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BUSINESS ECONOMICS. EXERCISES

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1. Behavioral hypothesis: Self-Interest and Opportunism. Rationality. Anomalies. The Cost of Self-Control

1. The Hikers and the Tiger

Analyze the following critique from a Transaction Cost Economics perspective. If possible, skim before the first Chapter of Williamson's *The Economic Institutions of Capitalism* (1985).

“In business circles, a story is often told of two hikers who wake up one night to find a tiger lurking near their tent. One of the hikers immediately reaches for his running shoes. On being reminded by his partner that he could not possibly outrun the tiger, he responds that all he has to do is to outrun the partner. At a superficial level, the somewhat macabre humor of the situation also serves as a powerful reminder of the similarities between biological and economic competition. Survival of the fittest and, hence, the need to be the fittest, is seen as the moral of the tale.

On (still) deeper reflection ... the story reveals a set of assumptions and their self-fulfilling and ultimately debilitating consequences for the hikers that directly contradict the firstcut analysis. We begin our critique of transaction cost economics (TCE) with this story because much of TCE ... is based on a very similar set of assumptions with similar debilitating consequences for organizations whose managers knowingly or unknowingly adopt its prescriptions.

The first assumption is regarding human nature. In reaching for his shoes instead of considering any collaborative action with his partner, the first hiker represents the ‘model of humans’ that is embedded in Williamson’s brand of TCE logic. His behavior is opportunistic (i.e., an expression of ‘self-interest unconstrained by morality’) (Milgrom & Roberts, 1992). In deciding to abandon his partner, he assumes that he has no choice because he cannot be certain ex-ante that his partner will not behave opportunistically, and ex-post discovery can be costly (Williamson, 1975).

The second assumption is regarding the requirement for success. What matters is the speed of running, because that is the strength of the tiger. Going up a tree, or lighting a fire, or any other such ‘strategic’ actions are not contemplated. Rather, ‘efficiency’ within predefined rules of the game is the criterion that determines the desirability of the outcome (Williamson, 1991d).

In a world of hikers and tigers, given these two assumptions, tigers will ultimately prevail. Even if one hiker survives the first encounter by outrunning his partner, he would succumb in some subsequent encounter either to a faster partner or simply because he would soon run out of partners and would have to go hiking alone” (Ghoshal and Moran, 1996, pp. 13-14).

2. The variety of human beings

It might seem strange that during the high Middle Ages, the activity known as “computus,” consisting of the calculation of the date of Easter, that moves from March 22 to April 25, was a main intellectual problem. It may seem silly and boring. “To yawn, however, in the face of things that fascinated our ancestors is to fall into the historical sin of anachronism. Clearly, neither computus nor astrology was boring to the early and later Middle Ages, respectively, and our task is to discover why” (White, 1978, 332). How can this emphasis on computus be explained?

3. Short essay

Write a short essay (less than one page) analyzing critically one of the anomalies which are dealt with by R. H. FRANK in “Cognitive Limitations and Consumer Behavior” (Ch. 8 of *Microeconomics and Behavior*, McGraw-Hill, New York, 1991, pp. 226-50). Originality will be highly valued: you are advised to focus on real cases not discussed in the readings and/or to show new points of view in criticizing the analysis in the readings.

4. Self-control devices

After reading the relevant part of Jensen’s “Self-Interest, Altruism, Incentives, and Agency Theory” JACF 7(2), Summer, 1994, collect examples showing institutions or practices used to reduce the costs of self-control.

5. Games and education

Analyze the pedagogic properties of the following games and sports in terms of developing several personal traits (such as, for example, self-control, cheating, detecting cheaters, inspiring trust, etc.): chess, swimming, mountaineering, basketball, football, poker. Think in other capacities and activities. Lastly, examine the game known as “liars’ dice”, in which each player aims to mistrust false bids made by other players and to induce them to mistrust his true bids (see details in <http://www.aardwolfgames.com/rules/liarsdice/1974/index.pdf>, as well as a discussion of more modern versions in <http://www.gamecabinet.com/sumo/Issue20/node16.html> (visited January 12, 2002).

6. Devaluation in Argentina

Applying one of the theoretical frameworks on human nature, analyse the decision of the government of Argentina when it finally decided, in January 2002, to devalue its national currency, previously pegged to the US dollar. Newspapers reported that:

“The Argentine peso lost about 42 percent of its value today, the first day in 11 years it was allowed to float freely on currency markets, as thousands of rioters vandalized banks and destroyed ATMs [...] Argentina is attempting to control the devaluation through a new two-tier exchange rate system, which has failed in other countries that have tried it. The official exchange rate for imports and exports is 1.40 pesos to the dollar. The free market rate will be used by the public. The peso fell quickly after trading began. At one point it cost as much as 1.8 pesos to buy \$1. The peso closed at about 1.6 to 1.7, a devaluation of about 42 percent. The government has expressed hopes that the peso would level off at around 1.6 to the dollar” (Faiola, Anthony, “Argentina’s Peso Is Freed to Float, And Quickly Sinks”, *Washington Post*, January 12, 2002, p. A14.).

7. A trickle of news

In January 2002, the *El Mundo* newspaper published a series of articles on an apparent case of insider trading in a company created by the President of Telefónica when he was responsible for Tabacalera (now Altadis) and subsequently sold to one of his nephews. In addition to a number of editorials and information on the events and on the reactions to publication of these articles (such as “César Alierta unexpectedly fires all the top management of Telefónica Media” [12th], and “The PSOE asks the anti-corruption prosecutor to act against Alierta for ‘evidence of an offence’” [11th]), the newspaper gives prominence to the following articles in which additional information is

provided: “Investigation: a nephew of Alierta received 309 million in six months from shares in Tabacalera when his uncle was President” [9th]; “Financial scandal: the present Secretary of Telefónica helped to exonerate Alierta’s nephew in the National Securities and Exchange Commission” [10th]; “Insider information: Alierta set up the company himself and obtained the loan used by his nephew (14th); “Insider information: the Securities Commission closed the investigation when Alierta was summoned to declare” [15th]; and “Insider information case: Alierta chose a former employee to certify the alleged sale to his nephew” [16th]. Since all of these events had taken place long before, the newspaper probably had all the information on 9 January. If so, why did they prefer to spread it out throughout the week? How does this complicate the “crisis management” of the affected firm?

8. Advertising and teleshopping regulation

Analyze the following excerpts of an EU Directive on television advertising and teleshopping.¹ Focus on the costs and benefits involved by these marketing practices both in the short and the long run. Is there always a clear separation between news and advertising? Is it necessary? Is it necessary to have mandatory rules? What about the separation between facts and opinions in news reporting? How would you interpret the regulation (especially articles 15 and 16) in view of the assumptions about human behaviour, discussed in class?

Article 10

1. Television advertising and teleshopping shall be readily recognizable as such and kept quite separate from other parts of the programme service by optical and/or acoustic means.
2. Isolated advertising and teleshopping spots shall remain the exception.
3. Advertising and teleshopping shall not use subliminal techniques.
4. Surreptitious advertising and teleshopping shall be prohibited.

Article 11

1. Advertising and teleshopping spots shall be inserted between programmes. Provided the conditions set out in paragraphs 2 to 5 are fulfilled, advertising and teleshopping spots may also be inserted during programmes in such a way that the integrity and value of the programme, taking into account natural breaks in and the duration and nature of the programme, and the rights of the rights holders are not prejudiced.
2. In programmes consisting of autonomous parts, or in sports programmes and similarly structured events and performances containing intervals, advertising and teleshopping spots shall only be inserted between the parts or in the intervals.
3. The transmission of audiovisual works such as feature films and films made for television (excluding series, serials, light entertainment programmes and documentaries), provided their scheduled duration is more than 45 minutes, may be interrupted once for each period of 45 minutes. A further interruption shall be allowed if their scheduled duration is at least 20 minutes longer than two or more complete periods of 45 minutes.
4. Where programmes, other than those covered by paragraph 2, are interrupted by advertising or teleshopping spots, a period of at least 20 minutes should elapse between each successive advertising break within the programme.

¹ Source: Council Directive 89/552/EEC of 3 October 1989 on the coordination of certain provisions laid down by Law, Regulation or Administrative Action in Member States concerning the pursuit of television broadcasting activities, *Official Journal* L 298 , 17/10/1989 p. 0023 - 0030, amended by 397L0039 (*Official Journal* L 202 30.07.97 p.60).

5. Advertising and teleshopping shall not be inserted in any broadcast of a religious service. News and current affairs programmes, documentaries, religious programmes and children's programmes, when their scheduled duration is less than 30 minutes, shall not be interrupted by advertising or by teleshopping. If their scheduled duration is 30 minutes or longer, the provisions of the previous paragraphs shall apply. `;

Article 15

Television advertising and teleshopping for alcoholic beverages shall comply with the following criteria:

- (a) it may not be aimed specifically at minors or, in particular, depict minors consuming these beverages;
- (b) it shall not link the consumption of alcohol to enhanced physical performance or to driving;
- (c) it shall not create the impression that the consumption of alcohol contributes towards social or sexual success;
- (d) it shall not claim that alcohol has therapeutic qualities or that it is a stimulant, a sedative or a means of resolving personal conflicts;
- (e) it shall not encourage immoderate consumption of alcohol or present abstinence or moderation in a negative light;
- (f) it shall not place emphasis on high alcoholic content as being a positive quality of the beverages.

Article 16

1. Television advertising shall not cause moral or physical detriment to minors, and shall therefore comply with the following criteria for their protection: (a) it shall not directly exhort minors to buy a product or a service by exploiting their inexperience or credulity;

- (b) it shall not directly encourage minors to persuade their parents or others to purchase the goods or services being advertised;
- (c) it shall not exploit the special trust minors place in parents, teachers or other persons;
- (d) it shall not unreasonably show minors in dangerous situations.

2. Teleshopping shall comply with the requirements referred to in paragraph 1 and, in addition, shall not exhort minors to contract for the sale or rental of goods and services.

9. **Minimizing Self-Control Costs**

Relate a managerial application of the existence of self-control costs, i.e., a case where an organization spends resources to reduce the cost of self-control of its employees. (Notes: This will probably be a question in the final exam. You are advised to think about it. However, it will be one of many questions. Therefore, do not allocate too much time to it. The question will be competitively graded, with a fixed total amount to be shared out amongst all your answers. [Why?] Focus on a real case and analyze its optimality relative to alternative solutions).

10. Precious drops²

A wine-lover purchases two dozen bottles of “Pingus” wine. A few years later the price of the wine has increased substantially. The bottle she had bought for \$100 has now a price of \$1000 at auction. This economist drinks from this wine occasionally, but would neither be willing to sell the wine at the auction price nor buy an additional bottle at that price. Analyze the behavior of the economist in the standard consumer-choice framework. Try to explain her conduct using an alternative theoretical model.

11. AEA

The American Economic Association once considered to let the members elect to drop one of the three association journals and get a credit. The claim was that fewer members would choose to drop a journal if the default was presented as all three journals (rather than the default being two journals with an extra charge for getting all three).³ What is the difference between the two options? How would you explain the preference of the decision makers to offer the first one?

12. The Matrix⁴

In the series of movies, “Matrix”, “Matrix Reloaded” and “Matrix Revolutions”, machines are threatening humans and humans are fighting back to attain freedom. Taking this plot literally, analyze the reasonableness of such a scenario using the insights from evolutionary psychology. Discuss reasons why machines would want to threaten humans.

13. Volvo’s Kalmar plant case

In the early seventies, the Volvo automobile factories were facing many problems, including 25% absenteeism. The main interpretation of this was that Swedish workers, because of their cultural level and aspirations, were not happy doing routine jobs on an assembly line of the sort that Charlie Chaplin characterized in “Modern Times”. For this reason, Volvo designed its new factories, starting with the one in Kalmar, to be rather unconventional. The design was labeled “socio-technical” to indicate that social organization was not determined by technical aspects, and was based on autonomous groups which established their own working speed and work organization and produced an identifiable part of the product in noise-free environments with views of the countryside. They even agreed on their productivity with the management. However, neither turnover nor absenteeism decreased, in spite of the psychosociological predictions. Volvo continued to maintain a pool of workers to cover absenteeism and ended up introducing performance-tied payment in response to a report produced by a mixed committee of trade union representatives and managers, which is summarized in Aguren et al. (1984). According to this experience, however much jobs are “enriched”, human beings prefer to stay at home when their income does not depend on their actually going to work. The idea of converting the economic “evil” of work into something good is thus seen not only as inefficient but perhaps as impossible.

² Based on D. Kahnemann, D., Knetsch, J., and R. Thaler. (1991), “Anomalies: Endowment Effect, Loss Aversion, and Status Quo Bias,” *Journal of Economic Perspectives*, 5,1, pp. 193-206.

³ Based on D. Kahnemann, D., Knetsch, J., and R. Thaler. (1991), “Anomalies: Endowment Effect, Loss Aversion, and Status Quo Bias,” *Journal of Economic Perspectives*, 5,1, pp. 193-206.

⁴ Developed by Irina Cojuharencu.

14. Volvo's Kalmar revisited

After reading Jensen and Meckling (1994), carefully analyze again the Volvo case.

