

Understanding Real World Organizations

TSE M1 – Semester 1

October 2019

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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
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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
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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?

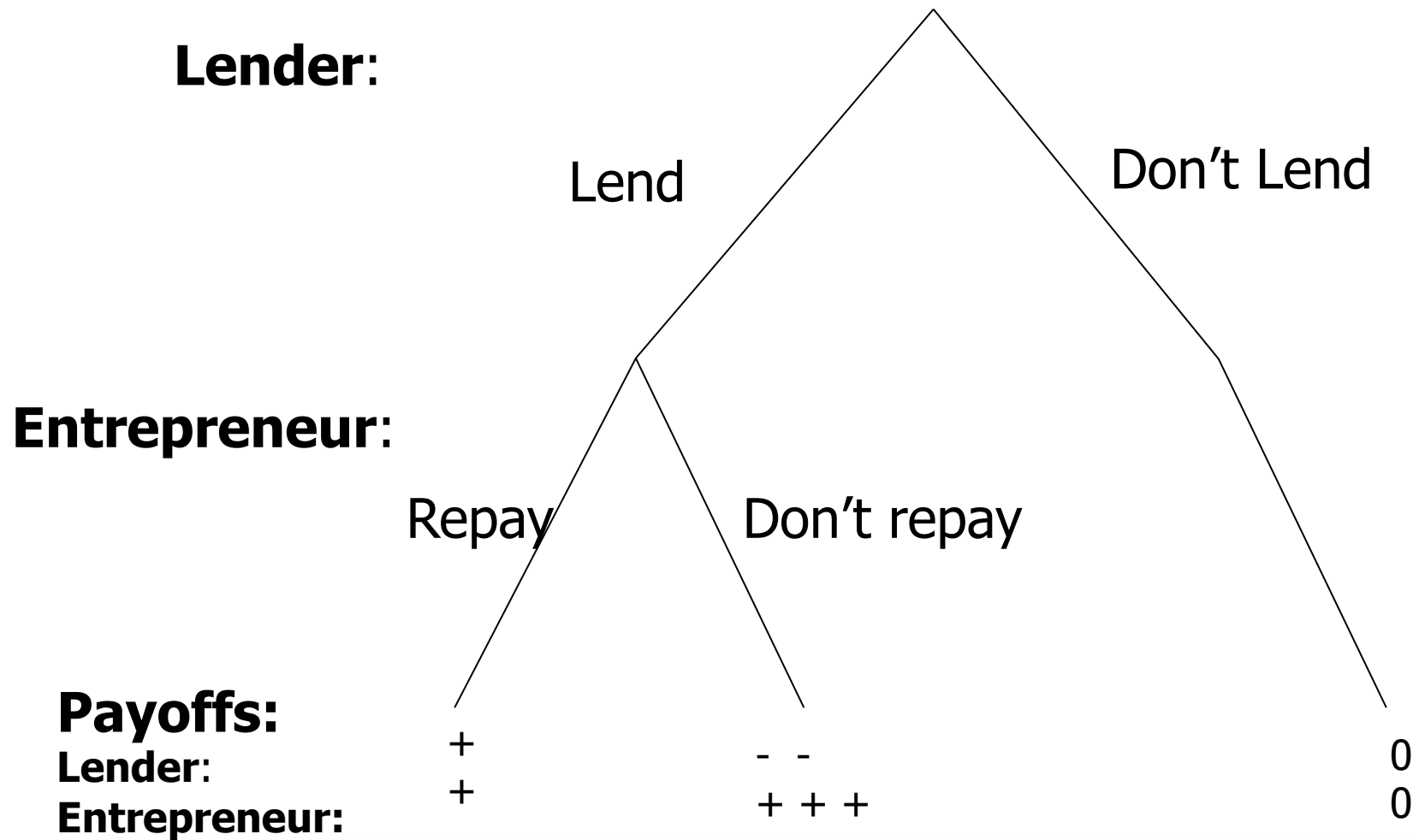
- In a modern economy many activities take place at too large a scale for one person to be the sole owner
 - Even if possible, it would not be a good idea for one person to concentrate wealth in one activity (very risky)
 - So often collective ownership by many shareholders
 - Even if one owner, cannot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

