Notes on "Assignment Problems and the Location of Economic Activities"

Koopmans and Beckmann, *Econometrica* 25(1), 1957

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Econon 345
This draft, January 16, 2007

Assignment Problem:

- Dispose of continuum assumption and implicit assumption that workers can be compared (e.g. A better than B everywhere). No aggregate "skill" or "capital" exists in model. Quality emerges as a special case of the model.

- **Perfect Certainty:**
  No transactions costs
  n **workers** n **firms**
  a homogeneous transferrable output.
  Can match one worker to one firm.

- a_{ij} : output of worker i at firm j.
- $A = (a_{ij})$ matrix of all possible assignments.
- We solve social planner's problem first to maximize output – then ask if it can be supported by a decentralized pricing function. Any assignment can be written as a permutation matrix $P = (P_{ij})$. Each row and column has $n-1$ zeros and 1 "1".
- Example

$$\begin{array}{c|ccc|}
 & & \textbf{Firm} & \\
\hline
 & 1 & 0 & 0 \\
\textbf{Worker} & 0 & 0 & 1 \\
 & 0 & 1 & 0 \\
\hline
\end{array} = P = (P_{ij})$$

- worker 1 - firm 1; worker 2 - firm 3; worker 3 - firm 2

Value of Total Output in Society

$$V = \sum_i \sum_j P_{ij} a_{ij}$$

- Problem: Find a P_{ij} that maximizes total output.
- Assume $a_{ij} \geq 0$.

- First: Consider fractional assignment problem.
- We split up fractions of workers and fractions of firms and allocate fractions.

$$\max_{\text{w.r.t. } X_{ij}} \quad \sum_{i,j} a_{ij} X_{ij}$$

- X_{ij} fraction of i assignment to j such that

$$\begin{aligned} \sum_j X_{ij} &= 1 \qquad i = 1, \ldots, n \\ \sum_i X_{ij} &= 1 \qquad j = 1, \ldots, n. \end{aligned}$$

- $X_{ij} \geq 0$.

- Solution can always be depicted on an "edge". Take $n = 2$.

$$A = \begin{pmatrix} a_{11} & a_{12} \\ a_{21} & a_{22} \end{pmatrix}$$

- Output is

$$a_{11}X_{11} + a_{12}X_{12} + a_{21}X_{21} + a_{22}X_{22}.$$

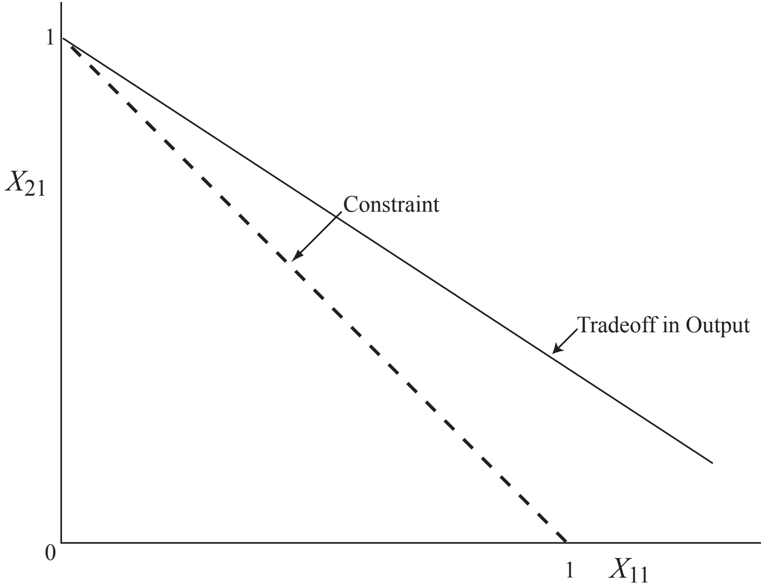
- Now

$$\begin{aligned} X_{11} + X_{12} &= 1 \\ X_{21} + X_{22} &= 1 \\ X_{11} + X_{21} &= 1 \\ X_{12} + X_{22} &= 1 \end{aligned}$$

