

THE FIRM

MPA 612: Economy, Society, and Public Policy

February 20, 2019

*Fill out your reading report
on Learning Suite*

PLAN FOR TODAY

Power and inequality

Firms

XYZ car sales

Owners, managers, and employees

Labor discipline

Outsourcing

POWER AND INEQUALITY

GINI COEFFICIENT

0–1 scale

\$10,000

0 = Perfect equality

\$20,000

1 = Perfect inequality

\$50,000

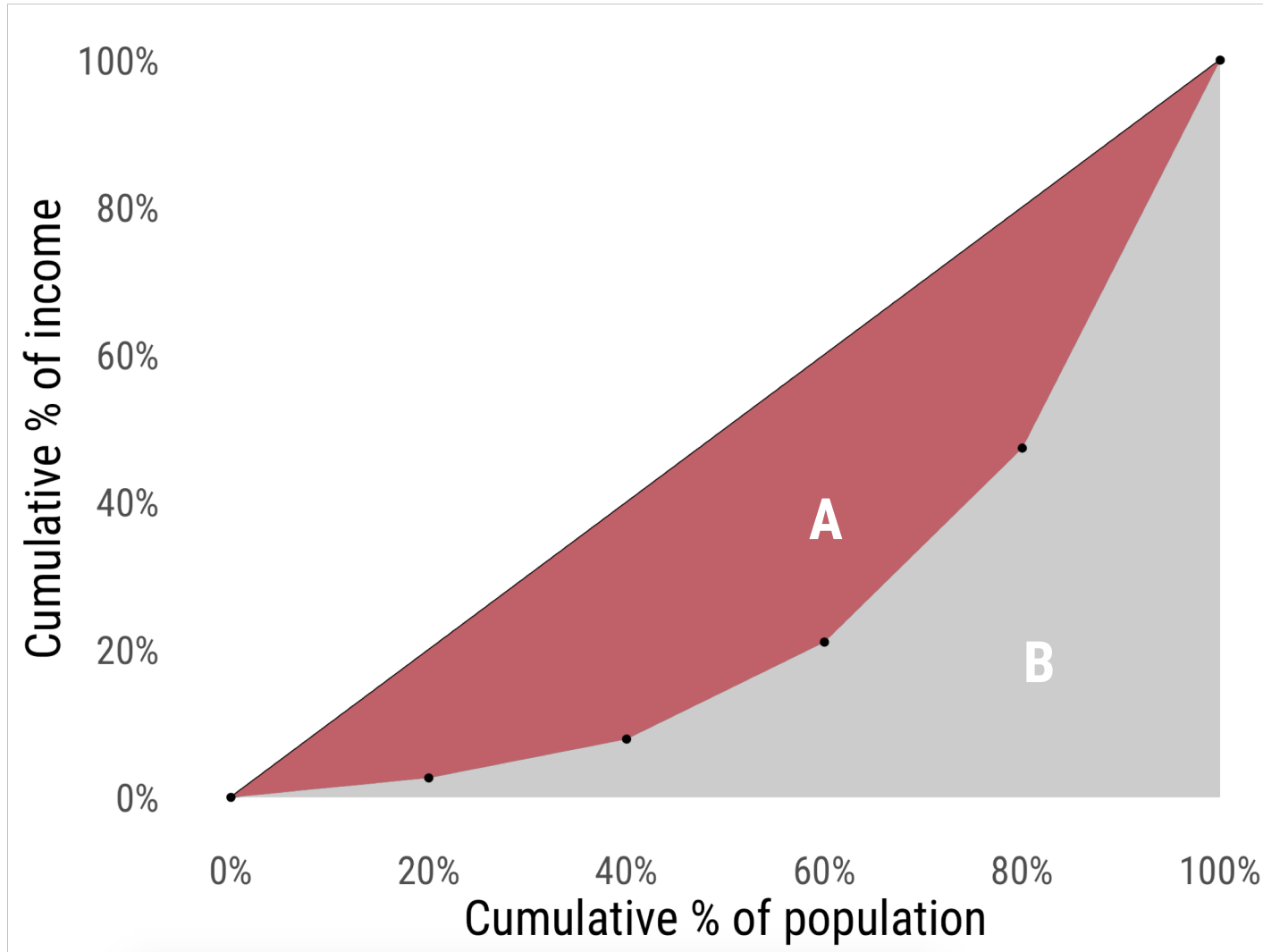
0.3ish = medium

\$100,000

0.5+ = high

\$200,000

GINI COEFFICIENT



$$\frac{A}{A + B}$$

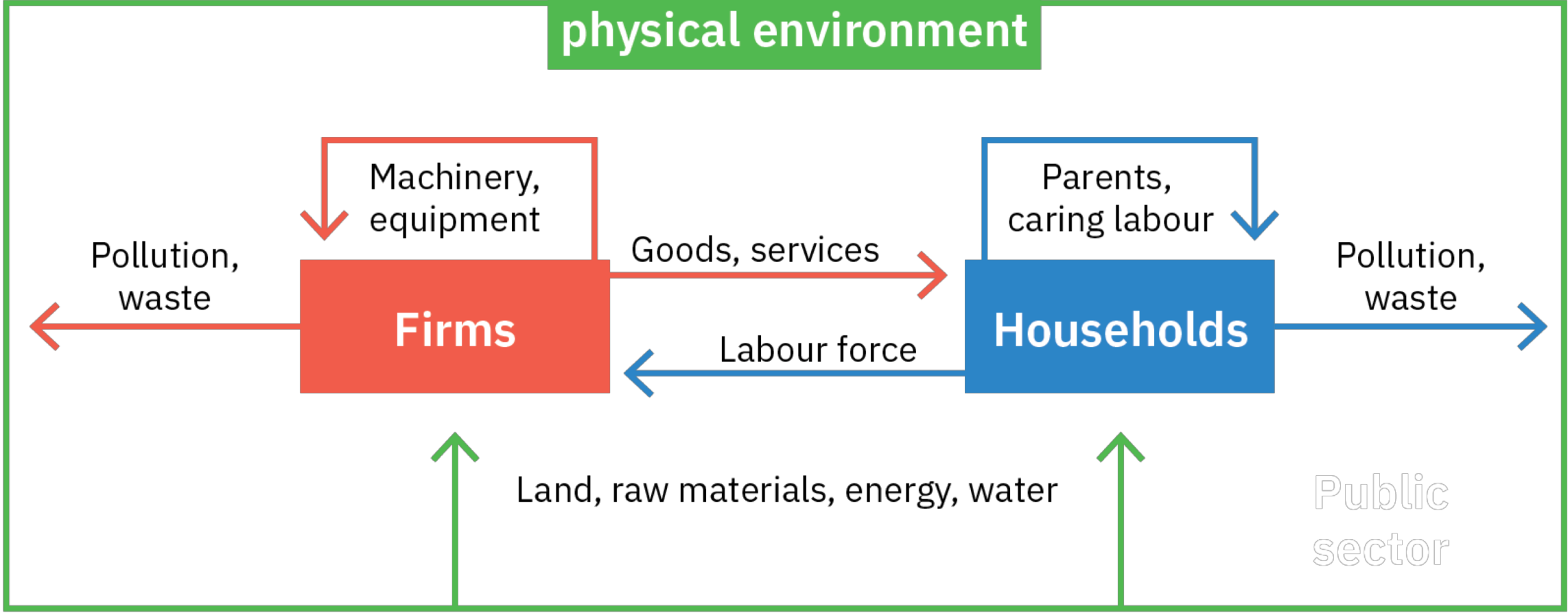
0.484

SHORTCUT

$$\frac{2}{\text{mean income}} \times \text{Cov}(\text{income, cumulative \% of population})$$

FIRMS

**Biosphere and
physical environment**



WHAT DO FIRMS DO?

Employ people

**Purchase inputs to provide
goods and services**

**Set prices higher than
cost of production**

HOW ARE DECISIONS MADE?

In markets

Choices emerge with no centralized planning

