Industry & Trade Summary

Franchising

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PREFACE

In 1991, the United States International Trade Commission initiated its current *Industry and Trade Summary* series of informational reports on the thousands of products imported into and exported from the United States. Each summary addresses a different industry area and contains information on U.S. and foreign producers, trade barriers, and industry trends. Also included is an analysis of the basic factors affecting trends in consumption, production, and international trade, as well as those bearing on the competitiveness of U.S. industries in domestic and foreign markets.[1]

This report on franchising services covers the period 1969 through 1994 and represents one of approximately 250 to 300 individual reports to be produced in this series. Listed below are the individual summary reports published to date on service industries.

USITC publication number	*Publication date*	*Title*
2456	November 1991	Insurance
2569	October 1992	Advertising
2594	February 1993	Legal Services
2638	June 1993	Commercial Banking
2864	March 1995	Leasing
2920	September 1995	Education Services
2921	September 1995	Franchising

[1] The information and analysis provided in this report are for the purpose of this report only. Nothing in this report should be construed to indicate how the Commission would find in an investigation conducted under statutory authority covering the same or similar subject matter.

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INTRODUCTION

A franchise is a privilege granted or sold, such as to use a name or to sell products or services. Franchises generally involve an elaborate agreement under which the franchisee (the recipient or purchaser of the privilege) undertakes to conduct a business or sell a product or service in accordance with methods and procedures prescribed by the franchisor (the grantor or seller of the privilege), and the franchisor undertakes to assist the franchisee through advertising, promotions, and other advisory services.[1] Franchise agreements generally provide for the payment of a fee and/or royalty, which may be either on a one-time or a continuing basis, by the franchisee to the franchisor.

This summary discusses two forms of commercial franchising: (1) product and trade name franchising and (2) business format franchising.[2] Business format franchising receives greater coverage in this report because it is in a more dynamic phase of development, particularly on the international level. This summary does not cover franchises granted by government entities, such as the right to supply certain telecommunication services, nor does it address franchising in the context of professional athletic teams.

Product and trade name franchising generally entails a franchisee's use of the franchisor's trade name in exchange for fees and royalties as well as an obligation to sell only the franchisor's products. Product and trade name franchising reportedly originated in the United States in the 1850s when Singer Sewing Machine Company established a distribution system based upon franchise agreements with sales representatives or dealers.[3] Product and trade name franchising experienced dramatic growth in the early 20th century with the arrival of the automobile and the accompanying need for a distribution system of gasoline filling stations. As of 1992, product and trade name franchising was dominated by automobile dealers, gasoline retailers, and soft-drink bottlers. These three industries accounted for approximately 69 percent of all franchising revenues in 1992.

[1] See *Black's Law Dictionary*, 6th ed. (St. Paul, MN: West Publishing Co., 1991), p. 658.
[2] Franchising is covered by Standard Industrial Classification Code 6794, Patent Owners and Lessors.
[3] William B. Cherkasky, "Introduction to Franchising and the International Franchise Association," ch. in *The Franchising Handbook* (New York: American Management Association, 1993), p. 1.

Business format franchising is similar to product and trade name franchising, except that the franchisee acquires the right to use the franchisor's entire business concept, from business plan to training materials. Howard Johnson is credited with being one of the first to apply the business format franchise concept as a means of expanding his restaurant business. In the 1960s, McDonald's and Burger King followed suit and business format franchising began to grow quickly. By 1992, there were more than 429,000 business format franchise establishments functioning in approximately 60 different industries, most of which are service industries.[4]

The objective of this document is to summarize available information on franchising in the domestic and international context. Following an overview of the benefits franchising provides to franchisors, franchisees, and consumers, the report presents a profile of the growing U.S. franchise market, including information on sales revenue, employment, and the number of franchised establishments, followed by a discussion of U.S. regulation that affects franchising. The remainder of the summary presents information on franchising in the international arena, beginning with a discussion of the numerous issues that affect international competitiveness, followed by information on the number of franchisors, franchised establishments, and revenues generated in major countries and regions. The summary then focuses on trade, including the U.S. balance of trade and international efforts at trade liberalization, and concludes with a presentation of future expectations for franchising. The principal findings of the summary are presented below.

- The success of franchising in the United States has led to international expansion, which presents additional marketing, legal, and organizational challenges. U.S. franchisors typically begin their expansion with highly developed markets that are geographically close or culturally similar.

- International expansion of U.S. franchisors has led to a substantial trade surplus in franchising fees and royalties. U.S. franchisors enjoy international competitive advantages as a result of the large domestic market, considerable experience with franchise management, and the favorable perception of U.S. products and

[4] Ibid., p. 4.

services around the world. The European Union constitutes the largest single market for U.S. franchisors, while Germany, Canada, and Japan are the largest country markets.

- International efforts at trade liberalization should impact franchising favorably and, when combined with favorable market and demographic trends, suggest that the future for franchising is bright.

THE ATTRACTION OF FRANCHISING

According to the academic and industry literature on franchising, the attraction of franchising lies in the benefits it offers to franchisors (the grantors or sellers of a privilege), franchisees (the recipients or purchasers of a privilege), and customers. Franchising enables franchisors to expand their businesses very quickly with limited financial commitment, often permits franchisees to enjoy relatively high incomes along with the satisfaction of self-employment, and provides consumers with a wide variety of products and services of consistent quality at low cost. When combined with favorable demographic conditions, which include high disposable income and demand for consumer goods and services, these benefits appear to explain the substantial growth of franchising.

Franchisor Benefits

From the franchisor's perspective, a franchise structure typically enables faster expansion, better management, and more efficient operations. Franchising permits businesses to expand very quickly and at relatively low risk without committing vast amounts of capital. Whereas an individual business may be able to raise the capital to open only a handful of new establishments per year, the franchise arrangement, in which franchisees finance their own establishments, may permit the opening of many more establishments in the same time period. Rapid expansion can provide a significant competitive advantage to the franchisor over independent establishments because, by growing quickly, the franchisor can develop a powerful brand image and capture market share well in advance of competition.

In addition to the advantages afforded by rapid expansion, some industry analysts maintain that franchisors enjoy better management as a result of an "agency theory" effect.[5] This theory asserts that a franchisee who has a personal financial interest in the success of the business will tend to have better entrepreneurial skills and higher motivation, and consequently will perform better than salaried staff. A second management advantage is derived from the fact that most franchisees are natives of the area in which their establishments operate. As a result, franchisees know the local community, including perhaps the region's business and government leaders. This local expertise can facilitate both start-up and day-to-day operations.[6]

While franchisors benefit from the small business aspects of local expertise and entrepreneurial motivation, they also enjoy efficiencies in both scale and scope that typically are reserved for large corporations. For example, a restaurant franchise system may realize scale efficiencies by purchasing all of its supplies centrally and in volume, training all employees using the same training program, and using the same cash and inventory control system in every unit. In terms of scope efficiencies, the franchise system can acquire and effectively utilize a full range of professional management services. This enables each unit in the system to benefit from access to state-of-the-art expertise in advertising, law, management, technology, and new product development. Essentially, franchising can capitalize on the advantages offered by both small and large businesses to create a strong and efficient business system.[7]

Franchisee Benefits

In addition to the many services franchisees receive from franchisors, franchisees may benefit significantly from the franchise arrangement by generating higher incomes, deriving greater personal satisfaction, and enjoying lower risk of failure than private business persons or employees of larger organizations. While franchisees must provide all or part of the necessary start-up financing, they also take home the majority of their franchise's profits, which typically are greater than average salaries. In 1992, the annual gross pretax median income of franchisees was in the range of $50,000 to $99,000, with more than 30 percent of franchisees

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[5] B. Elango and Vance H. Fried, "Franchising Research: Towards a Holistic Approach," College of Business Administration, Oklahoma State University, 1992, p. 6. Paper reproduced in U.S. House, Committee on Small Business, *New Developments in Franchising*, 102nd Cong., 2nd sess. (Washington, DC: GPO, 1992), pp. 155-191.
[6] Ibid., p. 14.
[7] Ibid., p. 7.

earning over $100,000 per year. This compares quite favorably with the median U.S. gross family income, which was $39,939 in 1991.[8] When compared with independent, sole-proprietor businesses, male-owned ventures generated approximately $50,000 in net income and female-owned ventures generated approximately $20,000 in 1991.[9]

Franchisees also appear to enjoy greater satisfaction with their jobs than other individuals, perhaps because franchisees are their own bosses.[10] Approximately 94 percent of franchisees perceive themselves as successful and 75 percent claim that they would repeat their purchase. By comparison, only 39 percent of all U.S. citizens respond that they would choose their current job or business again.[11]

Lower risk of failure is another advantage to acquiring a business format franchise instead of starting up an independent enterprise. However, there is considerable divergence of opinion on this issue, particularly concerning how much of an advantage franchising offers.[12] According to one study commissioned by the International Franchise Association, approximately 97 percent of franchised establishments founded within five years of the study were still in operation, and approximately 86 percent were still owned by the original owners.[13] Other industry analysts question such high numbers, with some suggesting that a conservative estimate would be in the range of a 60-percent success rate.[14] Nevertheless, a 60-percent success rate compares favorably with overall new business success rates, which are estimated at 40 percent after 2 years and 10 percent after 10 years.[15]

Regardless of the precise success rate, there is considerable consensus among those who study the industry that franchised establishments are more likely to succeed than independent operations.[16] The success of franchised establishments may be a result of greater personal commitment of money and time on the part of the franchisee, the more salable nature of franchised businesses, and the influence of professional management resources from the parent organization. According to data on small business development, most new firms begin with less than $10,000 in equity funds and use little or no borrowed capital.[17] In contrast, the cost of launching a franchised business ranges from $25,000 to $50,000, on average, with some franchises requiring as much as $500,000.[18] This increased financial commitment signifies a larger personal commitment undertaken by franchisees than by many independent entrepreneurs. Franchises are perceived as more tangible business entities than many independent start-ups, which is demonstrated by their greater ability to attract substantial third-party investors. Franchises are easier to value and exchange as assets than independent ventures because reports from other franchise units provide information regarding the earnings and asset value of directly comparable establishments.[19]

The influence of professional management from the parent organization further contributes to reduced failure rates. Industry data suggest that the average sales of franchised establishments are larger than those of non-franchised establishments.[20] Most likely, this disparity arises because business format franchisees buy a successful business, complete with a fully developed business plan and brand name. Franchisees benefit from the franchisor's assistance in developing and managing operations, which often includes help in finance,

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[8] James Trutko, John Trutko, and Andrew Kostecka, "Franchising's Growing Role in the U.S. Economy: 1975-2000," report no. PB93-182574, prepared by James Bell Associates, Inc., and JT International for the U.S. Small Business Administration, Office of Advocacy (Springfield, VA: National Technical Information Service, 1993), pp. 5-4 to 5-5.

[9] Bruce D. Phillips, "Franchising – The Optimal Organization for Small Firms (?)," paper presented at the Western Economic Association meetings, Vancouver, B.C., June 29-July 3, 1994, p. 17. Income data are from unpublished data prepared for the U.S. Small Business Administration under contract by the U.S. Department of the Treasury, Internal Revenue Service.

[10] Elango and Fried, "Franchising Research: Towards a Holistic Approach," p. 7.

[11] International Franchise Association, *Franchise Opportunities Guide* (Washington, DC: Winter 1995), p. 38.

[12] Attrition rate studies have yielded widely ranging results due to difficulties in defining and measuring success and failure across a representative sample. For example, if an individual franchisee fails, but the establishment eventually succeeds under another owner, this situation could be considered both a success and a failure. For a comprehensive review of the data difficulties, see Staff Memorandum, "Franchise Industry Research and Data," pp. 142-154, in U.S. House, Committee on Small Business, *New Developments in Franchising*, 102nd Cong., 2nd sess. (Washington, DC: GPO, 1992).

[13] Arthur Andersen & Co., "Franchising in the Economy 1989-1992," p. 16.

[14] Franchising industry analyst, interview by USITC staff, Society of Franchising Conference, Las Croabas, Puerto Rico, Jan. 21, 1995.

[15] Jeffry A. Timmons, *New Venture Creation: Entrepreneurship in the 1990s* (Boston: Irwin, 1990), p. 9.

[16] Franchising industry analyst, interview by USITC staff, Society of Franchising Conference, Las Croabas, Puerto Rico, Jan. 21, 1995.

[17] Phillips, "Franchising – The Optimal Organization for Small Firms (?)," p. 14.

[18] Ibid., p. 14.

[19] Ibid., pp. 15-16.

[20] Ibid., p. 3.

marketing, purchasing, and new product development.[21] These factors may reduce commercial risk and increase the profitability of franchised firms relative to independent firms.

Other Factors Encouraging Franchising

Demographics and technological advances have played a role in the successful development of the franchising industry.[22] As the number of double-income families has increased, the amount of time available to carry out household activities has decreased. These combined trends may explain the increase in demand for branded convenience services such as fast-food restaurants and automobile services, which offer easier choices for harried consumers.[23] Advances in computer technology have enabled franchised establishments to take advantage of highly developed systems for controlling cash, tracking costs and inventory, and monitoring financial performance. Telecommunication advances have allowed continuous communication with franchise headquarters, which, by establishing closer contact, have enabled each establishment to take advantage of professional management advice and assistance in a timely manner. The control and exchange of information then allows each unit to operate more efficiently, and the information reported back to headquarters provides valuable data for managing larger organizational issues such as strategic planning and system-wide marketing.[24] Even the U.S. cultural tradition may contribute to a favorable franchising environment by fostering respect for the efficiency offered by big business, as well as admiration for the virtues of self-employment and entrepreneurship.[25]

U.S. PROFILE

The following three sections present available information regarding trends in the U.S. franchising industry since 1969.[26] These discussions pertain to the number of establishments, the level of employment, and sales revenue.

Number of Establishments

The number of franchised establishments in the United States has grown significantly over the past 25 years. As of 1994, approximately one out of every 12 business establishments was a franchised business. A new franchise opens every 8 minutes of every business day.[27] As figure 1 shows, during 1969-92, the number of franchised establishments increased by approximately 45 percent, from 383,908 to 558,125 establishments. This represents an average annual growth rate of 1.7 percent. By business category, restaurants clearly dominate business format franchising, followed by non-food retailing, hotels/motels, and business aids/services (table 1). As measured by the number of franchised establishments, the largest franchise companies operating in the United States are 7-Eleven Convenience Stores, McDonald's Corporation, and Subway with 11,094, 10,339, and 9,240 franchised establishments, respectively (table 2).

