

# THE FIRM II

MPA 612: Economy, Society, and Public Policy

February 20, 2019

*Fill out your reading report  
on Learning Suite*

# PLAN FOR TODAY

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**Asymmetric information**

**Owners, managers, and employees**

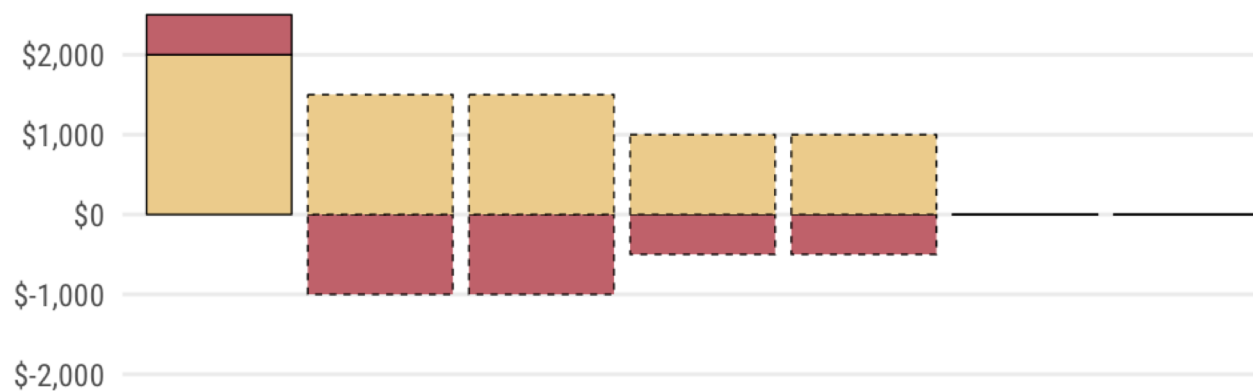
**Labor discipline**

**Outsourcing**

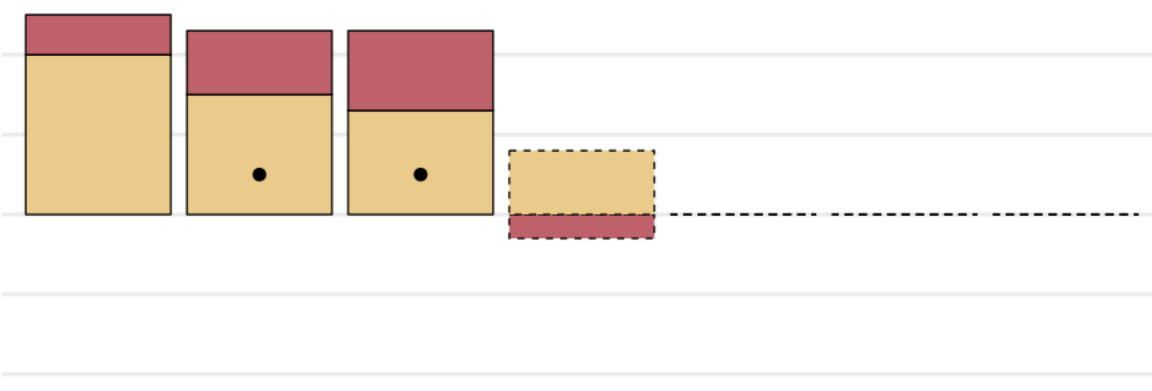