"[The market] is in fact a very Eden of the innate rights of man. There alone rule Freedom, Equality, Property."

Karl Marx, *Capital*, chapter 6

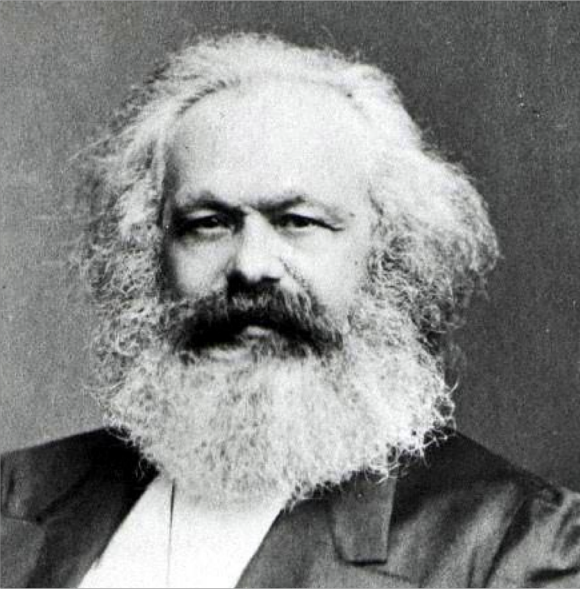
In firms

Decisions are centrally planned

"If a workman moves from department Y to department X, he does not go because of a change in prices but because he is ordered to do so."

Ronald Coase, "The Nature of the Firm"

CONSEQUENCES OF AUTHORITY



“The directing motive, the end and aim of capitalist production, is to extract the greatest possible amount of surplus-value, and consequently to exploit labour-power to the greatest possible extent.”

Karl Marx, *Capital*, chapter 13

CONSEQUENCES OF AUTHORITY



Costs of transacting in a market lead to the natural emergence of firms to deal with them. Firms make markets more efficient.

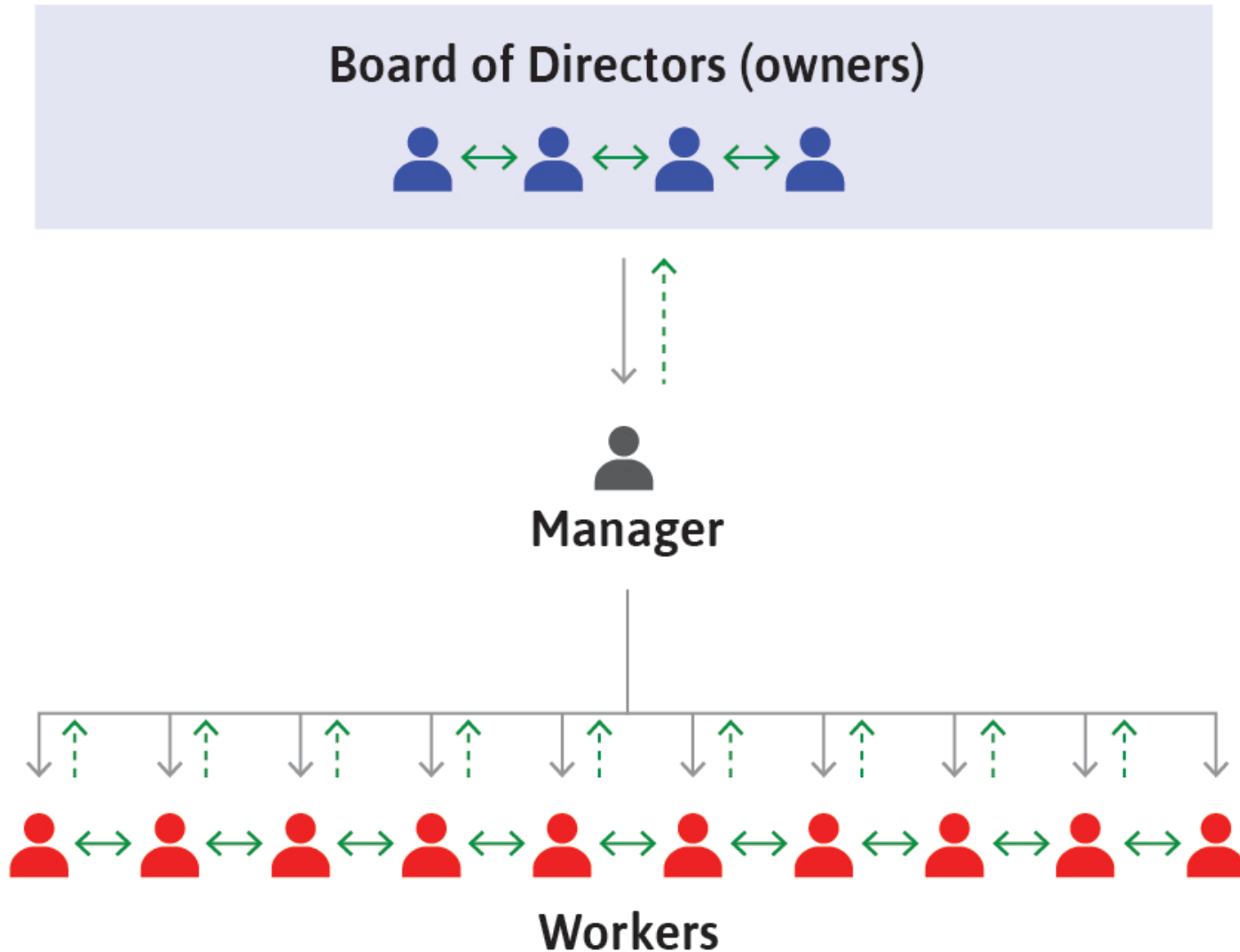
“The firm in a capitalist economy is a miniature, privately owned, centrally planned economy.”

