Privatization by Franchising: Commissioned Entrepreneurs
The Case of Sumer Holding Sales Outlets in Turkey
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ABSTRACT:
Franchise privatization of non-profitable Sumer Holding sales outlets across Turkey converted the civil servants working in these outlets to private, risk-taking and creative entrepreneurs. The success of and the efficiency gains from franchise privatization at the firm level originate, in part, from significant changes in motivation, attitudes and initiative of the new ‘commissioned entrepreneurs’, and at the social level, franchise privatization with a partial line forcing contract enabled the publicly held parent company to continue fulfilling its historical mission of providing cheap and essential inputs to the low income consumers and communities in an uninterrupted manner.

I. INTRODUCTION
Ownership matters. It is widely believed that the self-interested owner is subjected to higher financial discipline than is the administratively constrained public employee or the politically guided government bureaucrat. Nevertheless, governments may and do set political constraints in trying to implicitly or explicitly influence the management of the firms -whether publicly or privately owned (Schleifer and Vishny, 1994; Bardhan and Roemer, 1994). In one sense, privatization a move from an over controlled public firm to an over controlled private firm (Bos & Peters, 1988), through a process where public ownership of an asset is turned into private ownership with various degrees of control.

Public ownership in a market economy may be the source of many inefficiencies and a primary cause for resource allocation problems (Vickers and Yarrow, 1988; MacAvoy et al., 1988; Bos and Peters, 1988; Boycko et al., 1994; Anbarci and Karaaslan, 1998). In many cases and to a certain extent the original rationale for public ownership may justify the waste; for example, provision of essential inputs or services, distribution of primary commodities where private markets/resources are insufficient or lacking.

Sumer Holding Company (SHC) is one of the many SOE’s in Turkey. It specializes in the manufacture of a variety of textile products and wearing apparel including leather and footwear; its network of production plants and sales outlets stretch even to the smallest of Anatolian towns all around Turkey. The history of SHC (originally Sumerbank), in a way, parallels with the history of the government led industrialization process in Turkey. Over a period of two years prior to 1996 August, 291 of the 433 retail outlets of the SHC, which had been making losses for more than five previous years, were privatized by transferring ownership to private individuals, giving priority to the employees (sales persons, cashiers, clerks, etc) working in these enterprises. I examine the various determinants of post privatization performance of the sales outlets of SHC that were privatized by way of sales

1 It is ironic that, as in many countries around the globe, the privatization process in Turkey is itself being managed by the public sector.
2 The first post privatization survey of the then privatized sales outlets was conducted by Ozer Ertuna (Ertuna, 1995) in 1993. The second survey, in the same format with the first, came in 1994 by Gaye Gencer (Gencer, 1997). It consisted of 33 open end or fill in the blank questions.
to its existing employees under a franchise contract to carry and sell a preset volume of SHC products every year. I call this ‘privatization by franchising.’

A franchise contract is defined as one in which the owner –franchisor--, of a product, service, or trademark has authorized other firms to produce and distribute a product under his tradename, subject to a number of conditions. This paper focuses on the condition known as partial-line forcing whereby the franchisee agrees to purchase some of the inputs from the franchisor. The equivalence of revenue sharing and full-line forcing, and welfare implications of franchising are found in Inaba, 1980, 1982; Fratrik and Lafferty, 1985; Blair and Kaserman, 1980, 1985. Accordingly, the privatized sales outlets of the SHC would be allowed to use the Sumer Holding tradename, carry a full line of SHC consumer products and also carry rival products. Thus, the main focus is on the entrepreneurial transformation of the former public employees into local merchants and businessmen operating as SHC franchisees. Privatization by franchising serves a double purpose: first it eliminates the losses accrued to SHC by many of its sales outlets; second, franchising agreement keeps these shops as contractually bound sales outlets for many of the primary, and often times subsidized, commodities SHC produces. Such staple commodities are still essential for the poverty stricken populations of Turkey. Therefore, in one sense, the government has commissioned its salary-based employees who held guaranteed lifetime tenure to become private entrepreneurs in their local communities and to carry out its social objectives by providing them with appropriate incentives. Simultaneously, the government has created new entrepreneurs in these communities helping the development of private initiative.