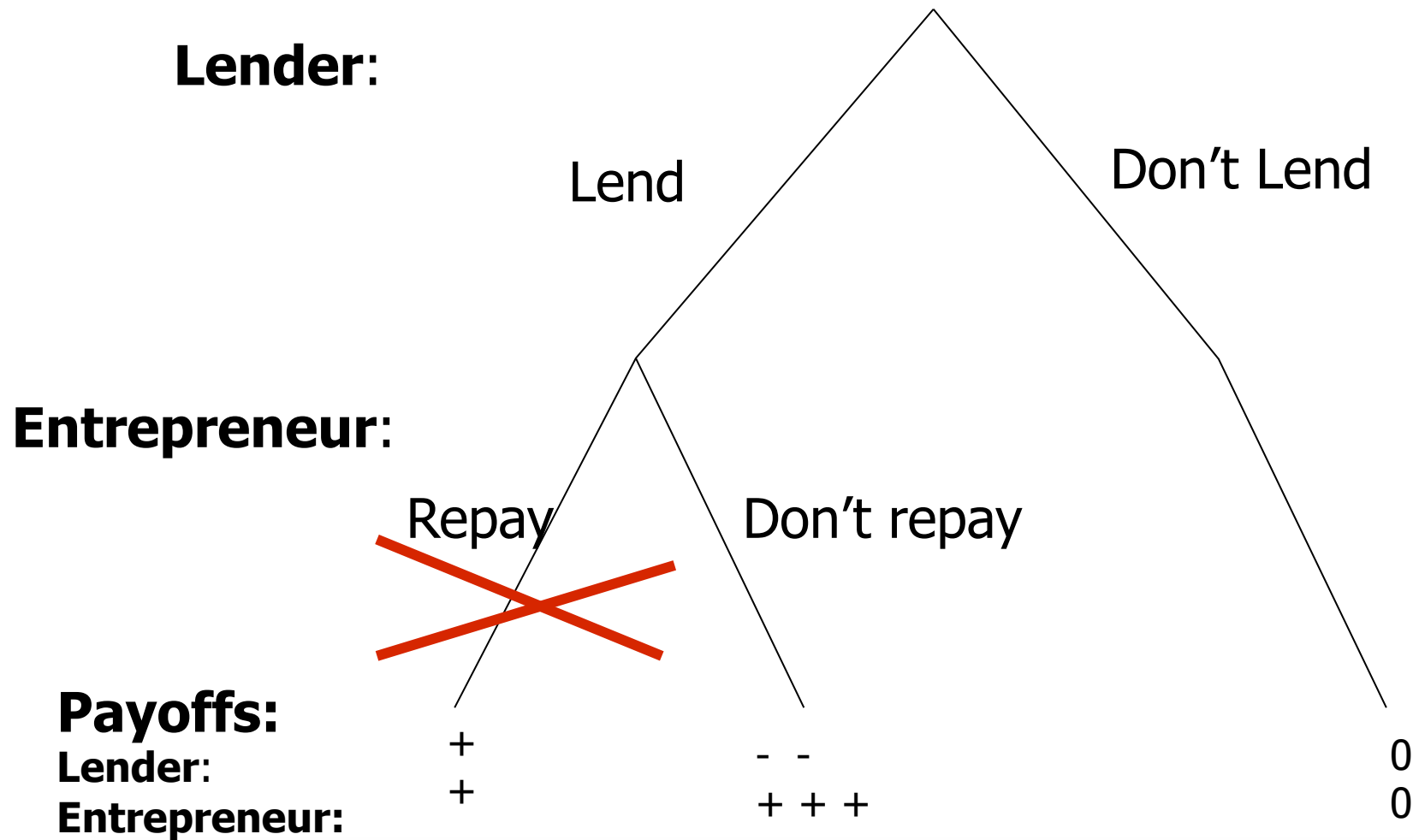
- The owner may need to hire managers
 - How to motivate them to work effectively?
- The owner may need outside finance
 - How to make a credible promise of repayment?
- Owner may be willing sincerely to promise \$1 million repayment for an investment yielding \$1.2 million
- But repayment promise may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