ESPP 6.2

“...islands of conscious power in this ocean of unconscious cooperation”

D. H. Robertson, *The Control of Industry*

ORGANIZATIONAL STRUCTURES



Ownership?

Strategy?

Implementation?

Nonprofits?

Governments?

ORGANIZATIONAL STRUCTURES

**AMNESTY
INTERNATIONAL**



Proposal power

Enforcement power

Centralize

Implementation power

Decentralize

XYZ CAR SALES

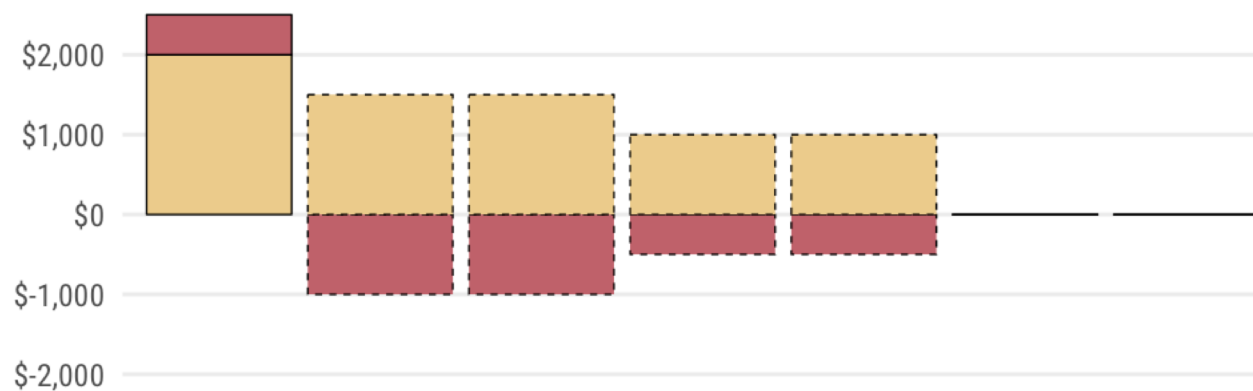
Lemons are resold for \$500

Good cars are resold for \$2,500

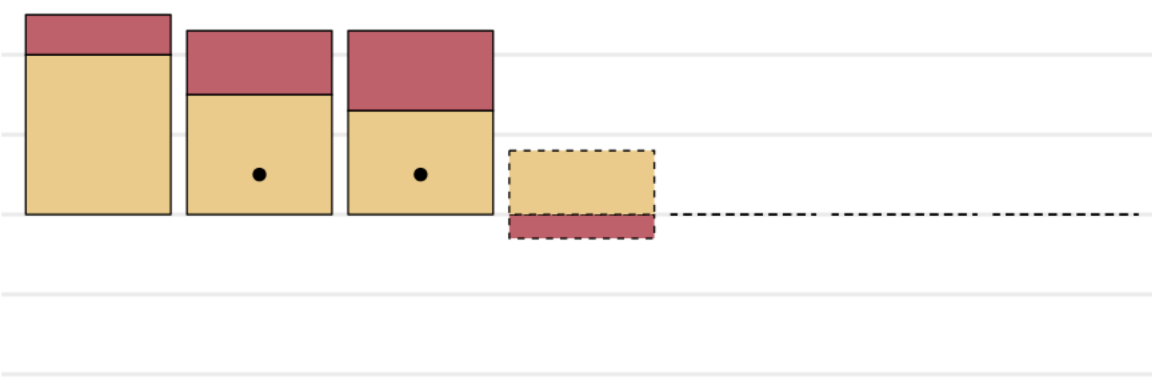