15. Withholding taxes

First, using some of the models of human rationality, analyze these features, common of many income tax codes: (a) Most of the taxes to be paid are collected by income payers (employers, banks) by withholding an estimation of the tax due by the taxpayer before the net income tax is paid to the taxpayer, instead of paying the taxpayer the gross income and having him or her paying the precise tax due afterwards. (b) Tax withholding is structured usually in such a way that most citizens get a positive refund or tax rebate once a year.

Second, discuss the welfare consequences of a constitutional rule preventing the government from using withholding taxes.

16. Tips and information

How can you explain the remuneration patterns in tipping in terms of the basic scheme explained in the theory? Where do you expect higher heterogeneity in service quality? Which compensation pattern is expected to generate fewer incentives for providing high quality service for non-repeating purchasers?

17. Buying at the cash-desks

Many retailers offer some merchandise such as shaving tools, batteries and candy just next to the cash-desks. Suggest two explanations of this commercial practice.

18. Do you really need a nap?

Sleeping seems to be one of the basic necessities that shouldn't be traded-off for anything else. Empirical studies demonstrate, however, that the time dedicated to sleep decreases the higher the value of it. People with high income sleep less. (They also spend less time having fun and are less faithful to their husband/wife.) The empirical estimations show that the time dedicated to sleep decreases 1 per cent for every 20 per cent increase in salary (Biddle and Hamermesh, 1989). Analyze this result. Does it contradict the fact that people in rich countries sleep more than people in poor countries? Can the concepts of *income effect* and *substitution effect* help in answering this question?

19. Gossip

Gossip is essential in all societies. Why? Why is it focused on sex, power, relatives, power, health and similar issues? What do they have in common? Why do we gossip now about movie stars? And about soap opera characters? How can these ideas be applied to advertising? How would you measure the effects of this advertising?

20. Is it possible to be too smart?

In the context of Evolutionary Biology, it has been said that "Evolution is about ends, not means; becoming smart is just one option" (Pinker, 1997, p. 153). Do you think this sentence is also applicable to the development of a professional career? How? Is it applicable to the specialization

of human capital? Are perhaps human beings becoming more productive but less smart as a consequence of specialization?

21. Lack of duty of filial love in the Ten Commandments

Analyze from an evolutionary perspective the curious circumstance, pointed out by Adam Smith in *The Theory of Moral Sentiments* (1759), that “In the Decalogue we are commanded to honour our fathers and mothers. No mention is made of the love of our children.”

22. Black bottles

Why might it be a good idea to keep poison in black bottles? What is strange about eating squid cooked in its own tint?

23. Missiles

You are allocating scarce resources in a nuclear defense program. On the basis of the theory of emotions developed by Evolutionary Psychology, would you recommend protecting your cities or your missiles?

24. Optimal irrationality

Why might be rational for terrorists, kidnappers, hijackers and dictators to look crazy? (Pinker, 1997, p. 411).

25. Optimal Ignorance

What’s the function of the sign “Driver does not know combination to safe?”

26. Face to face versus its alternatives

Examine and compare the properties of different communications techniques in the context of the “cheating detection” emphasized by Evolutionary Psychology, including: personal interviews versus telephone conversations and teleconference, mail versus e-mail, scientific papers versus seminars, radio versus television, classes versus online teaching, oral versus written examinations, Laurence Oliver versus Actors Studio’s stars such as Dustin Hoffman.

“Facial expressions are useful only if they are hard to fake. As a matter of fact, they *are* hard to fake... Some great actors, like Laurence Oliver, are highly coordinated athletes who have doggedly learned to control every muscle. Others learn method acting, inspired by Konstantin Stanislavky, in which actors make themselves *feel* an emotion by remembering or imagining a charged experience, and the expression pops on the face reflexively” (Pinker, 1997, p. 415).

27. Laughter

“What is the survival value of the involuntary, simultaneous contraction of fifteen facial muscles associated with certain noises which are often irrepressible?”—asks Koestler in his 1964 book *The Act of Creation*. Why do we laugh? When do we laugh more, alone or with other people? Why is it that the most inviting targets of ridicule are teachers, preachers, kings, politicians, military officers,

bosses, and other members of the high and mighty? What might be the evolutionary function of laughter?

28. The faculty of arts

Every college has a faculty of arts, which usually dominates the institution in numbers and in the public eye. But the tens of thousands of scholars and millions pages of scholarship have shed almost no light on the question of why people pursue the arts at all. Why do so many people choose to study arts?

29. Bayesian thinking

Explain and reconcile the following three results. (1) Researchers Griffiths (Brown) and Tenenbaum (MIT) gave “nuggets of information to each of the participants in their study ..., and asking them to draw a general conclusion. For example, many of the participants were told the amount of money that a film had supposedly earned since its release, and asked to estimate what its total “gross” would be, even though they were not told for how long it had been on release so far. Besides the returns on films, the participants were asked about things as diverse as the number of lines in a poem (given how far into the poem a single line is), the time it takes to bake a cake (given how long it has already been in the oven), and the total length of the term that would be served by an American congressman (given how long he has already been in the House of Representatives). All of these things have well-established probability distributions, and all of them, together with three other items on the list—an individual’s lifespan given his current age, the run-time of a film, and the amount of time spent on hold in a telephone queuing system—were predicted accurately by the participants from lone pieces of data.” (“[Bayes Rules](#),” *The Economist*, January 7, 2006, pp. 70-71). (2) Kahneman and Tversky found, when asked to estimate the percentage of African states at the United Nations, respondents estimated on average 25 and 45% when, before being asked, they extracted from a lottery a number which could be either 10 or 65, respectively (Frank, 1992, 277). (3) A sample of students divides by half in preferring one of two apartments, *A* and *B*, characterized on the basis of distance and price. When a third apartment, *C*, which being more distant and costing more than *B*, it is therefore “dominated” by *B*, is also offered, more students prefer now *B* to *A*. It seems inconsistent because the presence of an irrelevant option seems to be modifying the preferences, the price the students are willing to pay for shorter distance (Frank, 1992, 279-281).

30. Practicing Cosmides-Watson

Apply the Cosmides-Watson *test* to yourself again and think why some questions feel easier than others despite having the same logical structure. Try the test with a friend.

31. Biological conditioning of xenophobia

“Dr Kurzban observes that the three criteria on which people routinely, and often prejudicially, assess each other are sex, age and race. Judgments based on sex and age make Darwinian sense, because people have evolved in a context where these things matter. But until long-distance transport was invented, few people would have come across members of other races. Dr Kurzban believes that perceptions of racial difference are caused by the overstimulation of what might be called an “otherness detector” in the human mind. This is there to sort genuine strangers, who will need to work hard to prove they are trustworthy, from those who are merely unfamiliar members of the clan. It will latch on to anything unusual and obvious—and there is little that is more obvious than skin colour. But other things, such as an odd accent, will do equally well. Indeed, Dr Dunbar

thinks that the speed with which accents evolve demonstrates that they are used in precisely this sort of way.” (Carr, 2005, p. 11).

¿Why most people trust less people who look different from them?

¿What information do we use to classify someone as stranger?

¿What reasons may have lead the human mind toward a bias against strangers?

If such a bias exist, how does it affect our current interaction?

What consequences emerge for social policy, e.g., in education, immigration, criminal law?

32. Understanding evolution

Evaluate the following statement: “If evolution is so smart, why is it that humans only have legs and have not been endowed with wheels to move faster and more efficiently?”. Do you agree or disagree with this criticism of evolutionary adaptation, why?

33. Is a camel a horse poorly designed?

Is it a good joke the one that defines a camel as a horse designed by a committee?

34. Baby’s resemblance to parents

Explain these results: “Of the mothers who commented on the baby's resemblance to one of the parents, 81 percent indicated that the baby was more similar to the father.” ‘Subjects [in an experiment where they were shown pictures of three adults and the child of one of them] correctly matched one-year-old children with their actual fathers 49.2 percent of the time.... In contrast, subjects were not able to correctly match one-year-olds with their biological mothers at a rate greater than chance’ (David Buss, *Evolutionary Psychology*). (David Friedman, at http://www.daviddfriedman.com/Miscellaneous/past_quotes_of_the_week.htm, accessed April 10, 2004).

35. Hikers and Tigers revisited

Review again the story on “The hikers and the tiger”, now form the perspective of Evolutionary Psychology. Do your analysis change if the hikers are or not brothers? Members of the same or different army squads? Christians or Romans?

36. Diamonds without interests

Examine this advertisement: “A true diamond and sapphire three-carat ring for €29.90 each month *without interest*” (emphasis in the original).

37. Selfish economists

According to several surveys (for example, Frank, Gilovich and Regan, 1993), the probability that an American economist contributes to charities is around half that the one of the rest of its fellow citizens. Discuss several possible explanations. What consequences involve for the professional success of individual economists? What about the public perception about economics?

38. The income elasticity of marriage fidelity

Apparently, a negative relation between the level of income and married fidelity exists: the frequency of infidelity, which is 50 percent for a man who makes 40,000 dollars a year, goes up to 70 percent when his income increases to 70,000.⁵ Provide two explanations: economic and biological, and compare their predictive power.

39. The prenuptial agreement between Catherine Zeta-Jones and Michael Douglas

When Catherine Zeta-Jones and Michael Douglas got married in 2000, Zeta-Jones was “totally” in love but was “concerned” that Douglas had cheated on his first wife repeatedly, including with his wife's best friend. Therefore, in case of divorce, Zeta-Jones will get \$1.5 million for every year of marriage. She had asked for almost \$5 million a year, but accepted a lower figure in exchange for a lump sum of cash up front and a \$5 million “straying fee” if Douglas cheats on her. In return, Douglas also got a confidentiality clause from Zeta-Jones, barring her from ever revealing personal details from their marriage.

⁵ *The Economist*, “Gentleman's Relish” (November, 25, 1989, p. 73).

2. Information, Specialization and the Costs of Exchange. The Nature of the Firm. Methodology in the Study of Organizations

40. Rejected patient

This is the story of a patient with a wart who is rejected by five departments of a National Health Service. Firstly, the family doctor prescribes a cream for external use that is of low cost to the health service but unpleasant to use so is of high cost for the user. After it is seen to be inefficient, the patient is sent to a surgeon who removes the wart surgically. Since it is a large wart and treatment is given in the outpatients' department, the doctor does not remove all the wart and warns the patient that it is likely to reappear in which case he should return for a second surgical treatment before it grows too large. When the time comes, he is treated by a different doctor who considers—perhaps in view of the large number of people in the waiting-room—that he should be seen in the dermatology department. So the patient has to return to his family doctor in order to gain access to a dermatologist. The latter then prescribes the same, inefficient treatment that was initially prescribed by the family doctor.

Guide for discussion

Who has the best information to determine which treatment is the best? How can this be taken into account? More abstractly, is this a problem of “coordination” or “motivation”? How this problem could be solved from both points of view?

41. Videophone⁶

In 1964, AT&T began testing the first telephone offering images, initially called the “Picturephone”. In 1988, several Japanese companies sold about 250,000 telephones that, in addition to the voice, showed fixed images of the speakers. In 1992, AT&T returned with its “Videophone 2,500” which included small color screens and showed several images per second. But total sales did not even reach 100,000. Although the initial price was \$1,500, AT&T ended up giving away its last phones. Over the same period as these failures, there have been other electronic products that started off being expensive and not very efficient (video recorders and cameras, tape-recorders, television sets) and that eventually improved in quality and became much cheaper as they were produced in large quantities to meet the rise in demand. (a) It now looks as if there is not a large demand for video-telephones. Can you suggest why? (b) It is always difficult to estimate human needs but why were so many mistakes made with this product?

42. The vote and pensions

In Singapore, the possibility was considered of reducing the vote of pensioners to half its value. Make several suggestions as to how you think the election results might have changed expenditure on pensions, tax pressure, expenditure on policing, legislation on abortion. Consider what other policies might have been affected. What point is there in such a regulation from the point of view that considers the political system to be a decision-making apparatus for the more or less imperfect transmission of citizens' preferences? (For example, with respect to available information, the costs

⁶ Based on “A Word Is Worth 1,000 Pictures” (*The Economist*, 5 October, 1996, p. 100).

of acquiring it, the costs of voting, potential costs and benefits.) Is this acceptable from an ethical point of view having reached the 21st century? Why do we use the word “reach” in the previous question?

43. Waiting for medical services

Basic microeconomic theory indicates that the demand for products or services that are priced at zero tends to exceed optimum levels, giving rise to queues and black market mechanisms to distribute the shortage. In the outpatient clinics of the many national health services, this phenomenon seems serious. What is the real price of this service? How is it distributed socially? What type of customer would you expect to find most frequently waiting in such clinics? What services, apart from a hypothetical improvement in health, are supplied by such outpatient clinics? Diagnose the problem and discuss several solutions such as increasing capacity, opening more clinics, charging everyone a flat fee per prescription or charging only the rich who do not evade the taxman or charging everyone except the elderly, chasing up those who misuse the system, etc.

44. Complaints about new futures markets

Aluminum producers opposed the establishment of a futures market in aluminum in the late 1970s. Why existing firms in an industry often complain about the introduction of a new futures market?