- $\therefore$ output can be written

$$\begin{aligned} &= a_{11}X_{11} + a_{12}(1 - X_{11}) + a_{21}X_{21} + a_{22}(1 - X_{21}) \\ &= (a_{11} - a_{12})X_{11} + (a_{21} - a_{22})X_{21} + (a_{12} + a_{22}) \end{aligned}$$

- Assume $(a_{11} - a_{12})(a_{21} - a_{22}) > 0$.
- We obtain th following figure, assuming $a_{21} - a_{22} > a_{11} - a_{12}$.


1
X_{21}
Constraint
Tradeoff in Output
0
1
X_{11}

- Constraints $\Rightarrow$ that when $(a_{11} - a_{12}) = -(a_{21} - a_{22})$, and the slope $= 1$, the solution is indeterminate but lies along 45° line $\therefore$ we have solution at extremes as one case.

- Solutions are given at corners generically. $\therefore$ Use Linear Programming to solve problem and we get P as one representation.
- Permute original subscripts so that in equilibrium new labels have worker i matched with firm i. From standard duality theory in Linear Programming, we can derive dual prices. (Koopmans and Beckmann).

Theorem:

- There exists a system of wages w_i, $i = 1, \ldots, n$ a system of profits π_j, $j = 1, \ldots, n$, $a_{kk} = \pi_k$, $k = 1, \ldots, n$, $k = 1, \ldots, n$, i.e., worker k and firm i must be able to get more elsewhere than they do in an optimal assignment. In particular,

$$\pi_i \geq a_{ki} - w_k$$

(profits greater with i than with other workers given equilibrium assignments).

- On the worker side, we have

$$w_i \geq a_{ik} - \pi_k$$

(wages greater with i than elsewhere).

Theorem:

- Social optimum is decentralizable.
  Competition in the market leads to an optimum.
  Further: Given a set of π^S and w^S that satisfy (a) and (b), **output is maximized**

Proof:

$$V = \sum_{i,k} a_{ik} P_{ik}$$

By hypothesis $\pi_i + w_k \geq a_{ik}$

$$\begin{aligned} V &= \sum_{i,k} P_{ik} a_{ik} \leq \sum_{i,k} P_{ik}(w_i + \pi_k) \\ &= \left(\sum_k P_{ik}\right) \sum_i w_i + \left(\sum_i P_{ik}\right) \sum \pi_k \\ &= \sum w_i + \sum \pi_k = \sum a_{ii} \end{aligned}$$

(using biostochastic nature of permutation matrices, i.e., that rows and columns sum to one).

- **Observe:** Optimization for society does not necessarily imply picking best absolute matches in society.
- **Moreover:** Underlying principle of the problem is *not* comparative advantage.
- It is *opportunity cost*, more generally, although comparative advantage is consistent with opportunity cost.

$$\begin{array}{cc} & \textbf{Firm} \\ & \begin{array}{cc} 1 & 2 \end{array} \\ \textbf{Worker} \begin{array}{c} 1 \\ \\ 2 \end{array} & \left|\begin{array}{cc} 5 & 1 \\ & \\ 6 & 4 \end{array}\right| \end{array} \qquad \text{Max Output} = 9$$

- Here: Optimum is $1 \rightarrow 1, 2 \longrightarrow 2$
- **Worker 1**: Has comparative advantage in Firm 1
- **Worker 2**: Has comparative advantage in Firm 2

- Suppose instead that

		Firm	
		1	2
Worker	1	1	9
	2	2	11

Here: Optimum: $1 \rightarrow 1, 2 \rightarrow 2$

- Worker 1 has a comparative advantage in Firm 2:

$$\frac{9}{1} > \frac{11}{2}$$

- If both workers could work at the same firm (2) total output $= 20$.
- This change rules of 1-1 assignment — lets there be unlimited supply of firms.
- Worker 1 assigned to firm 2, gain 8 units, worker 2 assigned to firm 1, lose 9 units.
- In second assignment problem, worker 2 has absolute advantage over worker 1.

