Toulouse School of Economics

TSE M1 – Semester 1

September 2018

Paul Seabright

Understanding Real World Organizations Week 4:

What's special about firms?

Some types of non-market institutions

- Firms
- Governments
- Charities and NGOs
- Schools and universities
- Armies
- Networks
- Informal exchanges

Non-firm organizations

- May have very different legal structure from that of firms
- But can face very similar challenges to those of firms
  - Motivating agents to act in the interests of the group
  - Competing against rival groups trying to do the same thing
- Three striking examples
  - Governments (see Tiebout, 1956)
  - Churches
  - Armed groups

What’s special about firms:

- In organization and incentives
- In law
- In values

What’s special about firms? Organization and incentives:

- Trust, mutual benefit, and delegated trust
- The separation of ownership and control
- Three ideas that define the modern corporation: legal personhood, tradable shares, limited liability
- The prehistory and history of the corporation: technology, size, risk
- Communication, values and the modern corporation

The problem of economic exchange

- Trust in bilateral contexts

- Delegated trust

The separation of ownership and control

- Has been a management buzz-phrase since the 1940s but the underlying predicament is ancient
- Ideas need to work with resources, but those who have ideas do not necessarily own resources
- Why can’t they simply sell their ideas?
- Managerial talent is as hard to transfer as ideas

Ownership and control: why is there separation?

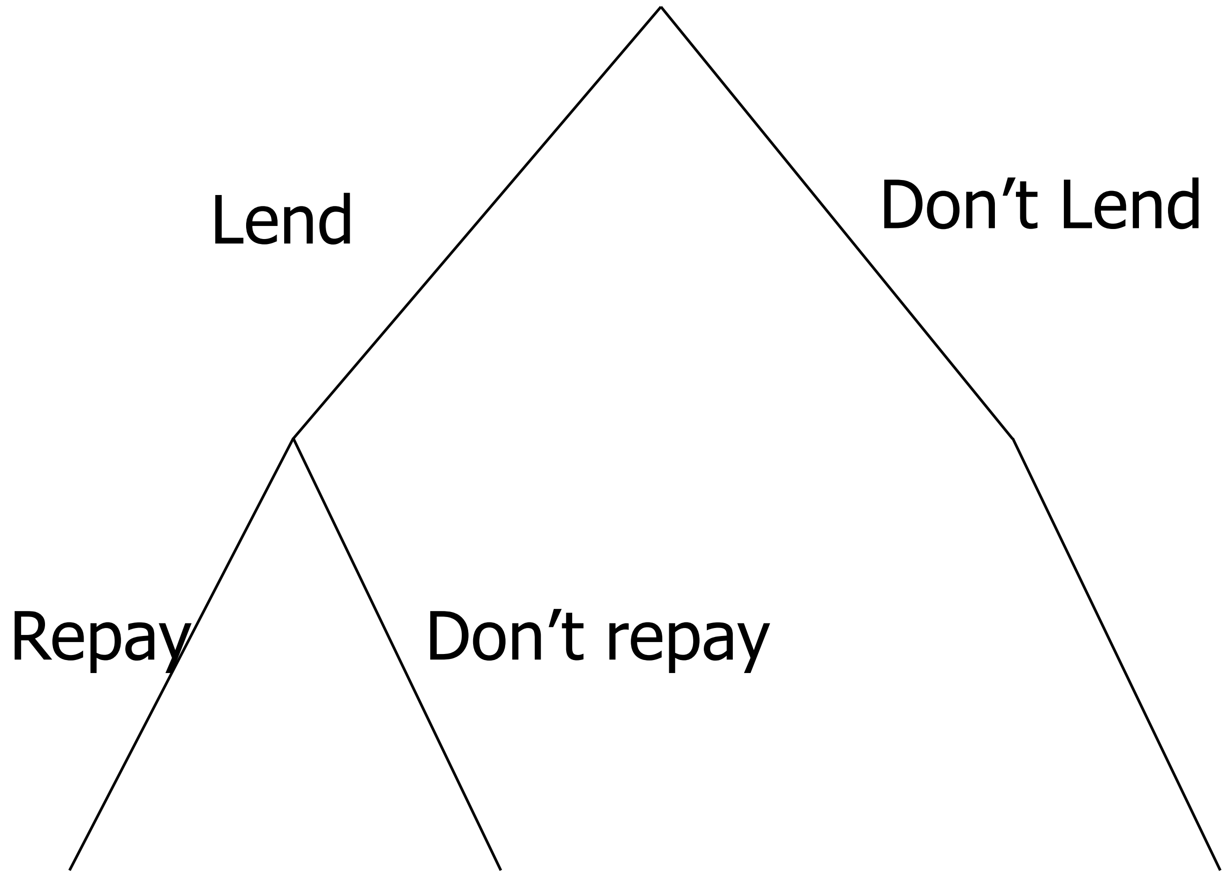
- In a modern economy many activities take place at too large a scale for one person to be the sole owner
- Even if possible, it would not be a good idea for one person to concentrate wealth in one activity (very risky)
- So often collective ownership by many shareholders
- Even if one owner, cannot manage all activities; need to employ manager(s)
- How to make the manager act in interests of owner(s)?