$\approx 50\%$ of cars are lemons

Profit

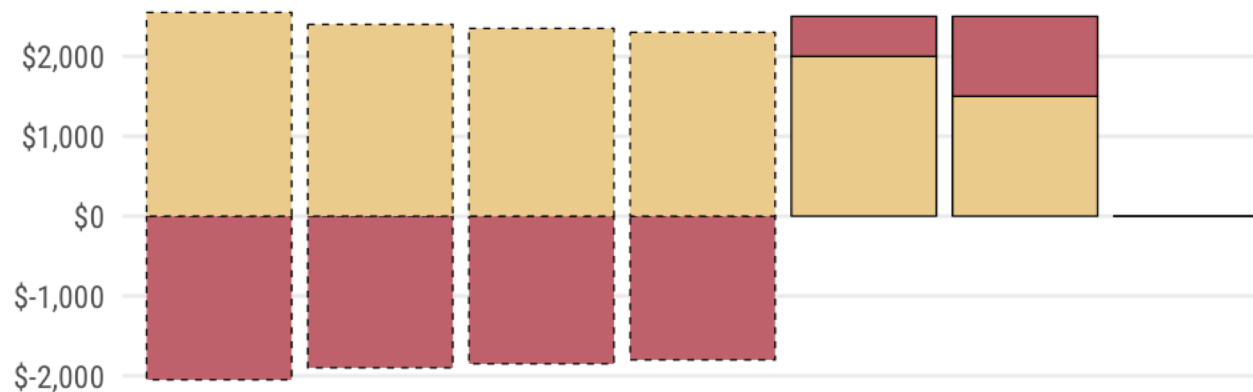
8:00
Round 1



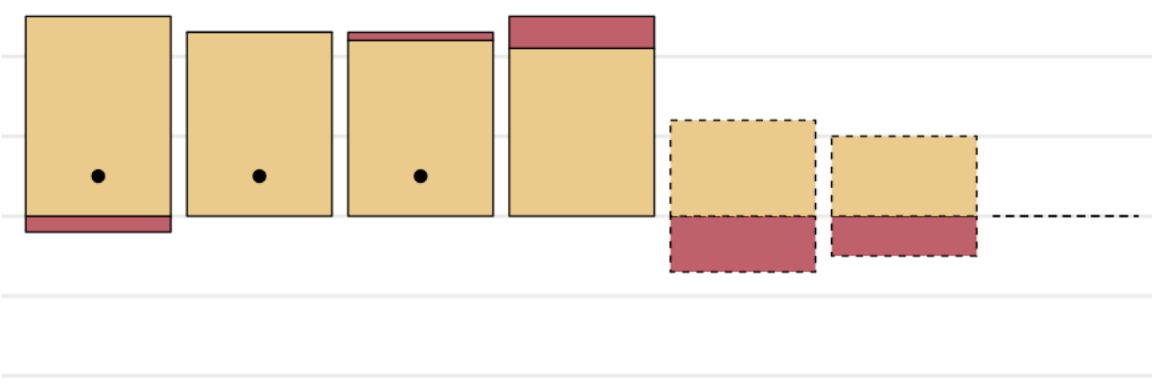
8:00
Round 2



9:30
Round 1



9:30
Round 2



■ Seller profit ■ Buyer profit □ Lemon □ Not a lemon • Carfax purchased

ASYMMETRIC INFORMATION

Adverse selection

Hidden knowledge

Lemons

Insurance

Death spirals

Moral hazard

Hidden action

Repairs

Crime prevention

Reaching exact incentives

ASYMMETRIC INFORMATION

Adverse selection

I'm going skydiving next week so I'll get insurance

