Analyzing Inter-Firm Relationships: The Knowledge Perspective[1]

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Abstract

This paper intends to shed light on aspects of organizational design, in particular the firm's (entrepreneur's) choice in concomitantly making *and* outsourcing production. To this end, it proposes the knowledge view to help understand the persistence of the plural forms phenomenon. We describe plural forms as an organizational strategy aiming both: i. to provide tacit knowledge allowing for the experience of market opportunities; and ii. to codify and replicate the knowledge acquired through the firm's activities in order to better control its use and maximize economies of scale. Considering the dynamic market situation, in which product and service innovation is continually required in the competitive process, the successive generation of tacit knowledge is impeded. Moreover, contingencies emerge which raise the need for decisions in environments of uncertainty. Under these conditions, the firm cannot defer its capacity to generate knowledge in order to benefit from economies of scale when there are gains to be had in maintaining the concomitant use of different governance systems with similar structures: vertical integration and outsourcing. Gaining a strategic advantage requires the integration of external activities and technologies, while the ease of transferring codified knowledge will lead to the market. In other words, the scope of the firm will result from the balance between the use of economies of scale in the outsourcing of codified activities and in the exploitation of new resources developed within it. Empirical evidence from franchising is provided in support of our theoretical arguments.

Introduction

The literature that seeks to explain the logic of organizational choices has focused on the idea that, if competition is strong enough, a single structure would be efficient to govern a particular transaction or set thereof (Eisenhardt, 1985; Williamson, 1985). In this respect, the Agency Theory predicts that the confrontation of agents' characteristics, such as degree of risk aversion and opportunity costs for participation in the contract, in conjunction with the informational asymmetry between the parties, determines the choice of optimal contract. In turn, Transaction Cost Economics (TCE) assumes that, given the transactional characteristics (asset specificity, uncertainty, and frequency) and the formal and informal rules that define the space of interactions between economic actors, it is possible to determine the governance structure (choosing between making or buying) that is more efficient in reducing transaction costs. That is, both theoretical frameworks predict a single adequate governance structure in similar transactions.

Contrary to these theoretical assumptions, empirical studies show that organizational choice allows the adoption of a stable portfolio of contractual arrangements over time, even in situations in which the transaction attributes are similar. This empirical evidence, based on longitudinal data, suggests that economic actors are not restricted to the choice of a single governance structure, and therefore make the strategic choice of making *and* buying.

This paper intends to shed light on aspects of this puzzle, more particularly on the firm's (entrepreneur's) concomitant choice of making *and* outsourcing production. To that end, we propose the knowledge view to understand the persistence of the plural forms phenomenon. Empirical evidence from franchising is provided in support of our theoretical arguments.

We state that plural forms should be understood as an organizational strategy aiming both: i. to provide tacit knowledge, allowing for the experience of market opportunities; and ii. to codify and replicate the knowledge acquired through the firm's activities in order to better control its use and maximize economies of scale.

This paper is structured as follows. First, we argue how knowledge furthers the organizational design. Second, franchising evidence is presented in support of our arguments. Finally, we present some implications and remarks.

1. A puzzle to be solved

The contemporary understanding of one of the most important global trends in the marketing of products and services—franchising—dates to the 1950s, when traveling salesman Ray Kroc became interested in formatting (encoding) the tacit knowledge developed and owned by the McDonald brothers for marketing hamburgers and milkshakes in the United States. Ray Kroc's interest in encapsulating the tacit knowledge involved in the business was in order to facilitate its replication (transmission) in order to be able to reproduce it with greater chances of success (reducing uncertainty), regardless of location.[2]

The result was the conception of what was at the time a revolutionary organizational form, referring to a new packaging of the franchise: *Business Format* Franchising. Until then, the organizational practice of franchising was limited to a contractual arrangement in which the trademark holder only undertook to supply the

2 From this contemporary organizational revolution, Ray Kroc was successful in replicating the enterprise he pursued; he acquired, a few years later, the McDonald's trademark rights. From this same "formula," the process of internationalization of the McDonald's brand began in 1967 with the arrival of the Golden Arches in Canada and Puerto Rico. Benefitting from this same formula, other important names in global franchising, such as Burger King and Dunkin' Donuts, began similar operations. Through the internationalization of these and other networks, franchising has spread worldwide to become one of the most important forms of marketing.

products to be sold by third parties, in retail outlets that were not necessarily exclusive and under the same brand.