While the number of franchisors doubled during 1975-88 (1,115 to 2,239 franchisors), most of the growth in sales revenue and in the number of establishments has been generated by a few very large business format systems. In fact, the business format franchisors with more than 500 franchised establishments represented only 6 percent of all franchise systems in 1986, but accounted for approximately 66 percent of franchise sales and establishments.[28] The increasing importance of these business format franchisors becomes evident when one considers that the overall number of franchised establishments has increased substantially, whereas the number of product and trade name franchised establishments actually declined during 1969-92, from 262,700 establishments to 128,908 establishments. This trend suggests that product and trade name franchising is approaching a mature state, while business format franchising still is expanding rapidly.

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[21] Trutko, Trutko, and Kostecka, "Franchising's Growing Role in the U.S. Economy: 1975-2000," p. ES-10.

[22] Thomas Dicke, *Franchising in America: The Development of a Business Method, 1840-1980* (Chapel Hill: The University of North Carolina Press, 1992), pp. 125-126.

[23] Ibid.

[24] Ibid.

[25] Ibid.

[26] Data for 1969 to 1988 were provided by the U.S. Department of Commerce, International Trade Administration series entitled "Franchising in the Economy." Data from 1988 to 1994 were provided by the International Franchise Association. The change in

(continued...)

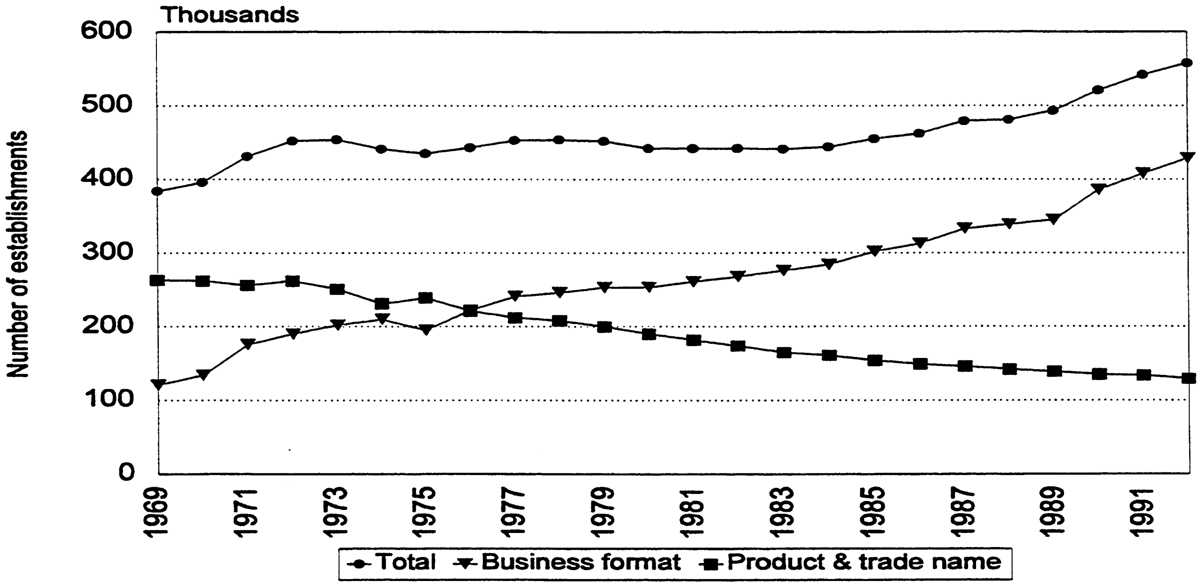
[26] (...continued)

source and methodology has resulted in trend data that may not be strictly comparable over time, but that generally support trends perceived by those in the industry.

[27] International Franchise Association, *Franchise Opportunities Guide*, p. 38.

[28] Trutko, Trutko, and Kostecka, "Franchising's Growing Role in the U.S. Economy: 1975-2000," pp. ES-4 to ES-5.

Figure 1
U.S. franchised establishments, 1969-92



Source: U.S. Department of Commerce, International Trade Administration; International Franchise Association; and USITC staff estimates.

Table 1
Business format franchising sales in the United States, by business category, 1989-91

Business category	1989	1990	1991
	Billion dollars		
Restaurants	70.1	77.8	85.5
Retailing, non-food	26.7	29.2	31.4
Hotels/motels	21.6	23.8	26.0
Business aids/services	16.9	18.6	20.8
Automotive products/services	12.5	13.8	15.4
Convenience stores	14.3	14.3	15.0
Retail food, non-convenience	10.0	11.7	12.1
Auto/truck rental	6.9	7.3	8.0
Construction, home improvement	5.8	6.4	7.1
Recreation	3.5	4.8	4.8
Educational products/services	1.6	2.0	2.3
Rental equipment	0.7	0.8	0.8
Laundry & dry cleaning	0.4	0.4	0.5
Other	1.0	2.4	2.6
Total	192.0	213.3	232.3

Source: International Franchise Association.

Table 2

Entrepreneur Magazine's **top 20 franchise companies in the United States, by business category and number of establishments,[1] 1994**

			Number of establishments	
Rank[2]	Franchise company	Business category	Franchised	Company-owned
1	Subway	Restaurant	9,240	1
2	McDonald's	Restaurant	10,339	3,823
3	Burger King	Restaurant	6,382	934
4	Hardee's	Restaurant	2,959	1,039
5	7-Eleven Convenience Stores	Convenience stores	11,094	2,509
6	Dunkin' Donuts	Restaurant	3,596	19
7	Mail Boxes Etc.	Business services	2,441	2
8	Choice Hotels Intl.	Hotels & motels	3,206	33
9	Snap-On Inc.	Hardware	2,922	376
10	Dairy Queen	Restaurant	5,368	1
11	Baskin Robbins USA Co.	Restaurant	3,705	11
12	Jani-King	Cleaning services	4,033	27
13	Coverall North America Inc.	Cleaning services	3,083	0
14	Arby's Inc.	Restaurant	2,449	271
15	Chem-Dry Cleaning	Cleaning services	3,755	0
16	Century 21 Real Estate Corp.	Real estate services	6,069	0
17	ServiceMaster.	Cleaning services	4,179	0
18	Coldwell Banker	Real estate services	2,017	320
19	Midas Intl.	Automobile services	2,201	339
20	Re/Max Intl.	Real estate services	2,328	0

[1] Includes U.S. and international establishments.

[2] Ranking based upon numerous factors, including length of time in business and number of years franchising, number of operating franchised and company-owned units, start-up costs, growth rate, percentage of terminations, and the company's financial stability.

Source: "The 16th Annual Franchise 500," *Entrepreneur,* Jan. 1995.

Employment

U.S. franchising employment data reveal patterns similar to those for franchising establishments. Employment in franchised establishments approximately doubled, from 3.5 million in 1975 to 7.0 million in 1988. Approximately 90 percent of this increase was generated by business format franchises, for which the employment level grew by 162 percent from 1975 to 1988. In comparison, employment by product and trade name franchising grew by only 18 percent during the same period. The average number of employees per establishment grew by approximately 80 percent during 1975-88, from 8.1 to 14.6 employees, suggesting a trend toward larger franchised establishments.[29]

Sales Revenue

Sales revenue generated by franchised establishments also has grown steadily since 1969. Domestic sales through franchised establishments increased from $113 billion in 1969 to $803 billion in 1992. When adjusted for inflation, sales grew by approximately 86 percent during 1969-92, for an average annual growth rate of 2.7 percent (figure 2). During 1970-92, franchising sales grew faster than the retail trade industry as a whole, which experienced an inflation-adjusted average annual growth rate of 1.7 percent. As franchising has grown, retail sales through franchised establishments have accounted for an increasingly large proportion of total retail sales, moving from 28.2 percent to 34 percent of total retail sales during 1975-90.[30] In relation to economic performance as a whole, sales through franchised establishments have grown faster than gross domestic product (GDP), which grew by an average of 2.5 percent per year from 1970 to 1992 (figure 3).

Selected types of franchise systems have grown particularly fast. For example, franchised restaurants' contribution to total restaurant sales increased from 28 percent in 1975 to 45 percent in 1990 (table 3). By contrast, product and trade name franchises such as gasoline service stations and automobile dealers had already captured 99 percent and 83 percent of their respective markets in 1975. The five fastest growing franchising industries during 1975-90, in terms of sales, were franchises that provide services (table 4).[31]

Although business format franchising is growing faster than product and trade name franchising, the latter still generated 69 percent of total franchising sales in 1992 (figure 4). However, the data suggest that product and trade name franchising is in a more mature state that is characterized by consolidation, while business format franchising is in a more rapid growth phase. During 1969-92, sales through business format franchises grew by 164 percent, whereas sales through product and trade name franchises grew by only 64 percent. On the basis of sales per establishment, however, business format franchising sales grew by only 23 percent during 1971-92, while product and trade name franchising sales grew by 200 percent (figure 5). These results indicate that overall business format franchising sales growth is a result of significant increases in the number of establishments, rather than increases in sales on a per establishment basis, suggesting that business format franchising is expanding into untapped regions and business formats. Conversely, product and trade name franchising revenue has grown while the number of establishments has declined. This suggests that product and trade name franchises have penetrated their markets and now are experiencing trends toward consolidation and greater efficiency. The maturity of the two forms of franchising are compared in figure 6 relative to overall economic factors of gross domestic product (GDP) and private sector employment. The resulting matrix reveals that business format franchising is out pacing the economy as a whole in both categories, while product and trade name franchising is out pacing the overall economy in terms of revenue generation, but trailing in terms of job creation.

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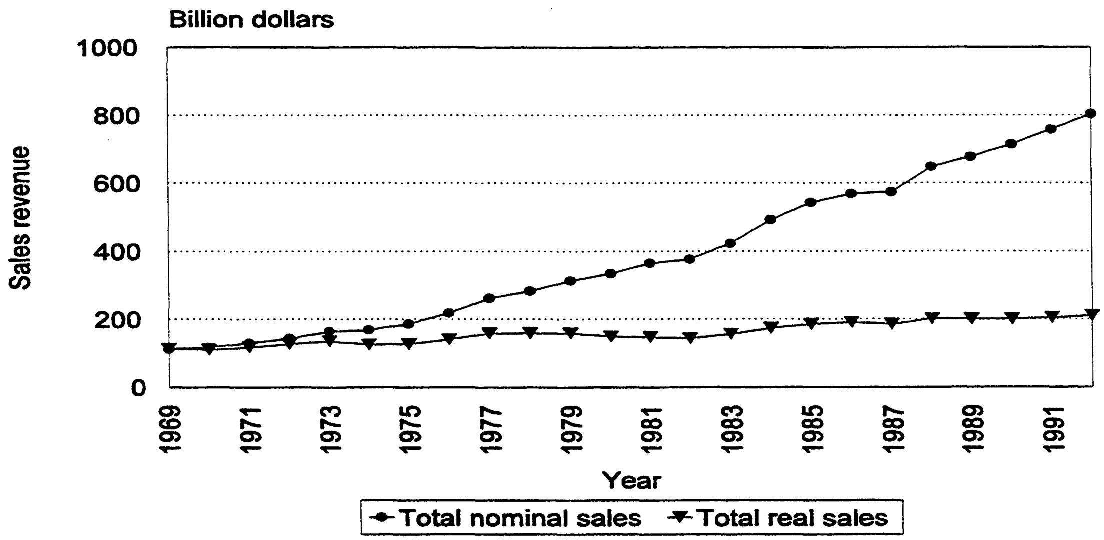
[29] Ibid., p. ES-2.
[30] Ibid., p. 2-4.

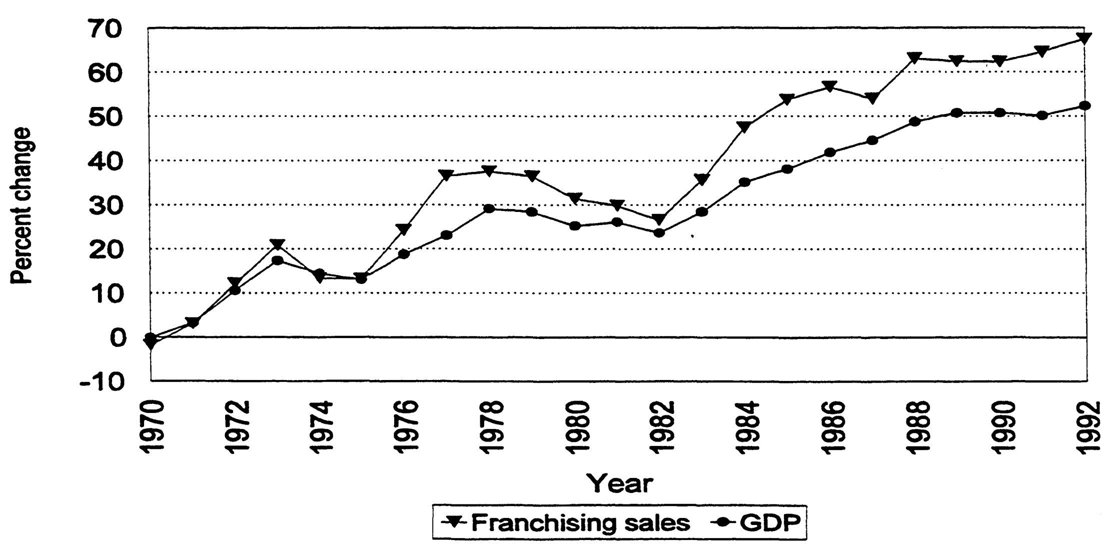
[31] The findings presented in tables 3 and 4 are supported further in Jeffrey Bracker, "Franchising in the Economy 1991-1993," as referenced in *Franchising World* (Mar./Apr. 1994), pp. 6-7.

Figure 2
Total U.S. franchising sales revenue, nominal and real, 1969-92



Source: U.S. Department of Commerce, International Trade Administration; International Franchise Association; and USITC staff estimates.