45. Abnormal profits

The leading firm in an industry produces better quality and enjoys better reputation. Comment on a recent study based on accounting data which argues that this leading firm is earning an abnormal rate of return because of market power.

46. Old democracies

In the classical democracies of Greece and Rome and in the first phase of modern democracies, the vote was reserved for certain citizens according to their tax status or sex. For example, in nineteenth-century Spain, only those who were subject to direct taxation were entitled to vote—according to the law of 1858 those who paid over 400 ‘reales’ and, with the law of 1865, those who paid over 200. This gave an electoral census of 1 and 3 per cent of the population respectively (Vicens, 1975, p. 566). Compare the system of universal suffrage with these alternatives, taking care to avoid ethical or political considerations and focusing only on the consequences for the use of relevant information in decision-making.

47. Overbooking

Airlines often sell more tickets than seats there are in a given plane, a practice known as ‘overbooking’. Their goal is to maximize the utilization of the plane while at the same time selling at least some tickets with a right not to show up. This is also in the interest of passengers, because empty seats are costly and their cost would cause higher prices. Deciding how many seats to sell is difficult, because actual demand is uncertain and depends on many contingencies. To optimize their allocation, prices also have to be adjusted. Anyway, it is unavoidable that some flights will leave partly empty while in others more passengers will show up than seats are in the plane. The latter case poses the problem of how to allocate the scarce seats available. This can be done following many rules and often by a mix of these rules.

1. First, early birds usually get a seat. (Which problems will this cause?).

2. Secondly, a waiting list may be built for those who check in later. An airline agent will then allocate available seats. Can you think which criteria should this agent use?

3. A sophisticated solution was promoted by an economist (Julian Simon) and mandated by law in the USA in 1978. Since then, airlines were required to auction the available seats, in a so-called 'voluntary bumping system'. The whole issue can be seen from the property rights perspective. In any case, airlines sell property rights to seats, but these rights are different. Traditionally, they were conditional. Now they are not conditional. When airlines sell the same right more than once, they have to purchase it back from the client that value it less. Can you think of any reason why the new system might be inefficient? Consider the fact that it was not introduced voluntarily and the positive costs of running the options. On the other hand, airlines may lack motivation to introduce a system like this voluntarily even if efficient. Discuss briefly the practice of US airlines when dealing with overbooking.

4. Compare this solution to the one applied in Europe. Since 1991⁷, the European Union requires airlines to compensate clients in case of overbooking (see the excerpt at the end of the case). In 2000, the European Commission increased the pressure on the airlines for complying with the regulation by launching an information campaign aimed at the consumers and displaying a Charter of Passenger Rights in most of the EU airports.⁸ As of 2002, the Commission was proposing an increase of the indemnities.⁹

⁷ Council Regulation (EEC) No 295/91 of 4 February 1991.

⁸ "Passenger Rights in case of overbooking:

'European Union rules require that passengers must receive fair treatment and proper compensation when they are denied boarding at a European Union airport:

A passenger has a valid ticket indicating a confirmed reservation and arrives within the time limit for check-in at an airport in the European Union. If the airline then prevents the passenger from boarding because it has overbooked the flight, the following rules apply.

1. The airline must offer that passenger a choice between: reimbursement without penalty of the cost of the ticket for the part of the journey not made, re-routing to the passenger's final destination at the earliest opportunity or re-routing at a later date at the passenger's convenience.

2. In addition, the airline must pay minimum compensation in cash as follows: €150 for flights up to 3,500 km (€75 if the delay to the passenger is less than two hours) and €300 for flights over 3,500 km (€150 if the delay to the passenger is less than four hours). The compensation need not exceed the price of the ticket. Only if the passenger agrees can it be paid in vouchers or other services rather than cash.

3. In addition, the airline shall offer the following assistance, free of charge: a telephone call and/or telex or fax to their destination, meals and refreshments in reasonable relation to the waiting time, accommodation in cases where an additional stay of one or more nights is necessary, onward transport to their original destination if the passenger accepts a replacement flight to an alternative airport. Moreover, where a passenger is placed in a lower class than that for which the ticket was purchased, he or she shall be entitled to a reimbursement of the difference. Where a passenger is traveling with a package tour, the airline must compensate the tour operator who must then pass the sums collected on to the passenger. A passenger should not have to apply to the airline for the compensation and assistance mentioned above the airline should offer them as a matter of course.' (Air Passenger Rights in the EU, http://europa.eu.int/comm/transport/themes/air/english/pass_prot_cons/index.htm, visited on January, the 16th, 2002).

⁹ "MEPs vote to compensate overbooked passengers up to EUR 600 Compensation of up to EUR 600 would be paid to passengers who arrive at airports to find their flights overbooked under new draft rules adopted by the European Parliament today. MEPs made a number of amendments to the proposal for a regulation, which establishes common rules on compensation and assistance to air passengers in the event of overbooking, cancellation and long flight delays.

In case of boarding passengers being denied access, MEPs want passengers to be compensated as follows:

- a) EUR 200 for flights less than 1000 kilometres
- b) EUR 400 for flights between 1000 and 3500 kilometres
- c) EUR 600 for flights of 3500 kilometres or more.

The regulation would not apply to package travel, but only to 'seat only' bookings.

Rules have been modified later. What are and would some of the most likely consequences of these policies? (Note: You should use updated information on the case).

48. Home owner associations

Home owner associations are a kind of private local government very popular in the USA. Typically, a real estate developer purchases land to build homes. When selling them, he attaches use conditions governing all kinds of externalities ('spillovers'). For example, you, the owner, cannot hold a party with more than 20 people, or you have to paint your house in a certain colour, or use only a certain style when renovating it. These conditions 'run with the land,' meaning that future buyers are constrained by them. However, this cost is compensated by the benefit of having neighbours equally constrained. By designing a good trade-off of costs and benefits, the developer will sell the homes for a higher price. This is not the only trade-off, however. The developer should probably contemplate the possibility of changing the rules. Circumstances change and what is optimal now may not be so in the future. It is difficult, however, to decide how easy a change of rules should be made. The possible overruling of some these regulations by the courts may help in adapting them to changes but also adds uncertainty.

From 1962 to 1992 the number of home owner associations went from 500 to 150,000, covering 32 million people (DeLong, 1997, p. 68). At the same time, the regulation of land uses by local governments ('zoning') expanded considerably. Are the two trends related? Should they be governed similarly?

49. "Trashumancia"

Mesta and Trigolimpio operate two contiguous fields dedicated respectively to growing sheep and planting wheat. Fences could be built for 9 million but the fields lack them, reason why the cattle enters and usually destroys young wheat. The harvest is worth a million by ton and the value of the damages produced by the cattle depends on the size of the herd, being of one, three, six and ten tons when the herd is made up of, respectively, one, two, three or four sheep.

Number of sheep	Wheat loss (Tm.)	Marginal loss(Tm.)
1	1	1
2	3	2
3	6	3
4	10	4

- 1) Supposing that Mesta is responsible for the damages caused by the cattle, how many animals would he breed and given what size of the herd would he decide to build a fence?

The Parliament also adopted amendments demanding a better definition of "force majeure" and of "denied boarding". Such definition should take into account, they say, the fact that the absence or non-validity or other safety concerns were valid reasons for refusing to transport passengers and should not be considered cases of denied boarding.

The scope of the Regulation should be extended to cover all carriers which fly to the Community.

Finally, MEPs wanted all modes of transport to be treated equally, urging similar compensation rules for rail, ferry, bus and coach transport. It would be irrational, unfair and a distortion of competition, they say, to compensate for denied boarding or a long delay in the case of a plane journey between two European cities whilst not offering compensation in similar circumstances for a high speed train journey between the two same cities." (Source: <http://www.eubusiness.com/item/94595/5e3a0A55/4300>; visited on the 28th of October, 2002.) The EU Parliament has increased the compensation airlines must pay in case of overbooking and bumping passengers off flights up to Euro 600 (Wall Street Journal Europe, July 4-6, 2003, p. A3).

- 2) How will the decision to cultivate the land be affected if the value of the potential harvest is of 12 million, the cost of cultivating the land is of 10 million and the optimal herd size is of 2 sheep? (suppose, that Mesta is responsible for the damage and has to compensate it).
- 3) Does the solution to point (1) above change if the Law does not make anyone responsible for the damage, so that Mesta does not have to compensate his neighbor for the damage caused?
- 4) Analyze the following point of view, held among others, by Samuelson (Coase, 1988, pp.159-163): “the reasoning of Coase is based on the ability of the parties to negotiate to a mutually satisfying agreement, through which total surplus is distributed. But the situation of the negotiators is one of a bilateral monopoly and there is no guarantee an agreement will be reached.”
- 5) (Following Coase, 1988, pp.163). The Coase Theorem is criticized due to the fact that its validity depends on whether the contracting parties earn profits in their respective activities. If they would not be, then one of the activities would cease to exist depending on whether the responsibility is allocated to the party which is involved in that activity or not: if the person causing damages is not earning profits, but the factors of production are remunerated at their opportunity cost, when he is made responsible for the damages, he will go into losses and terminate production. By the same token, if the suffering party is not compensated, this party will incur losses and also terminate production. It seems then, that the allocation of responsibility affects the final outcome. Of course, the argument is tricky, as in the case in which the same resources would be equally productive in two different activities, the value of the permission to inflict the damage to one of these activities would be zero. The following example will clarify the matter. Suppose now that Mesta and Trigolimpio earn different profits and suffer different damages as is listed in table below. Remember that the word “profit” here refers to the difference between what the factors of production are earning in their current use and what they would have earned in their second best use, so that maximization of the value of production implies the maximization of profits. For each of the five situations defined in the table below, establish the outcome depending on whether Mesta is made responsible or not for damaging the harvest of Trigolimpio. Forget about the possibility of building a fence or varying the size of the herd.

<i>Situation</i>	<i>Profits of Mesta</i>	<i>Profits of Trigolimpio</i>	<i>Value of damages</i>
A	100	100	50
B	100	25	50
C	25	100	50
D	40	30	50
E	30	40	50
F	20	10	50
G	10	20	50

50. The Power of Land Covenants

After reading on the experience of Wallace Kaufman on land covenants,¹⁰ consider (a) how efficiency is maintained through changed circumstances, and (b) which externalities are not considered. In particular, do land covenants protect ‘existence value’ (pleasure we may derive from

¹⁰ Kaufman, W. (2001), “The Power of Land Covenants,” *PERC Reports*, December (<http://www.perc.org/percrept.htm>). See also <http://www.adm.duke.edu/alumni/dm8/spotlight.html>.

knowing of the existence of some natural resource even if we do not get in touch with it)? What is it special about it?

51. Sears Roebuck

The USA corporation Sears Roebuck has a wide sprawl network of department stores. Since it was founded it has been selling through catalogues and mail, benefiting from a reputation of a guaranteed quality distributor. In 1992, however, Sears had to pay 200 million dollars in order to prevent litigation started by several states. They were accusing Sears' repair department of charging each about \$230 to its clients for unnecessary repairs. As a consequence of the settlement, Sears' shares fell 6 per cent in the New York Stock Exchange. In the course of investigation it was found that the employees had been paid according to an incentive system based on commissions. The commission depended on the amount of money the client was charged and there were some minimum levels to be met. A failure to meet the objective level could have ended in dismissal.

Why do you think Sears enter the market of repairs? Suggest an explanation based on the nature of the service and the competitive advantages of the company.

Suggest two solutions of the problem. (At least one should have an economics focus, e.g. put more emphasis on the restrictions over individual behavior instead of analyzing preferences.)

In addition to the inadequate incentive system should we consider as a source of the problem a possible opportunistic behavior on the part of Sears with respect to its badly informed clients? Who could have behaved opportunistically? (Hint: Sears is a corporation with specialization of ownership and control.)

52. Asymmetries in regulation

Compare how regulation and politics deal with these two kinds of technological innovations: the introduction of new medicines and the introduction of new pedagogical methods.

3. An Institutional Overview of the Contractual Process

53. Curbstoners

Please explain in terms of moral hazard and/or adverse selection the existence of “curbstoners.” In particular, why are they treated as cheaters?

“Private owners usually sell their used cars through newspaper ads. You may find a well-maintained car selling for less money than you would pay a dealer. If you buy a used car from a private owner, ask for the car’s maintenance and repair records and, if the seller is the first owner, for records of the original purchase. Also, check the title to make sure the person selling the car is the legal owner.

Note: Be wary of fraudulent, criminal dealers, commonly known as ‘curbstoners,’ who offer vehicles through newspaper ads and may disguise themselves as individual sellers. The cars offered may be stolen or damaged, and their odometers may be rolled back.”¹¹

54. Volvos ignore stop signs

It seems that Volvo cars, famous for their legendary safety, are ignoring more stop signs and traffic lights than all other cars (Milgrom and Roberts, 1992, p.200). Why? Formulate at least two hypotheses to explain the phenomenon.

55. Gratistelephone¹²

A Swedish company has created a new advertising channel using telephone. It works through inserting commercial announcements in private phone calls and it offers users the advantage that the phone call is for free. Gratistelephone, which is the name of the new service, functions like this: First, the owner of a traditional telephone line dials a toll-free number in order to connect with Gratistelephone. Then, he dials the number he is willing to phone to. While waiting to be connected he listens to the first advertisement. Once the connection is established, Gratistelephone interrupts the conversation every three minutes with ten-second commercials. Explain how the problems of adverse selection and moral hazard will affect this new product.

