Privatization by Franchising: Commissioned Entrepreneurs

The Case of Sumer Holding Sales Outlets in Turkey

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Abstract:

Franchise privatization of non-profitable Sumer Holding sales outlets across Turkey converted the civil servants working in these outlets to private, risk-taking and creative entrepreneurs. The success of and the efficiency gains from franchise privatization at the firm level originate, in part, from significant changes in motivation, attitudes and initiative of the new –commissioned- entrepreneurs, and at the social level, franchise privatization with a partial line forcing contract enabled the publicly held parent company to continue fulfilling its historical mission of providing cheap and essential inputs to the low income consumers and communities in an uninterrupted manner. To be sure, where the local markets are oligopolistic and concentrated, there is evidence of anticompetitive conduct and collusive behavior by the new owners due to the dominant and price leadership role historically played by Sumer Holding Company. This explains some of their success after privatization.

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Introduction

Ownership matters. It is widely believed that the self-interested owner is subjected to higher financial discipline than is the administratively constrained public employee or the politically guided government bureaucrat. Nevertheless, governments may and do set political constraints in trying to implicitly or explicitly influence the management of the firms -whether publicly or privately owned.[1] In one sense, privatization a move from an overcontrolled public firm to an overcontrolled private firm (Bos & Peters, 1988), through a process where public ownership of an asset is turned into private ownership with various degrees of control, can be a potentially useful means of promoting efficiency and growth under the appropriate circumstances. This process becomes especially important in developing countries and transition economies when it is treated as part of a broader effort to increase market forces, decentralize decision making, strengthen management incentives and capabilities, and improve the overall allocation of resources. It can safely be claimed that main goals of privatization are often spelled out in terms of efficiency gains.[2] Public ownership in a market economy may be the source of many inefficiencies and a primary cause for resource allocation problems. [3]

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[1] For a discussion on the role and involvement of the state in determining managerial objectives and efficient resource allocation, see A. Schleifer and R.W.Vishny, "The Politics of Market Socialism", *Journal of Economic Perspectives* 2 (1994): 165-76; P. Bardhan and J.E. Roemer, "On the Workability of Market Socialism," *Journal of Economic Perspectives* 2 (1994): 177-81

[2] Still, there are others who contend that privatization of state owned enterprises (SOEs) can and should be conceived of as an end in itself, rather than as a means to improve efficiency of all existing enterprises; Dusan Triska, Project Director of the Voucher Privatization, "Why and How to Privatize in Post-Communist Countries -The Case of Czechoslovakia", (Federal Ministry of Finance Publication, Prague, Czechoslovakia). Accordingly, privatization may be perceived as a process within which the ill-structured economy can free itself from ailing enterprises which the government would otherwise never find enough courage to allow to go bankrupt.

[3] To cite a few among the growing literature on privatization: J. Vickers and G. Yarrow, Privatization: An Economic Analysis (Cambridge: MIT Press 1988); P.W.MacAvoy, W.T. Stanbury, G. Yarrow, and R.J. Zeckhauser, *Privatization and State Owned Enterprises (*Rochester Studies in Managerial Economics and Policy Publication, 1988); D. Bos, "Privatization of Public Enterprises," *European Economic Review* 31 (1987): 352-60; idem, *Privatization A Theoretical Treatment*, (Oxford University Press, 1991); D. Bos and

A wide range of privatization policies are currently in progress in at least 83 countries throughout the world, including North America, Britain, Japan, and numerous developing and newly industrialized countries. The need for privatization often arises as a means of eliminating the burden of the public enterprise on public resources. The root of the inefficiencies arising from public ownership, the incentive compatibility constraints set on public employees and decision makers stem from satisfying social agendas. Consequently, resources could be wasted. The definition or the degree of this waste is a relative one. In many cases and to a certain extent the original rationale for public ownership may justify the waste. For example, provision of essential inputs and services, distribution of primary commodities where private markets/resources are insufficient or lacking may necessitate public enterprises, such as the historical task fulfilled by Sumer Holding Company (SHC) which I discuss in this paper.

