We study the effect of state level contract termination laws on the local entry decisions of franchisors. These laws, which exist in a number of states, restrict the franchisor’s ability to terminate a contract with a franchisee, thus increasing the cost of franchising. While these laws are enacted to protect entrepreneurs, we posit that they may have equilibrium effects which result in fewer franchises being opened and fewer outlets overall, suggesting overall negative welfare effects of such a policy.

We examine these equilibrium effects in two ways. We first extend the Hotelling linear city model to a two period setting where a monopolist franchisor chooses the optimal mix of corporate owned outlets and franchises in a local market. In the first period, the franchisor decides on the market structure, which can include no outlets, a mix between corporate and franchise outlets, or specialization in one of the organizational forms. By opening a corporate own outlet, the franchisor pays a fixed cost, but realizes all the profits generated from that outlet. By opening a franchised owned outlet, the franchisor realizes only a proportion of the revenue, but does not pay any fixed or marginal costs. We highlight the role of intra-brand competition, as the per-period profit of the franchisor depends on the competition between outlets that may vary in terms of their private incentives.

Importantly, when making their decision in period one, the franchisor has uncertainty of the franchisee’s quality. After the first period, the franchisor observes the quality of the franchisee and
can choose to fire him and hire a new one, although there is a cost associated with this action. This cost serves as a measure of how hard it is to fire an underperforming entrepreneur, which can be thought of as the stringency of the local contract termination laws.

We generate equilibrium predictions of the model depending on the local market conditions (i.e., ‘travel costs’) and the cost of firing an underperforming entrepreneur, while keeping the other parameters fixed. We find that, at any level of travel cost, an increase in the firing cost results in fewer franchisee owned outlets being opened. This is not surprising considering that an increase in the firing cost makes opening a franchisee owned outlet less attractive. Interestingly, the model demonstrates that there may be an increase or a decrease in the number of corporate owned stores as a result of an increase in the firing cost. At low levels of travel costs, we see substitution between having one franchisee owned outlet and one corporate owned outlet, suggesting that these markets are profitable enough for an outlet, but that the optimal organizational form of that outlet depends on the firing cost. At high levels of travel cost, we see that firing costs have a non-monotonic effect on the number of corporate owned outlets. This comes from complementarities that exist between organizational form in terms of recouping the fixed cost of opening a corporate owned outlet through the royalties received from a franchisee owned outlet.

Importantly, the model generates a number of predictions that are testable in data. First, the number of franchisee owned outlets decreases with the stringency of the local termination laws. Second, the number of corporate owned outlets may increase or decrease depending on the local market conditions. Third, the number of total outlets may increase or decrease, depending on the market conditions. We test these predictions while accounting for other local demand and cost factors using county level data from four of the top five quick service restaurant franchises. We find that counties that have strict termination laws have approximately 5% fewer franchisee owned outlets. Additionally, results indicate that, on average, complementarities between franchisee owned and corporate owned outlets exist, as the termination laws result in about 3% fewer corporate-owned outlets. Therefore, the laws lead to an overall reduction in the number of outlets. Together, this suggests an overall welfare loss due to the termination laws, as there is not only a decrease in opportunities for local entrepreneurs, but also an overall decrease in the number of quick service outlets.
restaurants, limiting both the choices available to consumers and the employment opportunities for the local labor force.