- **Absolute Advantage:** $a_{11} > a_{21}$ worker one better than worker 2 at each firm.

$$a_{12} > a_{22}.$$

- **Comparative Advantage**: $a_{11}/a_{12} > a_{21}/a_{22}$.
- Worker is more productive in sector 1.
- In the assignment problem, we have that for an optimum allocation

$$\begin{aligned} a_{11} + a_{22} &> a_{12} + a_{21} \\ \text{i.e.,} \quad a_{11} - a_{12} &> a_{21} - a_{22}. \end{aligned}$$

- Neither absolute nor comparative advantage is the controlling principle.
- Basic idea is opportunity cost.

- Let

$$\begin{aligned} a_{11} &= 3 \qquad a_{12} = 1 \\ a_{21} &= 4 \qquad a_{22} = 1 \end{aligned}$$

- Optimal assignment is

  2 worker - one firm; 1 worker - two firm

- Obviously absolute advantage is *irrelevant*.

Properties of Equilibrium

- Consider out of equilibrium matches and their associated prices
$$a_{ik} - a_{kk} \leq w_i + \pi_k - (w_k + \pi_k)$$
- The system is supported by wages *alone* and if wages satisfy above
$$(a_{ik} - a_{kk} \leqq w_i - w_k)$$
can define $\tilde{\pi}_i = a_{ii} - w_i$ that support equilibria.
- Each firm need only know all wages and its net output with all workers - not output of other firms (informational decentralization).

- Observe also: Nonuniqueness of the price equilibrium

$$\pi_k^* = \pi_k - \lambda \qquad w_i^* = w_i + \lambda$$

supports optimum as well for any λ ($\lambda \geq 0$; ≤ 0).
- Moreover can tamper with individual wages.
- Select λ_k and $\eta_i \ni \pi_k^* = \pi_k - \lambda_k$,

$$i = 1, \ldots, n, \qquad k = 1, \ldots, n$$

- Leads to rent division problem.
- Solved in Sattinger by continuum assumption.

- Observe also that if

$$a_{ik} > a_{kk} \Rightarrow w_i > w_k$$

(worker i more productive at k than worker k his wage is higher).

- Obviously if $a_{jm} \geq a_{\ell m} \qquad m = 1, \ldots, k$

$$w_j \geq w_\ell$$

Pairwise j is better than ℓ. If it is true for all pairs then each pair can be ordered. We have an ordinal efficiency scale for workers based on ranks.

- No notion yet of efficiency units: complete ordering defines a kind of ordinal efficiency unit.
- Not a *scale* which entails a sense of cardinality.
- Suppose we postulate a scale for workers:

$$\ell_1 > \ell_2 > \cdots > \ell_n$$

- Another scale for firms:

$$c_1 > c_2 > \cdots > c_n$$

Firm

$$
\begin{array}{c|cccc|}
\cline{2-5}
 & a_{11} & a_{12} & \dots & a_{1n} \\
\textbf{Worker} & \vdots & & & \vdots \\
 & a_{n1} & \dots & \dots & a_{nn} \\
\cline{2-5}
\end{array}
$$

- We can define a function

$$a_{11} = g(\ell_1, c_1), \quad a_{12} = g(\ell_1, c_2)$$

- We might get monotonicity in both arguments. If optimum has best worker with best firm $\Rightarrow$ complementarity in the sense that $\ell_j > \ell_k$, $c_j > c_k$ implies

$$\begin{aligned} g(\ell_j, c_j) + g(\ell_k, c_k) &> g(\ell_j, c_k) + g(\ell_k, c_j) \qquad (*) \\ \text{i.e.,} \quad g(\ell_j, c_j) - g(\ell_k, c_j) &\geq g(\ell_j, c_k) - g(\ell_k, c_k) \end{aligned}$$

- Increments in output between ℓ_j and ℓ_k higher the bigger c.
- Nothing in problem defines an order or even requires complementarity or any sorting condition.

