 1980). Although Carney and Gedajlovic (1991) argue that sharing creates high-powered *aligned* incentives, sharing may also *misalign* incentives (Bush, Tatham, and Hair, 1976; Zeller, Achabal, and Brown, 1980). And, while Alston (1981) claims that monitoring costs are essentially borne only by the principal, Lim and Frazer (2002) identify monitoring costs borne by agents.

Franchisees have two monitoring concerns: incentive misalignment and free-riding. First, franchisors want to maximize total system revenue, but franchisees want to maximize profits from their own operations. These goals will conflict in a network with overlapping service areas, when a principal sells competing franchise businesses, or when a fran-

chisee's profits from meeting marginal demand will not meet his marginal cost of capital. Second, agents must prevent free-riding by principals. For example, an agent who leases gold mining rights and invests in site-specific equipment will avoid fixed rent because the land may be unproductive (Hallagan, 1978a; 1978b). And, although franchisees often invest substantial sums, their franchise contracts typically allow franchisors to end relationships quickly (Hadfield, 1990). However, share contracts may also protect agents by defining their termination rights, protecting their capital improvements, and providing escape clauses (Hallagan, 1978b; Cheung, 1969; Ho, 1976). Other problems include principals exploiting monopoly power over inputs (Inaba, 1980), withholding relevant information (Brickley, Dark, and Weisbach, 1991; Castrogiovanni, Justis, and Julian, 1993), keeping better resources for themselves (Chaudhuri, Ghosh, and Spell, 2001), or simply abandoning their relationships (Brown, 1969; 1973; Luxenberg, 1985).

The number of share contracts can have diverse effects on system output (Rysman, 2001). Clearly, the relative availability of principals and agents should influence the parties' incentives, and agency theory offers the obvious solution: both parties should prefer sharing, as the number of principals rises relative to the number of agents.

For the principal, as employees become relatively scarce, the cost to obtain and monitor labor will rise. Franchising should become relatively less expensive than wage hierarchy. The share rate paid to franchisees should rise as well. However, it should rise more slowly than wages due to the strength of the incentive bond provided by sharing and due to the specialized investments made by both parties—these factors will tend to hold the parties together.

For the agent, as principals become relatively common, they become easier to replace. The threat of replacement should moderate a franchisor's opportunism and reduce the franchisee's monitoring costs. The agent's monitoring costs are particularly salient in share relationships—unlike wage employees, a franchisee must worry about the franchisor's impact on the franchisee's returns. Any decrease in monitoring costs should decrease the agent's incentives for a wage contract. Accordingly:

Proposition 2a: *Ceteris paribus, the ratio of principals to agents is positively related to the principal's preference for sharing over hierarchy.*

Proposition 2b: *Ceteris paribus, the ratio of principals to agents is positively related to the agent's preference for sharing over hierarchy.*

Extending the Risk-sharing Argument

Risk sharing, the second determinant in Figure 1, is an enduring explanation of organizational form (Knight, 1921) and an integral part of management and share research (e.g., Basu, 1992; Das and Teng, 1998). Share research has focused on external risks, but there are important risks internal to the relationship (Table 1) that create complex conflicts.

External risks. External price and productivity risks create an interesting misalignment of incentives. In a wage hierarchy, the principal bears the brunt of price and productivity risks (Agrawal, 2002; Cheung, 1968; 1969; Ho, 1976; Martin, 1988; Thompson, 1992); in franchising, the principal's price risk is lower because there are no fixed wages. Productivity risk from uncontrollable external events and long production cycles (Luckert, 1998) also will lead the principal to prefer share relationships. However, since these risks decrease the agent's expected returns, the agent will prefer wages. Thus:

Table 1. Impact of Risks on Desirability of Share Relationships		
Potential Economic Loss From:	**For Principals, Sharing is**	**For Agents, Sharing is**
External Risks		
Price risk due to overall demand and supply (like more competitors)	Less risky than wages	More risky than wages
Productivity (output) risk due to uncontrollable factors (like bad weather)	Less risky than wages	More risky than wages
Internal Risks		
Agent's exposure to financial losses by other agents	---------	Less risky than wages
Legal restrictions on principal's decision-making freedom	More risky than wages	More risky than wages

