LECTURE 10.2

INCENTIVES FROM OWNERSHIP

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There is a 'simple' solution to the problem: sell Ian the benefits of his efforts. If Ian owns the firm, he has an incentive to work hard (and balance benefits and costs).

In this case that would mean selling to Ian his output which is equal to $100e$ for a price of $1500. Why this amount?

Ian's problem then becomes:

$$max_e U(.) = I - e^2 \quad s.t. \ I = 100e - 1500$$

$$max_e U(.) = 100e - 1500 - e^2$$

First Order Condition: $100 - 2\hat{e} = 0$

$$e^* = 50$$

INCENTIVES FROM OWNERSHIP

In fact, this is what we see in the ‘real world’ all the time – many jobs are ‘sold’.

- A majority of businesses (by number, not value) are owner operated
- Franchisees effectively buy the right to a future stream of profits generated by his or her efforts. What incentives do such arrangements provide? At the same time, what constraints are imposed on the franchisees?

Of course there are limits from such an arrangement.

- Wealth constraints: few managers (or individuals more generally) have the resources to buy their share of the firm
- Risk aversion: typically, individuals are risk averse. Owners expose themselves to the inherent risks associated with the business environment. Employees avoid (to some extent) the risk associated with risky environments
- Team production: Output or the results from an individual’s efforts depend on not just the individuals own effort. Identifying the output from any one individual may be difficult or impossible.