Figure 3
Cumulative real growth rates in U.S. franchising sales and GDP, 1970-92



Source: U.S. Department of Commerce, International Trade Administration; International Franchise Association; and USITC staff estimates.

Table 3

U.S. franchise sales as a share of total sales in selected industries, 1975 and 1990

Industry	Total industry sales 1975	Total industry sales 1990	Franchise sales 1975	Franchise sales 1990	Franchising share of total sales 1975	Franchising share of total sales 1990
	—Billion dollars—				—Percent—	
All retail industries	647.7	1,825.5	165.7	614.7	25.6	33.7
Automobile dealers	107.3	385.1	89.2	345.9	83.1	89.8
Auto and home supply stores	10.1	32.2	5.0	13.9	49.5	43.2
Gasoline service stations	47.8	130.2	47.5	128.6	99.4	98.8
Restaurants	44.4	173.1	12.3	77.9	27.7	45.0
Laundry and dry cleaning services	6.3	17.6	0.2	0.4	3.2	2.3
Hotels and motels	17.8	60.5	4.6	23.8	25.8	39.3
Employment services	11.8	34.8	0.6	5.7	5.1	16.3
Automobile rentals	6.3	20.4	1.5	7.5	23.8	36.8

Source: Bruce Phillips, "Franchising -- The Optimal Organization for Small Business Firms(?)," p. 3.

Table 4

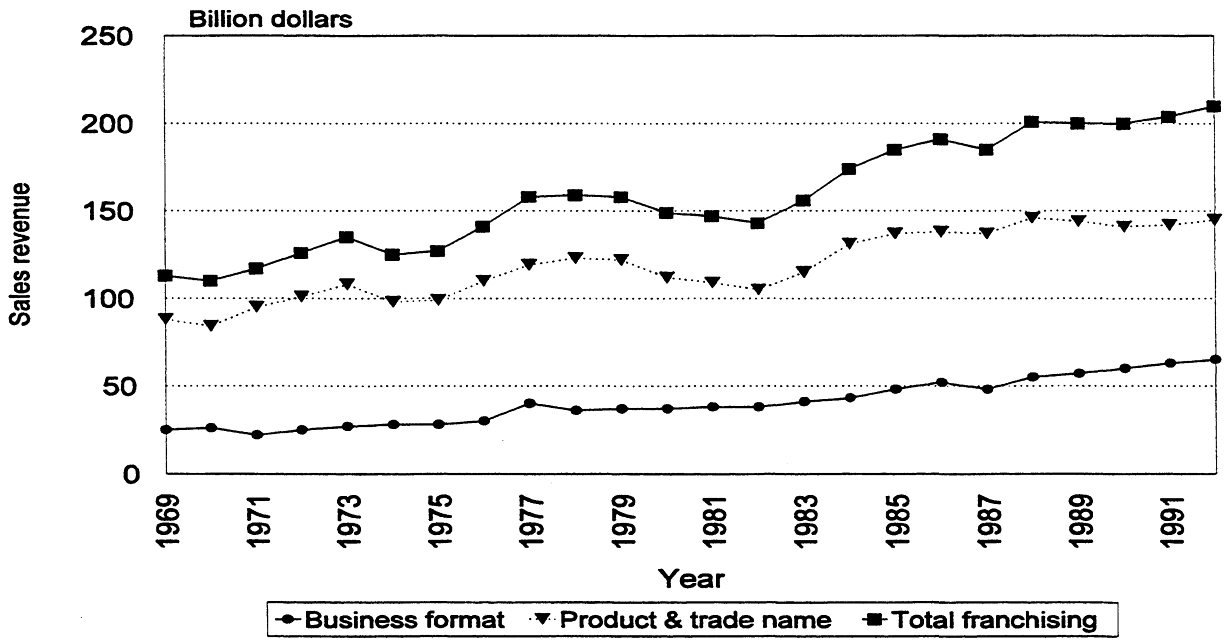
U.S. industries with the fastest increases in franchise sales, 1975-90

Industry	Sales 1975	Sales 1990	Change from 1975-90 Nominal	Change from 1975-90 Inflation adjusted
	—Million dollars—		—Percent—	
Recreation, entertainment, travel	162	4,843	2889.5	1131.8
Business aids and services[1]	1,397	18,640	1234.3	449.8
Educational products	173	2,031	1074.0	383.7
Construction, home improvement	639	6,454	910.0	316.2
Retailing/nonfood/convenience stores	1,443	11,706	710.1	233.8

[1]Includes real estate, printing and copying services, employment services, tax preparation services, accounting, credit, collection, and miscellaneous business services.

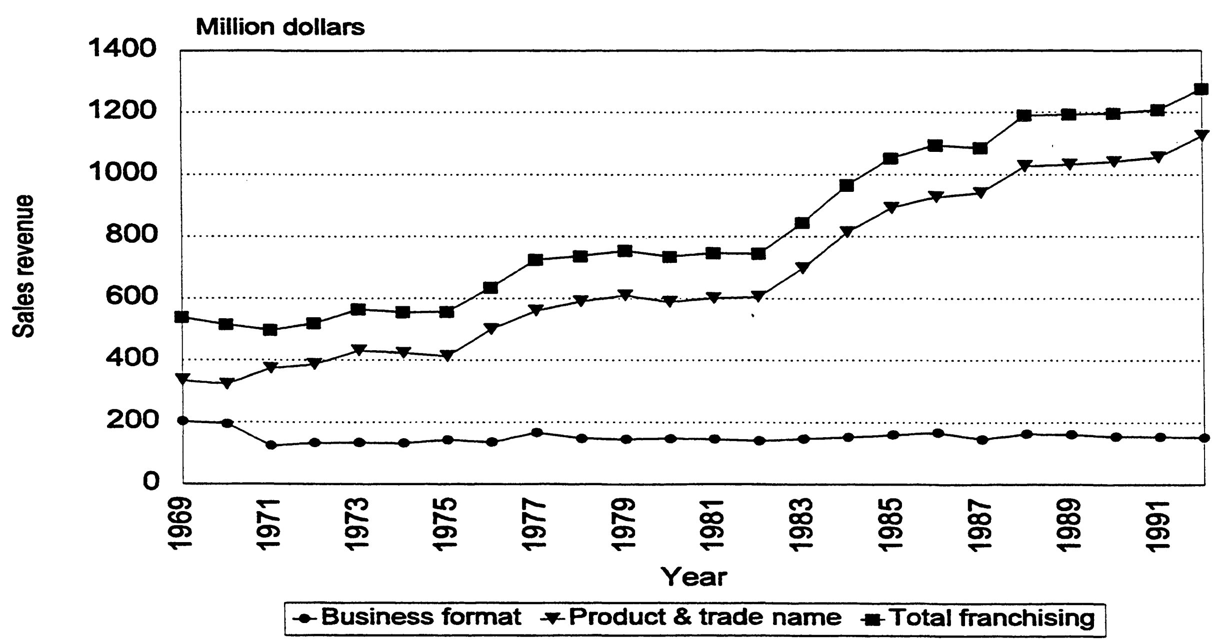
Source: Trutko, Trutko, and Kostecka, "Franchising's Growing Role in the U.S. Economy: 1975-2000," p. 2-9, and Bruce Phillips, "Franchising -- The Optimal Organization for Small Business Firms(?)," p. 6.

Figure 4
U.S. real sales revenue, by form of franchising, 1969-92



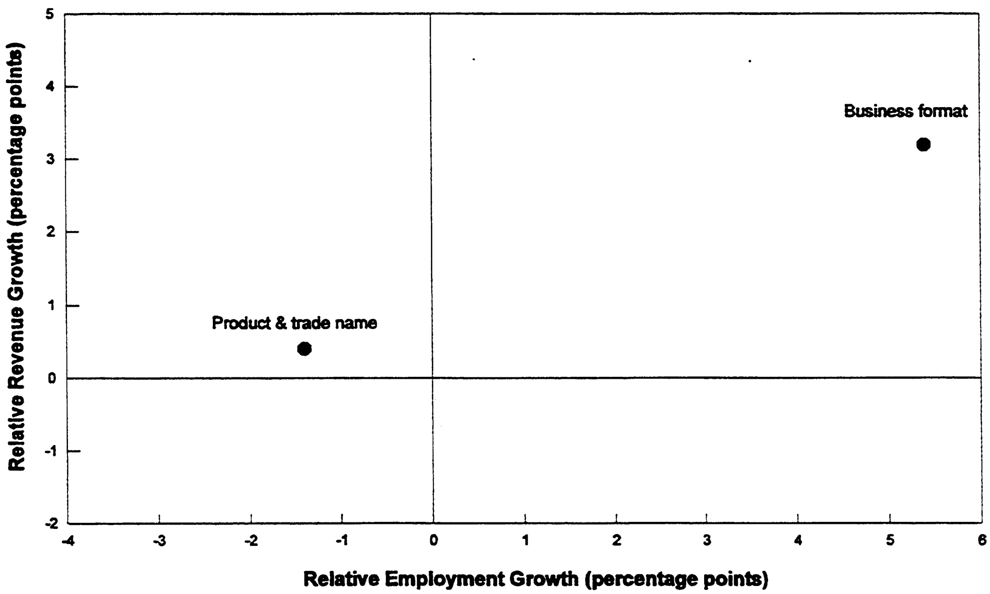
Source: U.S. Department of Commerce, International Trade Administration; International Franchise Association; and USITC staff estimates.

Figure 5
U.S. real sales revenue per establishment, by form of franchising, 1969-92



Source: U.S. Department of Commerce, International Trade Administration; International Franchise Association; and USITC staff estimates.

Figure 6
Relative growth[1] in revenue and employment of business format and product & trade name franchising, 1975-1988



[1] Relative revenue growth is the difference between the average annual revenue growth rate of franchising and the average annual growth rate of U.S. gross domestic product. Relative employment growth is the difference between the average annual employment growth of franchising and the average annual employment growth of the U.S. private sector.

Source: USITC Staff; International Franchise Association; and Bureau of Economic Analysis, *Survey of Current Business.*

U.S. REGULATION

Existing regulation of franchising generally focuses on ensuring that potential franchisees receive reliable information in advance of their investment. The only Federal regulations specifically pertaining to franchising fall under the Federal Trade Commission trade regulation rule set forth in 16 CFR Part 436, entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures" (referred to as the FTC Rule). The FTC Rule was adopted in 1978 and requires "...franchisors and franchise brokers to furnish prospective franchisees with information about the franchisor, the franchisor's business and the terms of the franchise agreement in a single document."[32] The FTC Rule specifies that the disclosure document must fulfill 20 basic information requirements (table 5).[33]

The FTC Rule also acknowledges that the Midwest Securities Commissioners Association, succeeded by the North American Securities Administrators Association (NASAA), adopted a disclosure format known as the Uniform Franchise Offering Circular (UFOC) in 1975. Since the UFOC fulfills the FTC's requirements and endeavors to harmonize different state disclosure requirements, the FTC Rule states that franchisors may choose to follow either the UFOC format or the format defined by the FTC Rule.[34]

The FTC Rule establishes a minimum level of protection for franchisees that may be enforced through "asset impoundments, cease-and-desist orders, injunctions, consent orders, mandated rescission or restitution for injured franchisees, and civil fines of up to $10,000 per violation."[35] The FTC Rule does not limit states from imposing their own regulations concerning information disclosure and the nature of the franchise relationship.[36]

Members of the franchising industry find that state regulations are more intrusive than the FTC Rule, primarily because a number of states require registration in addition to compliance with disclosure guidelines.[37] The first franchising law in the country was promulgated in 1970 in California. This law, entitled the Franchise Investment Law, requires franchisors to be registered with the state prior to offering or selling franchises. Since then, many other states have followed suit. As of 1994, the following states required registration:[38]

- Illinois
- Indiana
- Maryland
- Minnesota
- New York
- North Dakota
- Rhode Island
- South Dakota
- Virginia
- Wisconsin
- Washington

State registration involves filing disclosure documents "...consisting of an offering circular, franchise agreement, supplemental agreements, financial statements, franchise roster, mandated cover pages, acknowledgment of receipt, and special forms required by each state, such as corporation verification statements, salesperson disclosure forms, and consent to service of process documents . . . Initial filing fees range from $250 to $500, with renewal filings usually ranging between $100 and $250."[39] Other states that place additional requirements on franchisors include Hawaii, where franchisors must file an offering circular with the state and deliver an offering circular to prospective franchisees; Michigan, which requires filing a Notice of Intent to Offer and Sell Franchises; and Oregon, which requires presale disclosure to prospective investors.[40]

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[32] 44 F.R. 49966. Franchisors are broadly defined by the FTC as either "package and product franchises" or "business opportunity ventures." A package and product franchise relationship is covered by the FTC Rule if it involves 1) distribution of goods or services associated with the franchisor's trademark, 2) significant control of, or significant assistance to, the franchisee's method of operation, and 3) required payments by the franchisee to the franchisor. Business opportunity ventures are covered by the FTC Rule if each of the following criteria are met: 1) the franchisee sells goods or services supplied by the franchisor or its affiliate, or by suppliers with which it is required by the franchisor to do business; 2) the franchisor secures retail outlets or accounts for the goods or services, or secures locations for vending devices or racks, or provides the services of a person to do either; and 3) the franchisee is required to pay the franchisor or an affiliated person in order to obtain or commence the franchised business.

[33] 16 CFR 436.

[34] 44 F.R. 49970.

[35] Andrew J. Sherman, "The Regulatory Framework of Franchising," ch. in *The Franchising Handbook* (New York: American Management Association, 1993), p. 286.

[36] Ibid., pp. 287-288.

[37] Franchising industry representative, interview by USITC staff, International Franchise Association Convention, Las Croabas, Puerto Rico, Jan. 25, 1995.

[38] Sherman, "The Regulatory Framework of Franchising," pp. 285-286.

[39] Ibid., p. 295.

[40] Ibid., p. 286.

Table 5

Elements of franchise disclosure documents required by the Federal Trade Commission

1. Identifying information about the franchisor.
2. Business experience of the franchisor's directors 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 Summary."