Unlike that earlier model (Brand and Product Franchising), Business Format Franchising is based on the collective and geographically dispersed exploitation of the same brand, coupled with the encapsulation and transfer of knowledge of the business in terms of management practices and routines, including relationships with suppliers, along with continuing technical and commercial assistance.

Thus is formed a network in which the franchisor (the central party, which owns the brand and knowledge of business management) and franchisees (multiple economic agents, geographically dispersed, to whom are transferred the rights for use and exploitation of the brand) are associated under the motivation of bilateral profit sharing in the use of tangible and/or intangible assets, many of which are specific to the relationship—such as capital, products or services sold through the network, plus the brand and/or any knowledge acquired in the activity franchised in terms of organizational practices and administrative management.

By sharing a brand, the expansion of a franchise network contributes to a greater awareness of this asset by allowing both the franchisee and the franchisor to obtain economies of scale in advertising. Likewise, since the development of a technology, a product line, and/or administrative procedures may also be shared with third parties through a franchise, the same investment can provide a greater return to the franchisor, while sparing investment on the part of the franchisee (Azevedo et al. 2003).

With the expansion of the network, it is also hoped that the entire system will benefit from economies of scale through the increase in volume of purchases and distribution vis-à-vis the improved distribution channels for products, goods, or services.[3]

Franchising thus allows the influx of capital to the business; the franchise would be a solution for companies which, seeking to increase their market share, reach limits

[3] The economies of scale, however, should not prove unique to franchise agreements. A company which, for example, opts to license its brand to expand its production may also benefit from the same economies of scale provided by franchising (Azevedo et al., 2003). Similarly, an organization can benefit from economies of scale in production, distribution, and advertising if it leaves the distribution in the hands of independents (Klein, 1995:10).

in raising capital (Ozane & Hunt, 1971; Caves & Murphy, 1976; Mendelsohn, 1985; Coughlan et al., 2001; Azevedo et al., 2003).[4]

Nevertheless, compared to vertical integration, franchising enables a reduction in the monitoring costs and control of marketing as a direct result of its greater capacity to align the interests of the parties involved in the shared use of the brand: businesses and local managers (the franchisee replacing a manager with a fixed salary).

It is noteworthy, however, that despite the comparative advantages of franchising, it is observed globally that in the business world firms do not limit themselves to franchising as an organizational form. Instead, they choose, in the same institutional and competitive environment, to define a strategic percentage, stable over time, of company-owned outlets in addition to their franchised units.

Although the view of the transience of the phenomenon of plural forms has prevailed for decades in the economic debate, longitudinal empirical evidence now supports the thesis of stability in the use of plural governance forms:[5] what has been interpreted as a strategy of networks to reduce contractual risk (Carlton, 1979) and increase control (Bradach, 1997) and bargaining capacity in relation to franchisees (Mathewson; Winter, 1985; Bai, Tao, 2000; Michael, 2000). This is the contemporary understanding of the phenomenon of plural forms (traditionally portrayed in franchising by the associated use of company-owned outlets and franchised units): the former would serve as an instrument of control of the franchisor over the actions of its franchisees.

Going further in this discussion, we state the understanding of the organizational design based on the perspective of knowledge. In this sense, company-owned stores are not only seen as an instrument of control, but also as playing the role of an "antenna"

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[4] Though it is argued that the organizational choice for franchising should be influenced by issues of restricted sources of capital, it is assumed that this is not the most decisive organizational motivation, nor is the economies of scale provided by franchising. To the extent that neither of these advantages represents benefits exclusive to franchising, the gains arising from a reduction in monitoring costs and control of commercialization, compared to a verticalized expansion, should represent the key factor in the organizational decision for this type of commercialization mechanism (Rubin, 1978).

[5] It is assumed here that in the absence of exogenous changes to the basic conditions for the choice of governance structures, the plural choice of company-owned stores and franchised units will represent a stable choice (strategic function) over time and in the same institutional and competitive environment. The thesis of transience is based, thus, on the understanding that some basic condition, like reputation, information, or access to credit, changes endogenously over time—which, in turn would lead to the predominance of a single structure. Unlike this understanding, the notion of growing returns developed by Arthur (1989) shows that stability in the use of plural forms can be observed even in cases where there are significant changes in the dimensions of the transactions (Azevedo & Silva, 2001).

sensing patterns and consumption trends, which is one of the variables considered from the competitive environment aspect.