# ASYMMETRIC INFORMATION

Profit

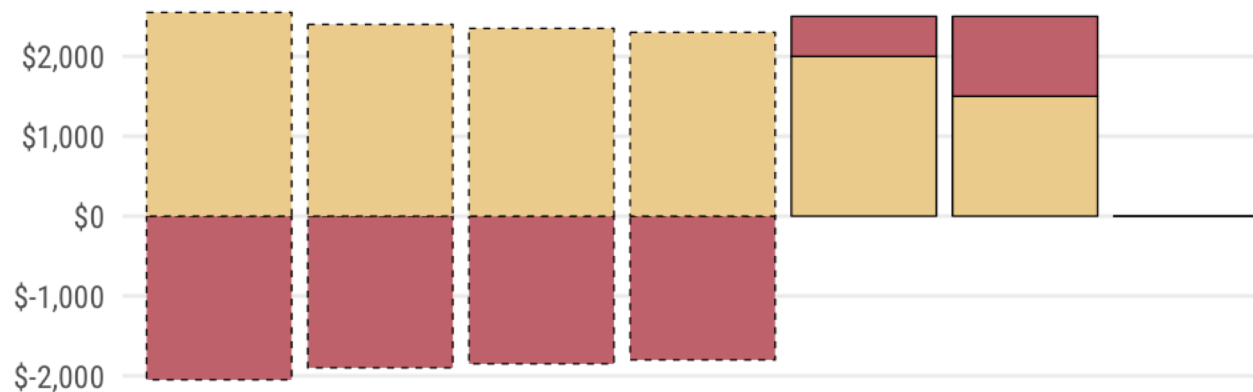
8:00  
Round 1



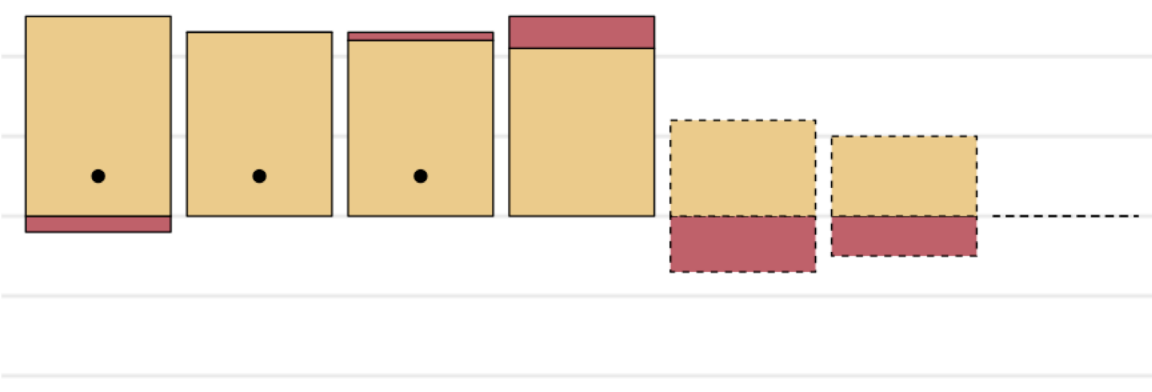
8:00  
Round 2



9:30  
Round 1



9:30  
Round 2



Seller profit Buyer profit Lemon Not a lemon Carfax purchased

# ASYMMETRIC INFORMATION

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## Adverse selection