There is some debate over whether additional regulation is advisable or required. Proponents of additional regulation believe that the current regulations do not ensure that franchisees receive adequate information. They also believe that the franchisor wields too much power in the agreement and may make decisions that adversely affect the franchisee.[41] One notable example concerned a contract dispute between Kentucky Fried Chicken (KFC) and most of its franchisees in Iowa over changes in territory and transfer rights. In this situation, the franchisor wanted to increase the number of establishments in the region by using non-traditional formats, such as kiosks located within department stores. The franchisees were concerned that the greater number of establishments would reduce their individual revenues. A second issue involved the terms and conditions for transferring ownership of the franchised establishment. The franchisor sought to have ultimate control over the selection of buyers, but franchisees viewed the establishment as a small, family business that could be held and transferred within the family without the approval of the franchise headquarters. The dispute escalated to the point where 375 out of 400 franchisees joined together and filed suit against KFC.[42] When the suit was delayed repeatedly, the franchisees appealed directly to the Iowa state legislature. The legislature sided with the franchisees and passed the Iowa Franchise Investment Act, which is intended to protect the interests of franchisees against the more powerful franchisors.[43]

The Iowa situation provides an example of how state legislative bodies have sought to address the apparent power disparity between franchisors and franchisees. Franchisors tend to be perceived as large, professionally managed organizations with considerable legal and financial clout, while franchisees tend to be perceived as individuals with limited resources and limited ability to affect the terms of a franchise contract.

[41] Joan Oleck, "The Battle of Iowa: How the biggest franchise fight in history was won--and lost," *Restaurant Business,* Aug. 10, 1992, pp. 88.

[42] Ibid., p. 86.

[43] Ibid., pp. 78-92.

This situation has led some franchisees and concerned legislators to call for increased regulation.[44] Proposals for improving the regulatory structure include:

- harmonizing disclosure rules across states;
- reducing costs of state-level registration;
- providing for better enforcement of existing disclosure laws;
- improving the availability and the quality of earnings claims made by franchisors;
- improving the ability of potential franchisees to obtain information from existing and former franchisees; and
- providing active assistance to potential franchisees on how to evaluate franchise systems.[45]

Opponents of additional regulation believe that current disclosure requirements are sufficient to provide a prudent investor with information needed to make an educated decision.[46] Indeed, current requirements provide potential buyers with more information than venture capital firms may have in selecting investments. The fact that franchise investors may be less sophisticated than other investors is irrelevant, they contend. They suggest that any additional regulation of business relationships would not be feasible to implement and might increase the cost of franchising, thereby impeding small business development.[47]

INTERNATIONAL FRANCHISING

The remainder of the summary presents information on franchising in the international arena. The section first discusses the numerous issues that affect competitive positions when franchise systems extend across international frontiers. This section lists some of the reasons cited for the rising popularity of franchising around the world and some of the complications encountered as a result of cultural, economic, and legal differences across countries. The section also provides available information relating to the level of franchising on a regional basis, including the number of franchisors, franchised establishments, and revenues generated in North and South America, Europe, and the Asia-Pacific regions. Finally, the section addresses franchising trade issues by providing information on the U.S. balance of trade, describing international efforts to reduce non-tariff barriers to franchising, and summarizing industry expectations concerning the future of franchising.

Factors Influencing International Competition

Rising competition and slowing growth among franchises in the domestic market have encouraged international expansion in order to maintain franchise growth and profitability. In the international arena, a number of favorable 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. In addition, franchising is increasingly being sponsored by developing country governments and development organizations such as the United States Agency for International Development.

International franchising can be a complicated business. Coping with different laws and governmental systems is costly and time-consuming. Geographic distance can make communication and transportation difficult and expensive, which in turn can impede management's ability to oversee operations effectively. Cultural differences can lead to miscommunication or misalignment of priorities, which also may weaken management's control over the franchise and, consequently, over the level of performance. These additional burdens on the management structure suggest that, in order to be successful internationally, the franchisor's management team must be highly skilled and have substantial experience in implementing franchise development programs. This appears to be supported by findings that international franchisors tend to have developed a solid foundation in home markets and acquired extensive operating experience before expanding abroad.[48] Another interpretation of these

[44] Trutko, Trutko, and Kostecka, "Franchising's Growing Role in the U.S. Economy: 1975-2000," p. ES-11.
[45] Ibid.
[46] Ibid., p. 8-37.
[47] Ibid., pp. ES-12 to ES-13.

[48] Survey results indicate that 44 percent of U.S. franchisors had between 100 and 500 establishments in the home market before they expanded abroad and 61 percent had more than 5 years of experience (continued...)

findings is that when domestic franchisors attain a significant market presence, they attract the attention of foreign investors. In such a case, international expansion is driven by the pull of international demand rather than the push of the franchising firm's marketing efforts. Industry representatives report that increasingly U.S. franchisors are approached initially by foreign firms and drawn into the international arena.[49] One industry expert noted that foreign offers are particularly enticing because they generally involve a large up-front payment.[50]

In spite of the temptation to enter foreign markets rapidly, industry representatives, consultants, and analysts universally advise franchisors to be selective and cautious.[51] One industry analyst pointed out that pursuing foreign offers may lead to a haphazard rather than a strategic expansion program.[52] Other industry experts supported the slower, strategic approach by noting that success is directly related to the franchisor's commitment to develop foreign markets. Franchisors are obliged to commit substantial management and financial resources to an international expansion program, and even then, success is not assured.[53] One analyst attributed the failure of a U.S. restaurant franchisor in Mexico to an attempt to duplicate its domestic operational strategy in a foreign environment without offering the kind of management and marketing support required.[54] Industry representatives also claimed that a failed venture into foreign markets may have lasting consequences because it may take several years before the franchisor is able to find other willing investors. Such a delay may permit the entry and development of competitors and result in excluding the franchisor from the market altogether.[55]

While the preceding discussion argues for caution in international expansion, industry experts also agree that successful international franchisors have been rewarded by substantial profits and dramatic growth.[56] For example, 60 percent of McDonald's growth in the number of restaurants came from outside the United States over the period 1988-93. In addition, while only 34 percent of McDonald's 13,993 restaurants were located abroad in 1993, these foreign operations generated more than 45 percent of operating income.[57]

A number of other factors influence the international competitiveness of franchisors, including market conditions, product suitability, and legal issues ranging from taxation to antitrust regulation. These factors are discussed in the following sections in greater detail.

Market Conditions

Economic conditions, cultural disparities, and physical limitations can have substantial impact on the viability of foreign markets for a franchise concept. In terms of economics, the level of infrastructure development is a significant factor. A weak infrastructure may cause problems in transportation, communication, or even the provision of basic utilities such as electricity. Similarly, if the financial sector is weak, franchisees may not be able to obtain local financing, which would place a greater financial burden on the franchisor. Price stability, disposable income levels, wage rates, and the performance of related industry sectors are other economic factors to consider. International franchisors frequently encounter problems finding supplies in sufficient quantity, of consistent quality, and at stable prices.[58] All of these elements can impact the operating costs and anticipated revenues of the franchise.

Cultural differences and physical distance also can have significant impact on franchise performance. Differences in language, religion, education level, or

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[48] (...continued)
prior to expanding abroad. Bruce J. Walker, "A Comparison of International vs. Domestic Expansion by U.S. Franchise Systems" (Washington: International Franchise Association, 1989), p. 12.
[49] Franchising industry representative, interview by USITC staff, Washington, DC, Feb. 10, 1995.
[50] Ibid.
[51] Franchising industry representatives, interviews by USITC staff, round-table discussions, and presentations, International Franchise Association Convention and Society of Franchising Conference, Las Croabas, Puerto Rico, Jan. 21-25, 1995.
[52] Franchising industry representative, round-table discussion, International Franchise Association Convention, Las Croabas, Puerto Rico, Jan. 23, 1995.
[53] Franchising industry representatives, interviews by USITC staff, round-table discussions, and presentations, International Franchise Association Convention and Society of Franchising Conference, Las Croabas, Puerto Rico, Jan. 21-25, 1995.
[54] Franchising industry analyst, presentation, Society of Franchising Conference, Las Croabas, Puerto Rico, Jan. 22, 1995.

[55] Ibid.
[56] Franchising industry representatives, round-table discussions and presentations at the International Franchise Association Convention, Las Croabas, Puerto Rico, Jan. 23 and Jan. 25, 1995.
[57] McDonald's Corporation, *1993 Annual Report*, pp. 18-21.
[58] Frank Go and Julia Christensen, "Going Global," *The Cornell H.R.A. Quarterly* (Nov. 1989), p. 77.

attitudes toward relationships and business may make it difficult for foreign franchisors to develop an effective working relationship with franchisees. A poor relationship may in turn lead to disputes, poor quality, or even commercial failure.[59] Physical distance also can adversely affect a franchise concept and arrangement. Long distances create communication and transportation problems, which may complicate the process of sourcing supplies, overseeing operations, or providing quality management services to franchisees.[60]

Product Suitability

Even if market conditions are favorable, it still may be necessary for a franchisor to modify the franchise concept. Cultural factors, such as local preferences, lifestyle, standard of living, religion, or diet, may cause an otherwise successful franchise to fail. Examples of measures taken by franchisors to avoid such problems include Pizza Hut adding fish as a pizza topping in Russia,[61] and Swensen's Ice Cream substituting a vegetable protein for cream in Saudi Arabia.[62]

Changes may need to be made in the physical structure of the franchise as well. For example, differences in real estate prices and construction costs may make it impractical to construct free-standing establishments, a condition that forced Kentucky Fried Chicken to adopt a townhouse design for its restaurants in Japan.[63] Operations also may need to be adapted if operating costs are high due to scarcity of capital equipment and other supplies, or if transportation is difficult and expensive. Training programs may need some adjustment in order to succeed in a different language and culture, or to compensate for differences in the trainees' level of education.

While product adaptation may be essential to the success of the franchise, it represents a departure from standard franchise practice. In the initial stages of expanding a franchise system, the franchisor must concentrate on replicating the business concept and building a brand image. To adapt to a foreign market, franchisors may suddenly have to customize a product that they had carefully standardized. Selecting the appropriate balance between change and consistency to meet market characteristics and yet sustain brand image and scale economies poses a key challenge to franchise management.

Legal Issues

National variations in legal systems, commercial regulation, and specific legislation concerning antitrust and competition can have significant impact on franchise development and competitive position.[64] The following sections present brief discussions of some of the major legal issues involved in international franchising.

Regulation

With respect to franchising, the United States is considered to have the most stringent regulatory environment in the world due to the national disclosure requirement and various state registration requirements.[65] There are few other countries with any form of regulation that is specifically directed toward franchising.[66] Those countries that do regulate franchising follow the pattern established by the United States of requiring information disclosure and registration. For example, France passed what is known as the Doubin law in 1989 that requires pre-sale disclosure by franchisors.[67] Similarly, Mexico's 1991 Industrial Property Law requires franchise disclosure and registration.[68] Periodically, there has been discussion concerning whether to increase regulation. For example, Unidroit, the Organization for Economic Cooperation and Development, the International Labor Organization, and the World Intellectual Property Organization have studied franchising and considered

[59] Ibid., p. 75.
[60] Ibid.
[61] Philip Zeidman and Michael Avner, "Franchising in Eastern Europe and the Soviet Union," *DePaul Business Law Journal*, vol. 3:307 (Spring/Summer 1991), p. 326.
[62] Go and Christensen, "Going Global," p. 78.
[63] Ibid., p. 79.

[64] Warren Pengilley, "International Franchising Arrangements and Problems in Their Negotiation," *Northwestern Journal of International Law & Business*, 7:185 (1985), pp. 194-205.
[65] Franchising industry representative, interview by USITC staff, International Franchise Association Convention, Las Croabas, Puerto Rico, Jan. 25, 1995, and Zeidman and Avner, "Franchising in Eastern Europe and the Soviet Union," pp. 314-315.
[66] Zeidman and Avner, "Franchising in Eastern Europe and the Soviet Union," p. 314-315.
[67] Ibid., p. 315.
[68] Enrique A. Gonzales, "Mexico adopts long-awaited disclosure, registration rules," *Global Franchising Alert*, vol. 1, No. 13 (Dec. 1994), p. 1.

the merits of additional regulation.[69] Discussions such as these combined with the passage of legislation in France and Mexico could explain the trend within the industry to pursue self-regulation and adherence to a code of ethics.[70]

Despite the small number of regulations that specifically apply to franchising, many other foreign regulations may have considerable impact on franchising.[71] For example, in Italy, retail regulations require establishments to obtain an individual license for each product offered. To comply with these regulations, Mail Boxes Etc. had to acquire ten different licenses.[72] In the Netherlands, regulations tend to offer strong protection to the individual or entity that rents a retail location rather than the ultimate business owner, which potentially favors the franchisee over the franchisor. Consequently, some franchisors rent retail locations and sub-lease to franchisees in order to protect themselves.[73] In the United Kingdom, "pyramid selling" is regulated under Part XI of the Fair Trading Act of 1973. This act limits the value of goods to be supplied to a participant in a pyramid selling arrangement to 75 pounds Sterling; prohibits non-returnable deposits; prohibits charging participants for training or other services; and guarantees the right for a participant to terminate without penalty at any time on 14 days written notice. These provisions technically forbid franchisors from using area or development agreements involving sub-franchising in the United Kingdom.[74] However, according to industry sources, the law never has been applied in practice.[75] In China, foreign-owned enterprises can only "franchise" by forming multiple joint ventures. Once established, total foreign ownership cannot exceed 25 percent, and fees and royalties must be paid in local currency. As of 1992, retail operations were permitted only for joint ventures, and only two such operations were permitted per city.[76]

Antitrust/Competition Laws

In most franchise agreements, franchisors place some limitations on the activities of the franchisee, such as pricing guidelines and the granting of territories. The rationale for these limitations, also known as vertical restraints, is to maintain control and consistency and to minimize competition between franchisees within the same franchise system.[77] However, since franchised establishments are individually owned businesses, as opposed to subsidiaries or branches, vertical restraints may be perceived as a form of coercion that distorts competition in the market. As such, they may be subject to antitrust or competition legislation that could impact a number of elements of the franchise and the franchise agreement, such as sourcing, quality, control over product mix, territorial restrictions, prices, non-competition provisions, or restrictions on confidential information.[78]

One example of the application of competition legislation is the 1986 case in which Pronuptia, a French bridal wear and accessories franchisor, filed suit in the German courts against a German franchisee for unpaid franchising fees. Pronuptia initially won the case, but the ruling was overturned on appeal based upon the application of Article 85 of the Treaty of Rome,[79] which addresses general competition rules for the European

[69] Philip F. Zeidman, "Watch Out! Here Come the Supra-Nationals," *Franchising World* (Sept./Oct. 1991), pp. 30-31.