2. How the knowledge view furthers organizational decision

Despite recent developments in the field of organizational economics and the importance it has attributed to the knowledge perspective in the firm's decision-making process, its influence on the organizational design still remains obscure.

It is natural to assume that knowledge is associated with uncertainty. The reason for this is that the entrepreneur faces two elements of uncertainty, which correspond to two types of foresight regarding the production of goods aimed to meet consumers' desires. The first element regards the evaluation, from the beginning to the end, of operational production issues. It is impossible to tell accurately what their results will be in physical terms (quantities and/or qualities of goods) before the resources are entered into the production process. The second element concerns demand issues. Products presumed to satisfy customers´ requirements involves uncertainty in the same way.

The business activity thus involves multiple types of knowledge about the the production steps and customers´ requirements. As a result, one cannot know in advance precisely what decision and what choices will be made in relation to the activities of planning, manufacturing, finance, accountancy, marketing, human resources, and strategy. Producers, then, must estimate both (1) the future demand requirements they are striving to satisfy, as well as (2) the future results of their operations in attempting to satisfy that demand (Knight 1964).

The design stages of the production process and market experimentation will characterize the tacit knowledge, which can be acquired only "through a time-consuming process of learning by doing" (Langlois & Foss 1999, p.207). According to Polany (1958), this type of knowledge cannot be formatted or conceived in words and, therefore, its transfer entails prohibitive transaction costs. These costs involve finding and negotiating relevant prices, measuring unknown attributes and formatting a contract. All of them may dissipate value, which leads the firm to engage in activities to protect the property rights of the resources, i.e., to retain knowledge within the firm (Barzel, 1997).[6]

The influence of this type of knowledge on the firm has been noted by various authors. Teece (1996) and Afuah (2001) suggest that vertically integrated firms have established processes for solving conflicts and coordinating their innovation activities. They observe that in the infancy of a new technology, the decision of "making" is better than that of "buying," essentially because the firms' communication channels are keys to successful innovation.

In other words, the exploitation of the firm's knowledge determines the degree of vertical integration in the transaction and the boundary of the firm. This is because the application of the knowledge shaped by the firm, which cannot be easily known by others, would be relatively or more efficiently concentrated than using an arms-length transaction. The intra-firm transfer of the firm's knowledge avoids the need for repeated negotiations, persuasions, coordination, and learning (Williamson 1985; Teece 1986; Langlois 1992).

However, the learning process is influenced by time. As learning is embedded in everyday actions and routines become established, it is expected that part of the tacit knowledge can be encapsulated and encrypted. This will bring about what Langlois (1992) has categorized as a "dynamic transaction cost." Learning through trial and error and the analysis of the respective feedbacks changes the quality of knowledge from a more tacit to a more codified knowledge.

Hence, the firm's decision to grow should take into account the three different types of knowledge (and their evolution) and their effects on profitability (Malerba & Orsenigo, 2000).

The extent of a company's vertical integration affects the nature of its accumulation of knowledge and the development of capabilities (Jacobides & Winter 2005; Malerba et al, 2008), which in turn affects the firm's capacity to absorb new external knowledge (Cohen & Levinthal, 1990). On the one hand, vertical integration would lead to the significant commitment of resources (Dierickx & Cool, 1989), insofar as the transfer of the knowledge generated and codified would allow the use of the market, if the latter allowed the realization of economies of scale. Given such a

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[6] It is observed that we are not assuming the absence of internal governance costs, but that these are below those of the market in the situation called into question, i.e. when starting a productive activity.

scenario, the choice of vertical integration as the only organizational form, instead of also using the market, could negatively affect the firm’s capacity to remain competitive.

However, the complete outsourcing of activities implies a loss in developing new knowledge and coordinating complementary assets (Teece, 1986; Stiglitz & Heine, 2007), which are of great importance for the competitive advantage of a firm, which is derived from a unique combination of the existing types of knowledge (Nelson & Winter, 1982; Fleming, 2001).

This means that there would be gains in maintaining both structures concomitantly: vertical integration and outsourcing. Seizing a strategic advantage requires the integration of external activities and technologies (Teece et al., 1997), while the facility in transferring codified knowledge will lead to the market.