As the firm grows, what can its owner do?

- The owner may need to hire managers
  - How to motivate them to work effectively?
- The owner may need outside finance
  - How to make a credible promise of repayment?
- Owner may be willing sincerely to promise $1 million repayment for an investment yielding $1.2 million
- But repayment promise may not be credible – because of limited liability which, was necessary for the investment

The Investment Game:

Lender:

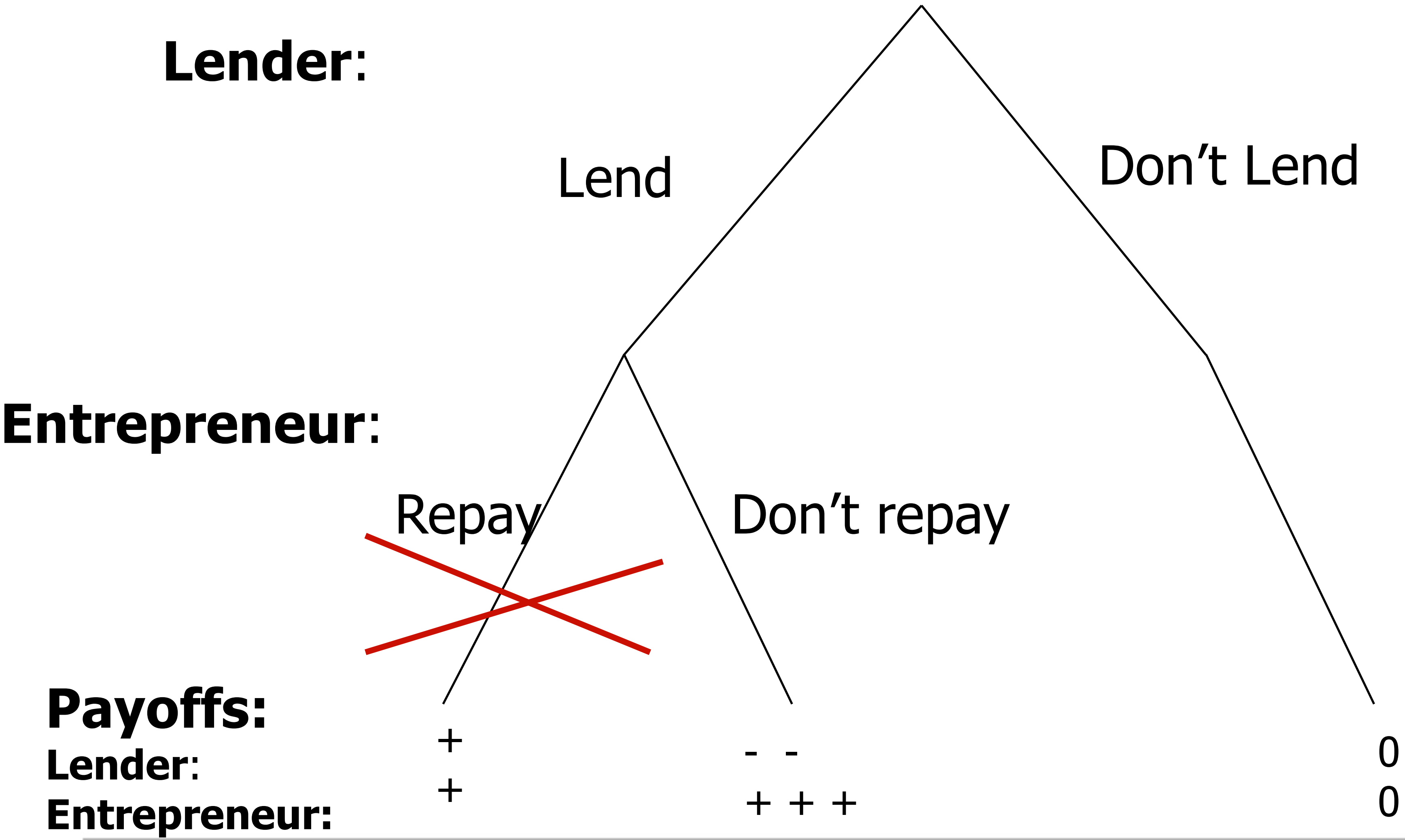


Entrepreneur:

Payoffs:

Lender:	+	- -	0
Entrepreneur:	+	+ + +	0

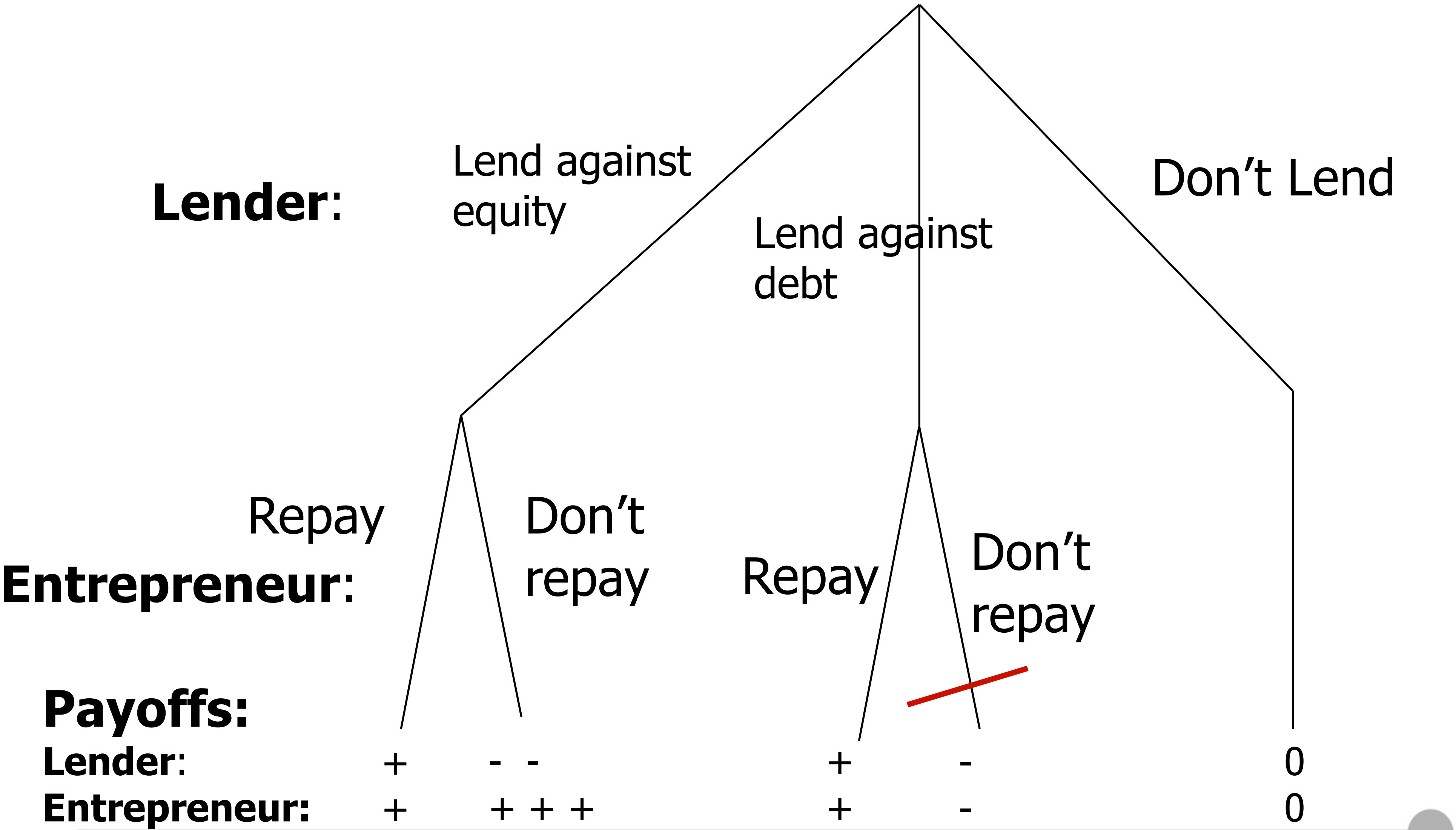
The Investment Game:



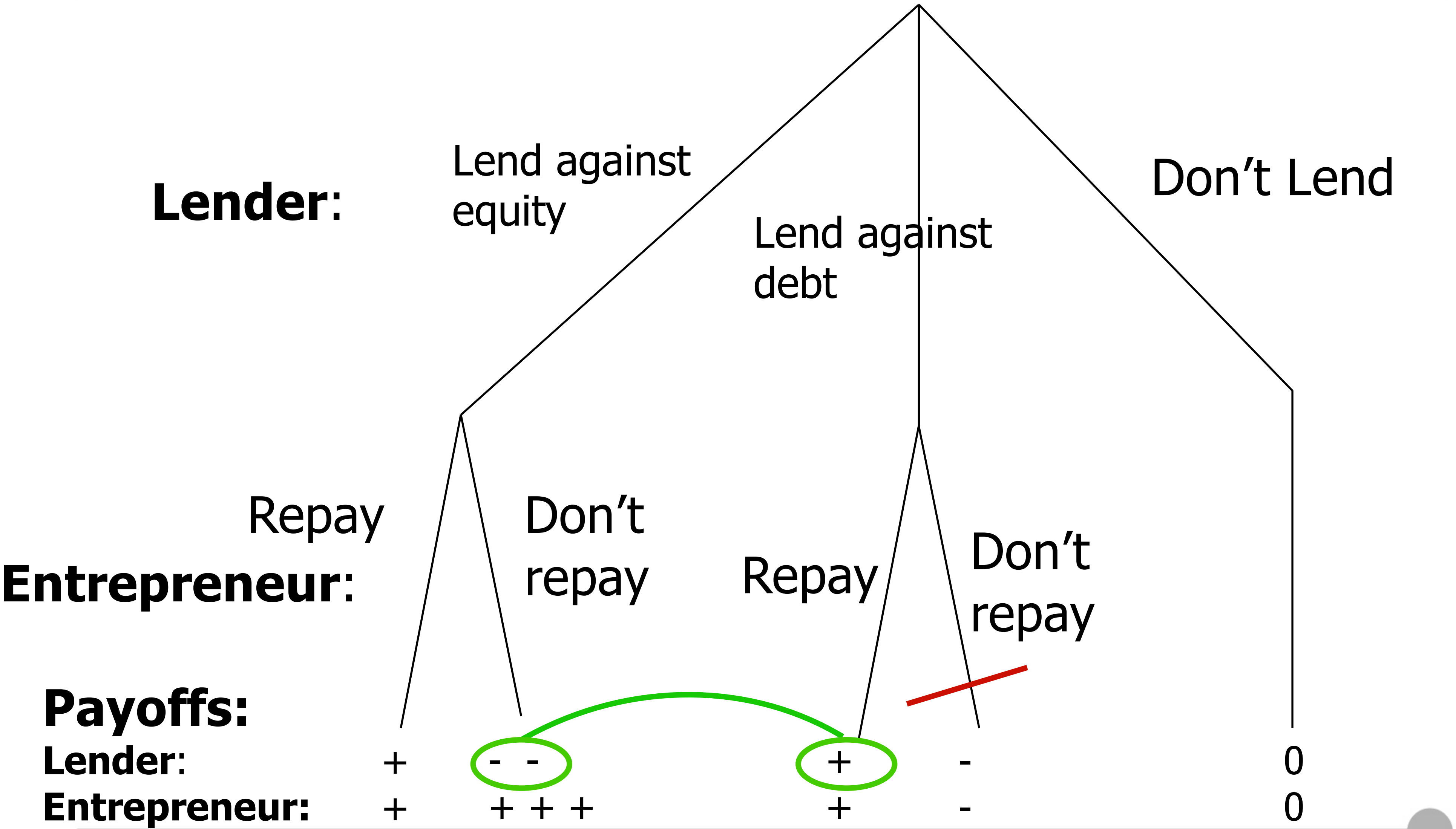
Two alternatives: debt and equity

- Equity means giving rights of ownership to suppliers of outside finance - they have rights to affect management decisions
- Debt does not involve ownership rights – so no right to affect management decisions
- But debt involves inflexible repayment commitments – enforced by an outside authority (the courts)
- You can’t have both – if you want flexible repayments you must give up some ownership rights

