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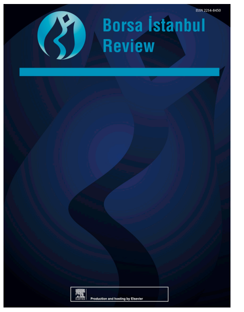

Profit Sharing between Managers and Investors:An Experimental Investigation

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Profit Sharing between Managers and Investors: An Experimental Investigation

Abstract

This study analyzes the effect of interest and power structures and conflict of interest among managers and investors and tests the effect of different payout mechanisms on willingness to pay. In this study 74 student subjects are involved in a setting where the manager is determining his own compensation. A series of experiments that vary managers' ability to determine their own compensation and investors' ability to punish inappropriate behavior are reported. The experiments involve pairs of subjects consisting of an investor and a manager with asymmetric decision making powers. When managers compensate themselves inappropriately, investors' recourse is to shun the company's shares—a model that arguably corresponds more closely to reality than the accepted efficient market traditional paradigm. The experiment shows that managers share profits even when investors cannot withhold investment and investors fairly compensate managers as well. This pattern explains both the ability of capital markets to function despite the presence of inherent moral hazard, and occasional managerial misbehavior.

Keywords: Behavioral Finance; Payout Policy; Experiment
JEL Codes: G02; G03