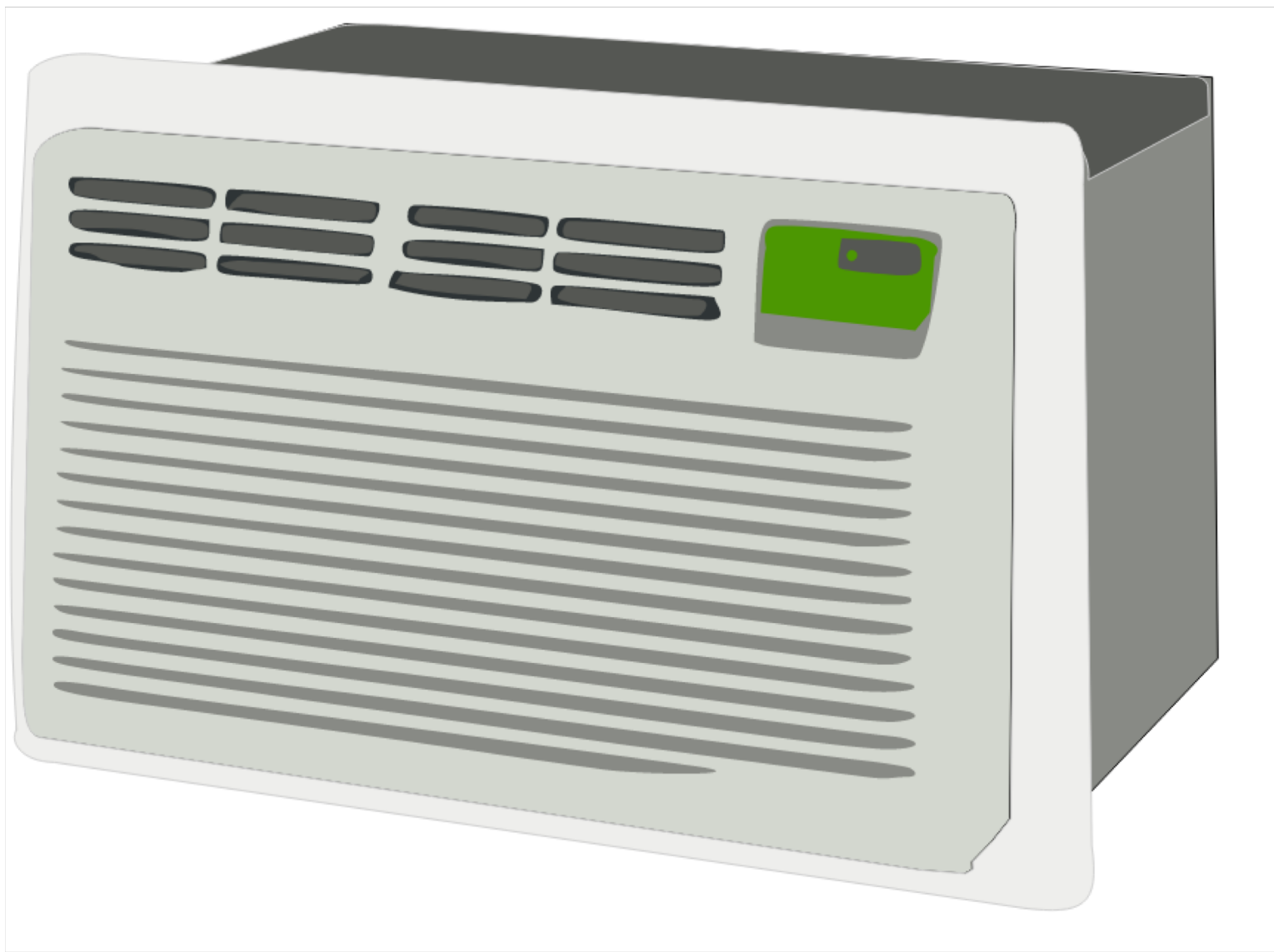
Hidden knowledge

Fix with screening

## Moral hazard

Hidden action

Fix with monitoring



**OWNERS, MANAGERS,  
AND EMPLOYEES**

# PRINCIPAL-AGENT PROBLEMS

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**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