56. IMF help

The International Monetary Fund organizes financial rescue operations for those countries (Indonesia, Brazil, Thailand,...) and financial institutions which, if they were to suspend payments or become bankrupt, might cause a systemic crisis. What are the implications of the possibility of being rescued for the behavior of the economic agents?

¹¹ “Buying a Used Car: Be a Smart Car Shopper,” Better Business Bureau, March 25, 2003, <http://www.bbb.org/alerts/article.asp?ID=432>, visited March 8, 2006.

¹² “La publicidad se cuela en las líneas de teléfono” (*Expansión*, January, 22, 1996, p.12).

57. Can a sacrifice be a test?

Traditionally, certain higher education institutions have required that their students pass examinations in subjects which have nothing to do with increasing their future productivity except that they possibly have some value as mental discipline. Can you give any examples of this? How can it be explained? Consider the hypothesis that the subjects which most raise productivity tend to become the easiest to pass whereas irrelevant subjects require the hardest work. Bear in mind that the majority of students coming out of teaching institutions in which such 'screening' subjects predominate, under normal economic circumstances, do not find it too difficult to find jobs and that such jobs involve tasks which are generally unrelated to the qualifications obtained in the teaching institutions.

58. Pale faces and suntans

How can you explain that pale skin and suntans have often been used as status symbols in different environments? Under which conditions?

59. Fashion

Apply the concept of adverse selection to explain the circles of fashion and style.

60. Nonconformity

Apply the concept of adverse selection to explain nonconformist behavior.

61. School uniforms

Draw up an explanation as to why many private schools insist on their students wearing uniform. Explain why this restriction was traditionally lifted for older students. Why do parents in Mediterranean countries spend so much on children's clothing in comparison with other European countries? Could expenditure on children's clothing and toys be related to the low birth rate in Spain?

62. "The more, the better"

Comment, from the prospective of the economics of regulation, this sentence, said by the Director of the Spanish Institute of Accounting: "The perfection of the accounting information is always good".

63. Family loans

Why aren't loans among relatives formalized in a written form? Is the higher/the lower degree of contract formalization a function of the money in question? Why do informal contractual practices seem to survive better among closed rural communities?

64. Credit in language-teaching schools

During the first few years of this century, a number of private language-teaching schools were offering their customers substantial discounts if they paid for their courses one year in advance. In order to facilitate these operations, they reached an agreement with a number of financial entities whereby their customers could receive loans. In 2002, several of these schools went into temporary

receivership and were unable to provide the promised services. The customers who had taken out loans refused to pay back the banks. The Public Administration took a number of actions with a view to protecting these consumers. Analyse the problem from the following points of view: (1) The need for public intervention in education because of difficulties for the market to finance investment in general human capital. (2) The problems of moral hazard inherent in a public policy that leads debtors to not return loans unless they receive the courses or provision of the courses is guaranteed by the State or the banks. To what extent are the incentives similar to those created by insuring bank deposits? (3) What would the long-term consequence of such a rescue be?

65. Total control

The company Old Days Inc. is wasting a lot of money in conflicts related to agency problems because it has practically no system at all for monitoring, bonding or motivating the activity of its staff. Its CEO has taken on the services of MB Associates which has produced a report recommending the installation of a system for electronic-neuronal supervision and which promises, at a cost of 10 billion per year, that the problems will disappear altogether. They would achieve gross savings of 12 billion resulting in net profits of 2 billion (= 12,000 - 10,000). Assuming that these figures reflect all the economic costs and are totally correct and definite, should the company follow the advice of the consultants?

66. Falcons and pigeons

Imagine a population of falcons and pigeons¹³. When they meet an opponent, the falcons fight until they either win or are seriously hurt. The pigeons only threaten their opponents but withdraw if the other wants to fight. Let us suppose also that the long-term survival of the two types of bird depends on the results obtained in these fights and that the winnings of each possible fight are as follows: 50 points for winning, -100 points for being seriously hurt and -10 for wasting time making threats. In other words, (1) if a falcon meets a pigeon, the pigeon withdraws and obtains a zero result and the falcon gets 50 points; (2) if a falcon meets another falcon, they fight to the bitter end when one wins 50 points and the other loses -100; and (3) if a pigeon meets another pigeon, both make threats for a long time until one of them gives in with a probability of 0.50, so that both win on average 15 points (= $[50 - 10] 0.50 + [-10] 0.50$).

a) Let us suppose, first, that there is no way of knowing in advance if an individual is a falcon or a pigeon until the fight begins. Start with a population of pigeons. What result is obtained? Imagine that a mutant falcon appears. What would the result be? Suppose that, with their better results, the mutant falcons proliferate and the population is now made up of falcons, what result would they obtain and what result would a mutant pigeon obtain? What would the composition of an equilibrium population be? Why would it be an equilibrium population? Show graphically the results of the falcons and pigeons in terms of the proportion of pigeons.

b) Let us now suppose that it is possible to distinguish whether an individual is a falcon or pigeon before the fight starts, that both types of animals can choose before fighting whether to undertake or not the detection, and that the costs of detection amount to 5 units.

67. Lie detectors

Personal lie detectors have been sold in the market for a while. One of them ("Truster 2.4") boasts that it "provides a real-time analysis of vocal segments from phone or face-to-face conversations

¹³ Based on Dawkins (1986, pp. 104-109) following a model by Maynard Smith.

right on your computer screen. Now you can know what's really going on behind the words: "The check is in the mail" (False Statement); "We loved the script" (Inaccuracy); "You need a new muffler" (Subject Is Not Sure); or "I love you Daddy" (Truth). Up until now this type of information was the privilege of law enforcement agents conducting lie detector tests" (<http://www.truster.bizhosting.com/>, accessed January 5, 2002). If effective, what will be the effect of these devices in terms of theories that model a social equilibrium of cooperative and uncooperative human types?

Visit <http://www.truster.bizhosting.com/> if you want know more about the product, <http://www.liebusters.com/>, for other products, and http://www.geocities.com/the_alda/ for more extensive coverage. Why are these devices valuable? The manufacturer of "Truster" advises that users should "not attempt to reach decisions based solely on the system's results" (for a critique of polygraphs, see <http://www.polygraph.com/> and <http://antipolygraph.org/pubs.shtml>). What would happen if it were able to provide perfect detection?

68. Online Contracts

Visit sites such as <http://www.quickforms.net/>, <http://www.legaldocs.com/>, <http://www.digicontracts.com/index.html>, <http://www.contratosonline.com/> and <http://w3.el-mundo.es/contratosonline/> and comment on these initiatives (function, competition, safeguards, etc).

69. Contracting pirates

The organization of the buoyant piracy industry in the Caribbean seas during the XVII Century followed a curious pattern, as explained by Exquemelin (1678). Before each expedition a written contract was negotiated and formally signed by all participants. The contract stipulated how the gross loot or booty would be shared among the ship and the crew members, after paying common expenditures which included the indemnification due to seamen crippled in combat. For the most part, these organizations were democratically organized, with the captain and the other posts being elected and subject to a tough scrutiny of performance, and enjoying no privileges in terms of amenities and food. The captain's authority was absolute only during attacks. The norm ruling pirates' behavior prohibited seamen from individually appropriating or hiding any kind of booty which each pirate could find in the attacked ships. If caught, he would be harshly penalized and lose his part. How can you explain: (1) Why did they incur the expenditures of writing contracts if, being outlaws, they had not recourse to legal remedies? (2) The norm forbidding individual appropriation of booty?

70. Goliath wants discounts¹⁴

Analyze the following press clip: "After acquiring Simago [a supermarket chain], Continente [a large retailer who operates hiper and supermarkets and who was lately merged with Carrefour, another French retailer] informed its suppliers that they should support the deal giving up between one and two percent of their combined 1998 turnover with the merged firm.... Continente considered that after the acquisition of Simago, its buying power had increased and for that reason it could obtain better prices from the suppliers. Continente informed its suppliers that they should pay the difference in prices by offering new discounts with retroactive character. The new set-up

¹⁴ "Superdiplo y Continente encuentran nuevas fórmulas para pedir dinero a sus proveedores" (*Expansión*, June, 1, 1998, p.8)

was then applied with respect to all transactions performed since January that year. For example, imagine a producer who was selling one kg of rice to Continente for 0.60€. After the re-negotiation he starts selling it for 0.58 and he should pay 0.02 for every kg of rice he have sold since the beginning of the year.” Formulate and evaluate different rationales for such a change in the distributor-supplier relationship. In the case that there are proposals to declare this type of re-negotiations illegal, what practical issues can arise to impede outlawing them?

71. Compulsory gifts

In the relations between manufacturers and large distributors, it has been seen that when certain situations arise the terms of annual contracts are sometimes reviewed. The most striking case is what are often nicknamed “wedding presents”, namely, the discounts granted by suppliers at the request of distributors after these distributors merge with or purchase another company. Similar discounts are often linked with the organization of promotional events by distributors such as opening of new centers or anniversaries. In the case of mergers, such discounts may comprise two elements—lump sums that are determined in terms of the supplier’s sales to the distributor (somewhere between 1 and 2 per cent of annual sales), and a price reduction on all purchases in the year of the merger whatever the actual date of the merger. Give and discuss two explanations for such reviews and discounts based, first, on the argument that they generate efficient incentives and, second, on the argument that they exploit a dominant bargaining position.

72. Late delivery

An employee of Firm A sends a crucial contract bid by ordinary mail. The mail delivers the document late and, as a consequence, the firm loses the contract. Should the mail compensate the firm for the loss of the contract?

73. Exclusive territories

Many manufacturers assign exclusive territories to their distributors. Give an explanation for this practice based on an efficiency argument.

74. Paying for claiming payment

Analyze the policy of “Superdiplo”, a Spanish supermarket chain, who in 1998 sent to its suppliers a letter stating that when they claim to have suffered unjustified payments delays or errors and these turn out to be inadmissible, as judged by Superdiplo, Superdiplo will charge them three per cent of the amount of the payment claimed, as well as a minimum of 60€ to cover administrative costs¹⁵.

75. Managers

Describe under which set of conditions factory managers may be inclined to incur in the “ratchet” effect (i.e., moving standards of the incentive system upwards after workers have achieved performance above the previous standards) even if doing that is not in the best interest of the firm.

¹⁵ “Superdiplo y Continente encuentran nuevas fórmulas para pedir dinero a sus proveedores” (*Expansión*, June, 1, 1998, p.8)

76. Decentralization and payments to suppliers

Big supermarket chains pay their store and division managers a salary that has a considerable variable element depending strongly on the final result. These managers are frequently allowed to organize their purchases and payments in a more-or-less decentralized way. How can this arrangement affect the degree of compliance of the contracts with suppliers?

77. Reputational bankruptcy

After a firm initiates bankruptcy proceedings, it is usually more difficult for it to collect debts from its clients, even if their solvency is unaffected. Why?

78. Calabresi, Melamed and White Label

Hollywood actor Benicio del Toro, in an advertisement for White Label scotch whisky: "I prefer to ask for excuses than for permission" (*La Vanguardia (Magazine)*, February 24, 2002, contraportada). Which framework is more directly applicable, Coase (1960) or Calabresi and Melamed (1972)? Choose one and analyze the sentence.

4. Vertical Integration. Specific Assets and Expropriable Quasi-Rents

79. The value of former staff

For a long time, the value of their network of former alumni and employees has been well understood by top universities and auditing and consulting firms. An increasing number of firms are developing conscious policies to keep their network of former employees in good shape.

There is at least an firm (SelectMinds) specializing in managing these networks, designing different communication strategies for different groups of former employees (“SelectMinds was built on one principle—great relationships are the power behind great business. We specialize in building alumni solutions that help global corporations maintain lifetime relationships with their former employees. Let SelectMinds show you how our corporate alumni solution can help you improve your existing marketing and HR efforts. We will design and implement a custom corporate alumni solution optimized to your needs. Our industry expertise and strategic focus will give you a hassle-free, best-of-breed solution. It’s a strategic decision that will quickly pay for itself.”).

(a) How do you explain the increased interest in former employees?

(b) Visit <http://selectminds.com> and find out more about how it works.

80. Duffy-Mott¹⁶

Almost every year at harvest time in upstate New York there are serious conflicts between Duffy-Mott processing plant and the Apple Growers Association. The Association charges Duffy-Mott with exploitation and devious behavior in setting exceedingly low prices at which it will buy apples from local growers. Duffy-Mott contends the farmers are unrealistic and ill-informed about conditions in the apple market that influence the price it can pay for purchase of apples. Duffy-Mott complains that individual growers sometimes sell many of their apples in the fresh produce market and not to them as promised while arguing that low yields or other factors prohibited the fulfillment of short term supply agreements. Furthermore, the Apple Growers Association has begun to organize its members to withhold apples to increase their bargaining power.

Duffy-Mott is the sole surviving apple processor in an area that previously supported several processing plants. The Duffy-Mott plant is highly specialized and therefore has little value in other uses.