Moral hazard

I have insurance so I'll take up skydiving

ASYMMETRIC INFORMATION

Adverse selection

Hidden knowledge

Fix with screening

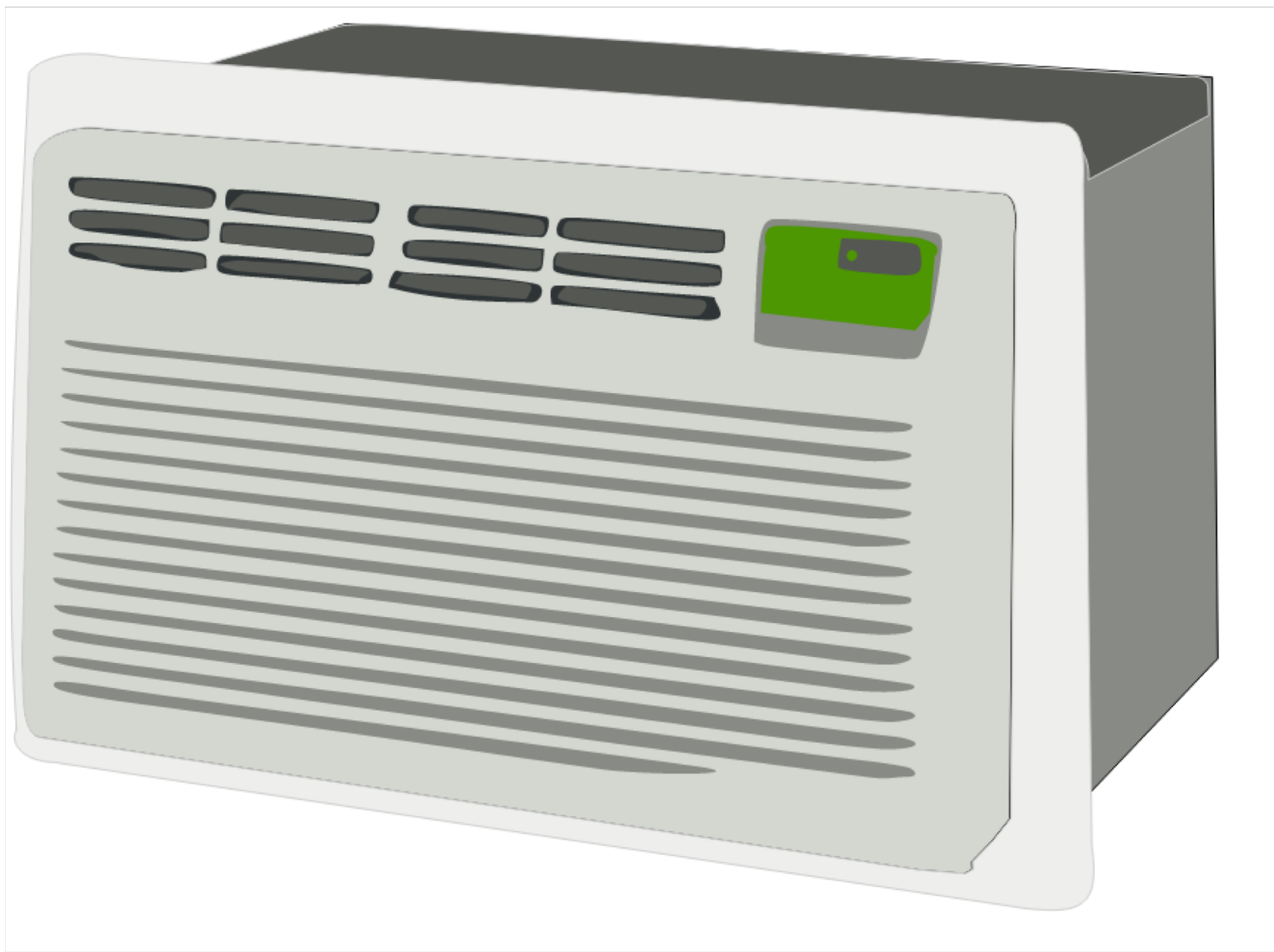
Moral hazard

Hidden action

Fix with monitoring

EXPLANATIONS GO BOTH WAYS





**OWNERS, MANAGERS,
AND EMPLOYEES**

PRINCIPAL-AGENT PROBLEMS

Principal gives an agent (1) authority, (2) autonomy, and (3) discretion to do something for them

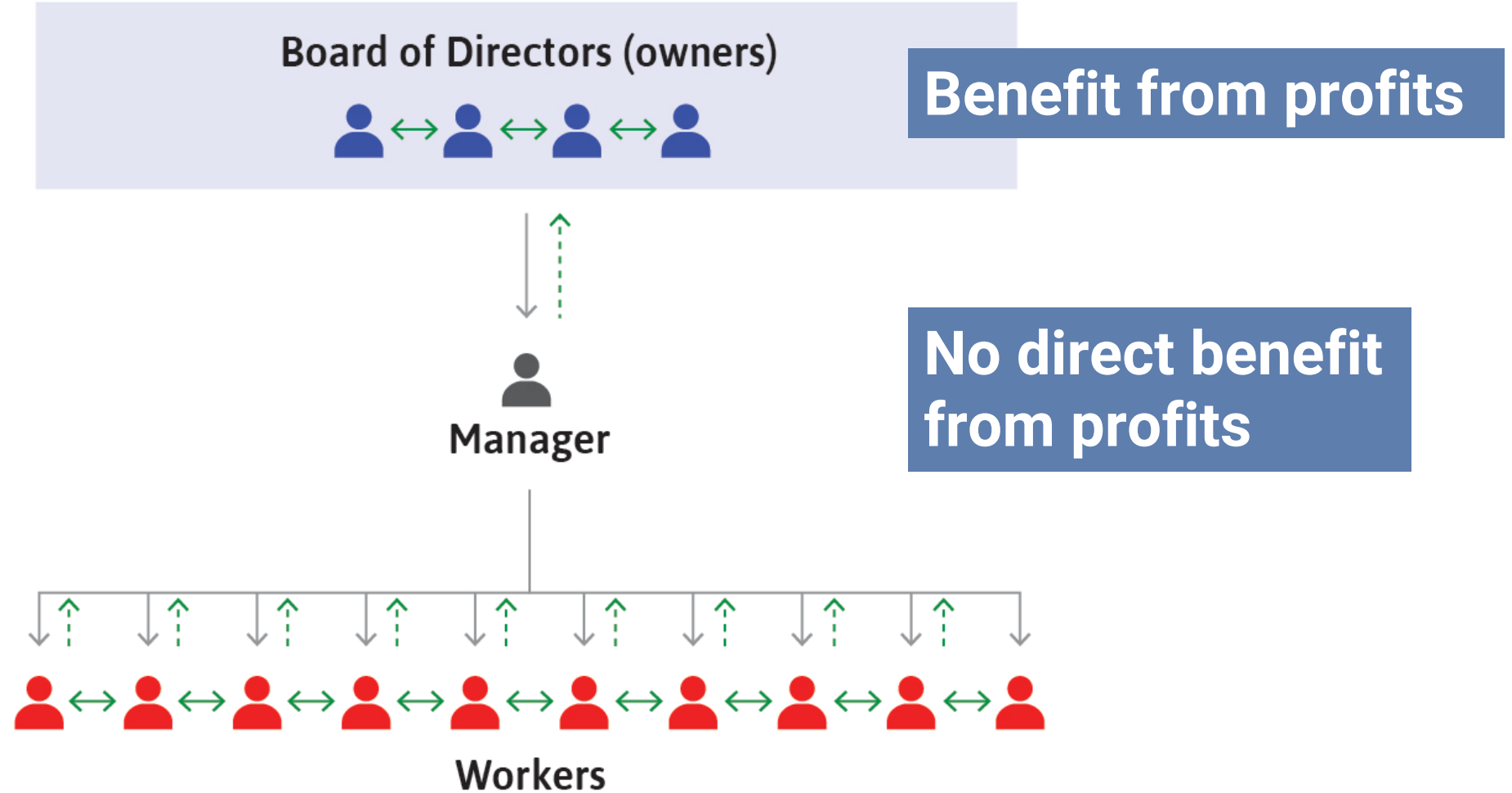
Principal lacks information to make sure agent does it