In this case, the optimal growth of the firm involves a balance between the exploitation of current resources and the development of new resources and capabilities as a function of the dynamics of the competitive environment (Penrose, 1959; Wernerfelt & Montgomery, 1988). In other words, the scope of the firm will result from the balance between the exploitation of economies of scale in outsourcing codified activities and the exploitation of new resources developed within it.

3. Make *and* buy: A two-stage model regarding the organizational decision to combine internalized and outsourced strategies

The *first stage* departs from establishing the firm in an innovative business. The firm’s need to learn and create internal competencies and understand the market for its product induces the integration of its major operations.

The entrepreneur (firm) needs to estimate the results of future events for which the probability distributions are uncertain. The initial expectation is realized through a process of trial and error (learning), through which the entrepreneur assumes the full risk of innovation. This option results from the difficulty of finding in the market the resources needed to conceive the investment required for the innovative project.

The difficulty in finding the necessary resources in the market arises from the transfer costs for innovative ideas. These costs emerge because innovations are difficult to commercialize, insofar as the proponents of the idea or discoverers of new attributes of a resource will tend to use them themselves. This is because the transfer involves the transaction costs of finding and negotiating pricing references of unknown attributes. Two further aspects impede the trade in innovation: 1. Because creative ideas are not initially well developed, their communication to other agents becomes difficult; 2. Innovations rely on adaptation and negotiation processes, which intensify the barriers to transfer. Such reasons can lead to value dissipation if they are not performed within the firm (Foss & Klein 2004; Foss et al 2005, Teece 1982).

Business success, with growth in demand and the possibility of obtaining economies of scale using the market, leads to the *second stage* of the strategic decision in relation to the production frontier of the business.

Thus, it is proposed that the boundary of the firm would be outlined in accordance with the thesis put forth by Langlois (1992), that of dynamic transaction costs. Hence, when there are economies of scale found in using the market, the growth of the firm will occur based on granting third parties the right to use and exploit the knowledge it has encoded , such as through licensing contracts of a product or technology.

In this case, the firm licenses autonomous units, because deciding to grow internally—internalizing expansion costs—incurs penalties for not using the market, since the firm's codified knowledge allows it to control autonomous units while generating economies of scale. That is, it is assumed that the production gains realized through integration and the market will be greater then those realized through vertical integration, or the market, only:

$$G(IV, M) > G(IV, 0)$$

and

$$G(IV, M) > G(0, M)$$

It should be emphasized, however, that the strategy of outsourcing will depend on the capacity that the firm has acquired to encode and encapsulate knowledge so as to enable its transfer without incurring the cost of dissipating value (of the brand).

However, since the market is dynamic, innovations in products and services are continually required in the competitive process, which entails the successive generation of tacit knowledge. In addition, contingencies emerge, raising the need for decisions in environments of uncertainty. Under these conditions, the firm cannot defer its capacity to generate knowledge in exchange for the benefit of economies of scale. See Figure 1.

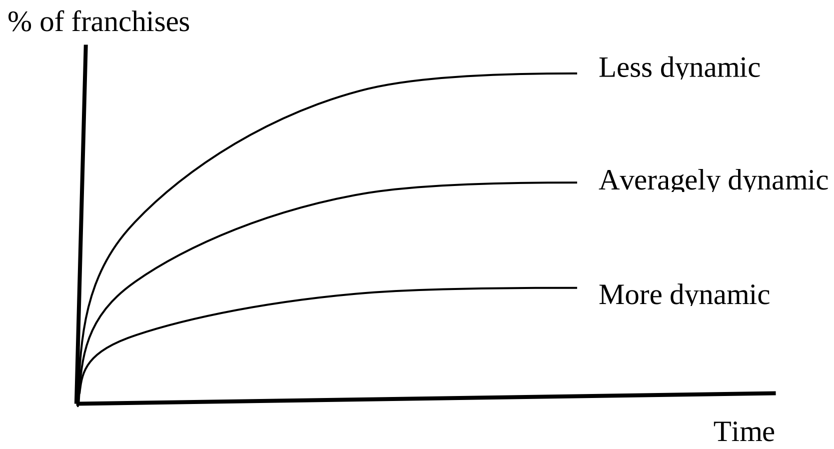

Figure 1. Percentage of franchises in relation to time.