In recent years growers have attempted to develop alternative outlets for their apples, including the fresh apple market and markets in Canada and neighboring states such as Pennsylvania. Transportation and other costs of reaching these markets are so high that these alternatives have not substantially resolved the growers’ problems.

1. What general organizational problem is illustrated by this conflict?

¹⁶ This case was prepared by Professors George P. Baker, Michael C. Jensen and Karen H. Wruck. Source: Michael C. Jensen and Karen H. Wruck, “Coordination, Control, and the Management of Organizations: Course Content and Materials,” Harvard Business School Manuscript, April 20, 1998, available in electronic form from Social Science Research Network Electronic Library at: <http://papers.ssrn.com/sol3/paper.taf?ABSTRACT-ID=77969>.

2. Suggest an alternative organizational structure that will reduce the conflict and make everyone better off. Explain why.

81. Pipelines in Texas

In Texas there are independent firms, whose only property is a pipeline that transports other firms' oil. Suggest an explanation of the absence of vertical integration.

82. Office to rent

Explain why, in general, firms rent their offices but own the productive facilities.

83. Decreasing rotation

In a study about the substitutability of the auditing firms, Levinthal and Fichman (1988) found that the probability of substitution increased during the first three years and then was constantly falling. How would you explain this fact?

84. Subcontracting rush

Nowadays many companies subcontract activities, which they were producing internally as, for example, highway transportation, restaurant and coffee bar services. Suggest and comment on several reasons why these activities are good candidates for being subcontracted.

85. Neighbors' cooperation¹⁷

When several apartments or offices belong to the same building there are many contractual formulas to arrange for service provision. Common use or production is often useful, because of economies of scale (heating), or because of the public-good-character of some services (lift, porter). Consider two solutions: (a) organizing a neighbor cooperative; (b) individual contracting with a specialized firm (often this is the constructor or the lender of the building). Is the second solution more or less probable when the neighbors are owners? Why?

86. Far West Railroads

Sometimes transportation is cited as example of positive externalities. It is mentioned, for example, that the construction of the railroad in the Far West lacked incentives because there was not people living there. At the same time, however, no people were living there because the lack of transportation made living difficult and farming unproductive. The Government solved the problem by granting the railroads rights to half the land along the railroad, land that the railroad could then sell to settlers. The railroads even sent hundreds of agents to Europe to recruit settlers.

In principle, it is unclear why this integration of land and railroad was necessary. Why was not possible for the railroads just to recover their investment by charging landowners for their transportation services?

¹⁷ Based on Klein *et al.* (1978, p.325).

87. The Langreo Railway

The Langreo Railway runs from the mining area of the valley of Langreo to the seaside harbor of Gijón, both located in what was the remote Northern Spanish region of Asturias. Construction began in 1847,¹⁸ with private money and a state guaranty of a minimum return of 6 per 100. The main promoter of the railway was the Duke of Riánsares, husband of the queen mother and at the time the owner of important mines and mining rights in the area of Langreo. The Duke was subsequently to lose control of the railway, after falling from political power.

At that time, import tariffs on coal were as high as 65.21 *reales* per ton, but were reduced by half in 1862, although they still accounted for 85 per 100 of the cost on board of British coal. However, in 1869, they were further reduced to 5 *reales* per ton (Nadal, 1975, pp. 135-6), approximately 10 per cent of the cost in Great Britain.

The railway began working in 1853 and was finally completed in 1856. When construction was almost complete, one firm was extracting three out of four tons of all the coal produced in the area served by the railway. Later, the company “Houillère et Métallurgique des Asturies”, created in 1865 and owner of the steel works “Fábrica de Mieres”, was said to have funds “for acquiring ... a block of shares of the Langreo railway and the coal mines of Sama” (pp. 171-2). The railway was extended in 1885 to reach Laviana, another mining town. This extension was undertaken as a joint venture with mining firms (Ojeda, 1985, p. 124).

From 1842 to 1856, transport costs from Sama to Gijón went down from 2.50 to 0.745 *reales* per *quintal* (a traditional unit of weight) but over the same period the price of coal at pit head increased from 1.50 to 2 *reales* per *quintal*. This increase coincided with a decline in the price of coal in Gijón as from 1849, from 4 to 3.30 *reales* per *quintal*. During its first year in 1853 the railway charged a standard price for all commodities, whether coal or iron ore. However, from 1855 iron ore and coke paid higher prices than coal, and from 1869 different prices were paid for screened coal as opposed to non-screened (*menudos*). The railway then charged a third more for iron ore, even though for the same weight this occupied a third less space than coal. The railway conceded a premium of Pta 3 per tm.—14.4 per 100 of the total transport fee for screened coal—to coal destined to foreign countries or locations to the south of Lisbon. There were also limitations on extraction and loading. (The capacity of Gijón harbor was insufficient at that time). The railway adapted its prices to the economic cycle. And the tariff reduction of 1869 (from 8.125 to 1.25 and later on to Pta 2.50 per tm) was accompanied by a reduction in the transport fee from Pta 5.89 to 5.21 per tm (11.59 per 100) and the concession of substantial volume discounts of up to 25 per 100 in 1869 and 35 per 100 in 1871 for coal transported in excess of 600,000 and 1,000,000 *reales*, respectively. Greater utilization of the railway did not seem to occur, however.

As soon as the railway was built, it faced strong opposition from its customers over its prices. A political battle was fought and, finally, the Government decreed a substantial reduction in the tariff in 1879.

Analyze the economic logic behind the main decisions in this case: (a) the construction of the railway, (b) the price reduction by the government, considering both short and long term effects; and (c) the prior price movements.

¹⁸ Most of the data for this case provides from Ojeda (1985). It has been further analyzed in Arruñada (1993, pp. 693-697).

88. Privatizing British Rail

Between 1996 and 1997, the British railways were privatized according to an original formula.¹⁹ The rails and stations were sold to a single company and 25 temporary concessions were auctioned to operate trains on various lines, mostly as monopolies. These concessions were of limited duration, usually seven years, but were renewable. This was expected to act as motivation as the concession would be lifted if the regulators did not approve of the prices and services provided.

Variations on this type of formula have often been used for public services such as waste collection. But an essential difference was forgotten when applying the system to the railways—the fact that the assets have a very different degree of specificity in the two cases. Railway assets are more specific than those used in waste collection. To transfer a waste collection truck from one city to another or to sell it on the second-hand market involves a low cost, but railway engines and carriages are usually designed specifically for the lines on which they are expected to work. This means they have little value for other lines and there is a limit to the number of possible purchasers. All of this reduces the incentives to invest in renovation and the purchase of new equipment. As a result, the operators have recently been pressuring the government to extend their concessions as a condition for further investment. The government is bound by the terms of the concessions and cannot risk permanent deterioration of the service while the current concessions are in force.

Solutions to the problem were difficult to find. There were three main possibilities: a) the government or one company with a very long-term concession should own the trains and the holders of the concessions should merely operate the services; b) the current operators should continue serving their routes after the end of the concessions even if a different operator were to win the concession, in which case both would operate as competitors; c) competition should be introduced from the moment of the concession, with the concessions being granted not to a single operator but to several on each line. It was thought the third solution would introduce competition in the provision of the services (and this in turn would encourage investment) while facilitating the extension of the market for second-hand assets.

Discuss the problems arising with these three possibilities.

89. Analyzing Grossman and Hart (1986)

Comment on the paper by Grossman and Hart (1986). (Limit your answer to no more than 2 pages of doubled spaced text). Some of the questions you might be interested on discussing are the following:

- 1) How are investment decisions introduced in the model? In particular, what is assumed about the verifiability of investments under different ownership possibilities?
- 2) Do their conclusions change when eliminating the assumption that auditing is equally effective under internal and market organization? Is this assumption realistic? See Williamson (1985, pp. 136, n. 4; 154-6). For which kinds of investments?
- 3) What are the authors assuming about the transfers which take place between both parties after *ex post* renegotiation? (Read carefully Section 3, case 2, that on “status quo utility”).
- 4) How do they conceive the initial investment decision? You might try to develop formally the coal case mentioned in page 699, assuming two mining areas of different coal quality and two boiling technologies. Are their predictions correct?

¹⁹ Data for this case comes from “After Privatizing, Extended Franchise?” (*The Economist*, 17 January 1998, pp. 75-76).

- 5) How is contractual enforcement modeled in the article?
- 6) How is the *ex post* bargaining process modeled in the article? What would be the value of “authority” (the right to choose **d**) under costly bargaining and enforcement? What other mechanisms would have to be used under costly bargaining and enforcement?
- 7) Analyze how is it that in the Grossman and Hart’ 1986 world parties can *ex ante* allocate rights over decisions (**qi**) which are not *ex ante* contractible.
- 8) To what extent is the empirical analysis in Section 4 of the paper related to the analysis in Sections 2 and 3? Would it be sufficient a more simple model to get the empirical predictions of page 714 (second paragraph). #How would that ownership structure would be explained by Barzel?
- 9) (a) What are the differences in the contracts which Tirole calls “complete” and “incomplete”? Pay attention not to the verbal description of the contracts, but to the models: for instance, compare (1) the contract on the 2nd column of p. 26 (1.2.1.1. in the slides) with (2) the one in the example developing the Grossman & Hart’ 1986 article on pp. 31-33. (b) In the example on pp. 31-33 of Tirole, you may consider an alternative contract, similar to the one on p. 26 (right column). This contract would simply stipulate a sequential authority mechanism: (1) The buyer would *ex post* choose a “price” or compensation to be paid to the seller for incurring the additional cost **c** which is associated to the relevant improvement. (2) The seller would then freely decide whether to improve or not. How would this contract work or would not work?

90. Comparing Klein *et al.* (1978) to formal models

Taking the example of the printing press and the publisher in Klein, Crawford & Alchian (1978, pp. 298-302—focus mainly on the *ex post* problem on p. 298), try to reformulate the problem on the terms of Tirole’s Chapter on the Theory of the Firm (1988, pp. 21-34). You are advised to pay careful attention to the explicit and implicit assumptions in both texts. In particular, you should begin by trying to think which of the Tirole’s models is closer to KCA and, moreover, which aspects of such a model substantially depart from the main problem that worries KCA. Notes: (1) Use two double-spaced pages as a maximum. (2) Please, go straight to the main issues.

		Complete contracts	Incomplete contracts	KCA
Contractual Variables	Specific investment, I	observable, but not verifiable; therefore, non contractible		Costly to observe and verify. Hence, costly to contract
	Value, v , for the buyer	Different assumptions about observability and verifiability provide different models with conflicting results		
	Cost, c , for the seller			
<i>Ex ante</i> transaction costs	Contractual completion	zero	costly	costly
<i>Ex post</i> transaction costs	Contractual enforcement	costless	costless	costly
	Contractual bargaining	costless & well defined <i>ex ante</i>	costless & well defined <i>ex ante</i>	costly & undefined

91. Fostering

Foster families offer an alternative to adoption but they aim for the children to eventually return to their natural parents. In 1998, advertisements appeared in the daily press that reproduced a handwritten sheet that had supposedly been written by a sad-looking, unkempt girl whose photo was also published. The text was as follows, “I want a man with a moustache and a lady with glasses, the sort of family that gives bread with chocolate for afternoon tea. Who will put plasters

and antiseptic on my knee if I fall over. Who will help me do my homework and teach me to ride a bike. I want a family who will tell me stories and cover me when I go to bed. Only for a while. While my parents sort out their problems. Maria.”²⁰. At the foot of the advertisement were the names of the Red Cross as sponsor, and the Spanish Ministry of Labor and Social Affairs and the Generalitat of Catalonia as being responsible for funding.

Compare the adoption and fostering systems. Develop a hypothesis for analysis taking the economic theory of contracts as the basis and explain what steps you would take to compare it. Does this theory justify the fact that traditionally it was very difficult to gain access to information on the natural parents of children who had been adopted? Why has this policy been gradually changed?

92. Federal Express²¹

In order to be *certified*, that is, given the right to represent workers within a certain firm, labor unions in the US should win the majority of votes in a referendum. The referendum is held if at least 30 per cent of the workers ask for it. In the 70’s and the 80’s the number of these elections raised considerably. (Levine, 1989; Fulmer, 1978). Federal Express (FedEx) faced this phenomenon in 1989. In 1973 a veteran of the Vietnam War founded FedEx, a parcel transportation company. At that time he was 30. In 1989 the company had 70.000 employees and among them, 2.000 pilots, including 961 pilots belonging to Tiger, a company that had been recently acquired by FedEx. Tiger was founded by veterans, too, but they were veterans of the WWII. When it was acquired it had 6.500 employees and was in the business of international cargo transportation.

The acquisition affected negatively the enthusiastic labor relations in FedEx. Before the acquisition, its employees had been working with flexible rules and timetables depending on the workload and in a situation of constant need for labor force. On the contrary, truck drivers of the biggest competitor—UPS—limited themselves only to carrying packages from the truck to the doorstep; their union rules prohibited participation in truck loading, for example. The pilots shared real “battle ethics”, that had one goal: punctuality, and one enemy: the competition. Their labor relations included a sophisticated system for conflict settlement; duty assignment according to seniority; free flights in cargo planes; incentive schemes and continuous chat line through a company-owned television channel.

