Levin and Tadelis (QJE 2005)
Profit Sharing and the Role of Professional Partnerships

Summary:

- Profit-sharing partnerships are advantageous when human capital plays a central role in determining product quality and when clients are at a disadvantage relative to firms in assessing the ability of employees.
- Model departs from the incentive view (e.g. Hansmann) by emphasizing the effect of profit sharing on the selection of employees rather than on their motivation.
    - Monitoring problem is between the firm and prospective clients rather than within the firm (P-A model).

Hypothesis:

- If market monitoring is sufficiently reliable, corporations perform better than profit-sharing partnerships: a profit-maximizing corporation hires efficiently while partnerships are too selective.
- If market monitoring is weak, partnerships are more profitable than corporations: both corporations and partnerships are tempted to reduce quality and hire less able workers, so corporations move away from efficient production while partnerships move closer to efficient hiring.

"Test" of Hypothesis:

- Case studies of professional service firms that faced decisions about organizational form: Goldman Sachs and Booz Allen Hamilton.
- Legal forms of organization:
    - Harder to assess quality of financial accounting (auditing) CPA firms than tax preparation firms—more financial accounting work than tax preparation work by partnerships and vice versa by corporations.
    - Harder to assess quality of management consulting than human resource services—more management consulting than human resource services work by partnerships and vice versa by corporations.
    - Harder to assess quality of lawyers than other legal services—more lawyer than other legal services work by partnerships and vice versa by corporations.
- Recent trends away from the traditional partnership structure in investment banking and law due to:
    - More active and competitive labor market
    - Better monitoring
- Features of partnerships:
    - Partnerships are at a disadvantage in raising capital.
    - Use of up-or-out promotion systems can be used to signal a partnership's commitment to guaranteeing the high quality of long-term employees.
    - Use of noncompete clauses prevents employees from taking up lucrative outside options rather than sharing profits.

"Rule Out" Alternative Hypotheses:

- Limited liability—perhaps partnerships can use unlimited liability as a signal of own ability, but almost all partnerships in the professional services are no organized as limited liability.

- Taxes—perhaps form partnerships to avoid the corporate income tax, which applies across all sectors, but mainly see partnerships in the professional sectors.
- Legal constraints—most state law prevents law firms from having non-lawyer equity investors, but this is to some extent self-imposed and consistent with the interpretation this organizational form induces higher quality for clients.

Possible Quantitative Analysis:

- Use the exogenous introduction of better monitoring technology in a certain industry to see if hiring quality, profits, and organizational form changes.