Government entrepreneurship has a long tradition in the Turkish economy. From the very early days of the Turkish Republic public companies and corporations (State Owned Enterprises -- SOE's) were set up and managed by the state as economic policy tools. SOE's were viewed not only as productive firms but also as mechanisms for altering social and regional income distribution, and achieving other non-entrepreneurial goals. Over the years, and as they fulfilled their original objectives, SOE's became overstaffed , bureaucratic and highly politicized. The consequent inefficiencies and losses of SOE's contributed to governmental budget deficits, an unmanageable public debt and the country's double digit inflation rate until very recently.

Sumer Holding Company (SHC) is one of the many SOE's in Turkey. It specializes in the manufacture of a variety of textile products and wearing apparel including leather and

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W. Peters, "Privatization, Internal Control, and Internal Regulation," *Journal of Public Economics* 36 (1988): 231-58; M. Boycko, A. Shleifer, and R.W. Vishny, "Voucher Privatization," *Journal of Financial Economics* 35 (1994): 249-266; World Bank, *Techniques of Privatization of State owned Enterprises, Methods and Implementation Vol. I*, (Washington, D.C.: World Bank Publication, 1988); Anbarci, N. and Karaaslan, M.E., "An Efficent Privatization Mechanism," *Journal of Policy Reform*, 1 (1998), 73-87.

footwear; its network of production plants and sales outlets stretch even to the smallest of Anatolian towns all around Turkey. The history of SHC (originally Sumerbank), in a way, parallels with the history of the government led industrialization process in Turkey.

During the 1980's when the Turkish government adopted the privatization program as part of its efforts to restructure the Turkish economy, many activities of SHC, including banking, were also included in the program, and many of those have already been privatized as of 2001. Privatization process, with different methods and mechanism adopted for different enterprises, is an ongoing process in Turkey, although at a snail's pace and sometimes with incomprehensible sequencing.[4] The process is mainly governed by the government thirst for privatization revenues, and ironically there are very few follow up studies that assess the quantitative effects and economic performance of privatized firms to see if the outcome is somewhat related with the mechanisms that have been adopted.

This paper examines the privatization experience of SHC's sales outlets. Over a period of two years prior to 1996 August, 291 of the 433 retail outlets of the SHC, which had been making losses for more than five previous years, were privatized by transferring ownership to private individuals, giving priority to the employees (sales persons, cashiers, clerks, etc) working in these enterprises.[5] While it has not been officially labeled by the Public Privatization Administration as such, I call it *'privatization by franchising.'*[6] I examine the various determinants of post privatization performance of

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[4] It is ironic that, as in many countries around the globe, the privatization process in Turkey is itself being managed by the public sector.

[5] The first post privatization survey of the then privatized sales outlets was conducted by Ozer Ertuna (Ertuna, 1995) in 1993. The second survey, in the same format with the first, came in 1994 by Gaye Gencer (Gencer, 1997). It consisted of 33 open end or fill in the blank questions.

[6] Here, the idea of *privatization by franchising* is different than *regulative franchising* of natural public monopolies. In the system of regulative franchising, the franchise is awarded for a period of time to the competitor offering to supply the product or service at the lowest price (or, more generally, the best price-quality package). Regulative franchising provides a very attractive way of combining competition and efficiency without any arduous burden of regulators. The competition for monopoly appears to destroy the undesirable monopoly of information that hinders traditional regulation, and the price is set by competition, not by administrators (Demsetz , 1969). Regulative franchising was used in the Ottoman Empire in tax collection (Salzmann, 1993); also, it was advocated by Edwin Chadwick, the Victorian social reformer. However, only a few of the Sumer Holding outlets were local monopolies for the product lines they carried

the sales outlets of SHC that were privatized by way of sales to its existing employees under a franchise contract to carry and sell a preset volume of SHC products every year.