In FedEx, hierarchy determined job position, timetable and salary. In 1986 the founder of the company promised his pilots that the employees who would enter the company as a result of future mergers would start from the base level of the hierarchy ladder. However, when he bought Tiger he accepted to mix the seniority lists of both companies. He was forced to do that, because the opposite was legally questionable.

Before the acquisition, the labor relations in Tiger had been very tense. Unions had always represented the employees. As the US legislation stated, the representative function of the unions was revoked automatically after the fusion with a non-unionized company. A referendum of *certification* was scheduled. 1.062 FedEx pilots and all 960 Tiger pilots participated in the elections. On 26 of October 1989, only 709 out of 2.022 pilots voted for being represented by the Union.

Do you think the merger was a wise decision?

²⁰ For example, *La Vanguardia* (24 May, 1998, p. 88).

²¹ The story is based on Waldman (1989a and 1989b).

FedEx was younger than Tiger. How can this fact influence the mixture of the two hierarchy ladders?

Assess the “implicit” contact between FedEx and its pilots. What would its implications be if it were not legally regulated? In addition to the ones mention in the text, can you think of another factor that makes the fusion of the hierarchy ladders advisable?

Evaluate the referendum results.

During the election campaign FedEx insisted that it was much easier to introduce a union in a company than take it out. What do you think about this argument?

5. Contrating labor

5a. Team Production and Hierarchies. Decentralization. Divisionalization. Franchising. Organizational Rent-Seeking

93. Tips (II)

In some bars and cafeterias, waiters divide in equal parts the total amount of tips to share them, while in other bars and cafeterias each employee keeps the tips received individually. Indicate what is the role of the tips in the hostelry business and establish hypotheses to explain under which conditions it is more probable to find each of these two systems.

94. Size of MBA teams

One very successful business school has recently started a MBA program based on group work. Every team has 5 members. During the first year part of the assignments should be presented as group work and they are graded as such. Comment the advantages and disadvantages of increasing the group members from 5 to 6.

95. Professional firms

What are the characteristics of the professionals' partnerships that make so efficient the internal control over performance? What are the problems that a highly successful and expanding professional partnership faces?

96. Fishy Firms²²

A basic feature of traditional fishing firms (with up to 13 crew members) is that all resource owners (shipowner, skipper, engineer, cook, seamen) are compensated with a share of the net revenue after paying certain common costs (e.g., nets, food). The shipowner pays for the fuel and the ship's repairs. The most elaborate fishing firms are the medium-sized ships which fish in deep-sea grounds for periods of one to four months, with 11 to 13 crewmen. Participants in this traditional fishing firm include: the ship-owner, who may be an individual, a partnership or a company; the fishing skipper, who is responsible for the ship and handles navigation while fishing, this being the reason why the team's productivity crucially depends on his performance; the coast skipper, who substitutes the skipper as the second in command; the engineer, who looks after the engines, the freezer and the electric systems, sometimes helped by a greaser; the cook, whose task is, obviously, to prepare the food; and, finally, the common crewmen.

In these medium-sized boats, the fishermen's wage varies greatly with the value of the catch and some of the expenditures incurred for each specific voyage, which is called the "share or lay system". The distribution of rewards begins with gross revenue, the monetary value of the catches obtained in a fishing expedition, which is established in open auction in the formal wholesale fish markets. The market takes care of the auction and the payments and also certifies the proceeds from the sale. Sharing follows a refined process. Gross revenue is first reduced by the commission paid to the market (between 3.5 and 4.5%). Next to be paid are common expenditures, which are

²² Taken from Arruñada and González (1988).

collectively supported, such as food provisions, fishing tackle (nets, rods, lines, etc.), bait, salt, ice and commuting expenses. The shipowner finances these common expenditures, recovering them only after the catch is sold out. If the value of the catch is lower than the expenditures, the difference is accumulated and deducted from future catches. Once the common expenditures have been deducted, the resulting net revenue is divided in two parts, one for the ship-owner and the other for the crew. In traditional wooden boats, this division is made more or less on equal terms. The allotment received by the crew is allocated among crewmen according to their relative human capital. The amount is divided by the number of fishermen plus 1.5 (so that $q = 0.49 [CV-CE] / [n+1.5]$, where n is the total number of people in the boat). The value of each resulting portion, q , is called a “share”. Every crewman earns one share, except the fishing skipper, who gets two, and the coast skipper, who takes one and a half. From his participation in net revenue, the shipowner pays two additional shares, one to the fishing skipper and another one to the engineer, as well as one half or one quarter of a share to the cook, and another quarter to the greaser, if there is one. Moreover, he has to pay for all the fuel consumption and the ship’s insurance and repairs. The residual income, if any, compensates him for the cost of capital.

You can find it useful to study the classic Alchian and Demsetz (1972) paper before answering the questions.

Questions:

1. How do you explain the prevalence of the pattern of sharing in net revenue?
2. And what about the sharing of some costs but not all?
3. The bigger ships have distinctive features: they are more costly and have larger crews (30-50), longer sailing times (three to five months) and they fish in remote seas. Many of them not only catch the fish but also clean and freeze it. They are usually owned by large ship-owning firms, some of which have hundreds of ships. Building on your explanation for the previous questions, predict how workers in these large ships are compensated.

97. Eat what you kill, or else

Explain the likely consequences of the two incentive systems referred to in the following newspaper clip. Guess under which circumstances will each system be more efficient. Try using the data below to test some of your conclusions. Which system requires more control?

“Most top-tier New York [law] firms also share profits among partners based on how much business each brings in. This is known in the trade as ‘eat what you kill’, which gives some idea of the kind of aggressiveness it encourages. All five of London’s top firms, by contrast, share profits among partners according to seniority, a system appropriately known as ‘lockstep’, which they believe encourages teamwork and minimises internal squabbling. To persuade Rogers & Wells to merge, Clifford Chance had to agree to a ‘modified’ lockstep, letting the New York firm’s biggest rainmakers keep their higher earnings until 2002, when lockstep is supposed to be reimposed”.²³

²³ Source: *The Economist*, “Lawyers Go Global: The Battle of the Atlantic”, February 26, 2000, p. 90.

1 The biggest and the best

Firm	City	Profits per partner, \$m	Revenue \$m	Number of partners	Number of lawyers
Wachtell, Lipton, Rosen & Katz	New York	3.11	269	65	143
Cravath, Swaine & Moore	New York	2.05	334	77	334
Sullivan & Cromwell	New York	1.65	427	119	454
Cahill Gordon & Reindel	New York	1.60	–	55	204
Davis Polk & Wardwell	New York	1.53	435	124	464
Simpson Thacher & Bartlett	New York	1.50	386	123	490
Skadden, Arps	New York	1.38	890	285	1,187
Debevoise & Plimpton	New York	1.20	255	90	379
Slaughter and May	London	1.16	268	102	590
Milbank, Tweed, Hadley & McCloy	New York	1.11	243	81	372
Cleary, Gottlieb	New York	1.08	366	136	492
Shearman & Sterling	New York	1.05	426	140	683
Willkie Farr & Gallagher	New York	0.96	237	108	376
Freshfields	London	0.93*	463*	275†	1,448†
Allen & Overy	London	0.93	413	175	1,136
Weil, Gotshal & Manges	New York	0.89	400	160	640
Clifford Chance	London	0.84‡	1,000‡	570†	3,100†
Linklaters	London	0.81	479	207	1,210
White & Case	New York	0.67	352	172	742
Baker & McKenzie	Chicago	0.56	785	535	2,330

*Pre-merger †Post-merger estimates ‡Based on 1998-99 results for Clifford Chance and 1998 results for Rogers & Wells and Pünder
Sources: American Lawyer; Legal Business; International Centre for Commercial Law; The Economist

2 Who's global

Firm	Lawyers outside home country, %	Number of countries
Baker & McKenzie	79.6	35
White & Case	46.8	24
Clifford Chance*	62.0	20
Linklaters	na	17
Allen & Overy	34.5	17
Freshfields*	51.1	15
Skadden, Arps	7.6	11
Shearman & Sterling	25.0	9
Cleary, Gottlieb	32.9	8
Sullivan & Cromwell	12.6	7
Weil, Gotshal & Manges	18.6	6
Slaughter and May	13.2	6
Davis Polk & Wardwell	12.7	6

Sources: American Lawyer; Legal Business; The Economist

*Post-merger

98. No tips

In many hotels and restaurants employees receive a substantial part of their remuneration in the form of tips. Why do people tend to tip in certain situations but not in others? Why do some fast food chains like McDonald's and restaurants situated in department stores forbid their customers paying tips? Where do you think waiters receive more tips—in highway restaurants or in local pubs, visited by frequent clients?

99. **Retailers' unequal rents**

Pashigian and Gould (1996) found that in large shopping centers rents paid by retailers were very different. Department stores paid an average of 11 times lower than shoe stores and 20 times smaller than jewelries. (1) How can you explain these unequal rents? If the urban geography of a country impedes the development of new shopping center, (2) how will this situation impact on the number of department stores? (3) Why?

5b. Incentives and Compensation Policies. The Economics and Management of Incentives within Organizations. The Tradeoff between Incentives and Risk Allocation. Internal Labor Markets

100. Baker, Jansen and Wruck²⁴

In 1985, Baker, Jensen and Wruck formed a consulting firm to conduct studies of corporate organizational problem and counsel clients on their solutions. The firm was organized as a partnership. Baker, the more studious of the three, took primary responsibility for analyzing clients' problems and developing organizational proposals for solving them. He had little interaction with clients and the outside world generally. Jensen, an orderly and systematic person, had strong managerial skills. He liked organizing and planning the activities of the firm. He concerned himself with methods of controlling the quality of work and costs. Wruck was an entrepreneurial type, outgoing, and active in various community organizations. She spent much time with clients, helping to identify their organizational problems and convincing them that though the organizational solutions proposed by her firm might seem controversial, they could be effectively implemented and would solve their problems. As a result, she was viewed by the outside world and many clients as the firm's leader.

Originally, the three partners agreed to share the profits equally. Profits, rather than salaries, were the primary form of compensation for partners. The agreement to share equally was based on the partners' belief that the labor contribution each brought to the firm had the same opportunity value, and that each took the same risks and made investment in getting the firm started. The firm turned out to be an instant success, and the demand for its services caused the partners over the first two years to hire nine young professionals (on salary) to help perform the work.

After 2 years of intense effort on the part of all three partners, each had invested heavily in his or her specialization, and the result was substantial increases in productivity and profits.

Immediately after the 1987 profit distribution, Wruck informed Baker and Jensen that she was dissatisfied with the equal profit sharing arrangement. She felt the equal sharing was unfair; that her contribution to the firm was much more valuable than theirs; and that unless they agreed to a revised sharing arrangement which will give her one-half of the profits, she would leave the firm. She intended in that event to form a firm of her own, taking with her several of the major clients and four of the professional staff who serviced those clients. Baker and Jensen realized this was not an empty threat because Wruck had the loyalty of the clients and they reluctantly accepted a reduced share of the profits.

The partners spent much of their time training young professionals the firm hired. In the fourth year of the firm's existence, three of the most highly trained young professionals left and opened a competing firm.

a) What organizational problem is illustrated by Wruck's demand and the departure of the three professionals? What could Baker and Jensen have done in forming the partnership to avoid the reduction in their share of partnership profits? What could the three partners have done to avoid the loss associated with the departure of the three professionals and the clients they took with them?

²⁴ Taken from: see footnote #.

In 1990, Backer, Jensen, and Wruck opened a branch office in a midwest city. They admitted Rock Climber, the best of their professional employees, to partnership and made him head of the new office. He was given 15% share in total partnership profits as compensation. Costs and revenues from his office were pooled with costs and revenues of the home office for purposes of calculating profits. Climber soon developed a reputation for high living (plush offices and lavish expenses for client development) and less and less of his time was devoted to hours that were billable to clients.

b) The difficulties with Climber's office were predictable in advance. Explain why and explain what general class of organizational problems this represents.

c) Jensen suggested that firing Climber and replacing him with I.M. Serious, an employee he had trained personally, would solve the problem. Do you expect this to solve the problems with the midwest office? What changes do you recommend to help resolve the problem permanently? Explain why you expect your recommendation to work.

101. **Proof reading**

At fancy US corporate law firms, new lawyers, that is recent law school graduates, are called associates and are often paid in excess of \$80,000. They are employed, among other tasks, to do "proof reading". When a public offering is printed, first year associates are assigned the responsibility of going to the printer and staying up past midnight to proof-read documents as they come off the presses. The printed copies are checked for errors and compared with an original copy. Why does a law firm allocate its high priced labor in this way? Why doesn't the law firm use secretaries or paralegals to do this job? Discuss the conditions, which make this system very effective.

102. **Mr. Hustle**²⁵

The Acme Company uses the following budget process for its Public Relations Department.

Before the fiscal year starts, the PRD proposes a budget and detail the quantity of services it will provide if the budget is approved. Usually after the initial request some bargaining takes place between the representatives of the budget office and the head of the PRD, after which a final budget and set of services are agreed upon. The head of the PRD, Mr. Hustle, is known as an "empire-builder". He knows that his status, salary and future promotions are all positively related to the size of his department. His philosophy can be described as "bigger is better". He also knows that he must produce the quantity of services he promises, and so plans accordingly.