II. DATA AND METHODOLOGY

Following is a brief summary of the survey results that was compiled from valid and useable responses out of a mailing of 393 sales outlets that were privatized over a period of two years prior to 1996 August. The total number of employees prior to privatization in 111 of these sales outlets that responded to the survey was 518. This number was down to 361 after privatization. 192 of this total (53%) are current owners themselves. Mean and the median number of employees in an outlet before privatization were 4.8 and 4 respectively. After privatization these numbers were down to 3.3 and 2 respectively. 69 out of the 111 are sole owners; 22 have one business partner; and the remaining 18 have 3 or more partners (Mean 1.76, st.dev 1.43. Normal scores confirm that the sample comes

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3 Here, the idea of privatization by franchising is different than regulative franchising of natural public monopolies. In the system of regulative franchising, the franchise is awarded for a period of time to the competitor offering to supply the product or service at the lowest price (or, more generally, the best price-quality package). The competition for monopoly appears to destroy the undesirable monopoly of information that hinders traditional regulation, and the price is set by competition, not by administrators (Demsetz, 1969). Regulative franchising was used in the Ottoman Empire in tax collection (Salzmann, 1993); also, it was advocated by Edwin Chadwick, the Victorian social reformer. However, only a few of the Sumer Holding outlets were local monopolies for the product lines they carried and there were no barriers to entry by private firms. More importantly, privatization proceeded by selling the ownership rights of the sales outlets as opposed to transfer of ownership for a period of time.

4 Franchise contract may contain a number of conditions, such as: (1) the franchisee agrees to pay a franchise fee; (2) the franchise agrees to certain business hours, credit, employee training, advertising as stipulated by the franchisor; (3) he agrees to adhere to certain quality standards for the product; (4) he agrees to purchase all or some of the inputs he needs from the franchisor (full and partial-line forcing); (5) the franchisee agrees to pay a royalty, usually a percentage of sales, to the franchisor (revenue sharing).
from a normal distribution). Of those that responded, 18 had a decrease and 2 had an increase in the number of partners since privatization; 5 had bought the business from its previous owner(s), and the remaining 80 had no change in the ownership structure.

73 (67.5%) of the outlets report that their earnings have improved since privatization. 15 (13.8%) have a decrease in earnings, and 20 had no change. Total population --as a proxy for customer base and market size-- of the 100 valid responses is 8,267,651. The mean and the median customer base per sales outlet were 82,677 and 30,000 (see histogram below).

The monthly earnings of an average customer are reported to be less than 10 million TL (Turkish Lira) for 13 (12%) of these outlets. For 67 of the sales outlets (61%) an average customer earned between 10-20 million TL, and for 30 (27%) the respondents estimated that it is in the range of 20-30 million TL. While 18 respondents report that they do not have any current debt, 44 had an increase in their debt holdings. 21 did not have a change, while 26 managed to lower their debt level since they took over. The regional distribution of the outlets are as follows: South 8 (7.2%), Central 17 (15.3%), East 15 (13.5%), West 18 (16.2%), North 22 (19.8%), Northwest 19 (17.1%), Southeast 7 (6.3%).

III. MARKET DETERMINANTS OF ENTREPRENEURIAL SUCCESS

Next, I explore the data conducting several chi-square tests on cross tabulations. The purpose of the tests is to explain the conditions under which the new owners have become successful entrepreneurs; in particular, to see if success is attributable to entrepreneurial talent and adaptation, or the degree of market power in the local markets they operated. I interpret the results using the industry structure-firm conduct-market performance frame of reference. Following the conclusion, the theoretical justification of many of the positive results obtained is provided with a theoretical example at the Appendix.

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5 One U.S. Dollar was equal to (c.a.) 80,000 Turkish Liras at the time. 10 million TL is equivalent to about 125 US Dollars.
A cross tabulation reveals that population size and average monthly earnings of an average customer are significantly related. The Chi-square value of 23.061 is in the rejection region for 2.5% level of significance \((df=12, p\text{-value}=0.01875)\). This is an expected result: urbanization provides higher earnings potentials, but also a higher cost of living. 32 respondents report an increase and 31 report a decrease in the population of their region in the last two years. In a country of positive population growth this result confirms the size of ongoing internal migration that has accelerated during the second half 1980’s. In 35 of the cases there has been no significant change in population. Another cross tabulation with change in earnings and change in population since privatization indicates significant positive association between the two, as expected, since population is an important determinant of demand for many of the necessities in the SHC product line. The null hypothesis is rejected at 1% level of significance \((p\text{-value}=0.001)\).