Proposition 3a: *Ceteris paribus, exogenous risk is positively related to the principal's preference for sharing over hierarchy.*

Proposition 3b*: Ceteris paribus, exogenous risk is negatively related to the agent's preference for sharing over hierarchy.*

Endogenous risks. Literature neglects two endogenous risks: the hierarchy agent's exposure to the business risk of other agents, and the share principal's reduced control.

Sharing reduces an agent's financial risk—operating losses incurred by fellow agents do not directly affect the agent. For instance, although a franchisee can be hurt by another's poor reputation (loss of trademark value), the franchisee is not directly hurt by another's unprofitable store. One franchisee can be highly profitable while others lose money. Thus, the business risks (actual or perceived) of other agents should influence an agent's desire for share relationships:

Proposition 4a: *Ceteris paribus, the business risk associated with other agents in the organization is positively related to the agent's preference for sharing over hierarchy.*

A similar logic holds for the share principal in terms of control. As a multilateral contract, franchising is more difficult to modify to adapt to external change (Levin, 2002). A share relationship reduces the principal's control by restricting decision-making freedom. This may be particularly important in franchising, where laws may restrict principals. For example, in the U.S. a franchisor's strategy and operations are restricted by anti-trust rules on retail pricing (resale price maintenance), product line mix (forcing), and bundling (tying) (e.g., Justis and Judd, 1989; Michael, 1996; 2002). In a wage hierarchy, however, that same principal is free to set retail prices, dictate changes in the product lines, and require its retail division to carry all products. The principal's loss of direct control is the reason franchise contracts often require franchisees to adopt recommendations. Absent such a stipulation, the franchisor's wishes may not be legally enforceable. In marked contrast, the wage-paying principal has substantially greater freedom and authority. So, the greater the legal restriction of the share principal's freedom, the less attractive the share contract becomes. Thus:

Proposition 4b: *Ceteris paribus, legal restriction of a share principal's decision-making freedom is negatively related to the principal's preference for sharing over hierarchy.*

These internal risk elements—the wage agent's exposure to the full organization's financial outcomes, and the share principal's reduced control—moderate the relationship between risk and organizational form. Our model's detailed view of risk may help explain the mixed results evident in previous risk-based research on share contracts.

Extending the Inefficient Resource Market Argument

The third determinant in Figure 1 is the inefficiency of markets for resources like financing, management expertise, support services, and brand name capital. Entrepreneurial principals may need the investment franchisees can bring, and franchisees may want a proven business concept, method, or reputation—the major contributions of franchisors.

Some researchers reject the factor argument because agency issues seem so obvious (e.g., Combs and Castrogiovanni, 1994; Lillis, Narayana, and Gilman, 1976; Norton, 1988a; 1988b; Thomas, O'Hara, and Musgrave, 1990; Rubin, 1978). Capital does not appear to be a constraint for many franchisors (Elango and Fried, 1997; Lafontaine and Kaufmann, 1994). More than 90 percent of franchise companies and their parents are privately owned, and roughly a third of all franchisors offer financing to prospective agents (International Franchise Association, 2007).

On the other hand, there is evidence (Combs and Ketchen, 1999; Dant, 1995; Hallagan, 1978b) for the long-standing practitioner argument (Kroc, 1982; Rosenberg and Bedell, 1969) that capital markets do not support start-ups. For example, small firms in developing countries have a hard time getting financing (Satta, 2007). Other resources, particularly managerial talent, may encourage the use of franchising (Carney and Gedajlovic, 1991; Combs and Castrogiovanni, 1994; Dev, Erramilli, and Agarwal, 2002; Erramilli, Agarwal, and Dev, 2002; Lafontaine, 1992; Lafontaine and Kaufmann, 1994; Windsperger, 2001; 2002a; 2002b). Specifically, the more a principal needs talented managers, the greater his preference for share agents, since they do not require cash outlays for salaries. And, entrepreneurs with greater financial resources may be more likely to become franchisee agents than to start independent businesses (Williams, 1999). Franchisees also may become disaffected if the franchisor does not provide the expected level of inputs like support and advertising (Morrison, 2000). However, an agent with little money or skill much other than labor is less useful in a share relationship. That agent is likely to desire hierarchy. We derive the following:

Proposition 5a: *Ceteris paribus, a principal's resource scarcity is positively related to the principal's preference for sharing over hierarchy.*

Proposition 5b: *Ceteris paribus, an agent's resource scarcity is negatively related to the agent's preference for sharing over hierarchy.*

Evolutionary Determinants of Preference

How do the contractual preferences of franchisors and franchisees change over time? Their preferences evolve as a consequence of evolutionary factors—size, technological scale, and the prospect of innovation (Figure 1).

System Size

Changes in size may lead to a complex misalignment of incentives. Since share contracts may lead to faster growth (Michael, 2003), the impact of size on incentives merits attention. One study (focused on age, not size) finds that resource scarcity gives way to agency factors over

time (Castrogiovanni, Combs, and Justis, 2006), while Combs and Ketchen (2003) find that size is positively related to the use of share contracts, in direct contrast to their hypothesis.

We believe the mixed findings in prior research result from incomplete disaggregation of the effects of size on the three explanations for share contracts.

For the share principal, size makes agency costs more important, risk and resource scarcity less important. For the agent, system size reinforces all three explanations. Thus, a franchisee will become increasingly committed to sharing as the organization grows. The franchisor, though, must trade off rising agency costs against decreasing risk and heightened access to resources.

Size and agency costs. An increase in size helps align the parties' agency incentives for sharing. Rao (1971) hypothesizes that supervision costs expand faster than organizational size and that larger organizations should use share relationships. A significant empirical association between increasing organizational size and decreasing use of hierarchy (Alston, 1981) supports Rao's argument. Some research finds that size and sharing are negatively related (e.g., Frazer, 2001). However, there is broader support for the alternative view that size has a monitoring diseconomy of scale and thus should lead to more sharing. Research supporting this view has studied franchisor survival (Shane, 1996; 2001) and the geography of franchise systems (Alon, 2001; Brickley and Dark, 1987; Cliquet and Croizean, 2002; Hoffman and Preble, 2001; Klein and Saft, 1985; Macho-Stadler and Perez-Castillo, 1998; Martin, 1988).

For both parties, size is a positive moderator of the agency and transaction costs incentives for sharing. It resolves the principal's diseconomy of scale in monitoring and, because there are more agents, any individual agent's exposure to free-riding is reduced:

Proposition 6a: *Ceteris paribus, organizational size is positively related to the principal's agency-motivated preference for sharing over hierarchy.*

Proposition 6b: *Ceteris paribus, organizational size is positively related to the agent's agency-motivated preference for sharing over hierarchy.*

Size and risk. An increase in size misaligns the parties' risk incentives. Research suggests that organizational size often is positively related to risk aversion and increasingly conservative behavior (e.g., Aldrich, 1979; Falbe, Dandridge, and Kumar, 1998; Selznick, 1957; Simon, 1948). Size should indeed reduce the risk of failure because, as a firm grows, it builds resources (e.g., experience, money, and brand name equity). Shane and Foo (1999) suggest that institutional legitimacy affects firm survival. Since institutional legitimacy should grow over time and reduce survival risk, it too should reduce the principal's desire for share relationships. However, from the agent's perspective a rise in institutional legitimacy, and the concomitant decrease in survival risk, should encourage the agent's share preference. The share agent in an institutionalized network faces less risk than before. Building on the earlier arguments in Propositions 3a and 3b, then:

