CHAPTER 10

INCENTIVE CONFLICTS AND CONTRACTS

CHAPTER SUMMARY

This chapter provides an overview of incentive conflicts and contracting within firms. It begins by defining the firm as a focal point for a set of contracts. It then discusses the many incentive conflicts that exist between the parties that make up the firm. The role of contracts in reducing these conflicts is examined. The importance of asymmetric information in limiting the ability to solve these problems in a costless manner is stressed. Both postcontractual and precontractual information problems are examined. The role of implicit contracts and reputational concerns in reducing incentive conflicts is discussed.

CHAPTER OUTLINE

FIRMS
Managerial Application—Enforceability of Implicit contracts

INCENTIVE CONFLICTS IN FIRMS
Owner-Manager Conflicts
Choice of effort
Perquisite taking
Differential risk exposure
Managerial Application—The Spectrum of Organizations
Differential horizons
Overinvestment

Other Conflicts
Managerial Application—Buyer-Supplier Conflicts
Managerial Application—Experimental Evidence on Free-Rider Problems
Managerial Application—Incentive Conflicts throughout the World

CONTROLLING INCENTIVE PROBLEMS THROUGH CONTRACTS
Costless Contracting
Managerial Application—Jack Welch’s Perquisites

Costly Contracting and Asymmetric Information
Managerial Application—Agency Problems with Owner-Managers

Postcontractual Information Problems
Agency Problems
Managerial Application—Pilots of Private Jets

Example of Agency Costs
Managerial Application—Technology to Reduce Monitoring Costs
Managerial Application—Incentive Problems between Firms and Their Law Firms

Precontractual Information Problems
Bargaining Failures
Adverse Selection
Managerial Application—Rising Health Care Costs Create Employee Conflict

IMPLICIT CONTRACTS AND REPUTATIONAL CONCERNS
  Implicit Contracts
    Managerial Application—Coke’s Implicit Contract
  Reputational Concerns
    Managerial Application—Corporate Scandal Affects Personal Reputations

INCENTIVES TO ECONOMIZE ON CONTRACTING COSTS
  Managerial Application—Can the SEC Reduce Contracting Costs?

SUMMARY

TEACHING THE CHAPTER

The incentive problem is represented using the utility-maximization framework initially presented in Chapter 2. Although it is likely students will remember the material well enough to understand the presentation of the material as it relates to this chapter, some students may need a brief review. One of the key points of the chapter is that incentives matter and the goal of a contract is to design an incentive system that will result in desirable outcomes. A second key point is that although in many of the analyses presented thus far the firm is considered to be a single actor, in reality, the firm’s actions are the aggregation of many individual decisions made by the employees of the firm. Properly structured contracts are an important tool to align the actions of the actors with the best interest of the firm.

There are two Analyzing Managerial Decisions scenarios presented in the chapter. The first, “Opening a New Restaurant”, asks students to consider the conflicts that might arise between the owner and the managers and how compensation might be structured to head off these conflicts. The second scenario, “eBay.com”, asks students to consider the conflicts that might arise in an online setting. Students should consider how the support services provided by eBay might limit the number of conflicts that arise. (See the Solutions Manual for the answers to these problems).

The Self-Evaluation Problems reiterate the core concepts of the chapter and ask students to make use of their quantitative skills. In particular, the first problem asks students to determine the total agency costs and to divide these costs into the residual loss and out-of-pocket costs, which could be particularly difficult for students and could be covered in class after that section of the lecture is presented. The Review Questions cover some of the core definitions but also ask students to apply the concepts of the chapter to understand how contracts might or might not alleviate conflicts.
Chapter 10 - Incentive Conflicts And Contracts

**REVIEW QUESTIONS**

10–1. What is a firm?

Economists have developed several different definitions of a firm. This book focuses on one particularly useful definition: “The firm is a focal point for a set of contracts.”

10–2. Give examples of incentive conflicts:

a. Between shareholders and managers.

Managers might want to invest in pet projects, rather than projects that increase shareholder value. They might also prefer to spend company resources for personal consumption rather than on productive investment projects. Many other examples are possible.

b. Between coworkers on teams.

One prominent example is the classic free-rider problem. Individually, team members can have incentives to shirk and hope that everyone else on the team works hard.

10–3. What is asymmetric information? How can it limit contracts from solving incentive conflicts?

Asymmetric information means that all contracting parties do not share the same information. With symmetric information incentive conflicts would be relatively easy to solve. The contracting parties could agree to take certain actions and if they do not they can be heavily penalized. Asymmetric information, however, can make it difficult to ascertain whether or not a party has honored the terms of the contract.

10–4. Name the two parties involved in an agency relationship.

Principal and agent.
10–5. What potential problems exist in agency relationships?

An agent agrees to act in the interests of the principal. However, the agent may subsequently act in his own self interest at the expense of the principal. For example, a real-estate agent has a legal obligation to represent the seller of a house. Nevertheless, the agent might provide confidential information to a prospective buyer (for example, the lowest price which the seller is willing to take) to speed the sale of the house and the receipt of the agent’s commissions.

10–6. Is it worthwhile for shareholders to seek to completely eliminate incentive problems with managers and directors through means such as monitoring? Why or why not?

Generally no. It is optimal to incur out-of-pocket expenses to reduce agency problems only up to the point where the marginal reduction in the residual loss is equal to the marginal increase in out-of-pocket expenses. A firm might want to stop employees from taking company pencils home for personal use. However, the costs of completely eliminating this behavior are likely to be too high to justify.

