

Unit 6

The Firm:

Owners, Managers, and Employees

Hui-Jun Chen

The Ohio State University

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Introduction

Introduction

How does the firm interacts internally and externally?

- Firms are legal entity, yet still are **composed by human**
 - internal: Owner(s) v.s. Managers
 - external: Employees (labor market), consumer (goods market)
- Internal conflict: asymmetric information (e.g. Akerlof (1970))
- External conflict: hidden action (Principal-Agent Problem)
- As before, wage is determined by $MRS = MRT$
- Further reading: [Unit 6](#)

Internal Structure of the Firm

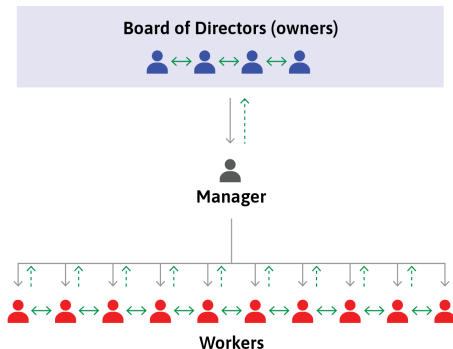
Firm's Internal Structure

Definition

Firm is a business organization which (1) hires ppl, (2) buy inputs to produce good/services, and (3) set prices \geq cost.

Black arrow downward:

- Owners: set long-term goal
- Managers: implement owners' goal by assigning tasks
- Workers: doing tasks



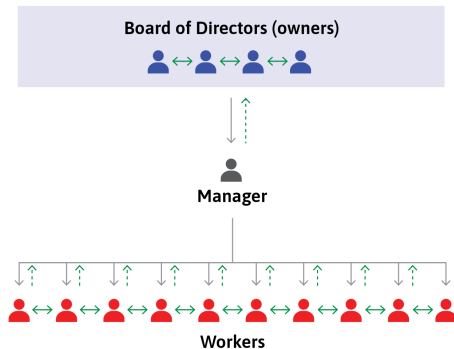
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Green arrow upward:

- Owners: Receive profit as a result of management
- Managers: payment not directly related to effort \Rightarrow other's \$, riskier investment / lowering effort
- Workers: salary not increasing with effort



Align the Interests

- Contracts are **incomplete**: outcome depends on **future/unknown** events, and hard to **measure** effort
- Incomplete contracts are inevitable, since modern job are mostly **not able to measure output** and **works as a team**
- Ways to alleviate incomplete contract:
 - ① pay with company shares: company profit ↑, share price ↑
 - ② piece rate pay: \$5 to assembly one toy (low-end job)
 - ③ monitoring

Labor Discipline Model

Why do workers work hard?

Workers work hard while firms' cannot directly measure effort because

- ① work ethic
- ② feelings of responsibility
- ③ reciprocate a feeling of gratitude for good working conditions
- ④ benefits for measurable output
- ⑤ promotions
- ⑥ fear of being fired

... Rational thinking sometimes means negative thinking 😊

Fear of being Fired

- **Rent** in Economics: payment to the owner greater than the costs
- If workers being unemployed, they get unemployment benefits \Rightarrow **reservation wage**
- **Employment rent**: benefit from employment — reservation wage, includes
 - lost income when searching
 - cost to start a new job, e.g. relocation
 - Loss of non-wage benefits
 - Social costs (scarring effects, lost of company connections/skill)

Appendix

References I

Akerlof, George A. (1970) "The Market for "Lemons": Quality Uncertainty and the Market Mechanism," *The Quarterly Journal of Economics*, 84 (3), 488, 10.2307/1879431.