Applying the Premium for Honesty

Three Examples

Why McDonalds rewards its franchisees

• A McDonald’s franchise has large value to the owner.

Why doesn’t McDonald’s just raise the franchise fee?

The answer seems to be to encourage honesty.
– It takes time to discover a dishonest franchise holder
– There must be a reward for honesty or else people would cheat.

Overpaying Managers

• John Smith has been doing good work, for $10 an hour, the market wage.

• You are willing to promote him to manager, on the basis of asymmetric information.
– That is, you know he is good but the market will not recognize that nor will it value it.
Applying the Premium for Honesty

Overpaying Managers

• The promotion means extra stress and calls for some extra compensation.
• You could give him a pay raise to $15 an hour, which would provide exact compensation for the extra stress. (That is, leave him on the same indifference curve)

Overpaying Managers

• You could raise his pay even higher to (say) $18 an hour.
• The extra raise is an inducement to be honest.

Overpaying Managers

• If you don’t Smith takes the promotion and the raise, but does not do a good quality job of being manager
• He doesn’t incur the stress.
• He gets fired when he is found out, but he can go somewhere else for $10 a hour.

Overpaying Managers

• It is all gain this way.
• He gets the extra $5 an hour until he is found out, without incurring the stress that comes with being a good manager.

Non-Salvageable Investments

• Another way of handling asymmetric information.

Non-Salvageable Investments

• Advertising and establishing a brand name
  – Sam’s Appliances spends $500,000 advertising “Sam is a good guy”.
  – If Sam is found to be a crook, that advertising was worthless.
Non-Salvageable Investments

• Advertising and establishing a brand name
• Building a plant that is worthless if the product fails.
  – Sam’s Appliances builds an elaborate store with fancy signs featuring the logo.
  – If Sam fails, those investments are worthless to the next tenant.

Must there be a premium for honesty?

• No.

Must there be a premium for honesty?

• No.
  • The premium comes about if the cost of paying the premium is less than the cost of ensuring honesty.
  • That will vary from case to case.

Must there be a premium for honesty?

• No.

Must there be a premium for honesty?

• No.
  • The premium comes about if the cost of paying the premium is less than the cost of ensuring honesty.

Back to John Smith

• Paying John $18 vs. $15 an hour costs you $6,000 a year.

Back to John Smith

• Paying John $18 vs. $15 an hour costs you $6,000 a year.
  • If John goofs off, how much will this cost you until you find out?
    – $5,000 and it takes a year to find out
    – $7,000 and it takes a year to find out
Back to John Smith

• Paying John $18 vs. $15 an hour costs you $6,000 a year.
• If John goofs off, how much will this cost you until you find out?
• How much will it cost to monitor John?