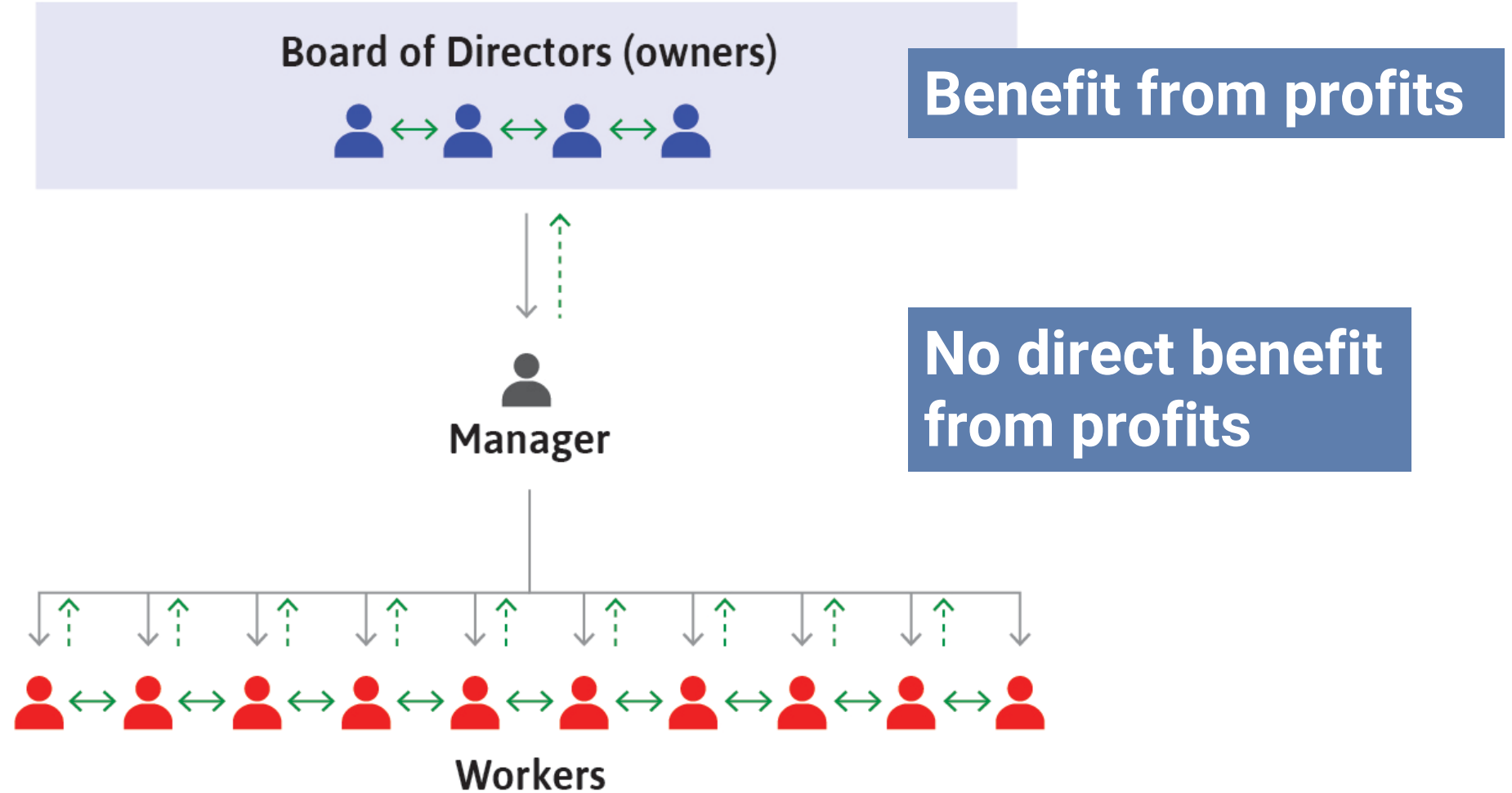
Agent's preferences don't always align with principal's