[70] For example, the December 1994 issue of *Global Franchising Alert* reports two cases where private franchising associations imposed self-regulatory measures: The Franchise Association of Southern Africa adopted a presale disclosure statement rule and the Italian Franchise Association required its members to adopt "rules of conduct based on principles of fairness and professionalism." *Global Franchising Alert*, vol. 1, No. 13 (Dec. 1994), p. 8. The International Franchise Association requires its members to act in accordance with its "Code of Principles and Standards of Conduct."

[71] For a detailed review of foreign regulations and their impact on franchising, see Philip Zeidman, *Survey of Foreign Laws and Regulations Affecting International Franchising* (Chicago: American Bar Association, 1990).

[72] U.S. Department of Commerce, International Trade Administration, "Italy - Franchising Trends - IMI940617," Market Research Reports, Aug. 27, 1994, National Trade Data Bank, IT MARKET 111092292.

[73] "Franchising in the Netherlands," International Nederlanden Bank, 1992, p. 3.

[74] Martin Mendelsohn, "Franchising in the United Kingdom," ch. in *Franchising in Europe* (New York: Cassell, 1992), pp. 365-366.

[75] Franchising industry representative, interview by USITC staff, International Franchise Association Convention, Las Croabas, Puerto Rico, Jan. 23, 1995.

[76] U.S. Department of Commerce, International Trade Administration, "China - Franchising Regs - IMI940412," Market Research Reports, Aug. 27, 1994, National Trade Data Bank, IT MARKET 111093706.

[77] *Competition Policy and Vertical Restraints: Franchising Agreements* (Paris: Organization for Economic Cooperation and Development, 1994), pp. 17-18.

[78] Martin Mendelsohn, "Competition Laws: Their Applicability and Their Impact," ch. in *International Franchising: An In-Depth Treatment of Business and Legal Techniques*, eds. Yanos Gramatidis and Dennis Campbell (Boston: Kluwer Law and Taxation Publishers, 1991), pp. 82-83.

[79] Ibid., p. 82.

Union.[80] The German Court found that, under Article 85, most of the franchise agreement's provisions were anti-competitive and consequently were void.[81] Pronuptia appealed to the German Federal Court of Appeal, which in turn asked the European Court of Justice to render an opinion.[82] Commenting on the significance of the Court's decision, one franchising attorney noted, "If that German Court's view had been upheld, franchising would have become impossible in Europe."[83] The European Court of Justice "considered that a distribution franchise agreement does not, in itself, interfere with competition. It considered, in particular, that a non-competition obligation on the franchisees did not fall under Article 85(1), because it was indispensable for the proper functioning of a franchising system."[84] Based upon this finding, the European Commission adopted a block exemption regulation for franchising activities that essentially resolves most of the concerns regarding Article 85.[85] The significance of the Pronuptia case for international franchisors is that the application of general competition laws to franchise agreements may result in the loss of control over franchisees.

Taxation

Taxation is one of the most difficult obstacles for franchisors to overcome when expanding internationally because tax policy differs from country to country and may substantially affect profitability.[86] The principal cross-border financial transactions for franchising involve the payment of initial fees and ongoing royalties.[87] The payment terms are determined in the franchise contract, which often requires franchisors to address taxation issues before having any operational experience in the foreign country.[88] Since the tax policy of individual countries may directly impact both forms of payment, an error in structuring payments may have lasting effects on the profitability of the foreign venture.[89] In addition, accommodating various tax regimes may be costly for franchisors if they have to change accounting practices, operational procedures, or even the form of business establishment on a country-by-country basis.[90]

Intellectual Property Protection

The value of a franchise is determined in large part by the perceived value of the trademark or brand name.[91] McDonald's and Kentucky Fried Chicken can charge franchisees several hundred thousand dollars more than a comparably equipped, lesser known restaurant because the reputation of their brands is so powerful. Consequently, anything that threatens the perceived value of the brand in turn threatens the strength of the entire franchise system.[92]

In the international arena, trademark and intellectual property protection usually is not as effective as it is in the United States. Until recently, a number of countries did not even recognize service marks, leaving franchisors with no recourse if their brand names were copied.[93] In countries where intellectual property legally is protected, many regions do not have the ability to monitor compliance and enforce the laws.[94] Even in countries with effective trademark protection, franchisors often find that unrelated speculators have registered their trademark on the assumption that the franchise would eventually enter

[80] OECD, *Competition Policy and Vertical Restraints: Franchising Agreements*, p. 83.
[81] Martin Mendelsohn, "Competition Laws: Their Applicability and Their Impact," p. 82.
[82] Ibid.
[83] Ibid.
[84] Jean-Eric de Cockborne, "The New EEC Block Exemption Regulation on Franchising," *Fordham International Law Journal*, vol. 12, No. 242 (1989), p. 245.
[85] Martin Mendelsohn, "Competition Laws: Their Applicability and Their Impact," pp. 82-83.
[86] Franchising industry consultant, telephone interview by USITC staff, Feb. 16, 1995.
[87] Sassoon Saleh, "Franchising and International Taxation Considerations," ch. in *International Franchising: An In-Depth Treatment of Business and Legal Techniques*, eds. Yanos Gramatidis and Dennis Campbell (Boston: Kluwer Law and Taxation Publishers, 1991), p. 76.
[88] Ibid., p. 80.
[89] For example, franchisees may experience differing tax treatment depending upon whether initial fees are deducted from income or depreciated over time. Franchisors may experience different treatment if the initial fees are treated as capital gains as opposed to income. In many cases, capital gains are taxed at higher rates. Similarly, if royalty payments are taxed as profits rather than royalties, they may be subject to higher rates. Sassoon Saleh, "Franchising and International Taxation Considerations," pp. 76-77, and Zeidman and Avner, "Franchising in Eastern Europe and the Soviet Union," p. 315.
[90] Sassoon Saleh, "Franchising and International Taxation Considerations," p. 80.
[91] Franchising industry representative, interview by USITC staff, Washington, DC, Mar. 2, 1995.
[92] Ibid.
[93] Ibid.
[94] Ralph Kroman, "International Intellectual Property Aspects of Franchising," ch. in *International Franchising: An In-Depth Treatment of Business and Legal Techniques*, pp. 88-89.

the market and then have to buy back its own trademark.[95]

Such problems are more than inconveniences for franchisors because they constitute a loss of control over the business. If another organization actively uses the brand name, logos, or copyrighted materials, the franchise may lose market share, consumers may become confused, and the reputation of the franchise may be damaged, particularly if the competitor does not meet the same quality or performance standards. These factors could drive down the asking price for each franchise in the particular market, which could in turn diminish the value of the franchise throughout the system.[96]

Dispute Resolution and Contract Enforceability

Another way in which franchisors may lose control over the business is as a result of disputes with franchisees. Disputes may arise for a number of reasons, including payments, financial control, quality control, training, breach of confidentiality, failure to display logo appropriately, and failure to comply with non-competition provisions.[97] Resolution of disputes generally can take the form of discussion, mediation, termination, arbitration, or litigation.[98] In the United States, the terms of the contract usually are enforceable and dispute resolution mechanisms function effectively. This is not necessarily the case on the international level. In many countries, the quality of contract law is inadequate, which makes enforcement and dispute resolution very difficult.[99] For example, choice of forum or law clauses used in franchise agreements may not be recognized in regions such as Latin America and the Middle East.[100] Similarly, foreign judgments may not be recognized or enforced in some countries.[101] Since franchises operate through contracts and relationships with numerous individual investors, dispute resolution and contract enforceability are major concerns that directly relate to the franchisor's control over the system.

Form of Business Establishment

The selection of the form of business establishment is one significant means of adapting to the demands of foreign markets and controlling the difficulties presented above. The franchise agreement defines the form of establishment and the roles and responsibilities of each party. It covers matters such as the location of establishments, the selection of subfranchisees and suppliers, the form of the unit or subfranchise agreement, and control of the advertising fund.[102] Other significant elements include determining the choice of law and choice of forum, dispute resolution procedures, and obligations relating to trademark protection.[103]

Franchise agreements negotiated by international franchisors tend to take one of four basic forms: (1) master franchising, (2) direct franchising, (3) branch or subsidiary, or (4) joint venture.[104] Each of these options is discussed below.

Master Franchising

Master franchise agreements involve the granting of a license to an individual or firm established in the foreign country to operate or subfranchise all franchises in a given region.[105] The primary benefit of such agreements is that they require less direct involvement by the franchisor.[106] Consequently, master franchise agreements are considered to be particularly appropriate if the franchisor does not have sufficient management and financial resources to franchise directly, if the geographic distance is great, or if cultural differences

[95] Franchising industry representative, interview by USITC staff, Washington, DC, Mar. 2, 1995.
[96] Ibid.
[97] Nicholas Rose, "Resolving International Franchise Disputes," ch. in *International Franchising: An In-Depth Treatment of Business and Legal Techniques*, pp. 113-114.
[98] Ibid.
[99] Franchising industry representative, telephone interview by USITC staff, Feb. 16, 1995.
[100] Nicholas Rose, "Resolving International Franchise Disputes," pp. 120-123.
[101] Ibid.

[102] Alex S. Konigsberg, "Analyzing the International Franchise Opportunity," ch. in *International Franchising: An In-Depth Treatment of Business and Legal Techniques*, pp. 28-29.
[103] Rochelle Spandorf, "Fundamentals of International Franchising," *International Business Lawyer* (Mar. 1992), pp. 161-162.
[104] Franchising industry representatives, interviews by USITC staff, Washington, DC, Feb. 10 and Feb. 16, 1995; Alex S. Konigsberg, "Analyzing the International Franchise Opportunity," pp. 18-27; and Warren Pengilley, "International Franchising Arrangements and Problems in Their Negotiation," pp. 191-193.
[105] Alex S. Konigsberg, "Analyzing the International Franchise Opportunity," p. 23.
[106] Warren Pengilley, "International Franchising Arrangements and Problems in Their Negotiation," p. 192.

are severe.[107] Master franchising is the most common form of franchising selected by U.S. franchisors because it offers a smaller commitment of financial and human resources than other options, shifts most financial risk to the master franchisee, and capitalizes on the local knowledge of the master franchisee.[108] Another powerful enticement is that master franchising may offer a large payment in advance.[109] Many franchisors find it difficult to turn away from a large sum of money, even if they are unprepared to enter the foreign market.[110] But master franchising also entails some disadvantages, which include potential loss of control over the system and trademarks, problems enforcing franchisors' rights, and risk in choosing the right master franchisor.[111] Franchising representatives report that selecting the right master franchisor is the most important factor in determining the success of a master franchise agreement.[112]

Direct Franchising

With direct franchising, the franchisor sells franchises for individual establishments directly from the home country to the foreign country without establishing any kind of a regional headquarters.[113] Direct franchising is effective for situations where the scope of the foreign franchise effort is small or where conditions are such that the foreign franchise system can be managed from the home country.[114] Generally this form is selected if the foreign country is geographically close and if the respective cultures and legal systems are similar.[115] Direct franchising is particularly popular for franchisors operating between the United States and Canada and between Australia and New Zealand.[116] The advantages of direct franchising include easier compliance with local regulations, greater profitability, improved control over the actions of franchisees, and lower costs than establishing a commercial presence.[117] Disadvantages include difficulties encountered selling establishments across a large distance, providing promised services to franchisees, obtaining financing and leases, and settling disputes.[118]

Branch or Subsidiary

A branch or subsidiary arrangement involves the direct presence of the franchisor in the foreign country, in essence acting as its own master franchisor. Whether a franchisor chooses to establish a branch or a subsidiary is highly dependent upon tax and financial considerations.[119] For example, the losses of a branch can be applied to the rest of the organization's profits and thereby reduce tax liability. Subsidiaries generally are preferred because they reflect greater commitment from the franchisor to the franchisee and they offer the franchisor greater protection from disputes.[120] In comparison to direct franchising and master franchising, establishing either a branch or a subsidiary offers more direct control over the foreign establishments because the franchisor actually is present in the foreign market.[121] This presence also permits the franchisor to have better knowledge of the market, improved relations with local banks, real estate owners, and suppliers, and, in the case of a subsidiary, protection from direct legal action.[122] Disadvantages include higher costs, greater commercial and financial risk, greater management burden, and higher tax liability.[123]

Joint Venture

A joint venture involves establishing a commercial presence in a foreign country in partnership with a local organization. The main benefit of a joint-venture arrangement is that risk is shared between the partners.[124] Another advantage is that often all of the capital is committed by the foreign partner, while the franchisor only provides the know-how.[125] One classic

[107] Alex S. Konigsberg, "Analyzing the International Franchise Opportunity," pp. 24-25.
[108] Ibid.
[109] Franchising industry representative, interview by USITC staff, Washington, DC, Feb. 10, 1995.
[110] Ibid.
[111] Alex S. Konigsberg, "Analyzing the International Franchise Opportunity," pp. 24-25.
[112] Round table discussions and presentations, International Franchise Association Convention, Las Croabas, Puerto Rico, Jan. 23-25, 1995.
[113] Warren Pengilley, "International Franchising Arrangements and Problems in Their Negotiation," p. 191.
[114] Alex S. Konigsberg, "Analyzing the International Franchise Opportunity," p. 17.
[115] Warren Pengilley, "International Franchising Arrangements and Problems in Their Negotiation," p. 191.
[116] Ibid.
[117] Alex S. Konigsberg, "Analyzing the International Franchise Opportunity," pp. 18-19.
[118] Ibid.
[119] Warren Pengilley, "International Franchising Arrangements and Problems in Their Negotiation," p. 191.
[120] Alex S. Konigsberg, "Analyzing the International Franchise Opportunity," pp. 20-21.
[121] Warren Pengilley, "International Franchising Arrangements and Problems in Their Negotiation," p. 191.
[122] Alex S. Konigsberg, "Analyzing the International Franchise Opportunity," pp. 20-21.
[123] Ibid.
[124] Warren Pengilley, "International Franchising Arrangements and Problems in Their Negotiation," p. 191.
[125] Franchising industry representative, interview by USITC staff, Washington, DC, Feb. 10, 1995.

disadvantage to joint ventures is weakness in decision-making caused by the sharing of management responsibilities.[126] Other disadvantages include the weakness of the franchisor's position because of cultural and geographic distance, problems repatriating profits, and difficulties selecting an appropriate partner.[127]

Regional Franchising

Franchising is practiced in virtually every region of the world. Data on the number of franchisors, the number of franchisees, and revenues generated from business format franchised establishments are presented in table 6.[128] This information indicates that the largest markets for franchising in the world in terms of the number of franchisors are the United States, Canada, and Japan, respectively. When measured by the number of establishments or revenues, Japan moves into second place behind the United States.

