

# The Firm

Sessions 7–8

PMAP 8141: Microeconomics for Public Policy  
Andrew Young School of Policy Studies

# Plan for today

Income and substitution effects

Firms

Asymmetric information

Owners, managers, and employees

# Income and substitution effects

# Why do we even care about indifference curves?

Indifference curve meeting budget line =  
**where happiness meets reality**

Policies change individual budget lines and move  
people to different indifference curves

## Normal goods

As income increases, you buy more

## Inferior goods

As income increases, you buy less

# Income effect

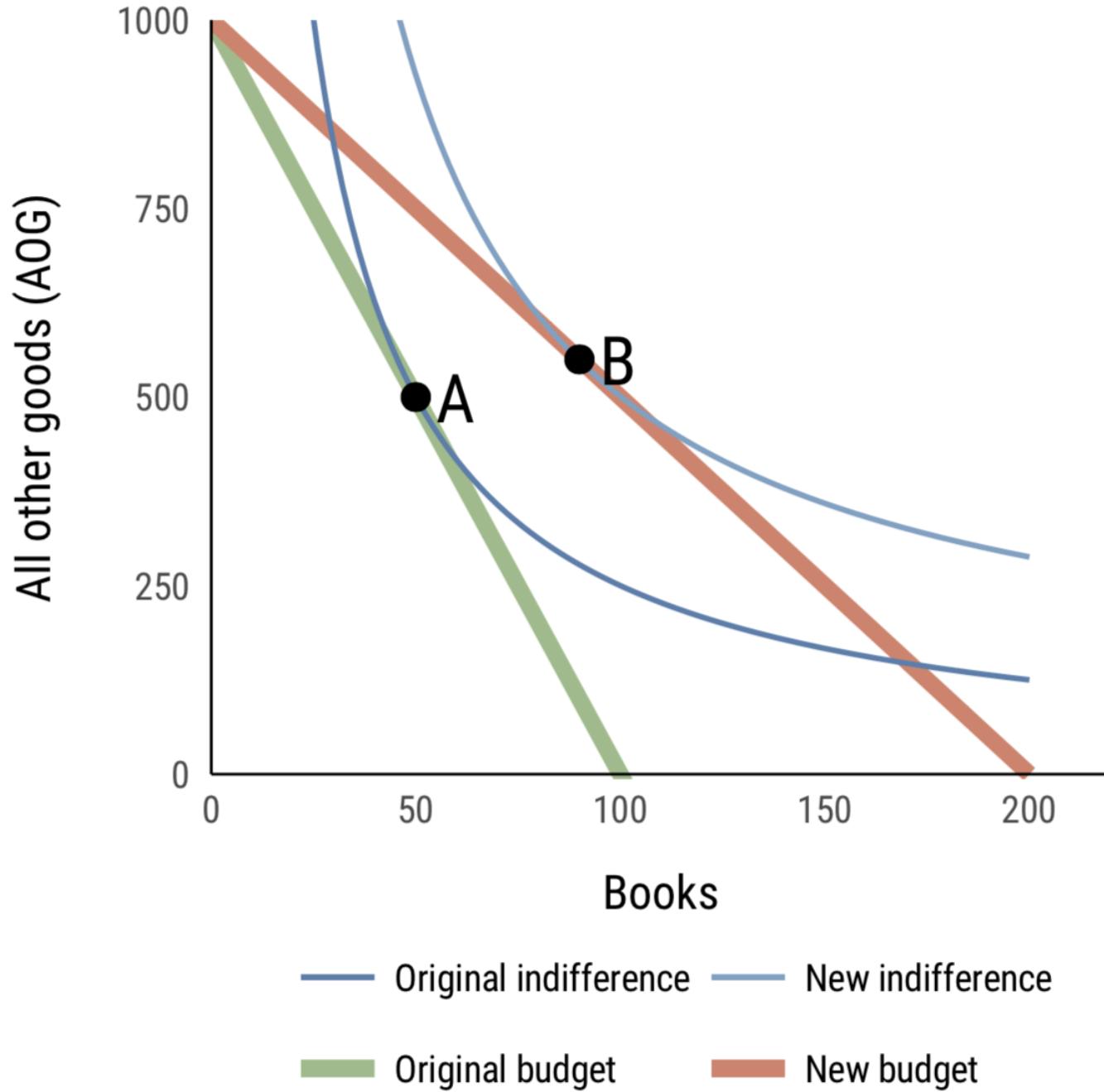
How much more/less of X you consume because you're richer/poorer