Three of the shops consider themselves to be monopolies, while 13 others have either one or two, and 27 have 3-5 competitors. The mean and the median number of competitors are 12.44 and 8 respectively. 5 of the shops report a decrease and 32 reports an increase in the number of competitors since privatization, the remaining 73 with no change. Separately, the market share of 62 (56%) sales outlets have increased, and 22 (20%) have decreased since privatization. Those who could increase their market share seem to have benefited disproportionately from population growth. The data indicates that population growth and market share growth are significantly related for the privatized SHC sales outlets. One interpretation of this is that the new entrepreneurs have benefited a great deal from their knowledge and past experience of the market conditions as government employees and unconstrained from bureaucratic rules, they have started practicing tools of competitive conduct freely and quite profitably, and better than their competitors in their newly found territories.

In a separate question, they were asked if the competitors’ economic power relative to theirs have changed since privatization. Only 10 responses stated that competitors’ relative economic power have increased. 48 respondents stated that their relative economic power has decreased, and 51 with no change. This question was intended not only to be a control variable for the market share question, but it also measures the potential difference between the market share and profitability as proxied by "economic power". The correlation between the two is strongly positive, but it should not always be expected to be close to one. In fact, the correlation between the change in market share and change in economic power was measured to be 0.56. The chi-square statistic of 47.7 \((df=4)\) enables us to strongly reject the null hypothesis that the changes in market share and economic power are independent.

33 respondents (34.7%) confirm that they occasionally colluded and cooperated with competitors\(^6\). 62 said they did not collude. 41 (42.7%) responded negatively to the question if there was any occasional price competition with the rivals, 55 (57.2%) responses were in the affirmative. However, a cross tabulation of the responses on collusion and price competition shows only 17 respondents (18% of the sample) both colluded/cooperated and avoided price competition with the rivals, while 38 (40%) said "NO" to collusion and "YES" to occasional price competition. On the basis of the chi-square statistic of 1.783 \((p\text{-value}=0.182)\) we fail to reject the null hypothesis; collusive/cooperative behavior and

\(^6\) A confession to collusion with the rivals is a violation of the Turkish antitrust laws. However, those laws were newly enacted at the time of the survey year (1996) and the government had not yet formed a regulatory board to enforce these laws.
occasional price competition are not significantly related. It is reasonable to think that those who occasionally engage in mutually damaging price competition will also be most willing to collude and cooperate occasionally.

Three other YES/NO type questions measure the extent of non-price competition: "We offer more frequent and longer term credit sales compared to the past" (52 YES, 43 NO.) "We monitor the competitors and try to carry different and a more varied stock of merchandise " (98 YES, 4 NO.) "We make use of local press, billboards and other media to advertise and to distinguish our name." (81 YES, 17 NO.)

In a cross tabulation of the change in earnings and change in debt we fail to reject the null hypothesis at 5% level of significance that earnings and indebtedness are unrelated (Chi-Square = 6.745, DF = 4, P-Value = 0.150). It seems that those who could increase earnings also increased the volume of credit purchases from suppliers.

The following proxy question is intended to measure attitude towards risk two years after being converted into a ‘commissioned entrepreneur.’ "If you were offered a more attractive business and/or job in a different city, would you be willing to sell this shop and relocate?" There are 44 YES and 58 NO responses to this question. Nevertheless, a cross tabulation of the responses to this question with the responses to the 'change in earnings since privatization" question revealed 'regret' and a "winner's curse" on the current owners.

| Are you willing to Relocate for an Attractive Offer in a Different City* Change in Earnings Crosstabulation |
|---------------------------------------------------------------|---------------------------------------------------------------|-----------------------------|-----------------------------|
| Change in Earnings since Privatization                        |                  | Increased | decreased | No change | Total |
| Willing to Accept Another Offer and Relocate                 | YES              | 22         | 9          | 11         | 42    |
|                                                            | NO               | 48         | 3          | 6          | 57    |
| Total                                                        |                  | 70         | 12         | 17         | 95    |

Only 31% with increased earnings were willing to accept a new offer. 75% of those with decreased earnings, and 65% of those with no earnings change were eager to accept the offer. We reject the null hypothesis that this choice is independent of the earnings record since privatization (chi-square statistic of 12.134 (d.f.=2, p-value=.002).