Proposition 7a: *Ceteris paribus, organizational size is negatively related to the principal's risk-motivated preference for sharing over hierarchy.*

Proposition 7b: *Ceteris paribus, organizational size is positively related to the agent's risk-motivated preference for sharing over hierarchy.*

Size and the resource market. An increase in size misaligns the parties' resource-market incentives. The lifecycle theory of franchising holds that firms should gradually shift from sharing to wages over time. It is rooted in Oxenfeldt and Thompson's (1968) original capital scarcity argument and underpins a variety of research (e.g., Anderson, 1984; Blair

and Kaserman, 1982; Carney and Gedajlovic, 1991; Hunt, 1973; Lillis, Narayana and Gilman, 1976; Oxenfeldt and Thompson, 1968; Sen, 1993; Shane, 1998a; 1998b; Thompson, 1992; 1994).

The "successful recipe" is a common view of franchising—agents follow a successful standardized business format. Paradoxically, franchisors are trying to tap the entrepreneurial spirit through franchising (e.g., Tuunanen and Hyrsky, 2001)!

Perhaps a large franchisor's size and experience make it a more valuable partner (Baucus, Baucus, and Human 1993) for diligent yet compliant agents, while a smaller franchisor may be the preferred partner for those with a more entrepreneurial flair. It is interesting to observe that small share organizations show considerable decision-making autonomy for agents (Alston and Higgs, 1982), while large ones have heavy supervision and little agent discretion (Alston, 1981).

Size makes the scarce resource motive less important for the principal. From an agent's perspective, however, a larger organization has more resources and is more capable of supporting the agent's efforts. Thus:

Proposition 8a: *Ceteris paribus, organizational size is negatively related to the principal's factor market-motivated preference for sharing over hierarchy.*

Proposition 8b: *Ceteris paribus, organizational size is positively related to the agent's factor market-motivated preference for sharing over hierarchy.*

Scale and Innovation

If size affects motives, what about the effect of economies of scale and innovation? Motives for franchising are related to demand volume, prospects for innovation, and scale economies, but only scale economies have received significant attention in the literature.

Scale economies. Literature neglects the ability of scale economies to misalign incentives. A technological change that standardizes production should reduce monitoring costs, making hierarchy less expensive (Alston, 1981). This standardization is driven by the rising scale economies often offered by new technology. Purchasing and advertising economies of scale may be exploited regardless of the use of sharing or hierarchy since they can be exploited over more than one production site. However, as Agrawal (2002) comments, production scale economies may be more readily exploitable in a wage hierarchy. A variety of empirical work supports this positive link between technological scale and hierarchy (Day, 1967; Eswaran and Kotwal, 1985; Rao, 1971; Ingram and Baum, 1997). Further, since significant capital investment may be necessary to exploit technological scale economies, the principal should be willing to pay more for hierarchical monitoring to ensure the efficient and careful use of that capital. Thus:

Proposition 9a: *Ceteris paribus, technological scale economies are negatively related to the principal's agency-motivated preference for sharing over hierarchy.*

Share literature typically stops at this point. However, an important corollary argument for technological returns to scale is evident if we consider the moderating effects of the level of market demand available to an agent. Research has shown that franchise retail outlets achieve lower sales than company-owned outlets (Seshadri, 2002). Often, the scale of a retail franchise operation is limited by local market demand. Many franchises produce services that attract only local customers (even hotel customers are necessarily, albeit temporarily, local) or they produce perishable goods (e.g., fast-food). This poses a form of price and productivity risk, since the principal may be unable to exploit technological returns to scale solely with local demand. Thus:

Proposition 9b: *Ceteris paribus, an agent's local demand volume is negatively related to the principal's risk-motivated preference for sharing over hierarchy.*

Interestingly, the reverse should hold true for the agent. As local demand rises, an agent should prefer sharing—decreasing uncertainty reduces price and productivity risk. There is less risk that scale economies cannot be exploited. Thus:

Proposition 9c: *Ceteris paribus, an agent's local demand volume is positively related to the agent's risk-motivated preference for sharing over hierarchy.*

Innovation. Innovation also has mixed effects on incentives. Existing research has done little to explore this except to ask an essentially *ex post* question: Do share contracts foster innovation? We reverse the question: How do the principal's and agent's prospects for innovation affect their incentives to remain in a share contract?