The Investment Game:



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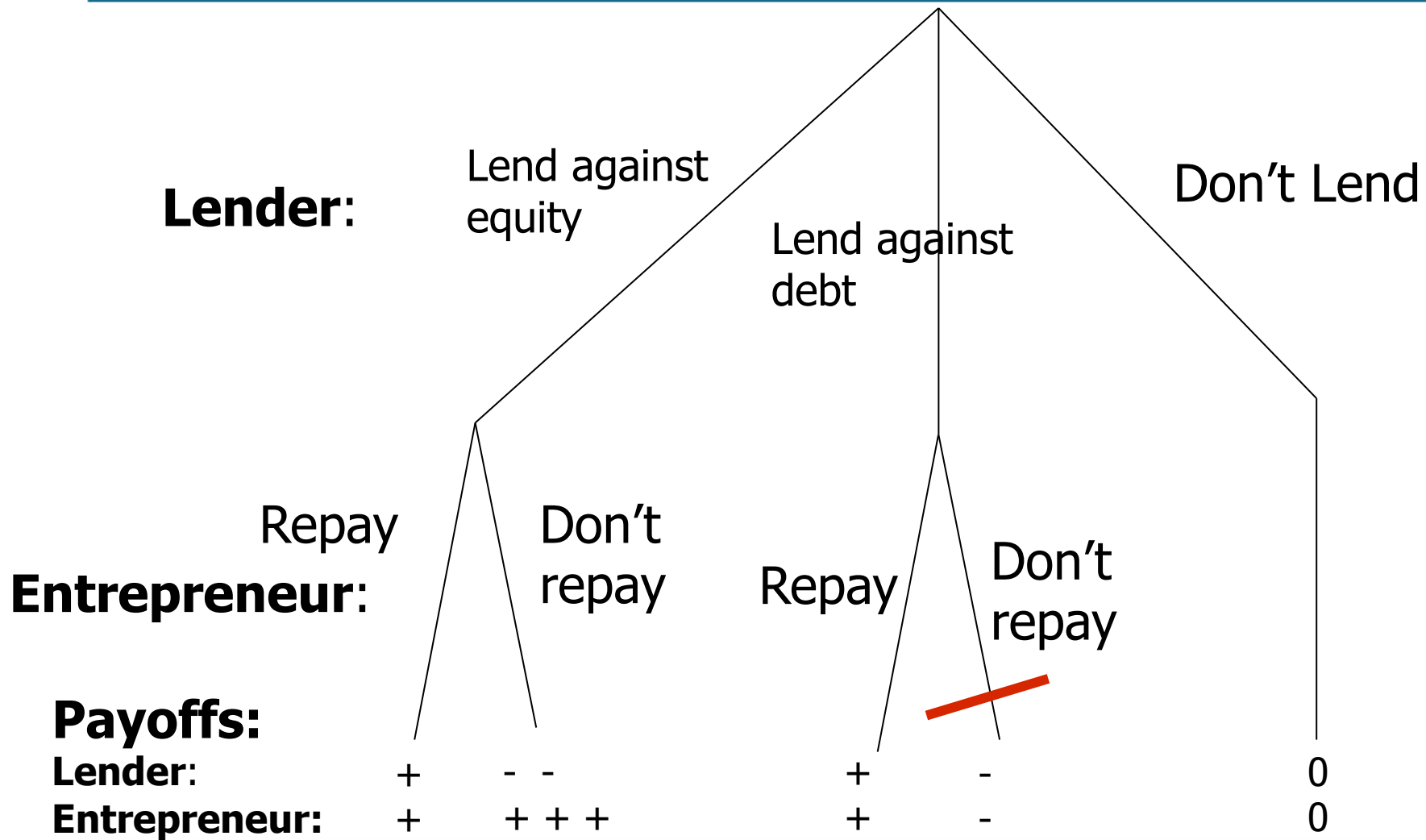