- Conversely, if we have complementarity in this sense, then best worker must be matched with best firm. Then, given complementarity we can meaningfully talk about absolute advantage and it is the controlling principle.
- Recall that, for such a model, *comparative* advantage is not relevant
- Why? Because we have (assuming $g > 0$)

$$\frac{g(\ell_j, c_j)}{g(\ell_j, c_k)} > \frac{g(\ell_k, c_j)}{g(\ell_k, c_k)} \qquad (**)$$

  (comparative advantage).
- $(**) \not\Rightarrow (*)$

- Now, if we have that

$$g(\ell_j, c_j) - g(\ell_k, c_j) \leq g(\ell_j, c_k) - g(\ell_k, c_k),$$

  the factors are substitutes. Solution is to match best worker with worst firm.
- To see why, take a 2-person problem:

$$\ell_1 > \ell_2, c_1 > c_2,$$

  but $g(\ell_1, c_1) - g(\ell_2, c_1) \leq g(\ell_1, c_2) - g(\ell_2, c_2)$, i.e., we have $g(\ell_1, c_1) + g(\ell_2, c_2) < g(\ell_1, c_2) + g(\ell_2, c_1)$.
- We get an inverse ordering.

- Example: Cobb Douglas

$$g = \ell c \Rightarrow + \text{ sorting}$$
$$g = \ell / c \Rightarrow - \text{ sorting.}$$

- Comparability of workers not required to define an equilibrium but we have that we get notions of "best" and "worst" — really of only heuristic value.

- Suppose that the number of workers and number of firms is not equal? Who is unemployed? Assume capital fully employed. Which type of labor is unemployed?
  Take our ordinal efficiency units assumption.

$$\ell_1 > \ell_2 > \cdots > \ell_N > \ell_{N+1} > \ell_{N+2} > etc.$$

$$c_1 > c_2 > \cdots > c_N.$$

Two Cases:

(A) All workers have same reservation wage w_R (What they earn if not working) (Ricardian notion).

Assume worst worker is laid off. We show that this is optimal.

Assume worst worker paired with worst employed c (complementarity). Then replace worst worker with someone *below* him, e.g. ℓ_{N+1}.
Total output loss is

$$\begin{aligned} & -[g(\ell_N, c_N) - w_R] + [g(\ell_{N+1}, c_N) - w_R] \\ = \; & g(\ell_{N+1}, c_N) - g(\ell_N, c_N) < 0 \end{aligned}$$

Least productive are the unemployed. (Obviously true if best ℓ work with worst c, i.e., substitute case). What governs this case is the greater productivity of worker ℓ_N.

(B) Now suppose that the reservation wage comes from *same technology*, i.e., $g(\ell_{N+1}, 0) \neq 0$, $g(0, c_j) \neq 0$ all $N+1$ all c_j.

Then test the previous equilibrium: gain in moving in ℓ_{N+1} in place of ℓ_N:

$$
\begin{aligned}
& [g(\ell_{N+1}, c_N) - g(\ell_{N+1}, 0)] - [g(\ell_N, c_N) - g(\ell_N, 0)] \\
= \; & [g(\ell_{N+1}, c_N) - g(\ell_N, c_N)] - [g(\ell_{N+1}, 0) - g(\ell_N, 0)] \\
= \; & \underbrace{[g(\ell_{N+1}, c_N) - g(\ell_N, c_N)]}_{\text{by complementarity this term}} + \underbrace{[g(\ell_N, 0) - g(\ell_{N+1}, 0)]}_{\text{is greater than this term}}
\end{aligned}
$$

$\therefore$ lay off worst.