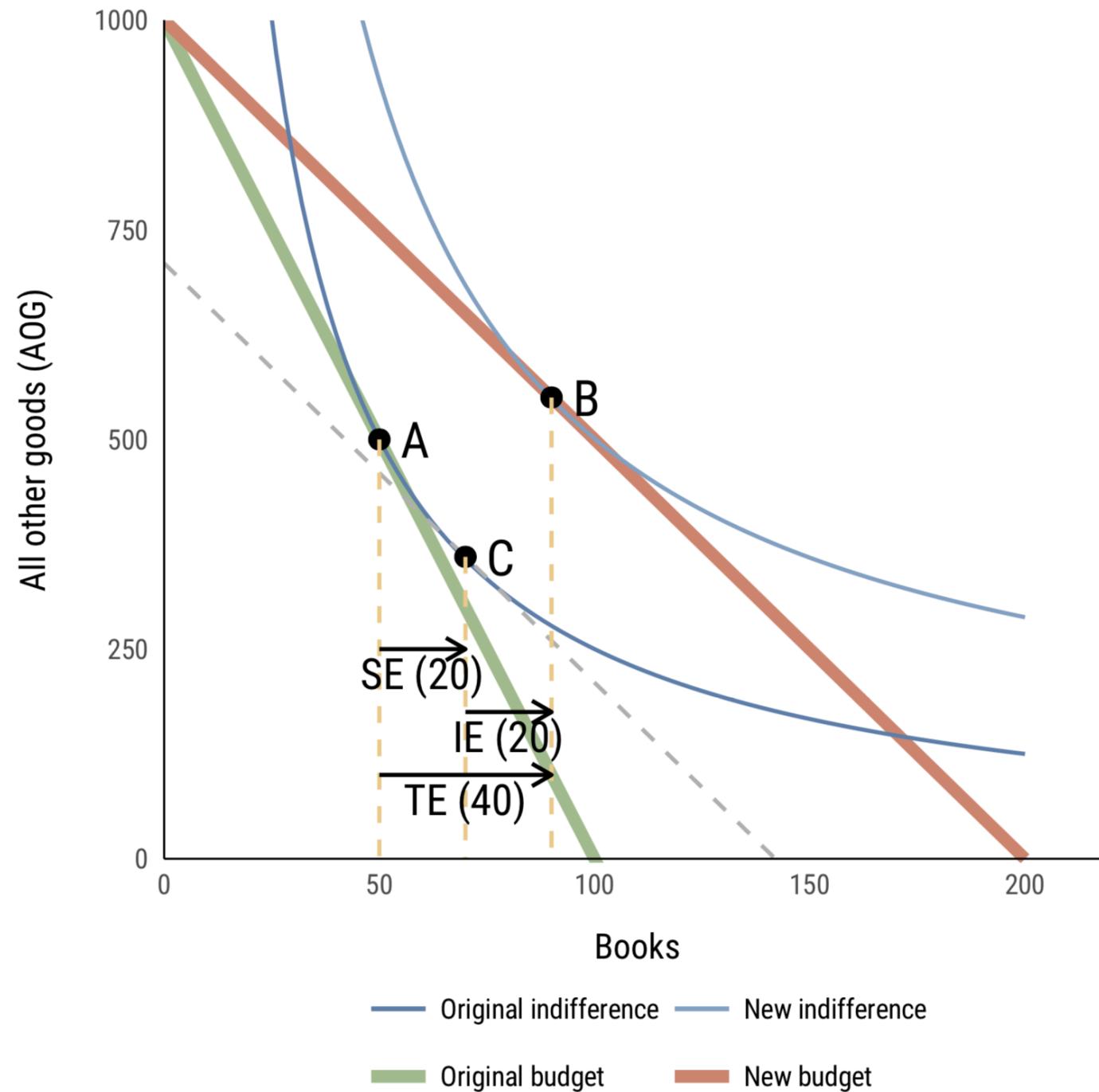
Movement **to** a new indifference curve because of a change in income or feasibility