Share relationships can lead to conflict. Increasing the agent's prospects for innovation will align the parties' incentives, but increasing the principal's prospects will misalign incentives. Peach and Nowotny (1992) argue that sharing hinders the adoption of beneficial technology only if the rate of return is low or the principal is risk averse. Franchising may depend on standardization (Kaufmann and Eroglu, 1998; Rosenberg and Bedell, 1969) and compliance (Wattel, 1968), but share agents have a strong incentive to innovate (Darr, Argote, and Epple, 1995). For example, many of McDonald's menu and operations innovations came from share agents (Kroc, 1982).

Viewing innovative potential as an asset relates it to the resource-scarcity motivation for sharing. Wage agents typically have fewer skills than entrepreneurial agents (Agrawal, 2002). However, an agent's ability to innovate is likely to increase over time due to experience and opportunity. For example, franchisees develop richer operational knowledge than do wage employees (Bradach, 1997; Sen, 2001) and differences in incentives between those groups foster different patterns of learning (Sorenson and Sørensen, 2001).

If the agent develops innovations, he will prefer franchising over hierarchy because he will share in the returns. The principal should, too, because simple wages do not offer the agent the strong incentive that sharing does. However, if the principal is the innovator, then he will prefer wages in order to capture more of the profits, but his agent will prefer to be a franchisee for the same reason. Thus:

Proposition 10a: *Ceteris paribus, an agent's prospects for innovation are positively related to the agent's resource-scarcity-motivated preference for sharing over hierarchy.*

Proposition 10b: *Ceteris paribus, an agent's prospects for innovation are positively related to the principal's resource-scarcity-motivated preference for sharing over hierarchy.*

Proposition 10c: *Ceteris paribus, a principal's prospects for innovation are positively related to the agent's resource-scarcity-motivated preference for sharing over hierarchy.*

Proposition 10d: *Ceteris paribus, a principal's prospects for innovation are negatively related to the principal's resource-scarcity-motivated preference for sharing over hierarchy.*

Conclusion

There is no one reason why entrepreneurs enter into share relationships. The monitoring, risk, and resource explanations are "…mutually compatible parts of a larger explanatory system" (Alston and Higgs, 1982: 333). Our evolutionary perspective shows how traditional explanations may wax or wane in relative significance, both at the outset and as the

relationship evolves. In so doing, the paper identifies and resolves a variety of conflicts and gaps in existing work.

Disaggregating and extending the traditional explanations yields new theoretical insights. Building on previous research, the arguments and propositions explore how incentives shape preferences for share relationships, and how those incentives are likely to change. Many analyses of the incentives in share relationships have been done as static snapshots, but our approach uses an evolutionary context to build a framework for further theoretical and empirical work. First, it strengthens the agency argument by incorporating the relative nature of cost and the competitiveness of markets for partners. Second, it strengthens the risk argument by disaggregating risk into exogenous and endogenous elements. Third, it makes explicit the impact of size, technological scale, and prospects for innovation on the three traditional explanations. The model provides a number of specific propositions for subsequent empirical testing.

For entrepreneurs, this paper offers important insights. It helps explain the choice of organizational form for a new business. It arrays the agency, risk, and resource incentives for entrepreneurial share contracts from the perspectives of both parties to enable more informed negotiation with business partners. Existing share-based networks can use this perspective to understand the impact of evolutionary factors. For example, the model clarifies many of the sources of conflict between franchisors and franchisees as systems grow.

The arguments and evidence from the agency, risk, and factor market perspectives, in conjunction with the role of evolutionary factors, explain the complex incentives to participate and remain in a franchise or other share relationship.

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