

Multifaceted transactions, Incentives, and Organizational Form

Discussion

WCGI 15

Thucydides

“Why did we go to war? Simply from a consideration of our own individual interests”
(The Peloponesian War, Book IV)

Classical principal-agent problem, static:

- If the agent is risk-neutral, then she gets performance-related compensation
- The principal does not need to provide insurance

Multidimensional problems:

- Tradeoffs
- The agent may be given “low-power” incentives (Holmstrom and Milgrom 1991)
- Examples:
 - teaching “to the test” vs. broader instruction
 - evaluating salespeople (Anderson (1985), Anderson and Schmittlein (1984)): in-house vs. outside contractors
 - clinical tests in pharmaceutical research (Azoulay 2004): outside contractors vs. internal teams (subjective evaluation plus flat rate)

Possible solutions in a dynamic context:

- Baker, Gibbons, Murphy (1994): combined subjective and objective performance measures in implicit/explicit contracts
- In come cases, the measures are complements

This paper:

- Looks at the multidimensional agency issues
- Shareholders may want managers to fulfil several objectives, and they try to optimize across several tasks
- E.g. the manager should both grow the firm and allocate capital optimally
- The solution chosen by shareholders will affect the firms performance and the way it is organized
- Interesting implications/similarities for issues of firm ownership firm boundaries

Setup:

- Risk and Knightian uncertainty
- Capital allocation: Arrow-Debrew securities for the risky states, constant return for the uncertain state/general/robust technology
- Managers can evaluate the risky states but at a convex cost

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Quibbles:

- Managers decide on the intensity of their evaluation of the states before the evaluation of the states
 - Circularity?
- Return on the risky states: in the original Falkinger (2014) model, financial arbitrageurs armed with unlimited capital level off expected returns across states
 - How does that work within the firm?

Alternative:

- The manager wants to minimize volatility given an expected payoff
- Risk-averse manager

Alternative:

- Risk-neutral manager (actually: no risk)
- Task: capital allocation: standard project vs.
 - Highly productive project
 - Managing effort whose cost increases in the size of the project; non-verifiable
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- Risk-neutral shareholders
 - They are less favourable to the high-productivity project (since they don't get all of the payoff)
 - They offer low-powered incentives
 - (No extraction: $\beta_1 = 1$, high-powered incentives)

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- Risk-neutral manager (actually: no risk)
- Task: capital allocation: standard project vs.
 - Highly productive project
 - Managing effort whose cost increases in the size of the project; non-verifiable
 - The manager can appropriate a proportion of the payoff from the project
 - How that works: report earnings, get compensated on that, but do not pay all free cash flows as dividends
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Thucydides

“They were in a dreadful condition; not only was there the great fact that they had lost their whole fleet, and instead of their expected triumph had brought the utmost peril upon Athens as well as upon themselves, but also the sights which presented themselves as they quitted the camp were painful to every eye and mind.”
(The Peloponesian War, Book VII)

When managers supply capital:

- What/who forces the manager to supply capital?
- Why is the cost of capital higher/lower for the manager than for the ordinary shareholder?
 - Lack of diversification?
 - But: the manager is risk-neutral
- Who decides the share m ?
- Would the alternative be stock-based compensation?
 - Would that be equivalent to a higher (excessive?) β_1 ?

Multiple tasks: firm growth and capital allocation:

- Task 1: firm growth
 - Determine the total amount of capital available to the firm
 - Quadratic cost of (the unverifiable effort of) increasing capital
 - Coefficient c
- Task 2 : capital allocation: standard project vs.
 - Highly productive project
 - Managing effort whose cost increases (quadratically) in the size of the project; non-verifiable
 - Coefficient k
 - (The manager can appropriate a proportion of the payoff from the project)

Multiple tasks: firm growth and capital allocation:

- Higher c and higher k : higher-powered incentives
- Higher $\frac{k}{c}$: higher-powered incentives; if the effort of setting up higher-productivity, but more opaque projects is higher relative to growing the firm, incentives should be stronger
- Theory of development?

Dynamics and implicit contracts

- It may be interesting to look at subjective payoffs and implicit contracts
- They may complement objective payoffs

Overall

- Interesting paper
- Wide range of applications
- Useful setup for many corporate governance issues