While many countries have native forms of business that bear resemblance to franchising, the U.S. style of business format franchising predominates for both home-grown and international businesses.[129] This factor most likely is caused by the long and successful history of franchising in the United States combined with the example set by the expanding presence of U.S. franchisors internationally.

U.S. Firms' Expansion into Foreign Markets

U.S. franchising organizations have been expanding their international operations significantly over the past 20 years. From 1971 to 1986, the number of U.S. franchisors abroad expanded from 156 to 354 companies and the number of U.S. franchised establishments abroad grew from 3,365 to 31,626, representing increases of 127 percent and 840 percent, respectively.[130] U.S. expansion has been most pronounced in recent years. Since 1980, 70 percent of U.S. international franchisors entered the international market, with 53 percent entering the market during 1987-93 (table 7). Approximately one-third of U.S. franchisors had foreign outlets by 1992. Within this group of internationally active franchisors, approximately 22 percent earned at least 10 percent of their income from foreign sources.[131] U.S. franchisors appear to be committed to continued international growth. According to one survey, approximately 93 percent of U.S. franchisors with foreign establishments planned further international expansion, and among those without an international presence, approximately 50 percent planned to expand internationally in the near future.[132]

On a sectoral basis, U.S. firms franchising internationally are predominantly those affiliated with the fast food industry, but non-food retail and other service businesses are increasingly expanding abroad.[133] One survey found that, among a group of franchisors heavily committed to international expansion, restaurants constituted the majority (36 percent), followed by personal services (18 percent) and construction, home improvement, maintenance, and cleaning services (12 percent).[134] These results correspond well with the data from another survey of international franchisors which found that among U.S. franchisors operating internationally, restaurants constituted the largest business category (23 percent), followed by franchisors providing business aids and services (9 percent). The sectors of non-food retailing, automobile products and services, construction and home improvement, and educational products and services each constituted 8 percent of U.S. franchisors in the sample. In terms of the number of U.S. franchisors' foreign establishments, restaurants also held the largest share (31 percent) of establishments; cleaning services and educational services held the next largest share (14 percent each); and automotive products and services held 13 percent (table 7).

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[126] Warren Pengilley, "International Franchising Arrangements and Problems in Their Negotiation," p. 191.
[127] Alex S. Konigsberg, "Analyzing the International Franchise Opportunity," pp. 26-27.
[128] The data presented in this section were collected from various regional franchise associations and U.S. Government cables. The available data generally address only business format franchising. However, differences in definition and methodology caused difficulty in discerning whether product and trade name franchising had been included as well. Given these considerations, the information presented herein is best used to indicate the relative size and scope of franchising activities.
[129] Franchising industry representative, interview by USITC staff, Washington, DC, Mar. 2, 1995.
[130] U.S. Department of Commerce, International Trade Administration, *Franchising in the Economy, 1986-1988* (Feb. 1988), p. 7.
[131] *Franchising in the Economy, 1989-1992,* pp. 112-113.
[132] Bruce J. Walker, "A Comparison of International vs. Domestic Expansion by U.S. Franchise Systems" (Washington, DC: International Franchise Association, 1989), p. 9.
[133] *Franchising in the Economy, 1989-1992,* p. 109.
[134] Faye S. McIntyre and Sandra M. Huszagh, "Internationalization of Franchise Systems," prepared for *Journal of International Marketing*, revised Mar. 1995, p. 31.

Canada appears to be the most popular international market for U.S. franchisors, at least in the early stages of international development. Approximately 57 percent of U.S. franchisors surveyed reported that they opened their first foreign establishment in Canada.[135] In addition, 81 percent of U.S. franchise systems surveyed had at least one establishment in Canada, while only 25 to 30 percent had establishments in Australia/New Zealand, the United Kingdom, the Caribbean, or Japan.[136]

When considering market penetration as measured by the average number of establishments per franchise system, available information suggests that relatively few U.S. franchisors have penetrated foreign markets deeply. Among U.S. franchisors that have entered international markets, one survey found that only 18 percent have over 100 foreign establishments, whereas 64 percent have less than 25 establishments operating abroad.[137] A second survey supports these results, finding that approximately 50 percent of franchisors have fewer than 20 foreign establishments, just 20 percent have more than 100 foreign establishments, and only 10 percent have more than 200 establishments (table 7). Canada and Japan are the leading markets for U.S. franchisors in terms of market penetration, with each averaging between 35 and 40 establishments per franchisor.[138] In light of the fact that Japan has fewer franchisors, this indicates that U.S. franchisors that have gained access to the Japanese market have expanded well. One likely explanation for this is the fact that most U.S. franchisors, including McDonald's, Kentucky Fried Chicken, Baskin Robbins and 7-Eleven, entered the Japanese market through joint-venture agreements with large Japanese companies that had the resources and market knowledge to support rapid expansion and market penetration.[139]

[135] Ibid., p. 13.
[136] Walker, "A Comparison of International vs. Domestic Expansion by U.S. Franchise Systems," p. 8.
[137] Ibid., p. 8.
[138] Ibid.
[139] U.S. Department of Commerce, International Trade Administration, "Japan - Franchising Industry - ISA9009," Market Research Reports, Apr. 24, 1993, National Trade Data Bank, IT MARKET 111107290.

Franchising Activity in North and South America

Within North and South America, the United States is by far the largest franchising market. As noted earlier, the 429,217 U.S. business format franchised establishments operating in 1992 generated sales of $249 billion. By comparison, in the same year, the Canadian market had only 25,052 franchised establishments, generating revenue of approximately $12.9 billion.[140] In terms of sales volume, Canada's franchising activities are dominated by the retail trade industry, which contributes 65 percent of business format franchising sales.[141] The Canadian food service and hospitality industries contribute 26 percent of franchising sales, and other services contribute only 9 percent of sales.[142] In terms of establishments, however, services is the largest sector with 41 percent, followed by retail (31 percent) and food service and hospitality (27 percent).[143]

Brazil is the next largest single country market for franchising in North and South America. As of 1993, Brazil had an estimated 21,244 business format franchising establishments that generated $4.9 billion in sales revenue.[144] The dominant industry sectors in Brazil are food services and clothing retail trade, which constitute 24 percent and 22 percent of franchising sales, respectively.[145] The concept of franchising is well accepted in Brazil, where it first originated in the 1950s. Approximately 89 percent of Brazilian franchises are home grown and some systems actually are owned by the government.[146] Indeed, as of 1992, the government postal service operated 1,645 franchised branches.[147] Brazil's large market size and growth trends suggest that the country will become one of the world's major centers of franchising activity in the future.[148]

[140] Price Waterhouse, "Franchising in the Canadian Economy, 1990-1992," report commissioned by the Canadian Franchise Association, p. 3.
[141] Ibid., p. 4.
[142] Services here include business aids and services, construction, home improvement, maintenance and cleaning services, and other miscellaneous services.
[143] Price Waterhouse, "Franchising in the Canadian Economy, 1990-1992," p. 4.
[144] Marlene Jaggi, "UN Voo Mais Alto," *Franchising I* (Dec. 1993), p. 39.
[145] Ibid.
[146] Allen Josias and Faye S. McIntyre, "Franchising in Brazil," School of Business Administration, University of Mississippi, paper presented at the Society of Franchising Conference, Las Croabas, Puerto Rico, Jan. 22, 1995, p. 8.
[147] Ibid., p. 7.
[148] Ibid., pp. 2-3.

Table 6

Business format franchising, by country, number of franchisors, franchised establishments, employees, and revenues, by year indicated

Country	Year	Franchisors	Franchised establishments	Employees	Revenues
		Number			*Billion dollars*
Europe					
Austria	1992	80	2,500	([1])	([1])
Belgium	1992	90	3,200	([1])	4.3
Denmark	1992	42	500	([1])	([1])
France	1993	550	27,000	400,000	38.9
Germany[2]	1994	500	22,000	([1])	12.1
Ireland	1989	20	([1])	([1])	0.1
Italy	1993	361	17,500	50,550	9.1
Netherlands	1992	331	12,640	69,750	8.4
Norway	1992	125	3,500	([1])	3.9
Portugal	1992	55	800	([1])	([1])
Spain	1992	117	14,500	([1])	2.7
Sweden	1992	200	9,000	([1])	7.8
United Kingdom	1993	396	24,900	188,500	7.5
North & South America					
United States	1992	2,500	429,217	4,721,387	249.0
Canada	1992	1,134	25,052	(1)	12.9
Mexico	1994	([1])	5,000	75,000	3.0
Brazil	1993	([1])	21,244	(1)	4.9
Chile	1994	35	200	10,000	0.1
Asia/Pacific					
Japan	1994	714	139,788	(1)	102.8
Hong Kong	1992	100	2,000	(1)	0.6
Australia[3]	1994	555	30,500	279,000	29.0
South Africa[3]	1992	90	2,700	(1)	1.5

[1]Information unavailable.
[2]Includes beverage industry (e.g., Coca-Cola).
[3]Includes product and trade name franchising.

Sources: International Franchise Association, Canadian Franchise Association, Japanese Franchise Association, European Franchise Federation, British Franchise Association, Mexican Franchise Association, US&FCS Cables, and USITC staff estimates.

Table 7
Survey of U.S. franchisors with international operations,[1] by business category and number of foreign establishments, 1994

Category	U.S. franchisors with international operations		U.S. franchisors' foreign establishments	
	Number	*Percent*	*Number*	*Percent*
Restaurants	41	22.5	4221	31.3
Business aids/services	17	9.3	302	2.2
Retailing, non-food	15	8.2	392	2.9
Educational products/services	14	7.7	1837	13.6
Automotive products/services	14	7.7	1775	13.1
Construction/home improvement	14	7.7	555	4.1
Cleaning services	12	6.6	1932	14.3
Personal care services	11	6.0	680	5.0
Printing/signs	8	4.4	582	4.3
Auto/truck rental	6	3.3	401	3.0
Postal/shipping	5	2.8	125	0.9
Travel services	4	2.2	346	2.6
Recreation	3	1.7	56	0.4
Laundry/dry cleaning	3	1.7	50	0.4
Retail food, non-convenience	2	1.1	9	0.1
Hotels/motels	1	0.6	12	0.1
Rental equipment	1	0.6	2	0.0
Other	11	6.0	229	1.7
Total	182	100.0	13,506	100.0

[1]Data reflects responses to a survey conducted by the periodical, *Global Franchise.*
Note.–Totals may not add due to rounding.
Source: Compiled by USITC staff from *Global Franchise*, "1994 International Franchise Directory," Second Quarter 1994, pp. 52-66.

Franchising also is developing a significant presence in Mexico. As of 1994, Mexico had 5,000 franchised establishments employing 75,000 people and generating $3 billion in sales revenue.[149] Franchising is expected to grow quickly in Mexico in the next few years due in large part to the reduction in trade and investment barriers in compliance with the North American Free Trade Agreement (NAFTA).[150] Franchising also is anticipated to continue to grow rapidly throughout the rest of Latin America as a result of increasing economic growth as well as the trend toward liberalization of foreign capital and investment regulations.

Franchising Activity in Europe

The largest market for franchising outside the United States is the European Union, where there were approximately 2,887 franchisors operating 137,540 establishments in 1992.[151] Within Europe, the largest country markets for franchising are France, Germany, the United Kingdom, and Italy. Comprehensive sectoral data across Europe are unavailable; however, data provided by the franchise associations of the United Kingdom, France, Germany, Italy, and the Netherlands suggest that, in terms of sales volume, the retail sector is the largest, followed by the food service and hospitality sector and then other services. Trends in terms of the number of establishments appear to be consistent with other regions of the world, where the service sector's share is as large if not larger than the share held by retail trade.[152]

Market conditions for franchising vary across Europe due to differences in business development, history, and culture. For example, Italy is a promising market for franchising as a means of distributing a variety of products and services because it currently has a highly fragmented distribution system based on small, family-owned establishments. Since franchising systems offer scale economies and are based upon the concept of small, independent ownership, they appear to be an ideal solution to current market inefficiencies.[153] In the United Kingdom, franchising began slowly in the 1950s and 1960s because it was associated initially with fraudulent pyramid schemes. As of 1993, however, the combined revenues from business format and product and trade name franchises accounted for approximately 32 percent of U.K. retail sales, which is closing in on the U.S. figure of 34 percent.[154] One notable characteristic of franchising in the United Kingdom is that it recently has been adopted by dairy delivery services. While there are relatively few dairy delivery franchisors, the number of franchisees has been growing dramatically. From 1992 to 1993, the number of "franchised dairy roundsmen" increased from 4,800 to 8,000, which constitutes one-third of all business format franchise establishments.[155] In France, franchising activity actually has declined since 1989 in terms of the number of franchisors and the number of franchised establishments. This decline was caused by a combination of economic recession and the passage of the Doubin law that requires greater disclosure of financial and commercial information. These factors encouraged some organizations to choose other forms of establishment.[156]

Eastern Europe and the former Soviet Union also present some unusual circumstances. The region generally is perceived as fertile ground for franchisors because of the overall absence of consumer goods and services.[157] However, numerous other factors are impeding the progress of franchising. For example, due to relatively high unemployment and inflation, low productivity, inadequate infrastructure, and low disposable income, there are few individuals with sufficient resources and expertise to acquire and manage franchises and few customers with sufficient disposable

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[149] Asociacion Mexicana de Franquicias, "Franchising in Mexico 1994," p. 2.