The Investment Game with debt and equity:

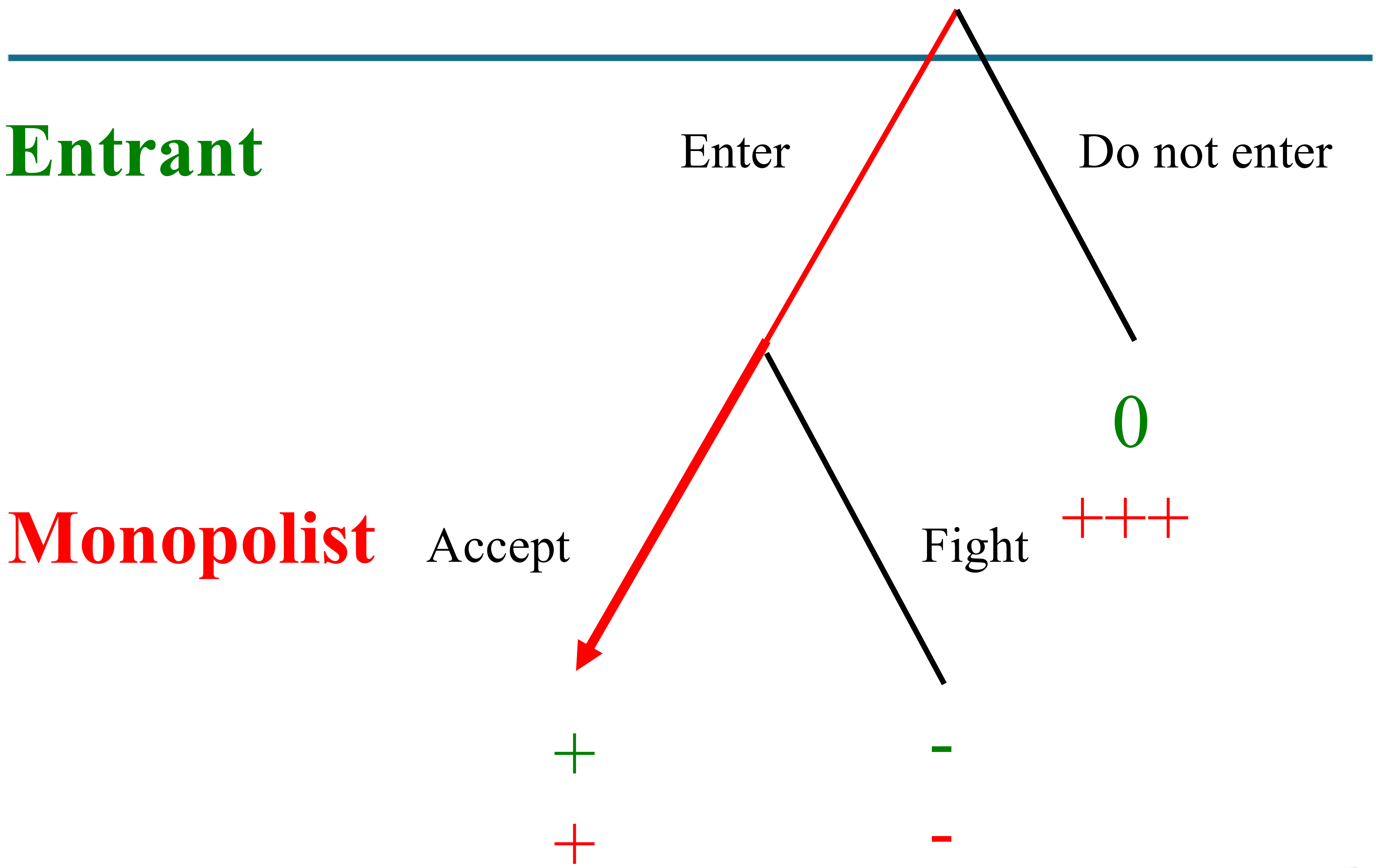