Agent's preferences don't always align with principal's

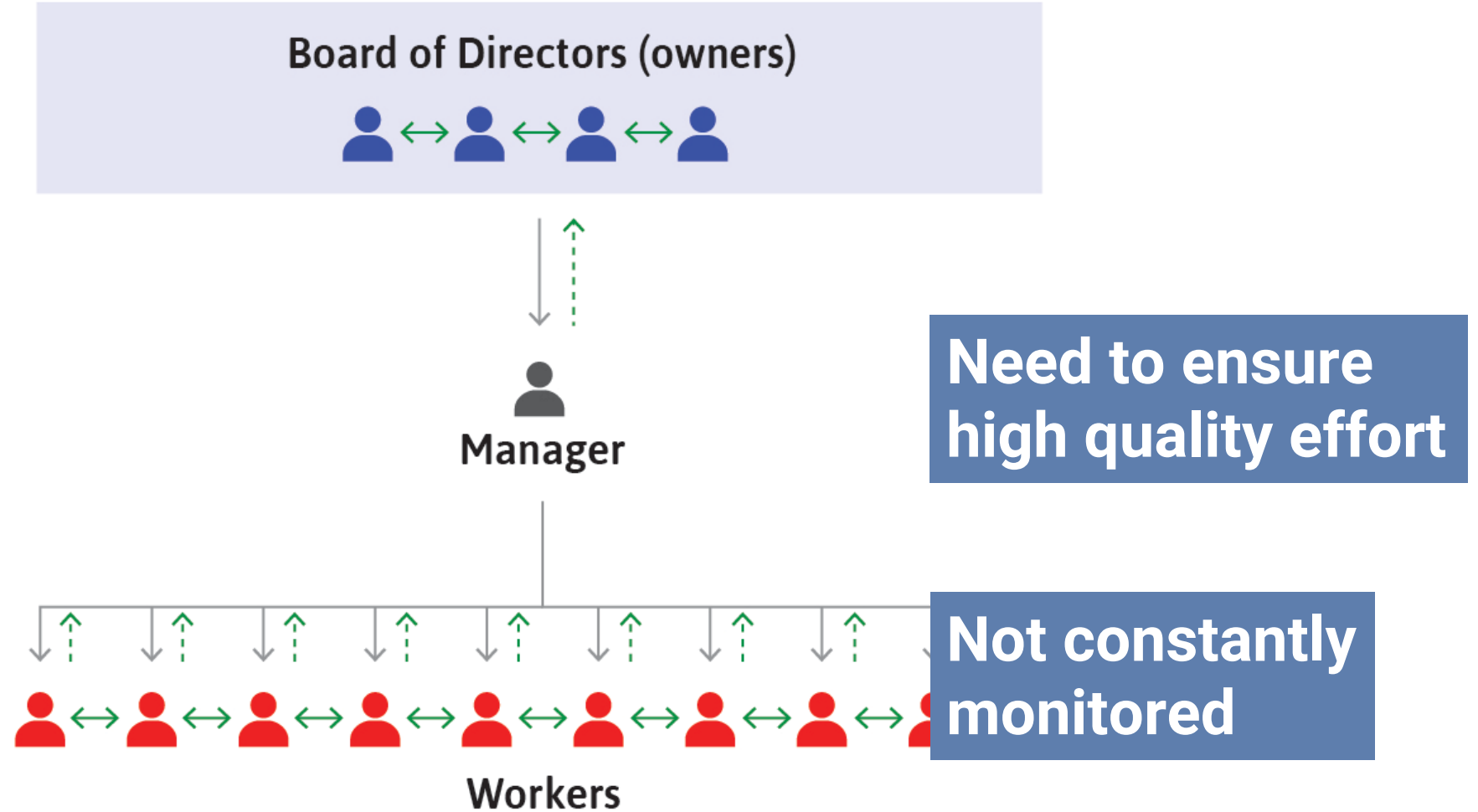


Principal	Agent	Action that is hidden and not covered in the contract
Employer	Employee	Quality and quantity of work
Banker	Borrower	Repayment of loan, prudent conduct
Owner	Manager	Maximization of owners' profits
Landlord	Tenant	Care of the apartment
Insurance company	Insured	Prudent behavior
Parents	Teacher/doctor	Quality of teaching and care
Parents	Children	Care in old age

CONFLICTS OF INTEREST



CONFLICTS OF INTEREST



How do you align everyone's interests?

Contracts!

A legal document or understanding that specifies a set of actions that parties to the contract must undertake

Temporary, limited transfer of authority
in labor markets

INCOMPLETE CONTRACTS

Contracts are inherently incomplete

Relationships are inherently asymmetric

Tasks based on unknown future

Tasks difficult to measure

Piece rate pay for MPA jobs?

But workers still work! Why?

Norms

Feelings of responsibility

Calling

Public service motivation

**For economists:
fear of being fired**

Next time!

LABOR DISCIPLINE

**Employers can't directly
monitor employees**

**Keep employees working by
increasing the cost of job loss**

Large employment rent →
large cost of job loss →
worker works more to avoid getting fired

ECONOMIC RENTS

Benefits of job

—

Costs of job

=

Employment rent

ECONOMIC RENTS

Benefits of her job (what Maria would lose if she lost it)	Example
Wage income (\$12 per hour)-unemployment benefit (\$6 per hour) while searching for a job	$12 - 6 = \$6$
Costs of her job (what Maria would gain if she lost it)	
Disutility of working (\$2 per hour)	\$2
Employment rent = Benefits - Costs	$\\$6 - \\$2 = \\$4$ per hour

