LECTURE 6.6

INCENTIVE CONFLICTS AND CONTRACTS

INCENTIVE CONFLICTS

A fundamental story of economics is utility maximising economic agents. Managers are no different. The actions that maximise a manager's utility won't in general be actions that maximise the utility of shareholders or owners.

More generally, parties that contract with a firm are unlikely to have interests that are aligned. Managers, employees, suppliers have different goals to owners

What types of conflicts arise in firms? Conflicts between an owner and manager include:

- Effort choice
- Perks (company car, nice office, travel)
- Risk exposure – managers have a portfolio (both financial and human capital) different from firm's owners
- Different time horizons
- Overinvestment and empire building

INCENTIVE PROBLEMS AND CONTRACTS

How can these conflicts be resolved?

- Implicit and explicit contracts can be used to align interests

Contracts define an organization's architecture:

- who makes what decisions
- the rewards and penalties which flow from them.

INCENTIVE PROBLEMS AND CONTRACTS: EXAMPLE

Assume we want to prevent a CEO from taking too many perks: the CEO likes perks, the owner wants to limit spending on perks.

Suppose the CEO has a utility function:

$$U = f(C, P)$$

Where:

C is their direct compensation

P is the perks they receive

Suppose the CEO must be ‘paid’ at least S: $U(C,P) \geq U(S,0)$. Otherwise, she will find a job at another firm.

INCENTIVE PROBLEMS AND CONTRACTS: EXAMPLE

Next, assume the owners of the firm know the maximum profit (π_M) that could be attained:

$$\pi_R = \pi_M - P$$

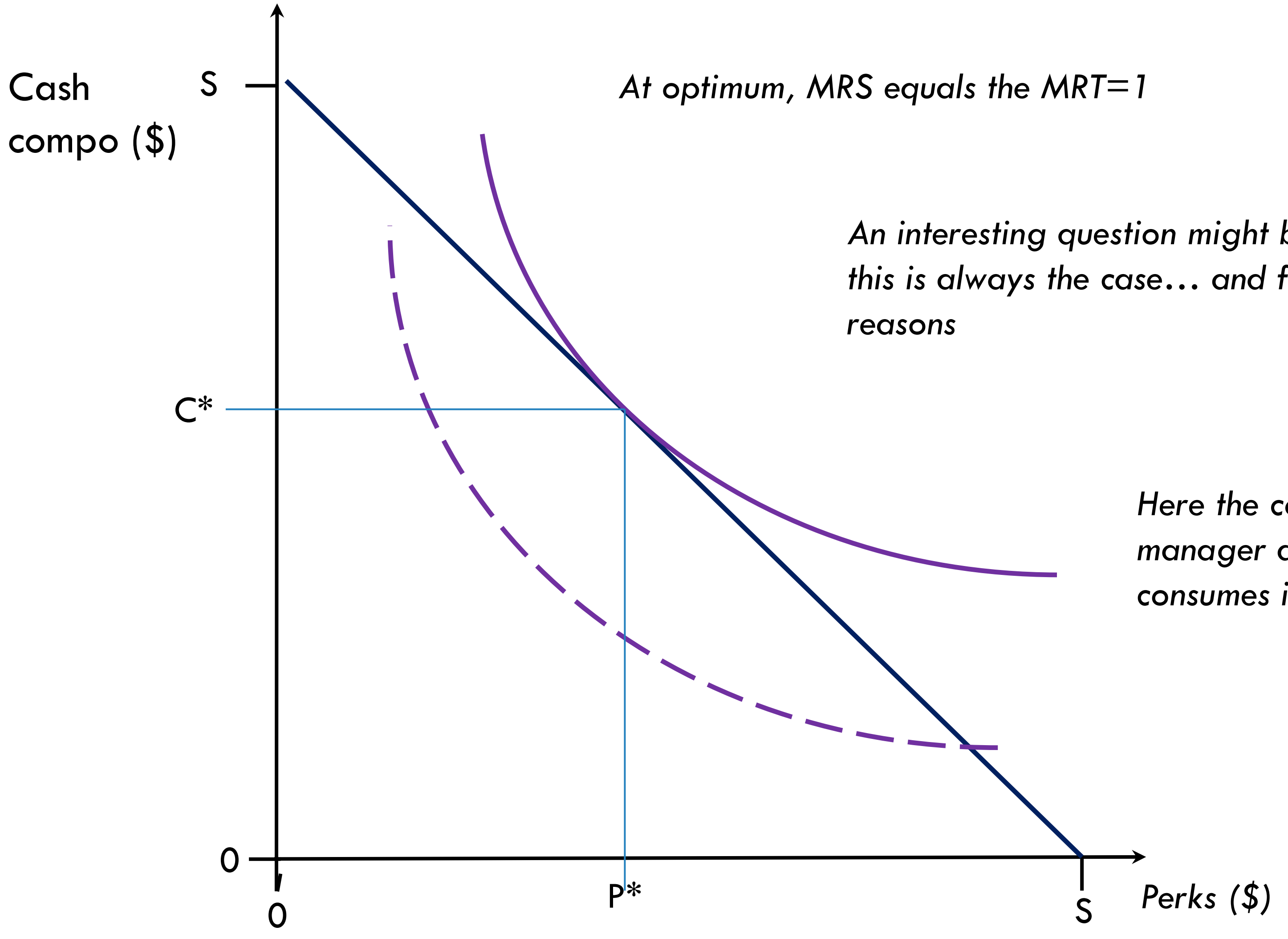
Where π_R is realized profits

If π_R is contractable, the optimal contract is:

$$C = S - (\pi_M - \pi_R)$$

This contract directly charges the CEO for any perks she consumes (i.e. $C = S - P$)

Whatever the CEO consumes in perks is lost in salary. This forces the CEO to internalise the costs of her perks



At optimum, MRS equals the MRT=1

An interesting question might be whether this is always the case… and for what reasons

Here the contract aligns the incentives of the manager and owner – whatever he consumes in perks is lost in salary.

INCENTIVE PROBLEMS AND CONTRACTS

Complications:

- Contracts are not costless to negotiate, write and enforce.
- Information is asymmetric. what is the most obvious aspects of asymmetry in the relationship above? Hint: think about π.
- Information asymmetries might occur before the contract is negotiated, and after.