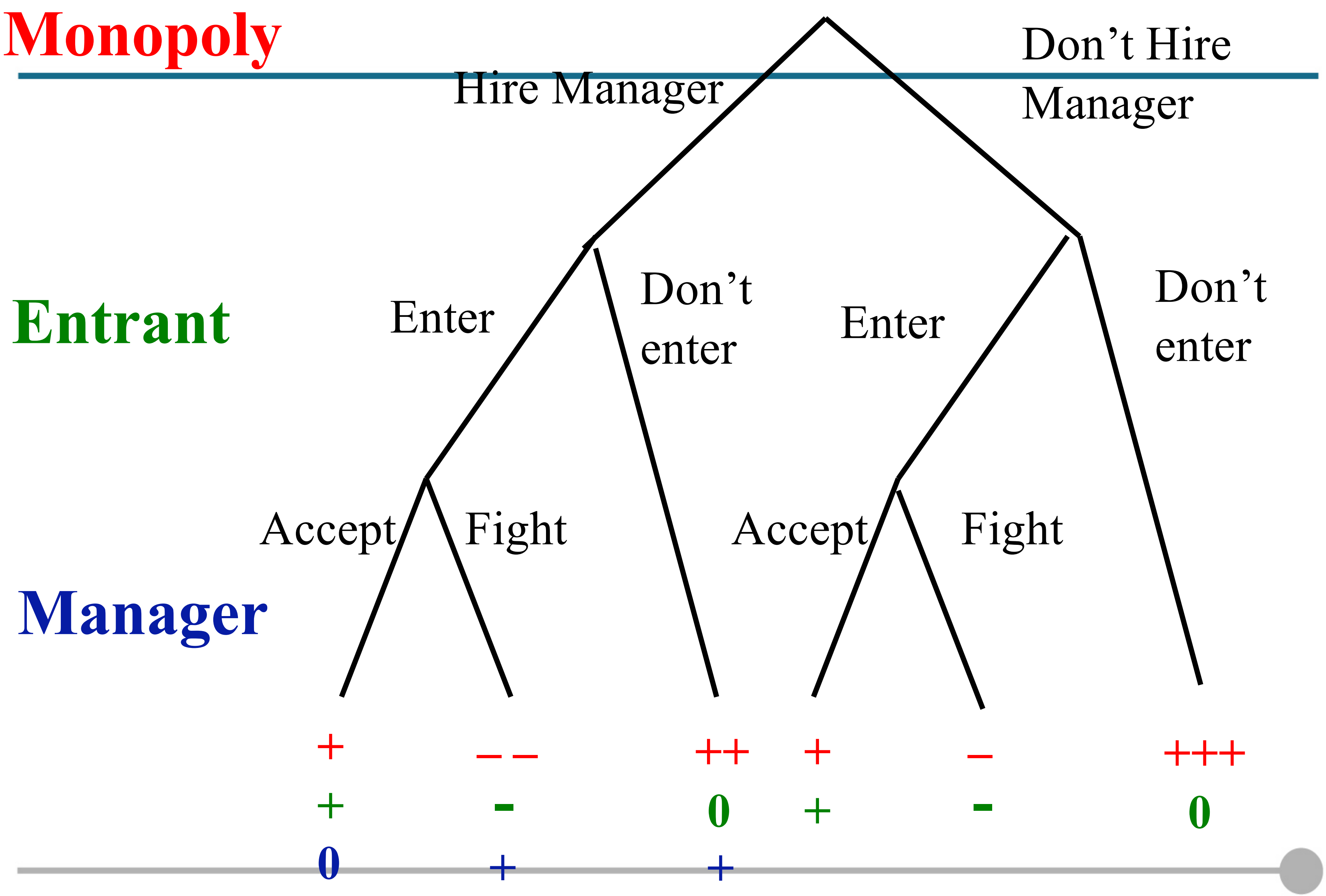
The Investment Game with debt and equity:

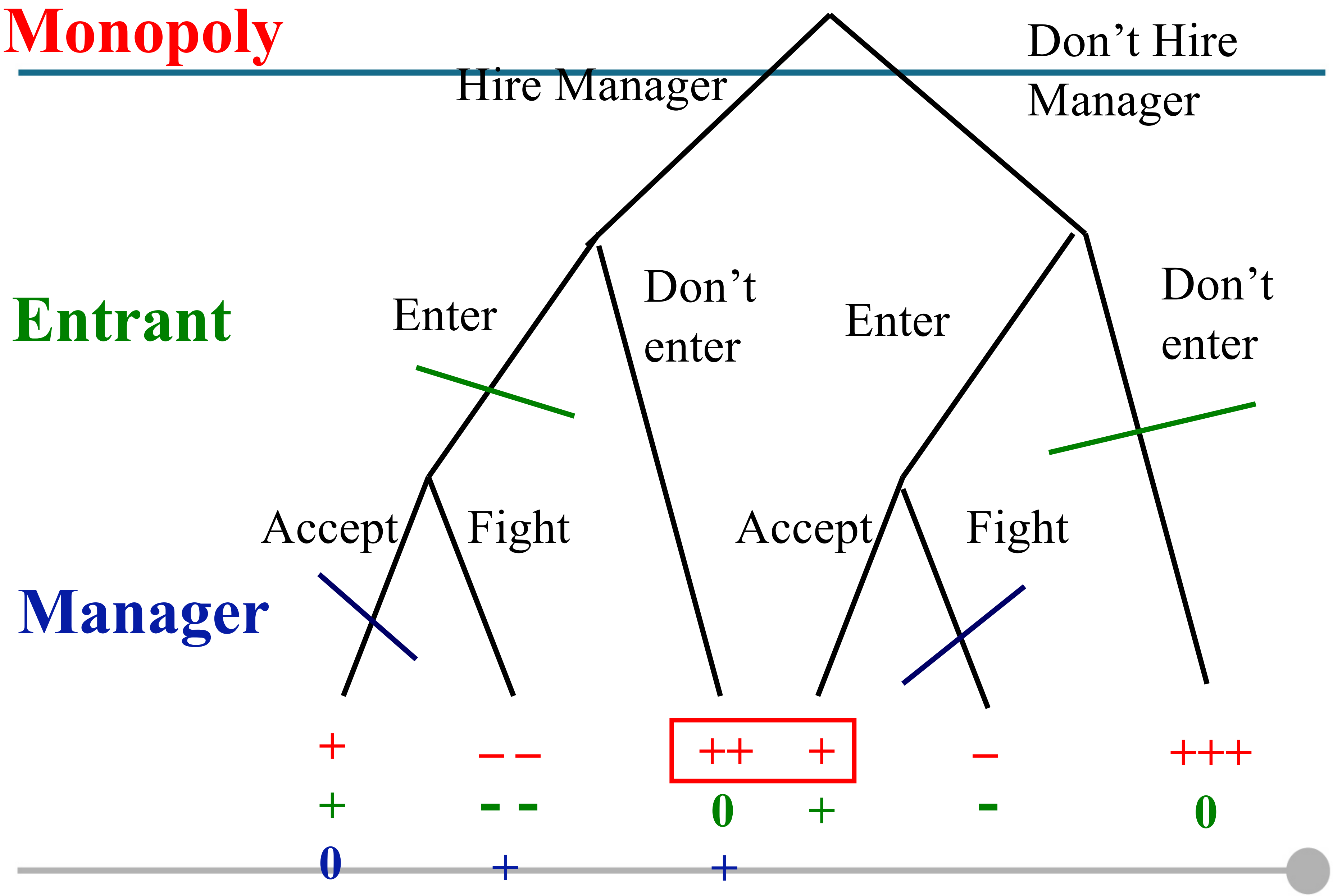


This presumes equity owners can't monitor managers

- In practice things are not always so bad
- Partly they have information given to shareholders
- Partly the shares, if traded, can reveal information held privately by some
- This may help to align the incentives of managers with those of equity owners
- This is desirable (but not always)


Entrant
Enter
Do not enter
0
+++
Monopolist
Accept
Fight
+
+
-
-


Monopoly
Entrant
Manager
Hire Manager
Don't Hire Manager
Enter
Don't enter
Enter
Don't enter
Accept
Fight
Accept
Fight
+ + 0
– – - +
++ 0 +
+ +
– -
+++ 0


Monopoly
Entrant
Manager
Hire Manager
Don’t Hire Manager
Enter
Don’t enter
Enter
Don’t enter
Accept
Fight
Accept
Fight
+ – – ++ + – +++
+ - - 0 + - 0
0 + +

Separation of ownership and control: conclusions

- The growing firm has to make compromises: hire managers, take on debt
- Some compromises are costly and inefficient
- But sometimes they commit the firm to do things that are, on average, efficient

TSE M1 – Semester 1

September 2018

Paul Seabright

Understanding Real World Organizations Week 4:

What's special about firms?