Note that the hypothesis conceived here differs from those that advocate that concomitant modes have as their justification the establishment of benchmarks to control and encourage the outsourced units (Heide 1994; Carlton 1979; Bradach 1997). What is claimed here contradicts the proposition of this literature by assuming that the codification of routines already permits this type of control. Hence, vertical integration in association with the use of the market plays an important role in creating innovation.

4. Empirical findings from franchising

Once again, the case of MacDonald's may be illustrative. On one hand, the design of Business Format Franchising attenuates one element of uncertainty to which any new development is subject: the evaluation from beginning to the end of productive operation issues. To that end, one seeks the maximum codification of the knowledge relative to the activity, including in the sense of preserving the information conveyed by the brand. In this regard, any and every proposed modification/inclusion to the standard menu of products must pass the scrutiny of McDonald's US head office. When the relation involves trademarked McDonald's products—the Big Mac is the classic case—the control exercised is even tighter: it is up to the US head office to supply the master-franchise (the group that holds the rights to exploit the brand in a specific country/region) with the desired formulation, within the global specifications of the group.

But this is only part of the story, including that which is traditionally told in business books about the success attained by Ray Kroc. Franchising *per se* (in the sense of the choice for growth guided by “pure franchising” of the brand and the codified knowledge of management activities) does not represent the optimal organizational decision regarding both the maximization of economies of scale and the minimization of activity risks in the transfer of the relevant encoded knowledge .

A successful business requires dealing with the continuing challenge of successive generation of tacit knowledge (derived from the monitoring of trends and investment in innovative products and services, as well as the need for decisions in uncertain environments). Within this scenario, it becomes inefficient for a firm to defer its capacity to generate knowledge to benefit from economies of scale, leading to the organizational decision to combine internalized and outsourced strategies. In the case of franchising, this is made explicit by the strategic combination, stable over time, of company-owned stores and franchising units.

In fact, despite the gains in franchising (compared to vertical expansion) through a decrease in monitoring costs and control of marketing, in addition to the higher chance of success in the replication of a business that is “encapsulated” and tested (thanks to the organizational formula developed by Ray Kroc), rare are those franchise networks that are pure franchise operations. Returning to the case of McDonald’s, for example, although the American corporation uses franchising as its main expansion and growth strategy, its international policy sustains a historic average of 20% company-owned stores. In the French market, the percentage of company-owned stores within the network is 15% (See Figure 2).

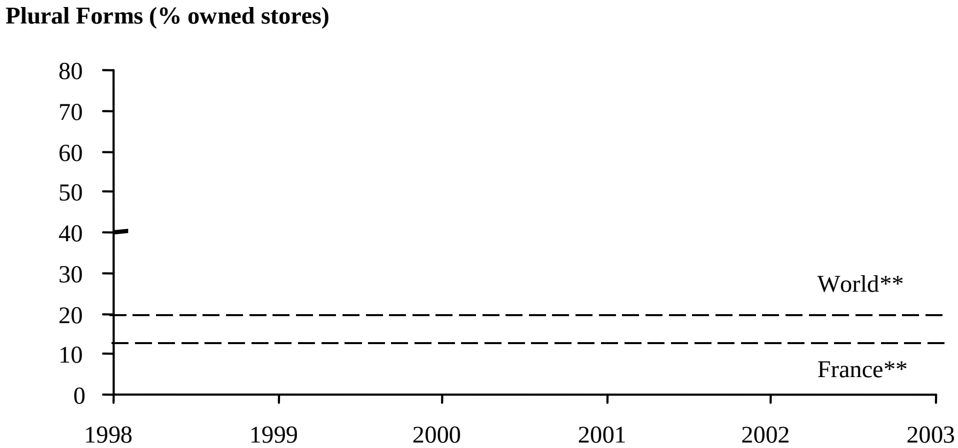

Figure 2. Evolution of the optimal, stable over time, combination of company-owned stores and franchised units (plural form) performed by *McDonald's* in France and in the world. Source: Azevedo & Silva (2007), based on estimates by the company.

Final Remarks

The argumentation presented in this paper has provided both theoretical and managerial implications. With reference to the former, our main objective was to make the analysis of inter-firm relationships more dynamic by including knowledge as a variable aimed to determine the firm's boundaries. Regarding managerial implications, we highlight the importance of identifying the amount and the characteristics of the knowledge acquired and shared by agents when analyzing the choice of a plural form. In these terms, for managers, the analysis of knowledge could indicate the type of the relationship which could provide their firms with more value.