A franchise contract is defined as one in which the owner, or franchisor, of a product, service, or trademark has authorized other firms to produce and distribute a product under his tradename, subject to a number of conditions.[7] This paper I focuses on the condition known as partial-line forcing whereby the franchisee agrees to purchase some of the inputs from the franchisor. The equivalance of revenue sharing and full-line forcing, and welfare implications of franchising are found in Inaba, 1980, 1982; Fratrik and Lafferty, 1985; Blair and Kaserman, 1980, 1985. Accordingly, the privatized sales outlets of the SHC would be allowed to use the *Sumer Holding* tradename, carry a full line of SHC consumer products and also carry rival products. Thus, the principal focus is on the entrepreneurial transformation of the former public employees into local merchants and businessmen operating as Sumer Holding franchisees.

From the point of view of the policy makers, privatization by franchising serves a double purpose: first it eliminates the losses accrued to SHC by many of its sales outlets; second, franchising agreement keeps these shops as contractually bound sales outlets for many of the primary, and often times subsidized, commodities SHC produces. Such staple commodities are still essential for the poverty stricken populations and regions of Turkey. Therefore, in one sense, the government has commissioned its salary-based employees who held guaranteed lifetime tenure to become private entrepreneurs in their local communities and to carry out its social objectives by providing them with appropriate incentives; and in another sense, the government has created new entrepreneurs in these communities helping the development of private initiative.

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and there were no barriers to entry by private firms. More importantly, privatization proceeded by selling the ownership rights of the sales outlets as opposed to transfer of ownership for a period of time.

[7] Franchise contract may contain a number of conditions, such as: (1) the franchisee agrees to pay a franchise fee; (2)the franchise agrees to certain business hours, credit, employee training, advertising as stipulated by the franchisor; (3) he agrees to adhere to certain quality standards for the product; (4) he agrees to purchase all or some of the inputs he needs from the franchisor (full and partial-line forcing); (5) the franchisee agrees to pay a royalty, usually a percentage of sales, to the franchisor (revenue sharing).

Descriptive Results of the Survey Data

A two page questionnaire survey, mostly with qualitative questions, was mailed to the 393 sales outlets of SHC that were privatized over a period of two years prior to 1996 August. Current owners of 111 of those sales outlets responded. Following is a brief summary of the results that was compiled from valid and useable responses.

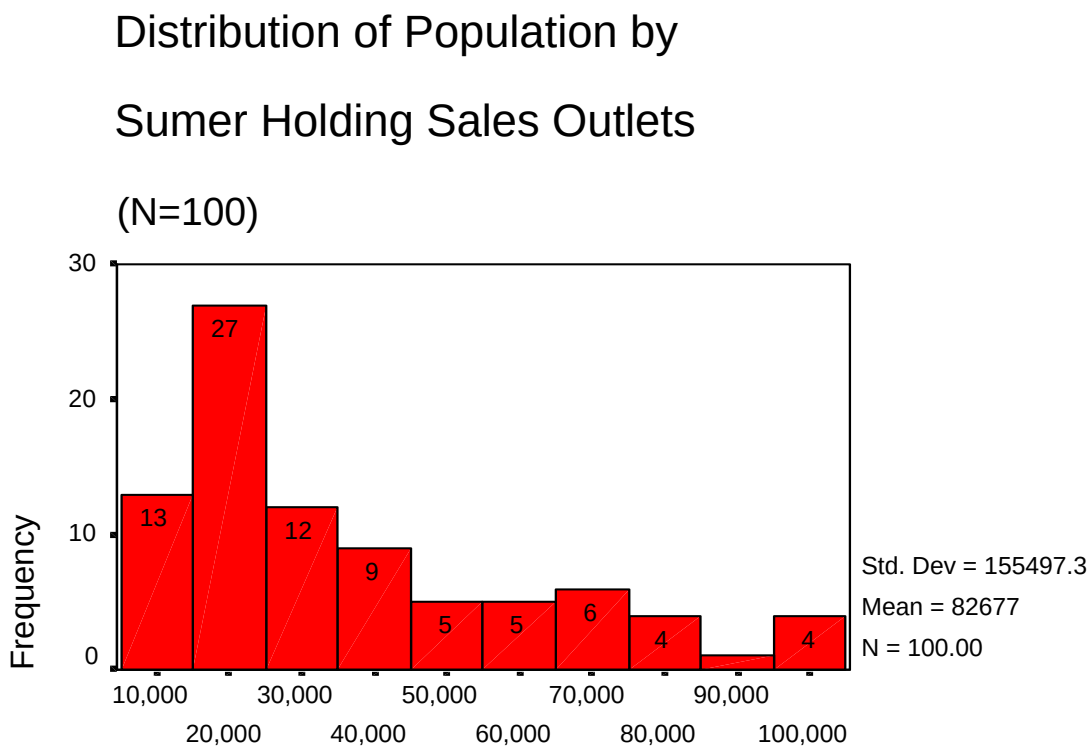
The total number of employees prior to privatization in 111 of these sales outlets that responded to the survey was 518. This number was down to 361 after privatization. 192 of this total (53%) are current owners themselves. Mean and the median number of employees in an outlet before privatization were 4.8 and 4 respectively. After privatization these numbers were down to 3.3 and 2 respectively. 69 out of the 111 are sole owners; 22 have one business partner; and the remaining 18 have 3 or more partners (Mean 1.76, st.dev 1.43) Normal scores confirm that the sample comes from a normal distribution). Of those that responded, 18 had a decrease and 2 had an increase in the number of partners since privatization; 5 had bought the business from its previous owner(s), and the remaining 80 had no change in the ownership structure.