Two alternatives: debt and equity

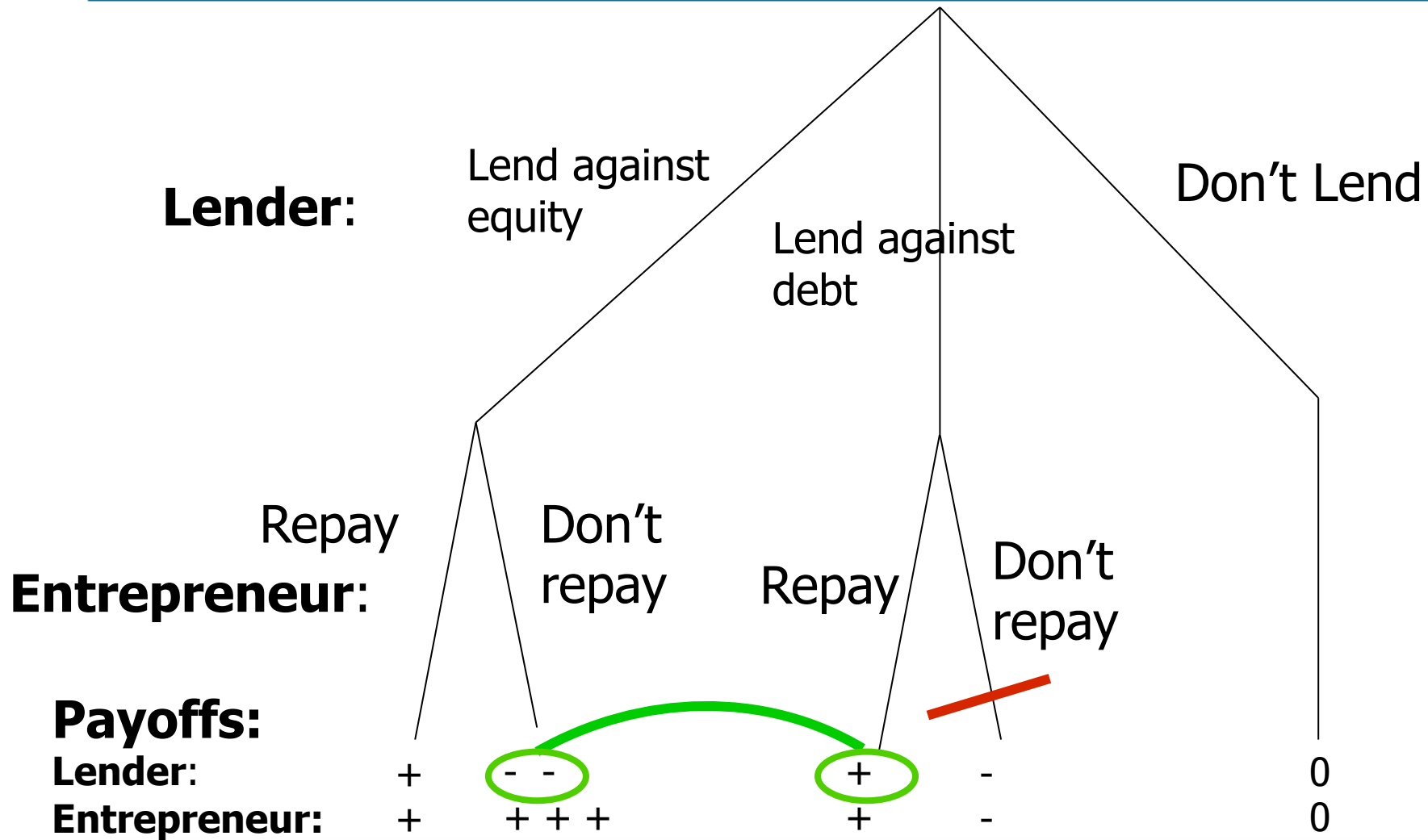
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Equity means giving rights of ownership to suppliers of outside finance - they have rights to affect management decisions
 - Debt does not involve ownership rights – so no right to affect management decisions
 - But debt involves inflexible repayment 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
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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