[150] The recent peso devaluation is expected to slow the growth rate of franchising for 1995 from 75 percent to 10 percent. "U.S. Cable on Effect of Peso Crisis on U.S. Exports to Mexico," *Inside NAFTA*, vol. 2, No. 5 (Mar. 8, 1995), p. 15.

[151] European Franchise Federation, Dec. 31, 1992.

[152] "Franchising in France," data sheet provided by the Fédération Française de la Franchise; "Franchising in the Netherlands," data sheet provided by Nederlandse Franchise Vereniging; "Franchising in Germany," provided by Deutscher Franchise-Verband e.V.; various data tables on franchising in Italy provided by Associazione Italiana del Franchising; and United Kingdom information from "The NatWest/BFA Franchise Survey, 1993," provided by the British Franchise Association.

[153] U.S. Department of Commerce, International Trade Administration, "Italy - Franchising Services - ISA9304," Market Research Reports, Aug. 27, 1994, National Trade Data Bank, IT MARKET 111100042.

[154] "The NatWest/BFA Franchise Survey: 1993" (National Westminster Bank, PLC, and British Franchise Association, Mar. 1994), p. 9.

[155] Ibid., pp. 2-3.

[156] "Franchise, la crise a changé les règles du jeu," *Tribune Côte Desfosses*, Mar. 15, 1994, p. 14.

[157] Zeidman and Avner, "Franchising in Eastern Europe and the Soviet Union," p. 309.

income to purchase franchise products or services.[158] In addition, franchisors that succeed in establishing themselves frequently have difficulty sourcing high quality, reasonably priced supplies.[159]

Franchising Activity in the Asia-Pacific Region

Japan represents the largest and most active market for franchising in the Asia-Pacific region. As of 1994, there were 714 franchisors operating 139,788 establishments in Japan with sales of $102.8 billion.[160] In terms of sales volume, business format franchising in Japan is dominated by the retail trade sector with 65 percent, followed by food services (24 percent) and other services (11 percent).[161] As in all other regions for which data are available, when measured in terms of the number of establishments, the category for non-food, non-retail services is largest, contributing 38 percent of all franchised establishments, as compared to 34 percent for retail trade and 27 percent for food services.[162] As noted, Japan has the highest average number of establishments per franchisor in the world, with approximately 200 establishments per franchisor, reflecting a high level of market penetration. One possible explanation for high market penetration could be the involvement of large Japanese firms, such as Mitsubishi, Mitsui and Itochu.[163]

Australia represents another large market for franchising, with approximately 555 franchisors, 30,500 establishments, 279,000 full-time, part-time, and casual workers, and revenues of $29 billion in 1994.[164] In terms of the commercial activity of franchisors in Australia, 49 percent are involved in retail trade, which includes motor vehicle sales, and 17 percent are involved in property and business services.[165] Franchising is viewed favorably in Australia because, with a survival rate believed to be 2.3 times higher than non-franchised establishments, franchising is thought to aid the development of stable businesses.[166]

Other promising markets in the Asia-Pacific region include Hong Kong, Singapore, Indonesia, Malaysia, and India. Although the Hong Kong market is small, with only 2,000 franchised establishments and $600 million in revenues in 1992, Hong Kong holds a strategic role due to its proximity and close relationship with China.[167] Singapore similarly is seen as a small but promising strategic market for franchisors interested in entering Asia due to its geographic location, relatively high per capita income, and strong government sponsorship of franchising activities.[168] Indonesia and Malaysia offer larger markets that have been experiencing strong growth in franchising due to economic improvements and official government sponsorship of franchising as a means of boosting employment and small business development.[169] India also offers a promising franchising environment due to its large population, economic growth, progressive steps toward trade and investment liberalization, and a significant tradition of home-grown, franchise-like establishments.[170]

China's market potential for franchising is highly favorable due to the size of the population, favorable trends in disposable income, and growing demand for consumer goods and services. Although income levels are quite low compared to other regions, living expenses also are low, leaving citizens with sufficient disposable income to spend on relatively expensive foreign

[158] Zeidman and Avner, "Franchising in Eastern Europe and the Soviet Union," pp. 324-325; and Dennis Campbell, "Introduction," ch. in *International Franchising: An In-Depth Treatment of Business and Legal Techniques*, p. 6.

[159] Zeidman and Avner, "Franchising in Eastern Europe and the Soviet Union," p. 324, and Dennis Campbell, "Introduction," p. 6.

[160] Japan Franchise Association, *Franchising in Japan* (Mar. 31, 1991), fact sheet supplement, Mar. 31, 1994.

[161] Ibid.

[162] Ibid.

[163] U.S. Department of Commerce, International Trade Administration, "Japan - Franchising Industry - ISA9009," Market Research Reports, Aug. 27, 1994, National Trade Data Bank, IT MARKET 111107290.

[164] Data include both business format and product and trade name franchising. Australian Bureau of Statistics, "Franchising Sector Survey Results – 1994," Department of Industry Science and Technology, 1994, p. 3.

[165] Ibid., p. 14.

[166] U.S. Department of Commerce, International Trade Administration, "Franchising in Australia - IMI920319," Market Research Reports, Dec. 26, 1994, National Trade Data Bank, IT MARKET 111107250.

[167] U.S. Department of Commerce, International Trade Administration, "Hong Kong - Retail Franchising - ISA9212," Market Research Reports, Dec. 26, 1994, National Trade Data Bank, IT MARKET 111098997.

[168] Peng S. Chan, "Franchising in Singapore – A Survey," *World Franchise & Business Report* (Fall 1994), p. 10.

[169] Peng S. Chan and Robert T. Justis, "Franchising in Indonesia," Department of Management, California State University-Fullerton, paper presented at the Society of Franchising Conference, Las Croabas, Puerto Rico, Jan. 22, 1995, p. 5.

[170] Audhesh K. Paswan and Rajiv P. Dant, "Franchising in India: An Introduction," School of Business, University of South Dakota, paper presented at the Society of Franchising Conference, Las Croabas, Puerto Rico, Jan. 22, 1995, pp. 4-8.

items.[171] This factor may explain how McDonald's Guangzhou establishment was able to break records for sales volume on opening day. Presently, however, it appears that indigenous franchising is non-existent and the market is very difficult for foreigners to enter. Some of the obstacles to overcome include government restrictions that impede business activities, weak intellectual property protection, poor infrastructure, and scarce supplies. Given these obstacles and cultural characteristics, most foreign franchisors established in China have entered the market from Hong Kong, Taiwan, and Japan.[172]

U.S. Balance of Trade

Available data on international trade in franchising provide estimates of the cross-border exchange of royalties and fees for franchising services. Franchising services include the right to use trademarks, the transfer of know-how or technology, and management or logistical support services. Exports then are defined as cross-border receipts from selling franchises abroad, and imports are defined as the cross-border payments for purchasing franchises from abroad. Although franchising also may take place through affiliates, information on international trade in franchising services through majority-owned foreign affiliates is not available.

Franchising trade data indicate that exports of franchising services amounted to approximately $408 million in 1993, while imports were only $5 million (figure 7).[173] The resulting trade surplus of $403 million is indicative of the level of U.S. franchisors' international competitiveness. The favorable position of U.S. franchisors reflects franchising's origin in the United States, the domestic industry's maturity relative to foreign franchise industries, and the high level of demand for "American-style" products and services. As a result of these factors, a very large number of U.S. franchisors have extensive experience in managing expansive franchise systems and implementing ambitious development programs. In addition, the large and uniform home market enables U.S. franchisors to amass significant financial resources to support international expansion.

Because the U.S. franchising market is so mature relative to foreign markets, foreign franchisors may have difficulty entering the U.S. market. For example, foreign franchisors may have problems developing novel product concepts or providing franchisees with the same level of management support offered by domestic franchisors. The U.S. market also is one of the most highly regulated in the world. Franchisors trying to enter the market must comply with Federal and state regulations on franchising as well as regulations that apply to the underlying business (e.g., local food safety regulations applicable to the operation of a restaurant). Representatives of foreign franchisors suggest that adapting to the unfamiliar U.S. regulatory environment imposes a high initial cost that they view as a non-tariff trade barrier.[174] While the regulatory environment is not discriminatory, in that U.S. firms face identical regulatory controls, it nevertheless increases foreign franchisors' market entry costs.

In terms of U.S. exports of franchising fees and royalties, the largest individual country markets are Germany, Canada, Japan, the United Kingdom, and Mexico (figure 8). Europe and the Asia/Pacific area are the dominant regions, representing 38 percent and 29 percent of all exports, respectively, while the Latin American/Caribbean region is far behind with only 14 percent (figure 9). Within Europe, Germany and the United Kingdom constitute 36 percent and 20 percent of exports to the region, respectively, with no other single country having more than 9 percent of exports. In the Asia/Pacific area, exports to Japan contribute approximately 37 percent of exports to the region, followed by Taiwan with 17 percent and then Australia and Hong Kong with 11 percent each. Within the Latin American/Caribbean region, Mexico is the largest market, with 47 percent of U.S. exports, followed by Brazil (9 percent), Venezuela (7 percent), and Argentina (5 percent). Available trade data also indicate that U.S. franchises are scattered throughout many countries in

[171] U.S. Department of Commerce, International Trade Administration, "China - Franchising - ISA9404," Market Research Reports, Aug. 27, 1994, National Trade Data Bank, IT MARKET 111091768.

[172] Ibid.

[173] Data from Department of Commerce, Bureau of Economic Analysis (BEA), *Annual Survey of Current Business*, Sept. 1994. While franchising royalties and fees effectively reflect trends in franchising activity, they are not indicative of the full impact of international franchising on the U.S. economy because they do not include exports of goods and services to foreign franchised establishments.

[174] Franchising industry representative, interview by USITC staff, International Franchise Association Convention, Las Croabas, Puerto Rico, Jan. 25, 1995.

the region. This distribution could suggest that the market is underdeveloped and therefore offers significant potential for future growth should the economic conditions in the region continue to improve.

The most popular countries and regions for U.S. franchisors are highly developed economies where consumers have relatively high disposable income; close geographic proximity, as in the case of Canada and Mexico; and close cultural, economic or political ties, as in Germany and the United Kingdom. U.S. franchisors apparently do not fare as well in countries such as France with which there are more significant cultural differences. Whereas France has the largest number of franchises in Europe,[175] it accounts for only 8 percent of U.S. franchising exports to Europe. One European franchising industry representative attributes this to a combination of cultural differences that limit the appeal of U.S. products and stiff competition for a limited pool of potential franchisees.[176]

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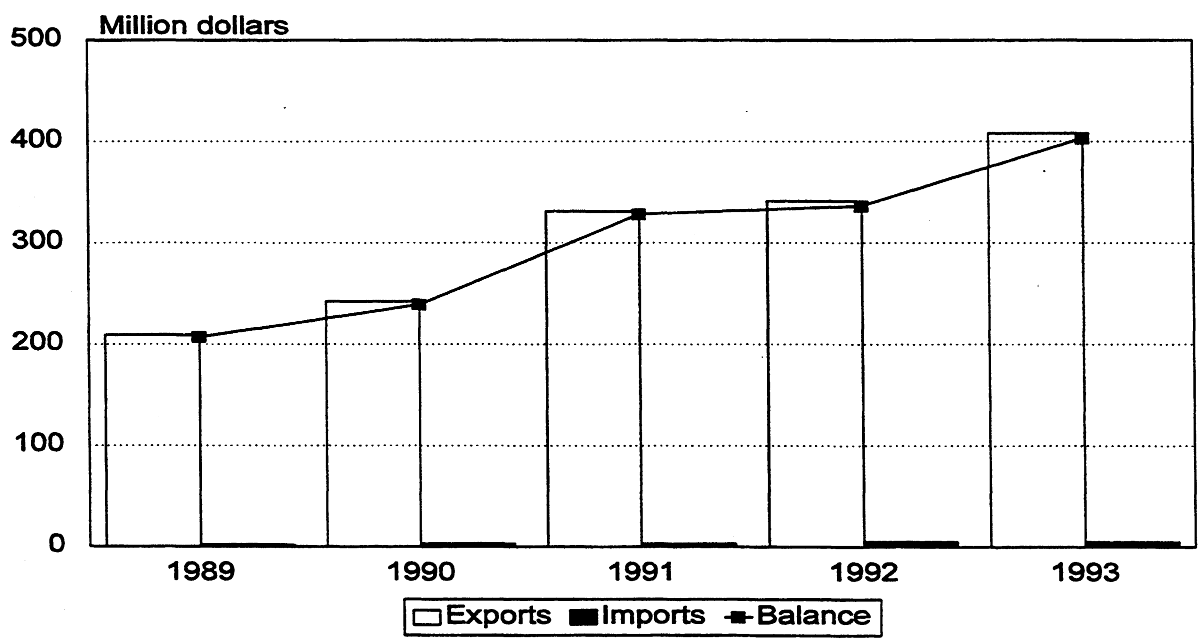
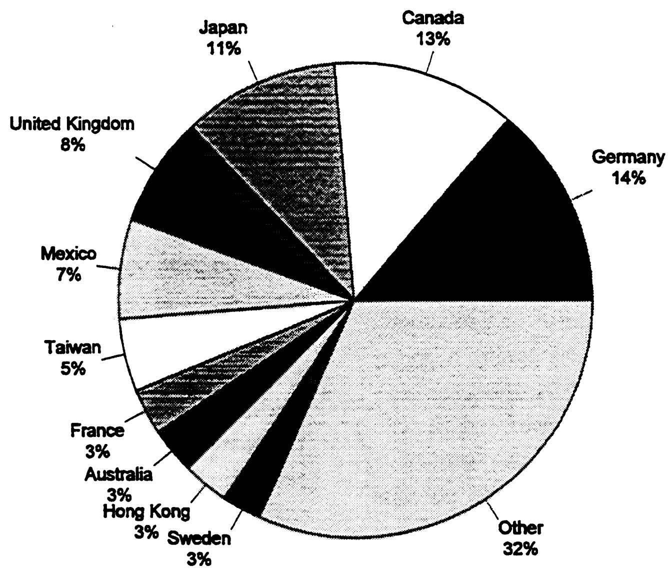
[175] European Franchise Federation, data sheet, Dec. 31, 1992.
[176] European franchising industry representative, interview by USITC staff, International Franchise Association Convention, Las Croabas, Puerto Rico, Jan. 24, 1995.