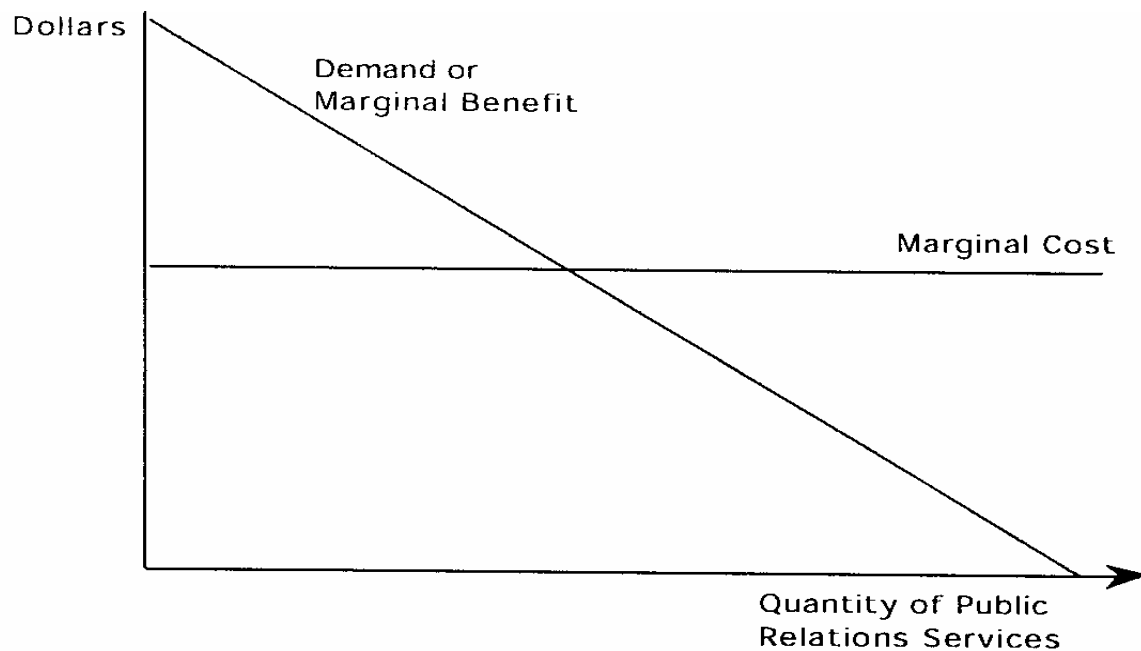
While it is extremely difficult for the Budget Office to obtain detailed knowledge of costs incurred by the PRD for various output decisions they are able to estimate reasonably well the total value to the organization of the total output of the PRD.

Public relations services are not available anywhere in the firm, and Acme has a rule forbidding the purchase of such services outside the firm.

1. In the figure below, you will see the marginal cost curve for the PRD, and the demand curve (or marginal benefit curve) for the PRD by the Company. What quantity of PR services would be optimal for the firm to produce in this situation. Why?
2. What quantity do you expect Mr. Hustle to produce? Why?
3. What general strategy do you expect Mr. Hustle to follow if the budget office suggests that his budget should be reduced? Can you provide some examples?

²⁵ Taken from: see footnote #.

4. What quantity would a profit maximizing monopoly PRD produce if it sold the services on a per unit basis and was constrained to charge a single price?



103. Discounts in fashion stores

Many clothes stores offer substantial discounts for their employees in case the latter want to buy something from the store they are working in. Why? List other examples where the same hypothesis can be applied in order to explain the use of the above-described compensation practice.

104. Hotel extras

Many organizations pay the travel expenses and hotel bills of their guests. Most of them, however, do not pay for hotel extras (meals, telephone calls and complementary services). This may seem bizarre, given that guests frequently pay these extras with income subject to taxation. One could imagine a more satisfactory arrangement, under which guests would receive a smaller stipend, the host organization would pay the extras and both parties would be better off. Provide two moral hazard explanations—linked to two of the parties involved, hotels and guests—why this alternative is probably inefficient.

105. Copy center

In a copy center servicing several departments within a university a new incentive system was introduced. Under the new compensation scheme every employee receives, apart from her fixed salary, a variable compensation of \$0,25 for every copy above the standard of 2.000 copies. This standard was calculated using the historical average number of copies per day made by the employees. Analyze the new compensation system. Pay special attention to possible negative consequences resulting of its implementation.

106. Maids' qualification

A wealthy family has two maids. One has an exclusive contract and receives a fixed salary. The other works a certain number of hours every day. Normally it is the full-time maid who cooks but sometimes the other one has to prepare the meals. The family has noticed that the food prepared by

the latter is worse and has concluded that she didn't know how to cook. Suggest other explanatory hypotheses and describe tests to compare them.

107. Covadonga Hospital

Some years ago, the director of the Covadonga hospital decided to distribute funds to improve performance. The fund was for the whole hospital but was shared out among the three divisions—doctors (28 per cent), nurses, and administration and general services. The 28 per cent for doctors were divided among all of them, giving a standard bonus per doctor of 140,000 ptas. per year (this was the bonus amount before taxes) . Each department or unit was given a total amount equal to the standard payment multiplied by the number of doctors attached to it.

Evaluation of each department. The bonuses could have been reduced up to 35 per cent by the Medical Manager after evaluating each department performance comparing four quality and quantity criteria with each department objectives set in advance. In fact, these discounts were applied only to 15 per cent of the departments.

Evaluation of doctors and heads of department. The funds were paid out in the form of two half-yearly bonuses. Doctors were divided in three levels, *A*, *B* and *C* (*C* being the highest), and the compensation difference between each two levels was about 20 per cent. The heads of departments were graded according to 15 criteria and they in turn classified the other doctors. Most of the heads of departments put all their doctors at level *C* and the supervisors—at level *B*. In order to evaluate the doctors, the *ABC* scale was used giving them 1, 1.2 or 1.4 points, depending on whether their performance was considered normal, good or very good. This grade was multiplied by a factor for responsibility, giving them 1, 1.11 or 1.28 points depending on whether the doctor in question was an assistant, a head of section or a head of department, respectively.

Table. Calculation of annual individual bonuses

Category	[1] points	[2] Evaluation	[3] point	[4] [1]X[3]	[5] [4]x(98,800 ptas.)
Head of department	1.28	C	1.40	1.792	177,050
Head of section	1.11	A	1.00	1.110	109,668
Assistant	1.00	C	1.40	1.400	138,320
Assistant	1.00	C	1.40	1.400	138,320
Assistant	1.00	C	1.40	1.400	138,320
Assistant	1.00	C	1.40	1.400	138,320
Total				8.502	840,000

The Table shows by way of illustration how the bonuses were calculated for the six doctors in a department for whom there was no deduction. The total fund for the department (840,000 ptas., that is, 140,000 ptas. for 6 doctors) was divided by 8.502 (the result of multiplying the points in column [1] for each category by the individual evaluations in column [3] to give the basic bonus—in this case 98,800 ptas.) In column [5] the individual bonuses are calculated, multiplying the basic bonus by the total points obtained by each doctor. In other words, the 840,000 ptas. are shared out in proportion to the points obtained by each doctor. The sums of the individual bonuses and the total for each department were announced publicly to all the staff. When the system was applied, compensation for these professionals ranged between four and six million pesetas.

a) Analyze the system, paying special attention to factors such as the quantitative and qualitative importance of these bonuses and the possible reactions of middle-level staff.

b) Propose a plan of action to improve the system.

108. Judicial salaries

Analyze in depth the simultaneous existence of the different compensation formulas mentioned in the article extracted below. Analyze both the actually adopted schemes and the ones in discussion (salary increase for the members of the Supreme Court, salary increase for all judges, salary increase based on the speed of issuing sentences).

“The Ministry of Justice will support an increase in the judges’ salaries. Although it doesn’t agree with the figure proposed by the judges—an increase of 25 per cent—, today it will propose increases based on performance, which can come in force next year. The Ministry wants to propose an increase, the size is still to be defined, based on objectives. The final formula is not agreed yet, but the General Council of Justice has already come up with a compensation scheme proposal based on individual judge’s productivity. According to the proposal, the salary will be composed of a fixed salary plus a bonus, which will be paid as a function of the speed of sentence issuing...The salary level of Spanish judges, in contrast with the practice in some neighbor countries, has not been revised since 1989. The result is clear. The purchasing power of an average Spanish judge is obviously inferior than the purchasing power of judges in the leading EU countries [see the table below]...This fact together with the salary increase for the Supreme Court judges, approved by the government last year, are the main arguments in the judges’ claims for higher salaries. The salary increase, reaching almost 60%, separated definitively the Supreme Court judges from the rest of the judicial body, and guaranteed them an annual compensation close to 16 million Pta.” (Cuesta, 1999).

Comparison of judges’ salaries in Europe (euros)

	<i>Spain</i>	<i>Germany</i>	<i>UK</i>	<i>France</i>	<i>Italy</i>
[1] Average gross annual salary for judges	29,518	56,783	125,301	53,253	48,795
[2] Gross Domestic Product per capita (purchasing power of average citizen in 1998)	16,090	21,700	19,780	20,610	20,040
[3] Average salary of judges divided by GDP per capita ([1] / [2])	1,83	2,62	6,33	2,58	2,43

Source: Cuesta (1999).

109. Star wages

“The North American investment banks have changed their method of paying their ‘star’ operators in spite of the drop in revenue resulting from the crisis in the emerging markets. The Merrill Lynch investment bank informed its staff in a memorandum that is published today in The New York Post that it will no longer be paying its stock exchange brokers and financial analysts an annual bonus.

“From now on, a complex mechanism will be used linking the company’s earnings with those of each of its executives. Citigroup too has announced a change in its payment structure whereby the traditional annual bonus will be replaced by a system that retains worker earnings for a longer period and that is more in line with the total earnings of the company”.

Explain what might be the tradeoffs involved in this change in the old system and what consequences might the new payment system bring.

110. Star CEOs

Discuss (a) the causes, and (b) the consequences of these ‘stars’ and (c) the research commented on in the following press clip:

“Today many corporate executive officers have a star status. They appear on the cover of business magazines, engage in stunts and like to be known by their nicknames such as “chain saw Al”, “slasher Bill” or “neutron Bob”. These professional managers have become household names such as Disney’s Michael Eisner getting a pop-star welcome wherever he goes, Chrysler’s former president Lee Iacocca publishing his modestly titled “Iacocca” in 1985, or Virgin’s Richard Branson appearing naked in several magazines but for a strategically placed copy of his recent book. At the same time, research has found that 85% of financial analysts claim to buy shares because of the chief executive’s “reputation”. In addition, this research found that companies run by the 10 most-admired bosses recovered almost four times faster from the recent market correction than those run by the 10 least-admired ones” (*The Economist*, November 28th, 1998).

The research was done by Burson Marsteller, a public relations firm.

111. **How CEOs should be paid**

Using as a basis the standard principal-agent model, design and discuss an incentive system for the Chief Executive officer or CEO, i.e., the boss, of a firm such as General Motors. Please, make explicit your assumptions about the preferences of the shareholders and the CEO. You might want to provide a brief discussion of: (1) the features of the situation or problem; (2) the basic solution; (3) the problems with such a solution; and (4) some potential solutions to such problems. Note: If you need to review the principal-agent model, you may use as a source Tirole (1988, the first part of section 2.1 on pp. 35-38) or Macho and Pérez (1994, Ch. 3).

112. **Accidents and statistics**

Use of efficiency indicators is vital for the success of any incentive system. The following two questions are dealing with the misuse of such indicators.

Some car insurance companies charge a lower price when the insured is a woman. Why? Can we assume that women drive more carefully than men do? (Actually, the number of accidents provoked by women is higher, but the average damage value is lower.) How can we measure the carelessness of a driver? and the “quality” of a driver? How are you going to use in your answer the “all the rest equal” condition?

In 1987 and 1988, mass media were constantly using statistical figures indicating an increase in the number of victims of traffic accidents. Considering this increase, what can be inferred about the carelessness of the Spanish drivers? Has this problem anything to do with the economic growth in the country during the period? And with a number of unsuccessful negotiations in OPEC?

6. Organizational structure and divisionalization

113. Double margin

Firm *C* assembles and sells personal computers. The firm is organized in two separate profit centers: manufacturing and sales divisions. The firm faces a demand $P = 3000 - 10Q$. The marginal cost of components and assembling PCs is constant and equal to 500 €. The sales division has a constant marginal cost of 50€ per unit sold. (a) Which price and quantity would maximize *C*'s profits? (b) If the manufacturing division has the authority to fix the transfer price to the sales division, which transfer price will it set, assuming it has all the information? (c) Calculate the profits of both divisions in this second case. (d) How would you manage the issue as a General Manager in charge of both divisions? Discuss the different possibilities.

114. Triple margin

It is often argued that having several layers of distributors may cause serious damage. The following model can prove this argument. Let us assume that final demand for a given product is $p = 10 - q$. The product is produced by a manufacturer incurring in a marginal costs of 2. The manufacturer then sells to an intermediary at price I , who, in turn, sells to a distributor at price D .