73 (67.5%) of the outlets report that their earnings have improved since privatization. 15 (13.8%) have a decrease in earnings, and 20 had no change. Total population as a proxy for customer base and market size of the 100 valid responses are 8,267,651. The mean and the median customer base per sales outlet were 82,677 and 30,000 (see histogram below).

The monthly earnings of an average customer is reported to be less than 10 million TL (Turkish Lira) for 13 (12%) of these outlets.[8] For 67 of the sales outlets (61%) an

[8] One U.S. Dollar was equal to (c.a.) 80,000 Turkish Liras at the time. 10 million TL is equivalent to about 125 US Dollars.

average customer earned between 10-20 million TL, and for 30 (27%) the respondents estimated that it is in the range of 20-30 million TL.



(6 Observations are below the first and 14 are above the last class)

While 18 respondents report that they do not have any current debt, 44 of them had an increase in their debt holdings. 21 did not have a change in their indebtedness while 26 managed to lower their debt level since they took over.

The regional distribution of the privatized SHC sales outlets is given below.

Regional Distribution of Sumer Holding Sales Outlets

		Frequency	Percent
Valid	Akdeniz (South)	8	7.2
	Central	17	15.3
	East	15	13.5
	Ege (West)	18	16.2
	Karadeniz (North)	22	19.8
	Marmara (Northwest)	19	17.1
	Southeast	7	6.3
	Total	**106**	**100.0**

In the next section, I explore the data conducting several chi-square tests on cross tabulations. The purpose of the tests is to explain the conditions under which the new owners have become successful entrepreneurs; in particular, to see if success is attributable to entrepreneurial talent and adaptation or the degree of market power in the local markets they operated. I interpret the results using the *industry structure-firm conduct-market performance* frame of reference. Following the conclusion, the theoretical justification of many of the positive results obtained is provided with a theoretical example at the Appendix.

Market Determinants of Entrepreneurial Success

Here, I use local population as a proxy for the market size of a representative sales outlet. Moreover, the results below reveal that population size and average monthly earnings of an average customer are significantly related.