Figure 7
U.S. franchising trade, 1989-93



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business,* Sept. 1994.

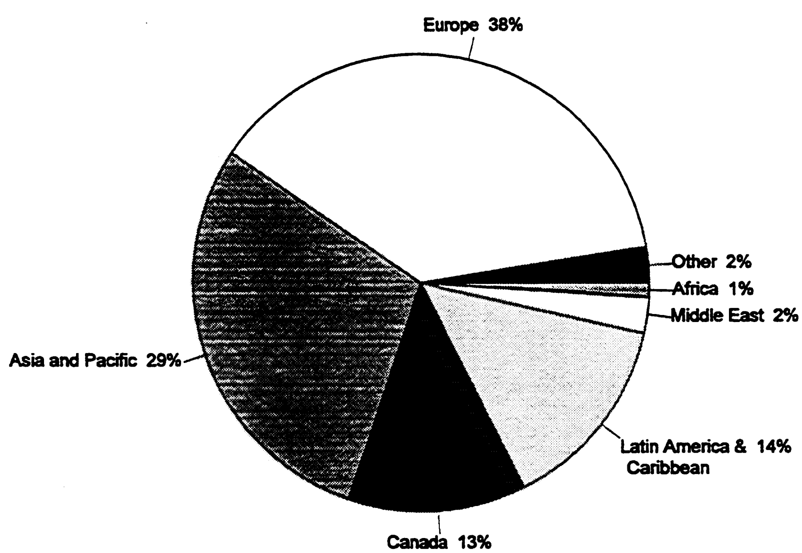
Figure 8
U.S. franchising exports, by country, 1993



Total exports = $408 million

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business,* Sept. 1994.

Figure 9
U.S. franchising exports, by region, 1993



Total exports = $408 million

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Sept. 1994.

Trade Liberalization

Trade agreements such as the North American Free Trade Agreement (NAFTA) and the General Agreement on Tariffs and Trade (GATT) may have significant impact on international franchising activities. Because franchising itself rarely is subjected to direct trade policy restrictions, the impact of these trade agreements on franchising will depend upon the extent to which they achieve their objectives of reducing or eliminating tariffs, reducing non-tariff barriers to trade, liberalizing investment and foreign exchange policies, and improving intellectual property protection. Liberalization in these areas should create a more favorable business environment for both domestic and foreign franchises. For example, lower tariffs will reduce the cost of importing merchandise. Similarly, more liberal policies on the presence of foreign nationals will facilitate franchise development, supervision, and training programs by permitting franchise representatives to travel and visit more freely. In addition, liberalized investment and foreign exchange policies will afford franchisors greater flexibility in choosing their form of business establishment while reducing financial risk and enabling greater profitability. The effect of other businesses increasing their presence abroad and the impact of general economic stimulation on disposable income should increase the number of potential customers and the demand for franchised products.

The recently signed Uruguay Round Agreements include the General Agreement on Trade in Services (GATS), the first multilateral, legally enforceable agreement covering trade and investment in the services sector.[177] The GATS is designed to liberalize trade in services by reducing or eliminating governmental measures that prevent services from being freely provided across national borders or that discriminate against firms with foreign ownership.[178] To accomplish this objective, the agreement establishes a legal framework for addressing barriers to trade and investment in services; includes specific commitments by signatory countries to apply the framework of rules to specific sectors, subject to defined exceptions; and provides for follow-up activities and further negotiations.[179] Specific commitments that delineate barriers are presented in Schedules of Commitments (Schedules). As of this writing, Schedules from approximately 90 countries are publicly available. Only 30 of these countries specifically include franchising in their Schedules (table 8), 12 of which were included in the European Union's Schedule. Many of the major trading partners of the United States are among those that have included franchising in their Schedules. The remaining two-thirds of the countries did not schedule commitments on franchising. This means that existing restrictions are not presented in a transparent manner and additional, more severe restrictions may be imposed at a later date. Subsequent rounds of negotiations under World Trade Organization (WTO) auspices will be held within five years of January 1, 1995, in an effort to encourage countries to expand their Schedules' coverage and liberalize restrictions.

Among the 30 countries that addressed franchising in their Schedules, 25 countries, including the United States, have committed themselves to maintain no limitations on franchising except for restrictions on the presence of foreign nationals within their respective countries. These restrictions permit the temporary entry and stay of senior managers and specialists, but limit the overall length of stay to comply with immigration policies. The remaining five countries are Brazil, Canada, Japan, Korea, and the Netherlands (specifically, the Netherlands Antilles). With the exception of the Netherlands Antilles, all of these countries have similar restrictions on the presence of foreign nationals.

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[177] U.S. House, *Message from the President of the United States Transmitting the Uruguay Round Trade Agreements, Texts of Agreements Implementing Bill, Statement of Administrative Action and Required Supporting Statements,* 103d Cong., 2nd sess. (Washington, DC: GPO, 1994), p. 297.

[178] Ibid.

[179] Ibid.

Table 8
Countries that have included franchising in their Schedule of Specific Commitments

- Argentina
- Aruba
- Australia
- Austria
- Belgium
- Brazil
- Canada
- Czech Republic
- Denmark
- Finland
- France
- Germany
- Greece
- Hungary
- Iceland
- Ireland
- Italy
- Japan
- Korea
- Liechtenstein
- Luxembourg
- Netherlands
- Norway
- Portugal
- Slovak Republic
- South Africa
- Spain
- Switzerland
- United Kingdom
- United States

Source: Compiled by USITC staff from GATS documents.

Additional restrictions are as follows:

Brazil:[180]

- Contracts must conform with the Industrial Property Code in order to be eligible for payment of royalties outside of the country.
- Brazil reserves the ability to maintain existing measures, which are unstated, or to impose restrictions at a later date on Brazilians' consumption of franchising services abroad as well as the cross-border supply of franchising services.

Canada:[181]

- The province of Alberta requires franchisors operating on a cross-border basis to designate a place within Alberta where legal documents may be served, and franchisors that establish a commercial presence in Alberta must have an attorney for the service of legal documents.
- The province of Prince Edward Island may restrict retail petroleum services based upon an economic needs test or "public convenience."

Japan:[182]

- Japan may impose limitations on franchising services related to petroleum, petroleum products, rice, tobacco, salt, alcoholic beverages, and any fresh food products supplied at a Public Wholesale Market.

Korea:[183]

- Korea limits the commercial presence of franchisors to no more than 20 shops with floor space less than 3,000 square meters per shop until January 1, 1996, and retailing for used cars and gaseous fuels is subject to an economic needs test.

[180] *General Agreement on Trade in Services, Brazil: Schedule of Specific Commitments*, p. 15.
[181] *General Agreement on Trade in Services, Canada: Schedule of Specific Commitments*, pp. 49-50.
[182] *General Agreement on Trade in Services, Japan: Schedule of Specific Commitments*, pp. 42-43.
[183] *General Agreement on Trade in Services, Korea: Schedule of Specific Commitments*, p. 36.

Netherlands Antilles:[184]

- The Netherlands Antilles limits the commercial presence of foreign franchisors to 25-percent ownership by the parent organization.

FUTURE EXPECTATIONS FOR FRANCHISING

Franchising has been highly successful within the United States due to favorable market and demographic conditions and its unique ability to satisfy the needs and expectations of various stakeholders. But projections for the industry as a whole suggest that U.S. growth will slow, particularly in traditional areas such as fast-food, convenience stores, and hotels. Mergers and acquisitions are expected to take place as larger chains seek to diversify and expand through acquisition rather than new development. The decline in growth opportunities in home markets should lead to further expansion abroad.[185] Franchising already is becoming a global business. Franchisors are being drawn around the world by foreign investors eager to meet rising demand for consumer goods and services. Reductions in trade barriers and improvements in international communications and transportation systems have made international operations much easier and more cost effective. In addition, franchise customers are increasingly becoming global citizens by traveling more widely and expanding their own businesses across borders. This further encourages franchisors to move into international markets in order to better serve and retain customers. The domestic strength and managerial expertise of U.S. franchisors should enable them to expand quickly, adapt to various market environments, sustain a powerful brand image, and build a substantial competitive advantage in the global marketplace.

[184] *General Agreement on Trade in Services, The Kingdom of the Netherlands with Respect to the Netherlands Antilles: Schedule of Specific Commitments*, p. 4.

[185] Cherkasky, "Introduction to Franchising and the International Franchise Association," pp. 5-6.

APPENDIX A
U.S. TRADE IN FRANCHISING ROYALTIES AND FEES, BY COUNTRY, 1989-93

Appendix A
U.S. trade in franchising royalties and fees, by country, 1989-93

	1989		1990		1991		1992		1993	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
	Million dollars									
Canada	21	(1)	34	(1)	40	(1)	42	(1)	51	(1)
Europe	107	2	89	(1)	118	1	148	1	155	3
Belgium	3	0	4	0	11	0	9	0	7	0
France	12	0	9	0	8	0	13	0	13	1
Germany	22	(1)	20	(1)	34	(1)	49	(1)	56	1
Italy	3	0	2	0	2	0	3	0	4	0
Netherlands	5	0	4	0	2	0	2	0	4	0
Norway	1	0	1	0	2	0	3	0	1	0
Spain	5	0	4	0	3	0	5	0	6	0
Sweden	8	0	6	0	11	0	12	0	11	0
Switzerland	5	1	3	0	3	0	3	0	3	0
United Kingdom	32	1	19	(1)	27	(1)	36	(1)	31	1
Other	10	0	17	0	15	(1)	14	(1)	18	0
Latin America & Other W. Hemisphere	11	0	13	0	29	0	39	0	58	(1)
South and Central America	9	0	9	0	24	0	33	0	51	(1)
Argentina	(1)	0	(1)	0	1	0	2	0	3	0
Brazil	1	0	1	0	2	0	3	0	5	0
Mexico	4	0	4	0	13	0	16	0	27	(1)
Venezuela	1	0	1	0	2	0	3	0	4	0
Other	4	0	4	0	6	0	8	0	12	0
Other Western Hemisphere	2	0	4	0	6	0	6	0	7	0
Bermuda	(1)	0	(2)	0	(2)	0	(1)	0	1	0
Other	2	0	(2)	0	(2)	0	6	0	6	0
Other countries	66	0	88	(1)	118	(1)	136	(1)	134	(1)
Africa	2	0	3	0	3	0	4	0	4	0
South Africa	2	0	2	0	2	0	3	0	3	0
Other	(1)	0	1	0	1	0	1	0	2	0
Middle East	2	0	4	0	6	0	6	0	10	(1)
Israel	1	0	2	0	2	0	2	0	4	0
Saudi Arabia	1	0	2	0	3	0	2	0	3	(1)
Other	1	0	1	0	1	0	2	0	3	0
Asia and Pacific	62	0	81	(1)	109	(1)	126	(1)	120	(1)
Australia	7	0	9	0	9	0	13	(1)	13	(1)
Hong Kong	4	0	8	0	9	0	12	0	13	0
India	(1)	0	1	0	(1)	0	(1)	0	(1)	0
Indonesia	1	0	1	0	2	0	3	0	4	0
Japan	40	0	48	(1)	65	(1)	59	(1)	44	(1)
Korea	2	0	3	0	6	0	5	0	7	0
Malaysia	1	0	1	0	2	0	3	0	3	0
New Zealand	1	0	1	0	2	0	3	0	3	0
Philippines	1	0	(1)	0	1	0	1	0	2	0
Singapore	2	0	2	0	3	0	4	0	5	0
Taiwan	3	0	3	0	4	0	18	0	20	0
Other	1	0	3	0	4	0	5	0	6	0
International organizations and unallocated	4	(1)	18	2	12	2	10	2	11	1
Addenda										
European Union (12)	87	1	74	(1)	94	1	120	1	127	3
Eastern Europe	0	0	(1)	0	1	(1)	1	(1)	2	0
All countries	209	2	242	3	331	3	341	5	408	5

[1]Less than $500,000.

[2]Suppressed to avoid disclosure of data of individual companies.

Source: Bureau of Economic Analysis, *Survey of Current Business*, Sept. 1994.

APPENDIX B
U.S. FRANCHISING SALES AND ESTABLISHMENTS, 1969-92

Appendix B
U.S. franchising sales and establishments, 1969-92

	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Sales						*Billion dollars*						
Business format (nominal)	24.7	27.5	24.1	28.7	32.7	37.3	40.9	46.6	65.8	64.3	72.4	83.5
Product & trade name (nominal)	88.1	89.1	105.3	115.2	131.0	131.3	144.9	171.3	195.9	217.9	241.0	250.8
Total nominal sales	112.8	116.6	129.3	143.9	163.7	168.5	185.8	217.9	261.7	282.2	313.3	334.4
Establishments						*Thousands*						
Business format	121.2	134.4	175.5	189.6	202.2	209.7	195.2	222.3	240.5	245.7	252.7	252.5
Product & trade name	262.7	261.9	255.6	262.1	251.4	231.0	239.3	220.9	212.0	207.9	199.8	189.8
Total	383.9	396.3	431.2	451.7	453.6	440.7	434.5	443.3	452.5	453.6	452.5	442.4

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Sales						*Billion dollars*						
Business format (nominal)	94.1	99.0	110.5	122.3	141.3	155.5	149.0	178.3	192.0	213.3	232.3	249.0
Product & trade name (nominal)	270.7	277.0	312.3	369.8	401.6	413.5	425.0	469.7	485.0	500.7	525.7	554.0
Total nominal sales	364.8	376.0	422.8	492.1	543.0	569.1	574.0	648.0	677.0	714.0	758.0	803.0
Establishments						*Thousands*						
Business format	260.6	268.3	276.2	283.6	301.7	312.8	333.0	339.1	353.8	385.9	407.7	429.2
Product & trade name	181.9	174.1	165.0	160.7	153.5	149.3	146.0	141.9	139.2	135.1	134.3	128.9
Total	442.4	442.4	441.2	444.3	455.2	462.1	479.0	481.0	493.0	521.0	542.0	558.1

Note.--Totals may not add due to rounding.
Source: International Franchise Association, the Statistical Abstract of the United States, and U.S. Department of Commerce, *Franchising in the Economy* series from 1979-1988.