THE LABOR DISCIPLINE GAME

Employer chooses a wage

If worker works hard enough, they keep job at that wage

Worker chooses level of effort

Worker considers costs of losing job if they don't work hard enough

Payoffs

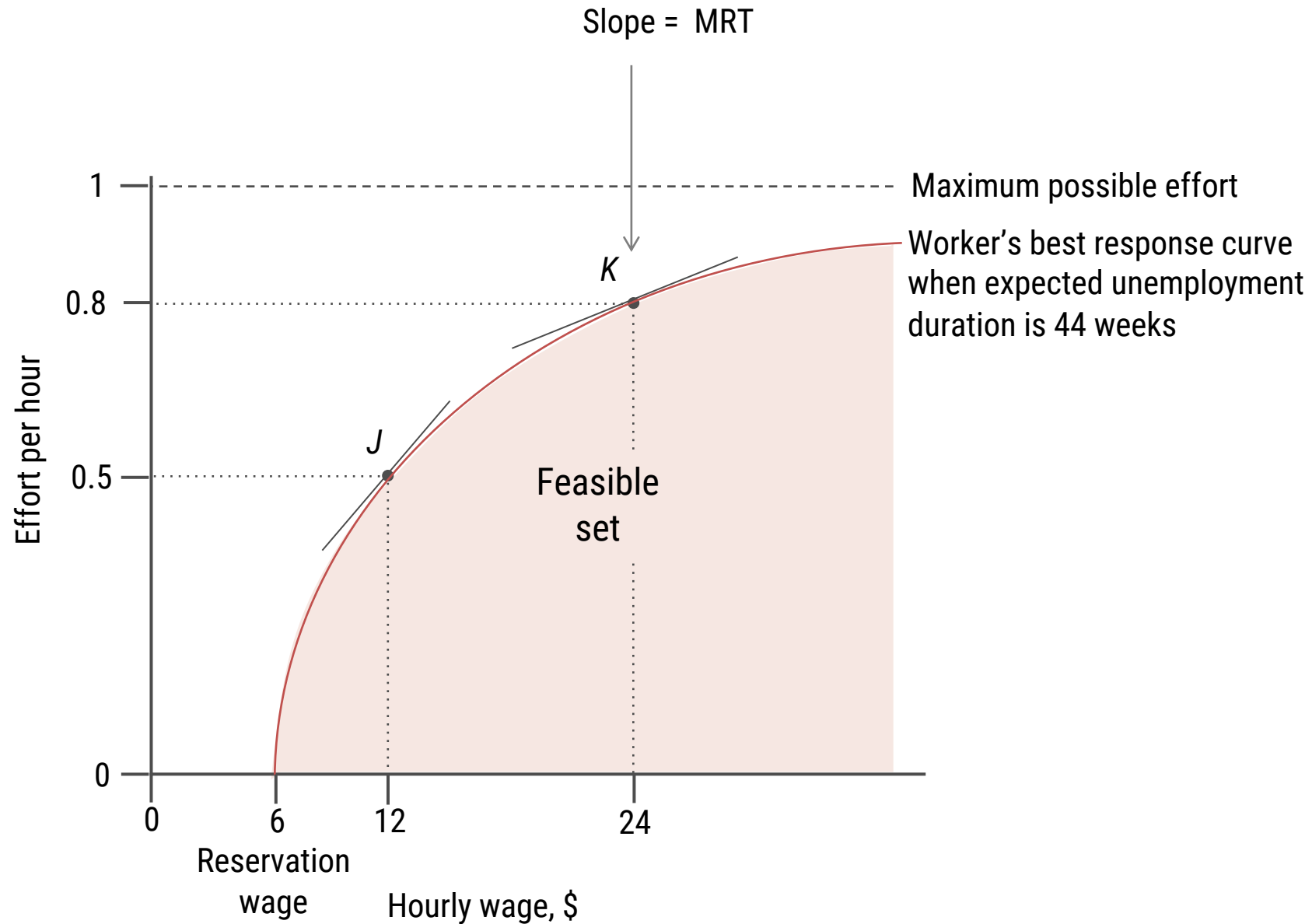
Firm: profit = worker's output – wage

Worker: employment rent

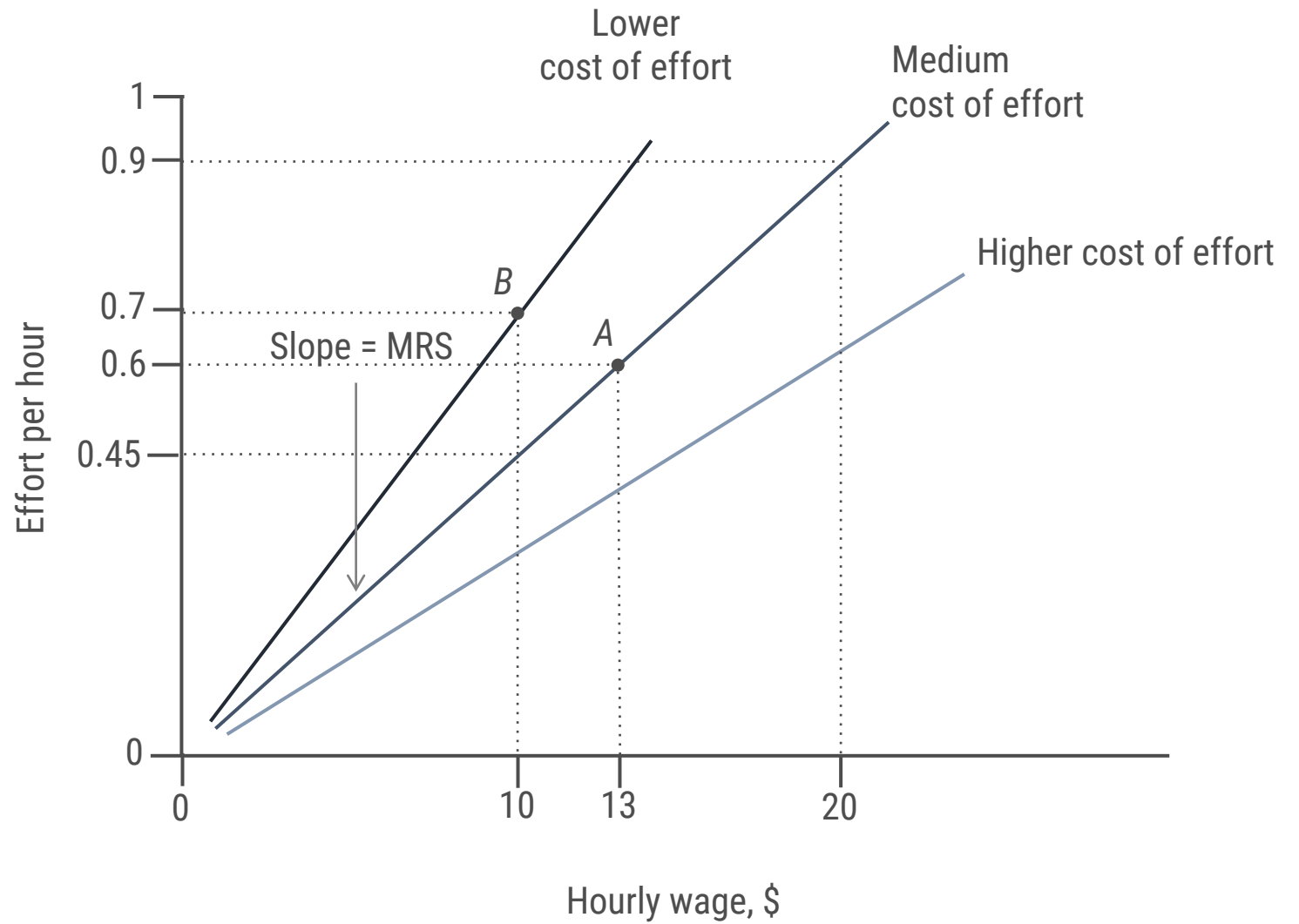
Response curve

Optimal effort
for each wage

Slope of feasible
frontier = MRT

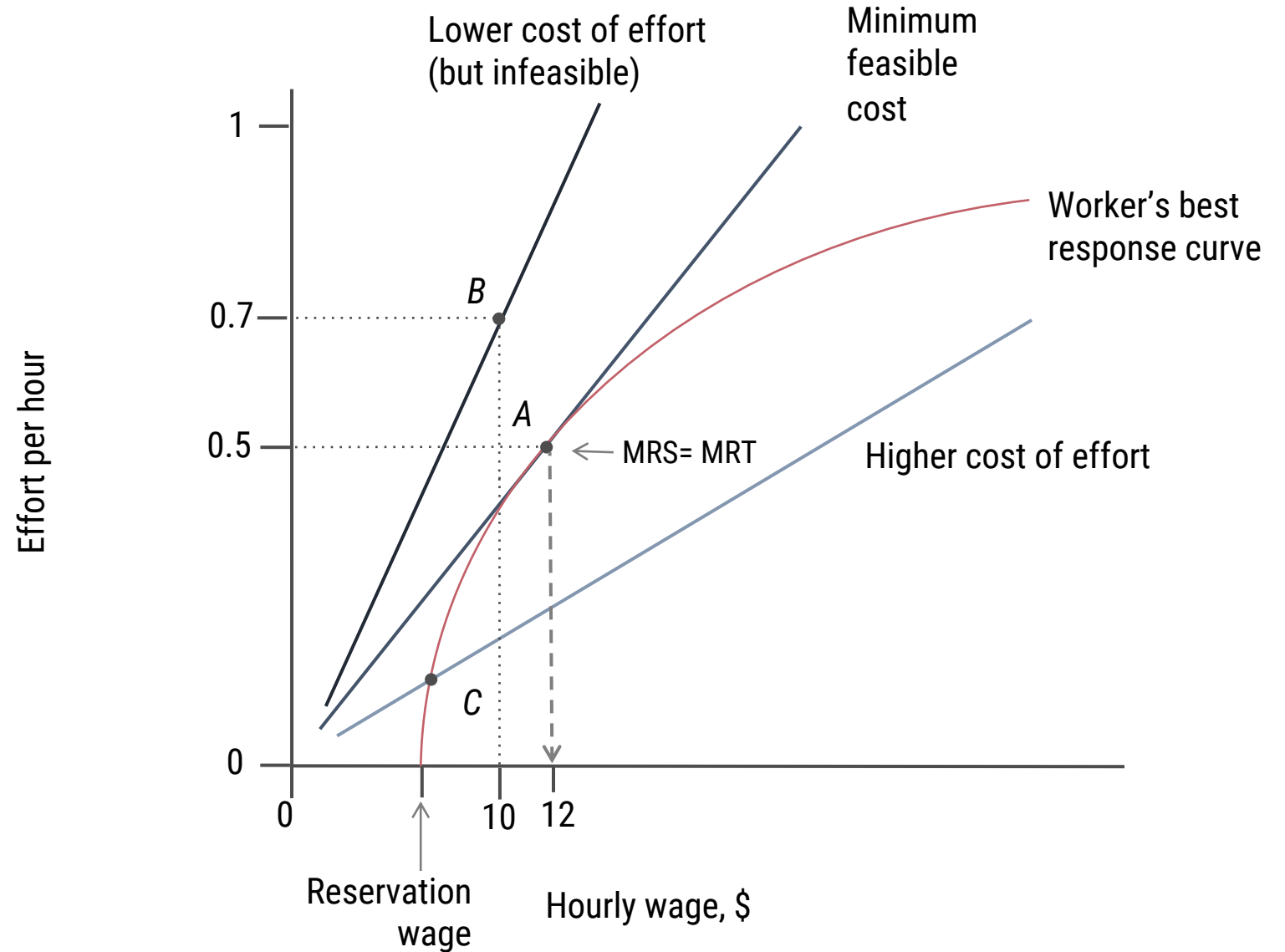


Isocost curves are like indifference curves for employers



MRS = MRT

Just like
indifference
curves and
budget lines



INVOLUNTARY UNEMPLOYMENT

**Necessary to keep
employment rent high enough
for workers to keep working**

4.5–6%

OUTSOURCING

Why is the outsourcing or privatization of government goods so popular?

How is outsourcing a principal-agent problem?

Is the privatization of public services a good thing?

Good: Lower cost

Bad: Lower quality

Irrelevant: Competition

THE PROPER SCOPE OF GOVERNMENT: THEORY AND AN APPLICATION TO PRISONS*

OLIVER HART
ANDREI SHLEIFER
ROBERT W. VISHNY

When should a government provide a service in-house, and when should it contract out provision? We develop a model in which the provider can invest in improving the quality of service or reducing cost. If contracts are incomplete, the private provider has a stronger incentive to engage in both quality improvement and cost reduction than a government employee has. However, the private contractor's incentive to engage in cost reduction is typically too strong because he ignores the adverse effect on noncontractible quality. The model is applied to understanding the costs and benefits of prison privatization.

I. INTRODUCTION

As a general rule, government employees provide most services paid for with tax revenues, such as the police, the military,

GIST OF THE MODEL

**Service provider can invest
in quality or in cost reduction**

**Cost reduction leads
to lower quality**

GIST OF THE MODEL

**If provider is government,
employee receives fraction
of returns on investment**

**If provider is private contractor, they
have control over asset and incentive to
improve quality *and* reduce costs**

GIST OF THE MODEL

***BUT* incentive to reduce costs
is too strong since private
contractors ignore the adverse
impact on quality**

CONDITIONS FOR OUTSOURCING

The bigger the adverse consequences of cost-cutting on quality, the stronger the case for in-house provision

In-house provision should focus on quality and provide enough incentives for employees

SHOULD GOVERNMENTS OUTSOURCE...

Snowplows

Garbage

Mail

Schools

Healthcare

Prisons

Police

Military