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

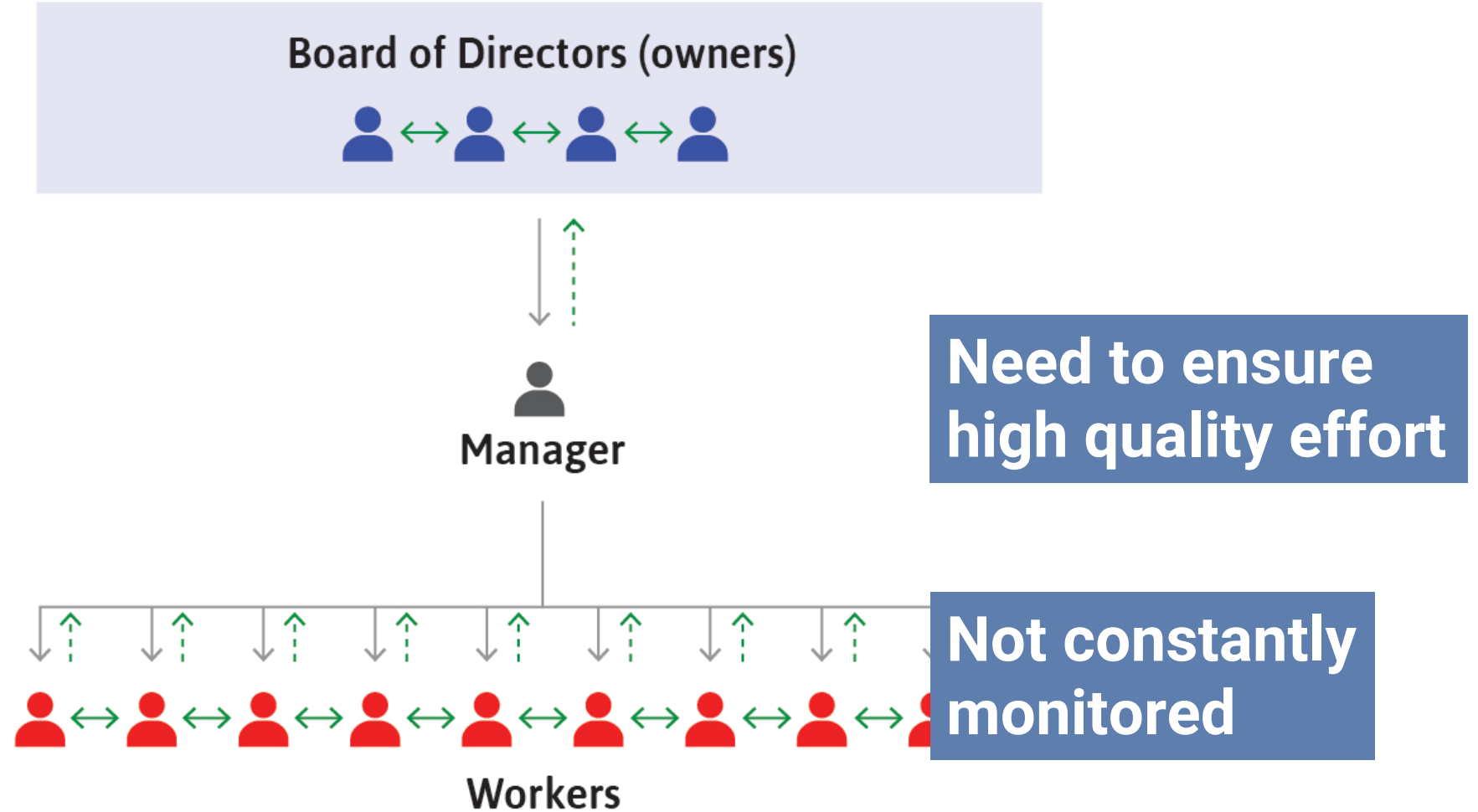
# CONFLICTS OF INTEREST

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# CONFLICTS OF INTEREST

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# 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

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**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

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**Benefits of job**

—

**Costs of job**

=

**Employment rent**

# ECONOMIC RENTS

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

# THE LABOR DISCIPLINE GAME

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**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**

