

The Organization of the Firm

Two major issues tackled in chapter 6:

1. How should a firm obtain the inputs that it requires to produce and sell its product?
2. How should a firm compensate its managers to achieve the best performance from them?

The Principal-Agent Problem, as it relates to managers who are not owners of the firm: The goal of the manager is not necessarily the same as the goal of the owner.

Goal of the owner: maximize profits

Possible goals of the manager:

- maximize happiness
 - maximize power in the organization (perhaps by accumulating workers beneath him/her)
- Our textbook focuses on one potential problem--the manager maximizing his own happiness by "shirking"

Shirking example: A manager is paid a flat salary of \$1000/day. The manager believes that he will not be fired if he works only 5 hours per day instead of 8 hours per day. (Shirking = 3 hours per day)

<u>Hours per work per day</u>	<u>daily profits of the firm</u>	
8	\$8,000	
7	\$7,000	
6	\$6,000	
5	\$5,000	shirking cost the firm \$3,000
4	\$4,000	per day in lost profits
3	\$3,000	
2	\$2,000	
1	\$1,000	
0	\$1,000	

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How to reduce shirking:

1. Reduce the income effect by reducing the base salary
2. Increase the substitution effect by instituting profit-sharing or revenue sharing

Example:

Old compensation: \$1,000 per day flat rate

New compensation: \$400 per day + 10% of daily profits
(profit-sharing)

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Suppose that the new compensation scheme causes the manager to work 7 hours per day instead of 5 hours per day:

<u>Hours per work per day</u>	<u>daily profits of the firm</u>	
8	\$8,000	
7	\$7,000	<--new profits
6	\$6,000	
5	\$5,000	<-- old profits
4	\$4,000	
3	\$3,000	
2	\$2,000	
1	\$1,000	
0	\$1,000	

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Compare:

At flat rate of \$1000 per day salary, firm profits were \$5000

At new compensation (\$400 per day + 10% of firm profits), firm profits are \$7000 and the manager is paid:

$$\$400 + (10\% \text{ of } \$7000) = \$1100 \text{ per day}$$

Surely it is worth an extra \$100 per day for the firm to get an increase in profits of \$2000.

In this case, profit-sharing increases compensation of employees and increases profits.

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How to institute profit-sharing:

1. Give workers an annual bonus that is larger if the firm's profits are larger. (UAW and Ford, Law partnerships, Goldman Sachs)
2. ESOP: Employee stock ownership plans. Give employees shares of the company stock as part of their compensation
3. Stock options: Grant employees the right to buy shares of the company's stock in the future at a price that is fixed today. (In this way, if the company is profitable then the stock price will rise and the employees will be able to buy the stock later at a discount to the prevailing price.)

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Stock Option example: Biff works for ABC Inc. Currently, shares of ABC stock sell for \$10 per share on Wall St.

Biff is given the right to buy 1000 shares of ABC stock at \$10 per share in 5 years.

Suppose that ABC does poorly over the next 5 years, so 5 years from now ABC stock sells for \$8 on Wall St. In this case, Biff's option to buy shares for \$10 per share is worthless, since the shares are only worth \$8 each on Wall St.

On the other hand, Suppose that ABC does WELL over the next 5 years, so 5 years from now ABC stock sells for \$25 on Wall St. In this case, Biff's option to buy shares for \$10 per share is very valuable. He can buy a share for \$10, then immediately sell it for \$25 on Wall St--a gain of \$15 per share.

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Revenue-Sharing vs. Profit-Sharing

Among salespeople, revenue sharing is a bit more popular than profit sharing. The "sales commission" given to a salesperson is commonly stated as a percentage of the sale (not as a percentage of the profit from the sale).

When using revenue-sharing, the firm must be careful to set pricing guidelines for the sales staff. It doesn't do much good for the firm to have a lot of sales if the sales price is below the production cost.