INSIDE BUSINESS 6–4

Compensation in Fast-Food Restaurants

About 30 percent of firms in the fast-food industry are owned by the company, and 70 percent are franchised to owner-operators. The owner-operator's income is entirely derived from the profitability of the individual store. Typically the franchising parent requires the owner-operator to be in residence. The franchise owner receives profits, less a franchise fee, as remuneration.

In contrast, the manager of a company-owned store is usually paid a flat fee for managing a restaurant. This leads the manager to have less incentive to lower employee costs and other operating expenses. The manager whose income is not tied to profits also has less incentive to ensure high sales. Given that the income of a franchise manager is directly tied to profits whereas the income of the manager of the company-owned store is not, we would expect profits to be lower in company-owned stores. Company-owned stores also would face higher employee wages and less effective supervision of employees.

Alan B. Kruger provides some interesting insights into the relationship between employees and managers in the fast-food industry. As the accompanying table shows, employees subjectively rate managers in company-owned stores as less effective than those in franchise-owned stores. Company-owned crew workers and franchise crew members earn roughly the same hourly wages; thus, the positive evaluations of franchise managers would not appear to be due to differentials in pay.

Historically, profitability is higher in franchised stores than in the company-owned stores. A 1967 survey showed that stores changing from franchise ownership to company ownership experienced a drop in profitability from 9.5 percent to 1.8 percent. It is clear why so many fast-food chains franchise their restaurants. Franchising mitigates the principal-agent problem by making managers' compensation dependent on profitability; thus, more profits are made than would otherwise be the case.

Employee Evaluation of Supervision in Company-Owned and Franchised Restaurants

	Proportion of Employees Agreeing (standard deviations in parentheses)	
Employee Evaluation of Manager	**Company-Owned**	**Franchise-Owned**
Manager provides adequate supervision to workers	0.326 (0.010)	0.452 (0.014)
Assistant manager provides adequate supervision to workers	0.332 (0.010)	0.405 (0.013)
Supervisor provides adequate supervision to workers	0.360 (0.011)	0.468 (0.014)

Source: Data based on Alan B. Kruger, "Ownership, Agency, and Wages: An Examination of Franchising in the Fast-Food Industry," *Quarterly Journal of Economics* 106 (February 1991), pp. 75–102.