Local Population * Average Customer Earnings (per month) Crosstabulation

			Average Customer Earnings (per month)			
			Less than 10 million TL	10-20 million TL	20-30 million Tl	Total
Local Population	<18,000	Count	1	12	9	22
		% of Total	1.0%	12.0%	9.0%	22.0%
	18,001-36,000	Count	8	27	2	37
		% of Total	8.0%	27.0%	2.0%	37.0%
	36,001-54,000	Count		6	1	7
		% of Total		6.0%	1.0%	7.0%
	54,001-72,000	Count	2	5	4	11
		% of Total	2.0%	5.0%	4.0%	11.0%
	72,001-90,000	Count		2	3	5
		% of Total		2.0%	3.0%	5.0%
	90,001-108,000	Count		2	2	4
		% of Total		2.0%	2.0%	4.0%
	144,000<	Count		8	6	14
		% of Total		8.0%	6.0%	14.0%
Total		Count	11	62	27	100
		% of Total	11.0%	62.0%	27.0%	100.0%

Chi-Square = 23.061, DF = 12. 15 cells (71.4%) *have expected count less than 5. The minimum expected count is .44.*

The Chi-square value of 23.061 is in the rejection region for 2.5% level of significance and *degrees of freedom* =12 (p-value=.01875). This is an expected result in the case of Turkey as well as many other developing countries: urbanization provides higher earnings potentials, but also a higher cost of living. 32 respondents report an increase and 31 report a decrease in the population of their region in the last two years. In a country of positive population growth this result confirms the size of ongoing internal migration that has accelerated during the second half 1980's. In 35 of the cases there has been no significant change in population.

A cross tabulation of the change in earnings and change in population since privatization indicates significant positive association between the two (see the table below). This is an expected result since population is an important determinant of demand for many of

the necessities in the SHC product line The null hypothesis is rejected at 1 % level of significance (p-value=.001).

Change in Earnings * Change in Local Population Crosstabulation

			Change in Local Population			
			Increased	Decreased	No Change	Total
Change in Earnings	Increased	Count	29	13	24	66
		% of Total	29.9%	13.4%	24.7%	68.0%
	decreased	Count		9	5	14
		% of Total		9.3%	5.2%	14.4%
	No change	Count	2	9	6	17
		% of Total	2.1%	9.3%	6.2%	17.5%
Total		Count	31	31	35	97
		% of Total	32.0%	32.0%	36.1%	100.0%

Chi-Square = 19.637, DF = 4, P-Value = 0.001. 2 cells (22.2%) have expected count less than 5. The minimum expected count is 4.47.

The mean and the median number of competitors are 12.44 and 8 respectively. Three of the shops consider themselves to be monopolies, while 13 others have either one or two competitors (see the frequency distribution below for the distribution of the number of competitors.)

Distribution of the Number of Rival Stores

Number of Rival Stores	Frequency	Percent
No Rivals (monopoly)	3	2.7
1 - 2 rivals	13	11.7
3 - 4 "	13	11.7
5 "	14	12.6
6 - 7 "	7	6.3
8 - 10 "	19	17.1
12 - 14 "	7	6.3
15 - 18 "	11	9.9
20 and above "	17	15.3

Total # of respondents	104	93.7
Missing	7	6.3

Five respondents said that there was a decrease in the number of competitors, and 32 of them report that there was an increase in that number since privatization. The remaining 73 report that there was no change. Separately, the market share of 62 (56%) sales outlets have increased, and 22 (20%) have decreased, while 26 (24%) reported "no change" since privatization.

Those who could increase their market share seem to have benefited disproportionately from population growth as the following cross tabulation suggests. The chi-square statistic of 28.291 yields a p-value of .0002 (with 4 degrees of freedom). On the basis of the p-value we reject the null hypothesis. The data indicates that population growth and market share growth are significantly related for the privatized SHC sales outlets. One interpretation of this is that the new entrepreneurs have benefited a great deal from their knowledge and past experience of the market conditions as government employees and unconstrained from bureaucratic rules, they have started practicing tools of competitive conduct freely and quite profitably, and better than their competitors in their newly found territories. The increase in local population should be interpreted not as a consequence of a high birth rate in the country but as a result of high domestic migration from the rural to the urban areas. During the 1990's This migration was triggered, for most part, by the domestic ethnic strive and separatist insurgency in the countryside of Southeast and East of Turkey which is populated mostly by ethnic Kurds. The government favored and adopted policies that accelerated migration of villagers to cities and bigger towns where it had proper control.