Monopolist

Accept

Fight

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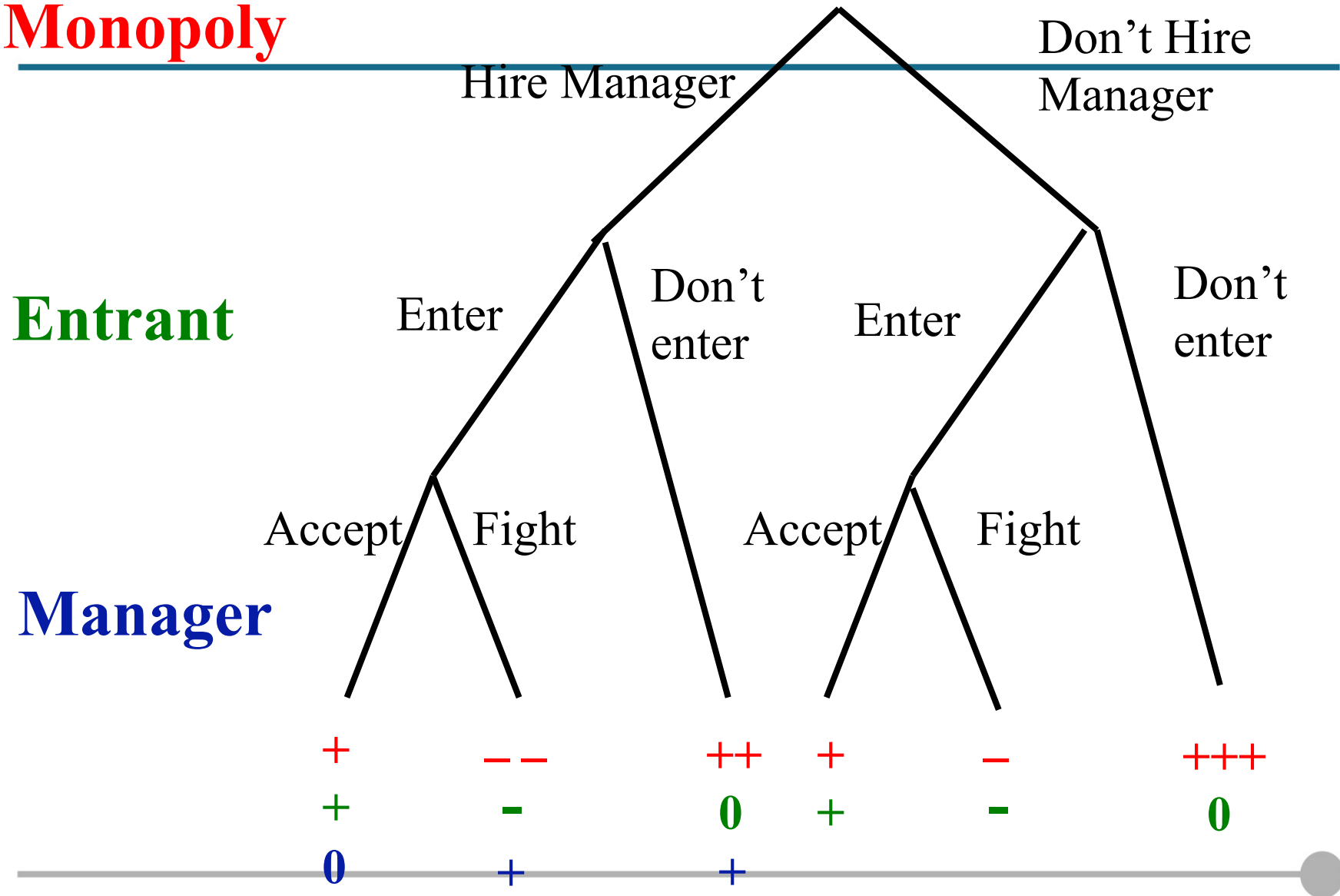
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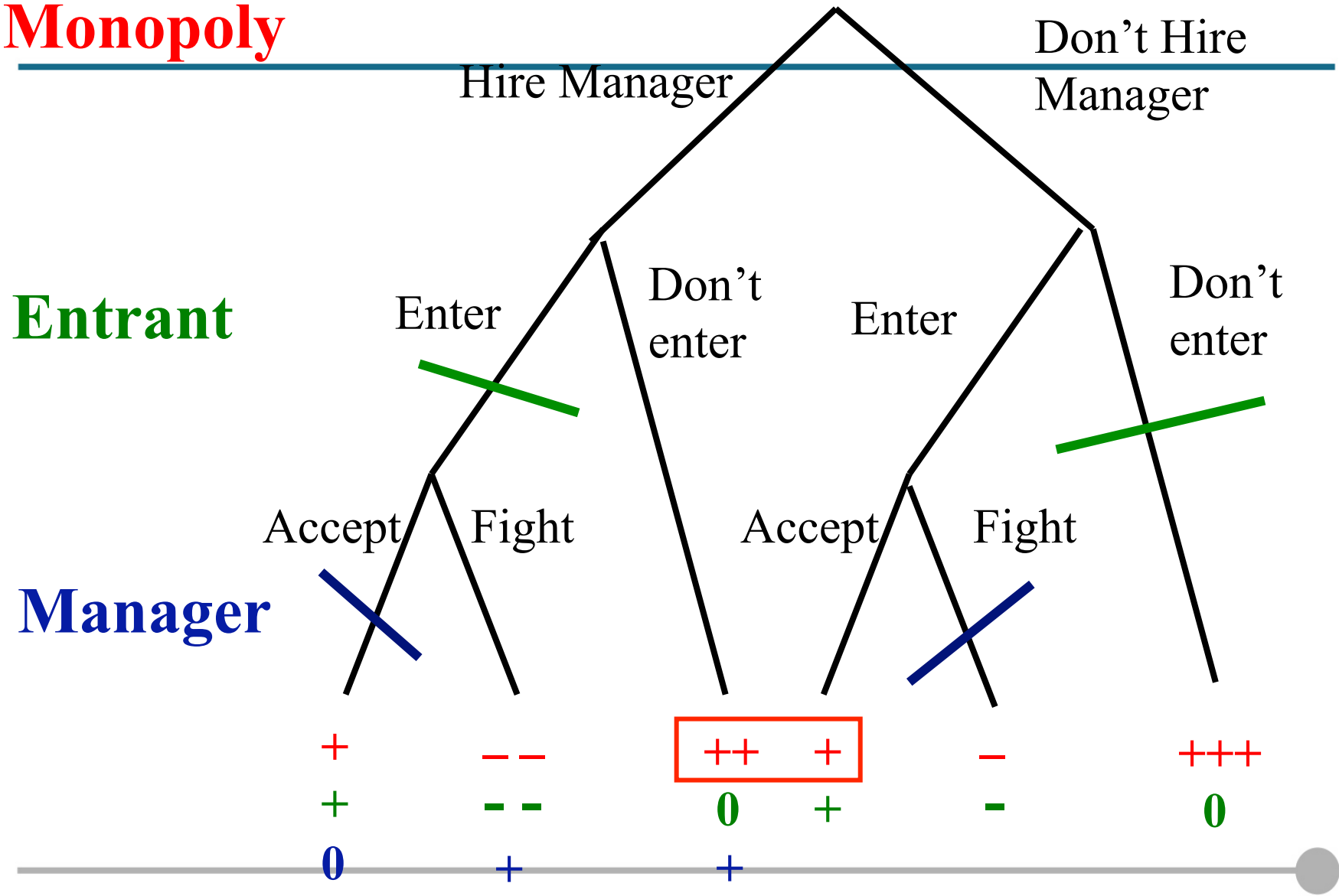
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Monopoly



Monopoly



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



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