1. Substitutability implies opposite.
2. In this case, you do not employ *best* workers. (Replace c_N with c_1 above to make proof rigorous). ■

- Now, we can refine bounds on wages. (See Sattinger, factor pricing in Assignment Problem). See also Shapley and Schubik.

Bounds

- Bounds on wages and an implicit technology: Set $(a_{ij}) = A$ assignment matrix (non-negative elements) assume it is of rank r. Use the singular value decomposition (spectral decomposition).
- Let A be square (not really needed). See C. R. Rao (1971)
  $\underset{\sim}{\lambda}$ is matrix of eigenvalues of A. Then we know from linear algebra that there exists
  $\begin{matrix} P & (M \times r) & \lambda(r \times r) \\ Q & M \times r & A = P\lambda Q' \end{matrix}$ where columns of P are orthonormal (mutually orthogonal L unit length)
  true even if A is $m \times n$ $m \neq n$
  P is $m \times r$ λ is $r \times r$ Q is $n \times r$.

- Unique if all $\lambda_i > 0$. Then

$$a_{ij} = \sum_{k=1}^{r} \lambda_k P_{ik} q_{jk}.$$

- Rank one case is Cobb-Douglas (assuming $\exists$ a cardinal scale)

$$\begin{aligned} a_{ij} &= \ell_i c_j \\ A &= \begin{pmatrix} n \times 1 \\ \underset{\sim}{\ell} \end{pmatrix} \begin{pmatrix} 1 \times n \\ \underset{\sim}{c} \end{pmatrix}' \\ A &= (\underset{\sim}{\ell})(\underset{\sim}{c})'. \end{aligned}$$

- The spectral decomposition assigns a Cobb-Douglas interaction to each component:

P_{ik} is quality k of worker i
q_{jk} is quality k of firm j.

- $\therefore$ implicitly we have a Cobb-Douglas technology in qualities

$$\begin{pmatrix} P_{11} & \cdots & P_{1r} \\ \vdots & & \vdots \\ P_{n1} & \cdots & P_{nr} \end{pmatrix} \begin{pmatrix} \lambda_1 & & 0 \\ & \ddots & \\ 0 & & \lambda_r \end{pmatrix}$$

$$\begin{pmatrix} q_{11} & \cdots & q_{n1} \\ \vdots & & \vdots \\ q_{1r} & \cdots & q_{nr} \end{pmatrix}.$$

- Observe $a_{ii} = w_i + \pi_i$. Now $a_{ji} \leq w_j + \pi_i$

$$\begin{aligned} a_{ii} &= w_i + \pi_i \\ a_{ji} - a_{ii} &\leq w_j - w_i. \end{aligned}$$

- $\therefore w_i - w_j \leq a_{ii} - a_{ji}$.

- Similarly we have that

$$a_{ij} - a_{jj} \leq w_i - w_j$$

$\therefore\ a_{ij} - a_{ii} \leq w_i - w_j \leq a_{ii} - a_{ji}$

- Now use spectral decomposition

$$a_{ij} - a_{jj} \;=\; \sum_{k=1}^{r} \lambda_k \left(p_{ik} - p_{jk} \right) q_{jk}$$

like marginal product

$$\therefore \sum_{k=1}^{r} \lambda_k (P_{ik} - P_{jk}) q_{jk} \leq w_i - w_j \leq \sum_{k=1}^{r} \lambda_k (P_{ik} - P_{jk}) q_{ik}$$

- Left and right hand sides are differential marginal product using firm j and firm i^s attributes, respectively. Suppose all firms alike: $q_{jk} = q_{ik}$ (firms possess no identity). Then we get Gorman-Lancaster form of the model

$$w_i - w_j = \sum_{k=1}^{r} \lambda_k (P_{ik} - P_{jk}) q_k$$

(pure factor structure model).
- Otherwise, we get the notion that workers have different productivities depending on properties of firms). (Then characteristics payment will depend on distributions of firms.