Change in Local Population * Change in Market Share Crosstabulation

Count

		Change in Market Share			
		Increased	Decreased	No Change	Total
Change in Local Population	Increased	27		5	32
	Decreased	8	15	8	31
	No Change	20	6	9	35
Total		55	21	22	98

Chi-Square = 28.291, DF = 4, P-Value = 0.000. 0 cells (.0%) have expected count less than 5. The minimum expected count is 6.64.

In a separate question, they were asked if the competitors' economic power relative to theirs have changed since privatization. Only 10 responses stated that competitors' relative economic power have increased. 48 respondents stated that their relative economic power has decreased, and another 51 said that there was no change. This question was intended not only to be a control variable for the market share question, but it also measures the potential difference between the market share and profitability as proxied by "economic power". The correlation between the two is strongly positive, but it should not be expected to be close to one under all circumstances. In fact, the correlation between the change in market share and change in economic power was measured to be 0.56.

The following table is a cross tabulation of the responses for these questions. The chi-square statistic of 47.695 enables us to strongly reject the null hypothesis that the changes in market share and economic power are independent.

Change in Market Share * Change in Relative Economic Power of Competitors Crosstabulation

Count

		Change in Economic Power of Competitors Relative to Ours			
		Better relative to us	No change	Worse relative to us	Total
Change in Market Share	Increased	2	17	42	61
	Decreased	7	12	3	22
	No Change	1	22	3	26
Total		10	51	48	109

Chi-Square = 47.695, DF = 4, P-Value = 0.000. 2 cells (22.2%) have expected count less than 5. The minimum expected count is 2.02.

33 respondents (34.7%) confirm that they occasionally colluded and cooperated with competitors[9]. 62 said they did not collude. 41 (42.7%) responded negatively to the question if there was any occasional price competition with the rivals, 55 (57.2%) responses were in the affirmative. However, a cross tabulation of the responses on collusion and price competition shows only 17 respondents (18% of the sample) both colluded/cooperated and avoided price competition with the rivals, while 38 (40%) said "NO" to collusion and "YES" to occasional price competition. On the basis of the chi-square statistic of 1.783 (p-value=.182) we fail to reject the null hypothesis, i.e., collusive/cooperative behavior and occasional price competition are not significantly related. It is reasonable to think that those who occasionally engage in mutually damaging price competition will also be most willing to collude and cooperate occasionally.

Three other YES/NO type questions measure the extent of non-price competition:

"We offer more frequent and longer term credit sales compared to the past" (52 YES, 43 NO.)

[9] A confession to collusion with the rivals is a violation of the Turkish antitrust laws. However, those laws were newly enacted at the time of the survey year (1996) and the government had not formed a regulatory board to enforce these laws. In any case, the respondents were, and probably still are unaware that collusion is unlawful and subject to severe monetary penalties if convicted.

"We monitor the competitors and try to carry different and a more varied stock of merchandise " (98 YES, 4 NO.)

"We make use of local press, billboards and other media to advertise and to distinguish our name." (81 YES, 17 NO.)

A cross tabulation of the change in earnings and change in debt is given below. We can not reject the null hypothesis at 5% level of significance that earnings and indebtedness are unrelated (p-value =.15). It seems that those who could increase earnings also increased the volume of credit purchases from suppliers.

Change in Earnings * Change in Debt Crosstabulation

			Change in Debt			
			Increased	Decreased	No Change	Total
Change in Earnings	Increased	Count	32	19	10	61
		% of Total	36.4%	21.6%	11.4%	69.3%
	decreased	Count	6	4	2	12
		% of Total	6.8%	4.5%	2.3%	13.6%
	No change	Count	5	3	7	15
		% of Total	5.7%	3.4%	8.0%	17.0%
Total		Count	43	26	19	88
		% of Total	48.9%	29.5%	21.6%	100.0%

Chi-Square = 6.745, DF = 4, P-Value = 0.150. 4 (44.4%) cells with expected counts less than 5.0, the minimum expected count is 2.59.