Applied to franchising, this discussion demonstrates that the decision to internalize and outsource growth based on the combined use of company-owned stores and franchised units is not an inefficient organizational choice. The use of plural forms may increase a firm's competitive advantage by providing it with the scale economies offered by the use of the market, while allowing it to generate and to control the use of its newly developed capabilities which rely on the tacit knowledge found within its vertically integrated part.

As a result, franchising begins to contribute to a reduction in the risks assumed by franchisees due to the possibility of joining an already-tested system. The gains in economies of scale are not limited to marketing, instead encompassing all the knowledge embedded in the business practices of the franchisor.

This view supports the thesis of the stability of employment of the plural forms. It is natural to assume that every business venture starts with 100% internalized. Over time, however, based on the codification of the knowledge generated, it becomes advantageous for the firm to combine company-owned stores with franchised units aimed at economies of scale too.

Over the past decades (2000s and 2010s), the phenomenon of the organizational mix has fueled a heated debate in the organizational literature, in particular that dedicated to franchising.

In the case of franchising, the most striking feature of choosing a portfolio of contractual arrangements to regulate similar transactions is the coexistence of different organizational forms in the marketing and distribution of products and/or services.[7] The literature dedicated to franchise contracts usually attributes this coexistence to four main reasons: i. The guiding role of company-owned stores and the relevant characteristics of the franchisor; ii. Organizational constraints of financial and/or human resources; iii. Reduction of contractual risk; and iv. Increased capacity to bargain and control the use of the franchised brand. Whereas the first two reasons lead to a transitional organizational mix (a situation in which in the long run a single structure should prevail: it is expected here that organizational maturity will lead to the use of a single

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[7] Azevedo and Silva (2007) also show that the phenomenon of multiple forms in franchising is not limited to the combined use of company-owned outlets and franchised units. Contradicting this classical premise of the literature about franchising, the authors show, through evidence of a multi case conducted in France, that networks do not necessarily restrict the franchising of their brands to a single and exclusive contract, and may alternatively choose the operation of a variety of formats. In France, representing what would be the European model practised by the networks, three distinct contractual formats were identified in the franchising of a single brand: 1) total franchising; 2) partial franchising; and 3) management contract. The total franchising contract is characterized by that traditionally referenced in the economic literature. In the partial franchising contract, the up front costs are shared between franchisor and franchisee. While the network assumes the costs of the property—and, consequently, the control of the commercial point—the franchisee is responsible for the decoration and equipping of the unit and the hiring of staff. In contrast, the chain typically receives, in addition to franchise fees, royalties, and other related fees, a further portion of the revenues of the franchised unit in the form of rent on the property. Finally, in the management contract, the figure of the franchisee most resembles that of a store manager. Under this arrangement, the franchisee is responsible for the franchising fees, royalties, and related fees, in addition to expenses of rent and of managing the commercial point, while the entire initial setup and staffing expenses are up to the network. Illustrating this discussion, *McDonald's* practices the concomitant offer of partial franchising and the management contract (facilitated franchise, in the company's own terms) worldwide. For their part, the French networks *Comtesse du Barry*, *La Boucherie*, and *Segafredo Zanetti*—despite being able to use the total franchising contract—do not reject potential candidates with financial restrictions, also providing the franchising of their brands through the hired management contract. At the extreme, the *Quick* network, in its major markets (France, Belgium, and Luxembourg), exclusively employs partial franchising and hired management contracts, and does not practice total franchising.

governance form), the last two predict the stability over time of the phenomenon of plural forms.

Going further, this paper intends to shed light on the stability of the plural forms thesis based on the knowledge view. In this sense, company-owned stores are not seen simply as instruments of control, but also play the role of an "antenna" for consumption patterns and trends, which is one of the variables considered in the competitive environment aspect.

In competitive and more dynamic environments, company-owned stores are an important mechanism for transforming tacit knowledge into codified knowledge to be then transmitted and shared throughout the network of establishments. What is put forth here is the assumption that the codification of routines already permits this type of control. Hence, vertical integration associated with the use of the market plays an important role in the creation of innovation, referring to a strategic choice to be maintained over time.

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