IV. CONCLUSION

It is largely believed that the self-interested owner is subjected to higher financial discipline than is the politically guided government bureaucrat. While this is rather general language the word "efficiency" is generally meant to imply production efficiency: elimination of organizational slack known as X-inefficiency, innovativeness that bring dynamic efficiency, organizational restructuring that bring incentive compatible management structures and higher profits. The other, equally important, dimension is "allocative efficiency" which means product prices are equal (or close) to marginal cost. In an ideal world both notions of efficiency would be attained if markets were sufficiently competitive. If the markets are very concentrated and already riddled with imperfections, privatization may only bring productive efficiency. In those circumstances, gain in allocative efficiency may be minimal, and in certain extreme cases there may be losses in allocative efficiency simultaneous with gains in productive efficiency. Results of our survey reveal the expected tradeoff-off between the market structure and efficiency gains. Most of the SHC outlets that had reached a stage of liquidation before the privatization are
now making profits, indicating gains in production efficiency. The franchise privatization helped to convert the civil servants working in these outlets to private, risk-taking and creative entrepreneurs. The success at the firm level is, in part, due to significant changes in attitudes, motivation and initiative of the new entrepreneurs, who were civil servants before (Brandstatter, 1997). While the dominant and price setting role historically played by these outlets in mostly oligopolistic local markets raises doubts about collusive behavior, it may explain some of their success after privatization. To a great extend, franchise privatization enabled the government to carry out its social objectives of providing cheap and essential items to low-income consumers in an uninterrupted manner. The government achieved this by setting up a network of privatized franchise outlets all around Turkey.

REFERENCES


APPENDIX

Example: Suppose that a generic SHC employee’s preferences w.r.t. work and income expressed in dollar amounts is given by the convex function: \( U = I - e^2 \). where \( I \) stands for income and \( e \) for the units of effort. Further suppose the employee’s reservation utility is equal to $1,000. The employee will not work for anything less than this amount: 1,000 > I - e^2. Let the following function represent the firm’s benefits (revenue) from the employee’s effort: \( B = 100e \).

Case I: Effort is costlessly observable

The firm must pay the employee: \( I = 1,000 + e^2 \). This suggest that the employee will receive her reservation utility: \( U = (1,000 + e^2) - e^2 = 1,000 \). Then, the firm’s profits, \( \pi \), is expressed as a difference between the firm’s benefits from the employee’s effort and what the firm pays to the employee in return for her effort, \( \pi = 100e - (1,000 - e^2) \). From the f.o.c. we obtain \( e = 50 \), and the firm obtains the following profits (per worker): \( \pi = 100(50) - (1,000 - 50^2) = 1,500 \). In return the employee is paid \( I = 1,000 + 50^2 = 3,500 \). The problem with this scheme is that (i) the assumption that effort is costlessly observable is not realistic, (ii) output is not always a good proxy for effort due to random events and variations in market conditions which are beyond the employee’s control, (iii) we have the well known agency problem: the employee may renege on her promise to deliver 50 units of effort, but still get paid $3,500; with lower effort level, her utility will increase.

Case II: Effort is not observable

Suppose the firm has historical records of its profits through which it can compute an expected profit of $1,500 from an average employee’s effort; and suppose the firm sells the employee the rights to the value of her own output (\( 100e \)) for a price of $1,500. Such a scheme is incentive compatible, i.e., it solves for the potential agency (moral hazard) problem that exists in any employee-employer relationship. Then the worker’s new utility function would be: \( U = I - e^2 \), where \( I = 100e - 1,500 \). Notice that, here \( (100e) \) which used to be the firm’s benefits from the employee’s effort is now transformed into the employee’s benefits from her own effort. Hence, \( U = (100e - 1,500) - e^2 \). To maximize the worker’s utility \( w.r.t. \) her chosen effort level and solving the f.o.c. we obtain \( e = 50 \). The employee will choose to exert an effort level of 50 units and she will obtain a maximum utility of \( U = 100(50) - 1,500 - (50)^2 \). \( \Rightarrow U = 1,000 \). But, this is the same effort level as we have obtained in case I where we assumed effort is costlessly observable -- hence no agency problem (Brickley, et al., 2004.)

SHC’s franchise privatization of unprofitable sales outlets has relied on essentially the same idea: salaried employees who got paid fixed salaries and who were subject to the moral hazard turned into successful entrepreneurs. Assigning property rights to the fruits of their own effort created significant efficiency improvements in a great majority of cases, and the losses that was a burden on the government under public ownership were eliminated. Many of the employee owners materialized their entrepreneurial skills and increased their profits. They achieved this both by eliminating the previous slack mostly by reducing the number of owners by buying and their shares on the privatized property and by increasing their actual effort level.