

## LABOR ECONOMICS (EE 471)

### ☺☺ Optional practice questions ☺☺

#### Chapter 11

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1. Consider three firms identical in all aspects except their monitoring efficiency, which cannot be changed. Even though the cost of monitoring is the same across the three firms, shirkers at Firm A are identified almost for certain; shirkers at Firm B have a slightly greater chance of not being found out; and shirkers at Firm C have the greatest chance of not being identified as a shirker. If all three firms pay efficiency wages to keep their workers from shirking, which firm will pay the greatest efficiency wage? Which firm will pay the smallest efficiency wage?

2.

(a) Why would a firm ever choose to offer profit-sharing to its employees in place of paying piece rates?

(b) Describe the free riding problem in a profit-sharing compensation scheme. How might the workers of a firm “solve” the free riding problem?

3.

(a) How does the offering of stock options to CEOs attempt to align CEO incentives with shareholder incentives?

(b) Enron was a company that was ruined in part because of the stock options offered to upper management. Explain.

(c) In addition to accounting reforms, how might stock options be changed to try to prevent situations like what happened at Enron from occurring in the future?

## Answers

**1. Consider three firms identical in all aspects except their monitoring efficiency, which cannot be changed. Even though the cost of monitoring is the same across the three firms, shirkers at Firm A are identified almost for certain; shirkers at Firm B have a slightly greater chance of not being found out; and shirkers at Firm C have the greatest chance of not being identified as a shirker. If all three firms pay efficiency wages to keep their workers from shirking, which firm will pay the greatest efficiency wage? Which firm will pay the smallest efficiency wage?**

In this example, there is no connection between the cost of monitoring and the efficiency of monitoring, as it is assumed that monitoring efficiency cannot be changed. Moreover, the value of unemployment is the same for workers regardless of their employer. Focusing just on the probability of being caught shirking, therefore, workers in Firm A have the least incentive to shirk (as they are most likely to get caught) while workers in Firm C have the greatest incentive to shirk (as they are least likely to get caught). The idea of efficiency wages is to use wages to buy-off the incentive to shirk. Therefore, Firm A will pay the lowest efficiency wage, while Firm C will pay the greatest efficiency wage.

**2.**

**(a) Why would a firm ever choose to offer profit-sharing to its employees in place of paying piece rates?**

Piece rates can be very difficult to pay in some situations. For example, in a situation in which a group of workers is responsible for producing the good, determining who made what may be impossible. Consider Southwest Airlines, which is known to have a profit sharing program that is well-liked by its employees. To pay a flight attendant a piece rate, the airline would have to survey passengers as they depart the plane, and then, from the passengers' opinions, pay the appropriate piece rates. Clearly this is unreasonable. Profit sharing, on the other hand, is a convenient way to approximate the piece rate system. Since all workers are covered by profit sharing at Southwest Airlines, all workers have a continuous incentive to do their job very well. They also have the added incentive to make sure that their co-workers also do their jobs well.

**(b) Describe the free riding problem in a profit-sharing compensation scheme. How might the workers of a firm “solve” the free riding problem?**

When all workers are covered by a profit sharing plan, an individual worker has the incentive to shirk his responsibilities as his direct effect on profits is tiny. If all workers do this, however, the total profit created by the firm will be much smaller than it would be if workers were paid a piece rate.

One way to “solve” the free rider problem is with social pressure. If the atmosphere of the workers is that everyone works and shirkers will be punished somehow – socially, annual reviews, being fired, etc. – then the incentive to shirk is diminished. Thus, a profit-sharing scheme works best when many workers must interact with each other (such as the flight attendants, pilots, luggage movers, and ticket associates at Southwest Airlines).

3.

**(a) How does the offering of stock options to CEOs attempt to align CEO incentives with share holder incentives?**

The idea of stock options is that the CEO will get paid more (via the option to purchase shares of the firms stock below market value) if the share price increases during his or her tenure with the firm. Thus, share holders want the firm to maximize the share price, and by offering the CEO stock options, the CEO has a greater incentive to take actions that accomplish this.

**(b) Enron was a company that was ruined in part because of the stock options offered to upper management. Explain.**

Although offering stock options can align CEO incentives with share holder incentives, what really happens is that the stock options provide an incentive to the CEO to maximize the short-run share price by any means possible. At Enron (and WorldCom and others), this led unethical CEOs to maximize the share price by improper accounting methods. Thus, the share price rose, but not for fundamentally strong reasons. The CEOs then cash in their stock options before the market discovers the problem. In the long-run, share holder value is not maximized, though CEO wealth may be.

**(c) In addition to accounting reforms, how might stock options be changed to try to prevent situations like what happened at Enron from occurring in the future?**

One possible solution to the problem in (b) is to issue stock options that cannot be cashed-in until the CEO has been gone from the company for some time (two, five, or ten years). Such options would supposedly cause the CEO to make the best long-run decisions for the firm.