10–7. What is adverse selection? Give an example.

Adverse selection refers to the tendency of an individual with private information about something that affects a potential partner’s benefits to make offers that are detrimental to the trading partner. A common example is from the insurance industry. Prospective customers are more likely to know about their health than insurance companies. The customers who are most likely to purchase insurance at a given price are those who are most likely to use it.

10–8. How do reputational concerns aid in the enforcement of contracts?

Individuals can find it in their interests to honor contracts and not engage in “short-run” opportunistic actions because they fear the loss of future business and profits from developing a bad reputation.
10–9. Schmidt Brewing Company is family-owned and family-operated. The family wants to raise some capital by selling 30 percent of the common stock to outside shareholders. The company has been profitable and the family indicates that it expects to pay high dividends to shareholders. The family will maintain 70 percent ownership of the common stock and continue to manage the firm. The rights of shareholders are specified in the company's corporate charter. The charter specifies such items as voting rights (procedures and items subject to a vote), meeting requirements, board size, rights to cash flows, and so on. Once adopted, a charter can only be changed by a vote of the shareholders. What types of provisions in the corporate charter of Schmidt Brewing might motivate minority shareholders to pay higher prices for the stock? Explain.

Minority shareholders will be worried about being "frozen out" by the Schmidt family. For instance, the family might decide to pay no dividends but pay themselves high salaries in order to take money out of the firm. Minority shareholders can limit this problem by having certain provisions in the corporate charter. One desirable provision might be to have mandatory dividend payouts. Minority shareholders might also demand supermajority voting rules where major assets sales, investment decisions, and changes in the corporate charter have to be supported by at least 75 percent or more of the outstanding shares.

10–10. Which of the following examples is an adverse-selection problem and which is an incentive problem? Explain why. In each case, give one method that the restaurant might use to reduce the problem.

a. A restaurant decides to offer an all-you-can-eat buffet that is sold for a fixed price. The restaurant discovers that the customers for this buffet are not its usual clientele. Instead, the customers tend to have big appetites. The restaurant loses money on the buffet.

Adverse Selection: A pre-contractual information problem. People seeing the buffet prices know how much they are likely to eat, but the restaurant does not. Consequently, the buffet price tends to attract people who will eat a lot of food. There are many potential ways to address this problem. For instance, the restaurant might raise the prices on the buffet to cover the costs of the largest eaters and then offer deals for other customers such as being able to fill a smaller plate for a lower price.

b. A restaurant owner hires a manager who promises to work long hours. When the owner is out of town, the manager goes home early. This action results in lost profits for the firm.
Incentive Problem: Post-contractual information problem. The manager promises to work hard, but once the owner is not around to monitor her, she shirks. Potential solutions include:

- providing incentive compensation (for example, a profit-sharing plan), and
- increased monitoring.

10–11. In 1992 the state of California charged Sears Auto Centers with overcharging customers for unneeded or unperformed repairs. Sears agreed to a settlement that could cost as much as $20 million. Sears had compensated its salespeople with commissions based on total sales. Following the settlement, Sears dropped the commissions and went to a straight salary. Sears recently indicated that it is planning to reinstate commissions for salespeople in their Auto Centers. It even plans on paying commissions for selling customers brake jobs and wheel alignments. These two products were the core of the 1992 scandal. Sears says that it has taken steps to prevent a recurrence of past problems. In particular, the decision right to recommend repairs is granted to mechanics who are paid a straight salary. Sales consultants are paid commissions for selling repair services but are not authorized to recommend repairs. Under the old system that caused problems, these individuals diagnosed repair problems and sold the corresponding service to customers. Why do you think Sears wants to reinstall commissions for its salespeople? Do you think that the new safeguard that separates diagnosing problems from selling services will prevent a recurrence of past problems? Explain.

Salespeople are likely to exert less effort on selling products if they are paid straight salaries than if they receive sales commissions. Sears Auto Centers probably wanted to reinstate commissions to increase the effort of their salespeople. Yet, there are still potential problems with the proposed safeguards. For instance, the salespeople might pressure the mechanics to recommend more repairs. The mechanics, in turn, might have incentives to respond to this pressure. They might be friends of the salespeople. They also might fear that the salespeople will be promoted to management positions and take it out on the mechanics if they did not help them earn higher incomes while they were salespeople. In rare cases, the salespeople might even offer financial bribes to the mechanics to make more recommendations for repairs. Also the customers deal with the salesperson, not the mechanic. The salespeople will have incentives to overstate/exaggerate the recommendations of the mechanics.
10–12. The Sonjan company currently purchases health insurance for all of its 1,000 employees. The company is considering adopting a flexible plan whereby employees either can have $2,000 in cash or purchase an insurance policy (which currently costs $1,000). Do you see any potential problems with the new plan? Explain.

The plan represents an increase in payouts to employees. However, this increase in pay might be necessary to attract and retain qualified employees. The plan also gives the employees flexibility in choosing their own benefits. One potential problem with the plan, however, is adverse selection. The people who are least healthy are the most likely to purchase insurance. The insurance company will realize this incentive. Most likely, it will begin requiring medical exams for applicants. This action will increase the costs of providing insurance to employees. The insurance company might also increase prices because it realizes that it will have a less healthy pool to insure. A second problem with the plan is administrative costs. The company must incur costs to explain the plan to employees and operate a system that keeps track of each employee’s choice, etc.