The following proxy question is intended to measure the former wage earner's attitude towards risk two years (c.a.) after being converted into a 'commissioned entrepreneur.'

" If you were offered a more attractive business and/or job in a different city, would you be willing to sell this shop and relocate?"

There are 44 YES and 58 NO responses to this question. Nevertheless, a cross tabulation of the responses to this question with the responses to the 'change in earnings since privatization" question revealed 'regret' and a "winner's curse" on the current owners (see the table below). Only 31% with increased earnings were willing to accept a new offer. 75% of those with decreased earnings, and 65% of those with no earnings change were eager to accept the offer. On the basis of the chi-square statistic of 512.134 (d.f.=2, p-value=.002) we reject the null hypothesis that this choice is independent of the earnings record since privatization.

Are you willing to Relocate for an Attractive Offer in a Different City* Change in Earnings Crosstabulation

Count

		Change in Earnings since Privatization			
		Increased	decreased	No change	Total
Willing to Accept Another Offer and Relocate	YES	22	9	11	42
	NO	48	3	6	57
Total		70	12	17	99

Chi-Square = 12.134, DF = 2, P-Value = 0.002. 0 cells (.0%) have expected count less than 5. The minimum expected count is 5.09.

Conclusion

Under appropriate circumstances privatization can be a potentially useful means of promoting efficiency and growth in an economy under transition if it is treated as part of a broader effort to increase market forces, decentralize decision-making, strengthen management incentives and capabilities, and improve overall allocation of resources. It is largely believed that the self-interested owner is subjected to higher financial discipline than is the politically guided government bureaucrat. While this is rather general language the word "efficiency" is generally meant to imply production efficiency:

elimination of organizational slack known as X-inefficiency, innovativeness that bring dynamic efficiency, organizational restructuring that bring incentive compatible management structures and higher profits. The other, equally important, dimension is "allocative efficiency" which means product prices are equal (or close) to marginal cost. Efficiency in this context would be more meaningful for the consumers who would be effected by the privatization. In an ideal world both notions of efficiency would be attained if markets are sufficiently competitive. If the markets are very concentrated and already riddled with imperfections, privatization may only bring productive efficiency. In those circumstances, gain in allocative efficiency may be minimal, and in certain extreme cases there may be losses in allocative efficiency simultaneous with gains in productive efficiency.

Results of a post privatization survey of SHC sales outlets reveal the expected tradeoff-off between the market structure and net efficiency gains. Most of these outlets that had reached a stage of liquidation before the privatization are now making profits indicating gains in production efficiency gains. The franchise privatization helped to convert the civil servants working in these outlets to private, risk-taking and creative entrepreneurs. The success and efficiency gains at the firm level are due, in part, to significant changes in attitudes, motivation and initiative of the new entrepreneurs, who were civil servants before.[10] On the other hand, while the dominant and price setting role historically played by these outlets in mostly oligopolistic local markets raises doubts about collusive behavior, it may explain some of their success after privatization. To a great extend, franchise privatization enabled the government to carry out its social objectives of providing cheap and essential items to low income consumers in an uninterrupted manner. The government achieved this by maintaining its network of privatized franchise outlets all around Turkey

[10] For a discussion on the personal traits of a successful entrepreneur see (Brandstatter, 1997).

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APPENDIX 1[11]

Example:

Suppose that a generic SHC employee's preferences w.r.t. work and income expressed in dollar amounts is given by the convex function:

$$\boldsymbol{U = I - e^2},$$

where,

I : income

e : units of effort

Further suppose the employee's reservation utility is equal to $1,000.

The employee will not work for anything less than this amount, i.e.,

$1{,}000 \geq \boldsymbol{I - e^2}$.