Assuming that both the distributor and the intermediary have no other costs apart from the transfer prices and that the three parties behave as monopolies with respect to their markets, which problems do this arrangement cause in comparison with the possibility of buying directly from a manufacturer who vertically integrated distribution?

7. Contracting Capital Resources. Debt. Open Corporations. Takeovers. Closed Corporations. Coops. Non-Profits. Mutual firms

115. Contractual slavery and specialization

The ancient practice of borrowing on personal security—meaning that in case of default the debtor or a family member had to “enter the house” of the creditor and serve him for some time or for life²⁶—finds a modern equivalent in charges levied on the future wages of the debtor. Why people ceased using voluntary personal securities to safeguard credit?

Leaving aside ethical considerations for a moment, purely productive reasons probably made ancient practice unsuitable for today’s economy. Indented labor had enforcement advantages over charges levied on wages but probably missed specialization opportunities. Think that the contractual costs of default-driven servitude increases with the level of specialization, which is now immensely higher. In ancient times, the relative absence of specialization meant that it was more efficient to have defaulting debtors or their relatives entering the house of the creditor. This was kinder and made redemption viable. Interestingly, the creditor was not usually allowed to sell them even when they became slaves. In Greece and Rome, contractually-driven bondage and slavery were two very different institutions: only the second ended up with a sale, usually abroad (Finley, 1965). In addition to likely harsher treatment, sale abroad meant no possibility of redemption.

116. Corporate reorganization

Corporate reorganization (“Chapter 11” in the USA; *suspensión de pagos* in Spain) is a procedure of voluntary bankruptcy in which management is allowed to continue operating the company. The corporation must prepare a reorganization plan that proposes convert some debt into equity. Debtors can object. The court, however, can impose a plan that estimates the value of the company and allocates it among the different classes of creditors and even shareholders. Why, if the firm has a positive value, the creditors will not consent? Why the law allows the court to impose a plan on dissenting debtors?

117. Maintenance in leasing

When customers of the car rental company National-ATESA enter their rented cars the first thing they see is a banner hanging from the rearview mirror that reads “Treat your rented vehicle as if it were your own and win fantastic prizes”. Visit <http://www.atesa.com> and find out more about how the scheme works.

²⁶ See, for instance, Silver (1995, pp. 117-122). This interpretation seems now more widely accepted than previous ones (e.g., Finley, 1965) that consider that many of these contracts were simple sale of labor.

118. Andersen

An illustration of the incentives of creditors to keep firms alive:²⁷

Plaintiffs' attorneys suing Andersen over the Enron matter don't want to kill the firm because it could leave them unable to collect damages for their clients.....

Before bringing an indictment against the firm, the Justice Department has to consider whether it wants to impose what would be seen as a "death penalty" on Andersen, according to people say the Justice Department has guidelines regarding indicting a company that federal prosecutors have to consider, including whether the indictment would make it more difficult to get restitution for the victims in case. Under the guidelines, the department also is required to look at how many of the top senior managers of the firm acted with criminal intent, or for Andersen, how many of the top partners knew of the document destruction in Houston, people familiar with the guidelines say.....

Three prominent audit clients have already decided to bolt from the firm. Andersen executives have logged extensive airline miles trying to keep audit clients on board, with Andersen Chief Executive Officer Joseph Bernardino himself addressing the board of Delta Air Lines. But Delta joined pharmaceutical powerhouse Merck & Co. and mortgage giant Freddie Mac in severing outside-audit pacts with Andersen.....

Besides the plaintiffs' lawyers, government regulators and law-enforcement officials who want to punish the firm for its work with Enron, another group with a big stake in its future is the Andersen partners themselves. These partners must approve major changes to the firm's structure. And in the past, getting partner approval has been difficult.

119. Andersen Partners' Accounts

Explain the advantages and disadvantages of these arrangements: (1) partners are required to keep significant sums invested in the firm until they retire; (2) after retirement, they typically withdraw these sums over 10 years; and (3) rules that prevent all the retired partners from grabbing all their capital at once.

"Arthur Andersen's partners also have significant sums socked away in accounts that they are required to keep invested in the firm until they retire. Partners must keep a portion of their salaries, which can top \$1 million a year for the highest executives, in these accounts. After retirement, they typically withdraw it over 10 years Partners can change their annual withdrawal schedules once a year, around the end of the company's fiscal year in August and there are rules to prevent all the retired partners from trying to grab all their capital at once".²⁸

²⁷ KRANHOLD, K., J. R. WILKE, and J. WEIL, "Andersen Seeks a Deal to Avoid Indictment: Criminal Charges Could Be a Fatal Blow to Firm," *The Wall Street Journal Europe*, March 11, 2002, pp. A1, A6.

²⁸ KRANHOLD, K., J. R. WILKE, and J. WEIL, "Andersen Seeks a Deal to Avoid Indictment: Criminal Charges Could Be a Fatal Blow to Firm," *The Wall Street Journal Europe*, March 11, 2002, p. A6.

8. Quality Assurance and Credible Commitments. The Managerial Problem of Quality. Guarantees

120. A register of lemons

After visiting the site <http://www.autocheck.com>, comment on the initiative (function, competitors, safeguards, etc) examining how the Internet helps to solve the lemons' problem.

121. Advertising Tricks

TV viewers of the 2000 Super Bowl were shocked by a commercial showing former actor Christopher Reeve, of Superman fame, vacillatingly walking toward a stage to pick up a prize given to a research foundation that supposedly had discovered a cure for his incapacitating spinal cord injuries. The scene had been produced by computer animation as part of a fund raising campaign. Arguments developed shortly afterwards. Some people were lead to think that Reeves had been really cured. However, people got informed about these injuries. At the same time, Benetton was launching a campaign showing tranquil-looking faces of people sentenced to death penalty, with a big legend "Sentenced to death", plus their names and jurisdiction in smaller print²⁹. Please, evaluate these campaigns focusing on their effect on the cost of information.

122. Life-time guarantees³⁰

Many firms which sell their products with a "life-time guarantee." Sometimes, it is unclear if this guarantee refers to the live time of the product, of the producer or of the client. Apart from this, the life-time guarantee is a fundamental part of the market strategy of some big firms as, for example, L.L. Bean, which is a catalog seller of sport outfit and shoes for long use. In some cases, it is believed that the company would go bankrupt if all its clients return their products. It seems that the majority doesn't return the product if it serves a reasonably long time.

1. What kind of products are eligible to be sold with a life-time guarantee?
2. Will you offer a life-time guarantee for courses like "How to stop smoking" or "How to lose weight"?
3. And what about "How to find the man/woman of your life"?
4. What is the reason why most of the clients don't return the purchases?

123. This Bud is for You

What do the "Budweiser" beer and "Levi's Strauss" have in common? On the one hand, both are "made in USA". On the other, they are considered low quality goods in their country of origin and high quality goods in the rest of the world. a) Does this demonstrate that consumers are irrational?

²⁹ The information on this case comes from G. González Andrio, "Anuncios-impacto" (*Expansión*, February 8, 2000, p. 18).

³⁰ Based on Zaslow (1987).

b) Does this show that producers can manipulate consumers? Suggest a hypothesis explaining why some products may have lower reputations in their countries of origin.

124. Celebrities

Does it have sense to pay a crazy sum of money to a celebrity for making an advertising video? Don't you think a professional actor can do this for less money?

125. Ethical interest rate

Moralists claim that ethical standards are decreasing. Might this be caused by a fall in the relevant discount rate? (a) Show why, using a model of self-enforcement based on quasi-rents. (b) (Only for discussion) Is this model correct for analyzing this problem?

126. Contractual interest

How are contractual (a) performance on existing obligations and (b) on contractual safeguards (i.e., on the use of different safeguarding technologies) affected by a decrease in the interest rate? (You must answer the two questions separately).

127. Why is the Boss so cheap?

In 1992 Bruce Springsteen gave a huge concert in the Olympic Stadium of Barcelona: a crowd of 60.000 people were then willing to pay Pta 4,000 (around 25 USD) each for each ticket. In the Spring of 1996 Bruce Springsteen came again to Barcelona. Tickets for attending one of two concerts in the small Tivoli theater (with a capacity of 3,000 seats) were sold for ptas. 5,000. Tickets where put on sale in some disk stores, but that was unknown to the public until 15 minutes before they were put on sale, when they announced the points of sale in a radio station. Long queues formed in minutes to purchase the tickets.

Keeping in mind that some other singers have made similar policies, which are also common in sports events, analyze the case tackling at least the following questions: (a) Is this an optimal pricing policy? (b) Why? What are the conditions for making such underpricing a sensible policy? (c) What about non disclosing the points of sale?

128. Eating attributes

Define precisely different attributes for the products in the following table.

Goods	“Search” attributes	“Experience” attributes	“Credence” attributes
Apples			
Tomatoes			
Cheese			
Yogurts			
Sausages			
Beef steaks			

129. **Le fast-food in Paris**

It is claimed that: “The moral hazard concept explains, for example, why many restaurants in the tourist zone of Paris offer food with lower than expected quality: the transitory character of consumption prevents reputation from having an important role in the transaction” (Tirole, 1988, p.107). Which arrangements can be expected to appear in order to solve the problem described by this prominent French economist?

130. **On sale**

In periods of sales, many retailers don't accept back their merchandise. This practice made some consumer associations lobby for regulation prohibiting that policy. Suggest a hypothesis explaining the retailers' behavior.

131. **Hotels for children**

In some residential districts, hotels for children have enjoyed substantial success. For a certain period, in most cases during the weekend, parents can leave their children there. We can assume that because of both price and location (residential districts), clients can find an alternative solution, using the service of a baby-sitter at their own home. Suggest a hypothesis based on contractual premises explaining why parents don't use this alternative.

132. **Your money back**

Analyse the following news item

A magistrates' court in Malaga has ordered El Corte Inglés to return the price paid for a garment purchased by a customer holding that the department store had not fulfilled its trading motto, “Your money back if you are not satisfied”.

This non-fulfilment took place when the claimant bought a woollen jumper for which she paid 10,950 pesetas (65.81 euros) in December 2000. The garment was worn by the claimant's husband on ‘three or four occasions’ according to the sentence but immediately ‘small balls of wool’ were formed. The purchaser decided to ask for her money back in accordance with the commercial motto but, after making her claim in El Corte Inglés on 20 January 2001, the return of her money was refused.

According to the sentence, the ‘abnormal’ deterioration of the garment ‘justifies the purchaser's lack of satisfaction’ and bases the return on the fulfilment of a commercial motto³¹.

List the various types of opportunism that this guarantee may give rise to.

Describe how this guarantee can function under two systems of *completion* and *enforcement*: relational contracting and contracting with judicial support.

Consider the viability of this type of guarantee when enforcement is carried out by the parties or by the judicial system.

What does conservation of a woollen garment depend on? Which of the parties—the seller or the purchaser—is in the best position to guarantee conservation? In the case of a more valuable product for which a more complex guarantee system would be of interest, how should the guarantee conditions be stipulated?

³¹ “Condenan a unos grandes almacenes por incumplir su lema comercial”, *El Mundo*, 21 January 2002.

9. Institutional Constraints on the Structure and the Strategy of the Firm. The Multiple Roles of Regulation

133. Spanish Labor Regulation

In the course of many years the Spanish labor regulation had been imposing a particular way for labor contracting. The norm demanded labor contract with infinite term and without possibility of dismissal. Figure out the condition (in terms of economic growth) under which a similar labor contracting practice would be less damaging. Explain your answer.

134. The draft Code for good commercial conduct

The Directorate General for Domestic Trade drew up in February 1998 a draft “Code of Good Commercial Practice”³². In general this Code places great emphasis on explicit contracting *ex ante* so that the parties have to define many conditions before entering a contract. It is stated textually that agreements should be drawn up in clear, precise terms “in order to avoid the need for subsequent interpretation”.

So, firstly, each party has to provide for “any party interested in entering into a contract with them a document stating their initial conditions in the negotiation”.

Written documents must be used whenever possible or when requested by one of the parties or if the agreements deals with several consecutive transactions, including the period of validity.

Basic rates that are affordable for any interested party must be given and on these any discounts will be agreed specifically and in detail by the contracting parties who “shall lay down clearly and concisely the method of calculation, the rate or rates to be applied, the terms for fulfillment, the scope and any other circumstances affecting the determination of prices”, in addition to specifying the discounts on any invoices.

Similarly, the Code forces the parties to agree on “the way in which orders are to be placed and the time limits, conditions and formalities required for delivery of goods”, specifying at least the means of reception, the method of recording orders, presentation, containers, packaging, transport and deliveries, etc.

Finally, the Code covers the obligation for an explicit agreement on payment conditions, with respect to both periods and methods, and on delivery of goods and interest in the case of delay which is to be applied automatically.

Analyze the content of the Code, especially its emphasis on explicit contracting and the possibility of uniformity in the matter of contractual patterns. Remember that the Code is voluntary but that if companies accept it, they have to comply with all its regulations, submit to the arbitration procedure and provide information to a controlling body.

³² “Código de Buenas Prácticas Comerciales”, Dirección General de Comercio Interior, Madrid, February 1998.