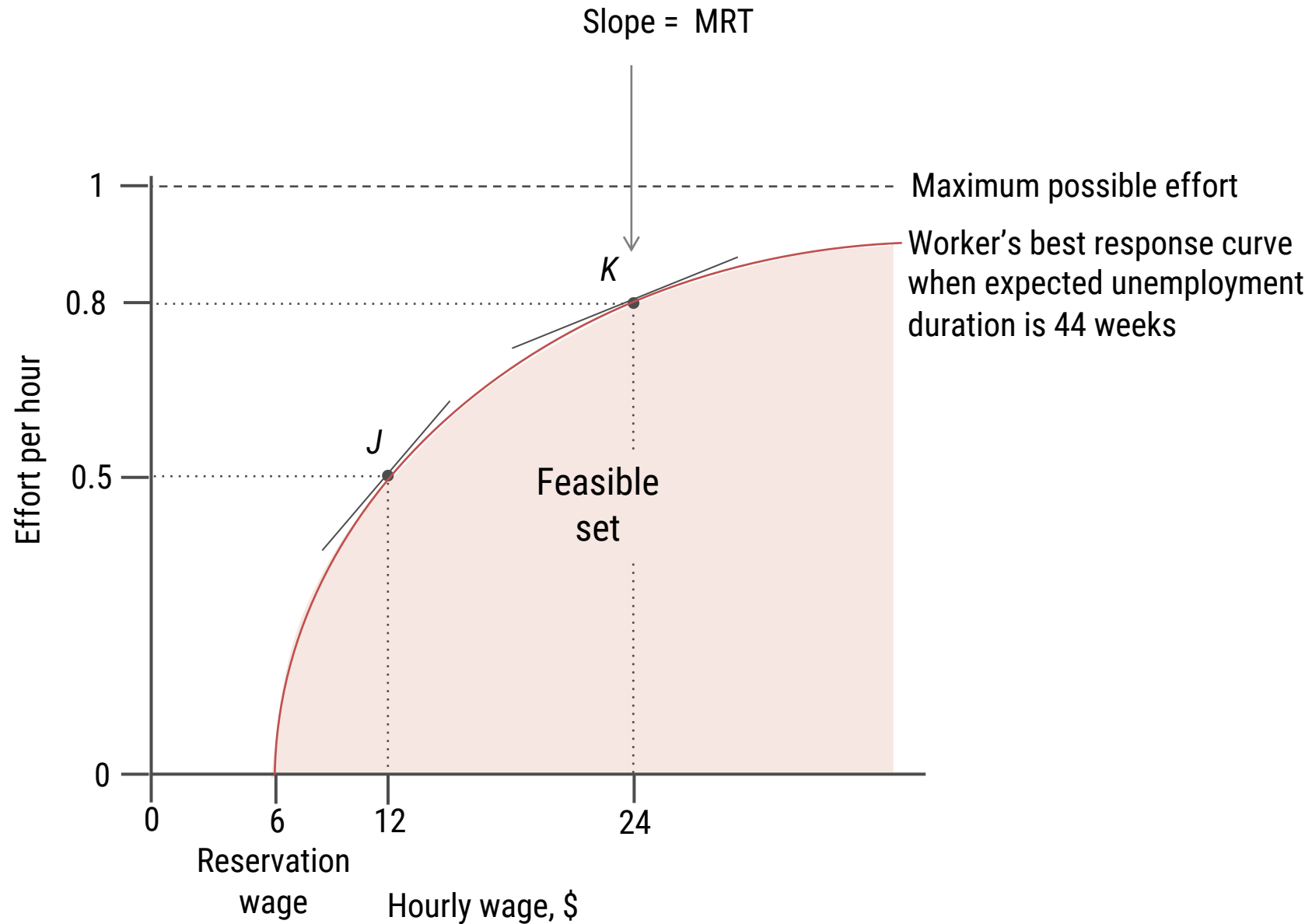
Firm: profit = worker's output – wage

Worker: employment rent

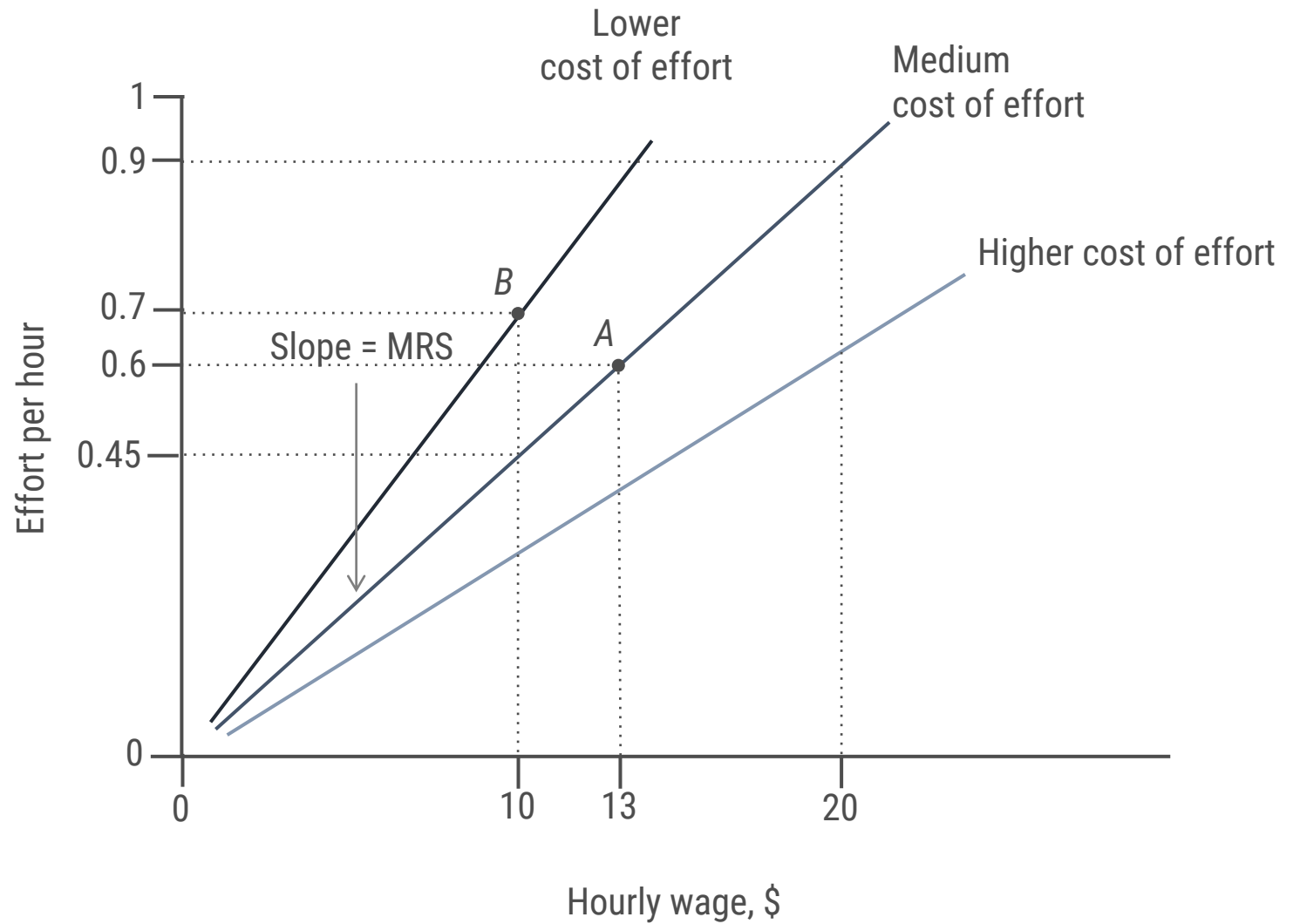
## Response curve

Optimal effort  
for each wage

Slope of feasible  
frontier = MRT

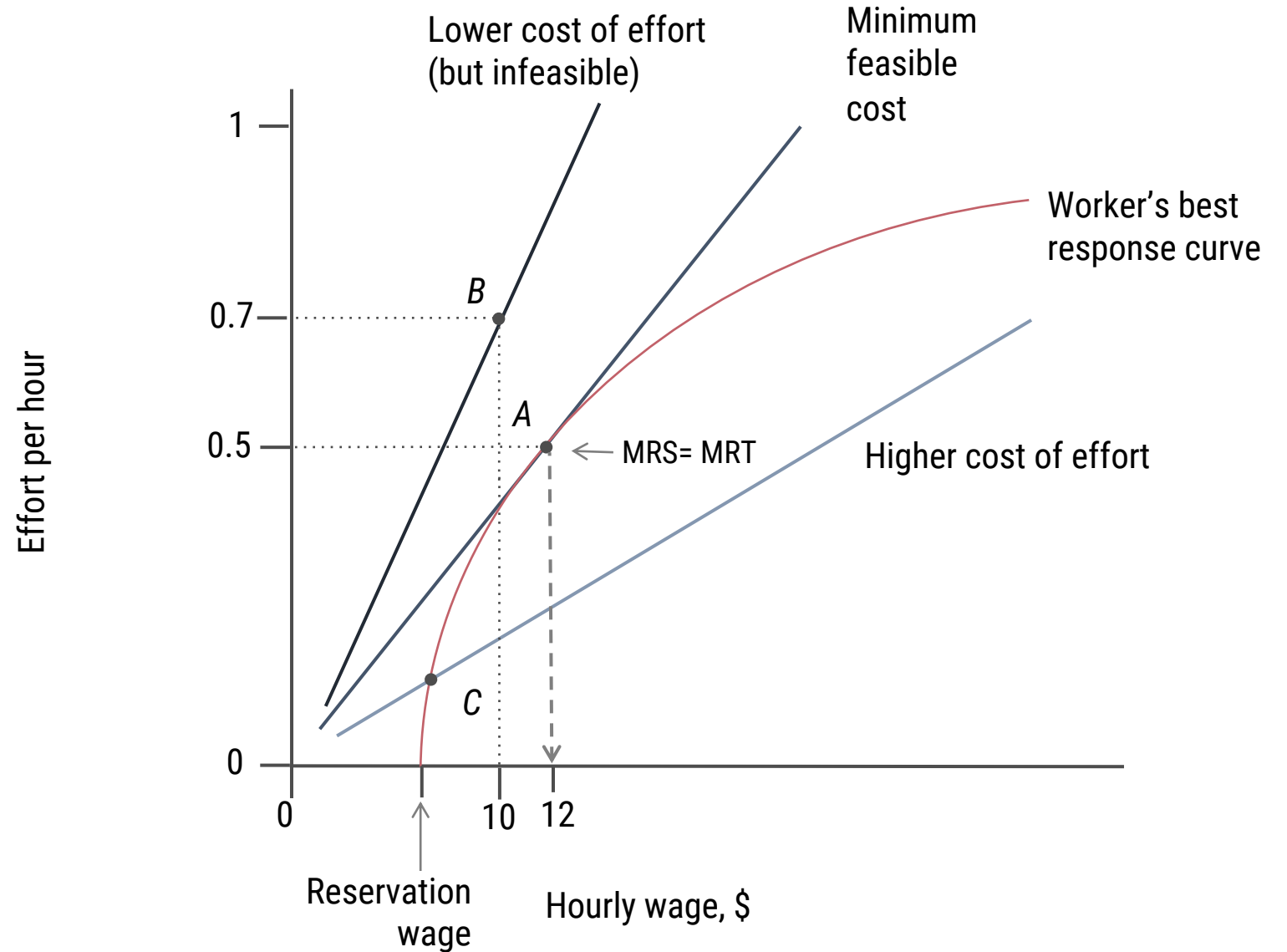


**Isocost curves** are like indifference curves for employers



$$\text{MRS} = \text{MRT}$$

Just like  
indifference  
curves and  
budget lines



# INVOLUNTARY UNEMPLOYMENT

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**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  
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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**

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

**Cost reduction leads  
to lower quality**

# **GIST OF THE MODEL**

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**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

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

# CONDITIONS FOR OUTSOURCING

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**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...

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**Snowplows**

**Garbage**

**Mail**

**Schools**

**Healthcare**

**Prisons**

**Police**

**Military**