Let the following function represent Sumer Holding's benefits (Revenue) from the employee's effort :

$$\boldsymbol{B} = \$100.\boldsymbol{e}$$

Case I: Effort is costlessly observable,

The firm must pay the employee :

$$I = \$1{,}000 + \boldsymbol{e^2}$$

This suggests that the employee will receive her reservation utility :

$$\boldsymbol{U} = (\$1000 + \boldsymbol{e^2}) - \boldsymbol{e^2}$$

$$\boldsymbol{U} = \$1{,}000.$$

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[11] For a discussion on the managerial incentives of franchise contracts see Brickley, Smith & Zimmerman, 1997.

Then, the firm's profits, π , is expressed as a difference between the firm's benefits from the employee's effort and what the firm pays to the employee in return for her effort,

$$\pi = 100.e - (1{,}000 + e^2).$$

To maximize profits we obtain the f.o.c. and solve for *e* in the following equation:

$$\frac{\partial \pi}{\partial \mathrm{e}} = 100 - 2e = 0$$
$$e = 50$$

By demanding an effort level e=50 from the employee the firm obtains the following profits (per worker):

$$\pi = 100.(50) - (1{,}000 - 50^2) = \$1{,}500$$

In return, the employee is paid:

$$\mathrm{I} = 1{,}000 + 50^2 = \$3{,}500.$$

However, the problem with such a scheme is that (i) the assumption that effort is costlessly observable is not realistic, (ii) output is not always a good proxy for effort due to random events and variations in market conditions which are beyond the employee's control, (iii) we have the well known agency problem: the employee may renege on her promise to deliver 50 units of effort, but still get paid $3,500. Obviously, with a lower effort level her utility will increase.

Case II: Effort is not observable.

Under this case we assume that the firm has historical records of its profits through which it can compute an expected profit of $1,500 from an average employee's effort;

conversely we can assume that a cross section industry data/statistics where this number can be obtained exists. A way out of the problems mentioned in case I is to sell the employee the rights to the value of her own output ($100.e) for a price of $1,500. Such a scheme is incentive compatible, i.e., it solves for the potential agency (moral hazard) problem that exists in any employee-employer relationship.

If the firm sells the worker the rights to the value of her output ($100.e) for a price of $1,500, then the worker's new utility function would be,

$$\boldsymbol{U} = \boldsymbol{I} - \boldsymbol{e}^2$$

where

$$\boldsymbol{I} = 100.\boldsymbol{e} - 1{,}500.$$

Notice that, here ($100.e) which used to be the firm's benefits from the employee's effort is now transformed into the employee's benefits from her own effort.

$$\therefore \quad \boldsymbol{U} = (100.\boldsymbol{e} - 1{,}500) - \boldsymbol{e}^2$$

To maximize the worker's utility w.r.t. her chosen effort level we solve the f.o.c.:

$$\frac{\partial \mathrm{U}}{\partial \mathrm{e}} = 100 - 2.\boldsymbol{e} = 0$$

$$\boldsymbol{e} = 50.$$

The employee will choose to exert an effort level equal to 50 units and she will obtain a maximum utility of :

$$\boldsymbol{U} = 100(50) - 1{,}500 - (50)^2$$

$$\boldsymbol{U} = \$1{,}000.$$

But, this is the same effort level (utility and revenue to the firm) as we have obtained in case I where we assumed effort is costlessly observable (and hence no agency problem).

Franchisees are an example of this mechanism. SHC's privatization of unprofitable sales outlets through a partial-line forcing type franchise contract has relied on essentially the same idea: salaried employees who got paid fixed salaries and who were subject to the moral hazard problem (shirking) turned into successful entrepreneurs. Assigning property rights to the fruits of their own effort created significant efficiency improvements in a great majority of cases, and the losses that was a burden on the government under public ownership were eliminated. Many of the employee owners materialized their entrepreneurial skills and increased their profits. They achieved this both by eliminating the previous slack mostly by reducing the number of employee/owners by buying and selling their shares (consolidating) on the privatized property and by increasing their actual effort level.