

Applying the Premium for Honesty

Three Examples



Why McDonalds rewards its franchisees

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- Why doesn't McDonald's just raise the franchise fee?

Why McDonalds rewards its franchisees

- 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

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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.

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.

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- That will vary from case to case.

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- 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?

End

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