# Substitution effect

How much more/less of X you consume because you trade off with Y

Movement **along** the same indifference curve because of a change in the mix of inputs



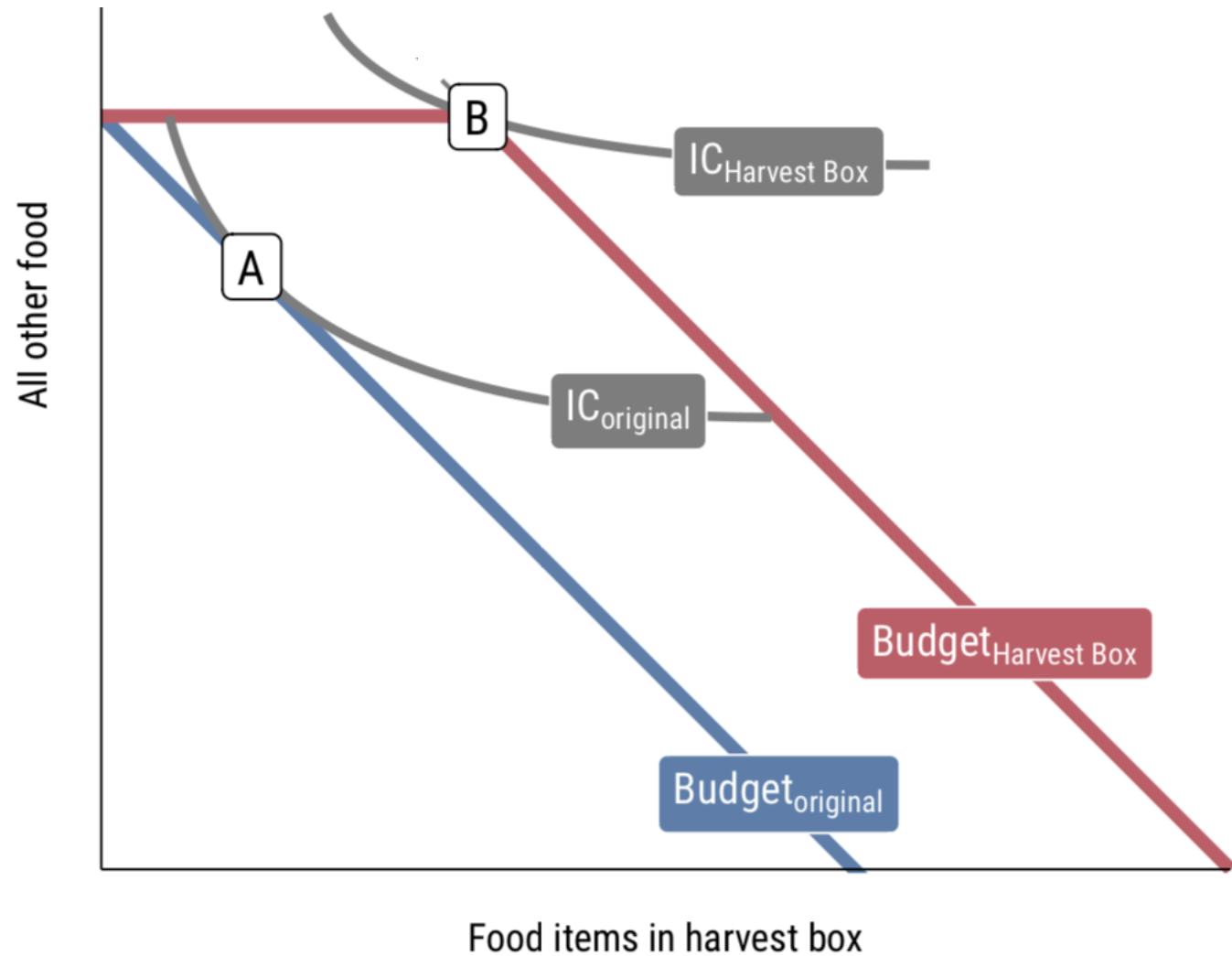


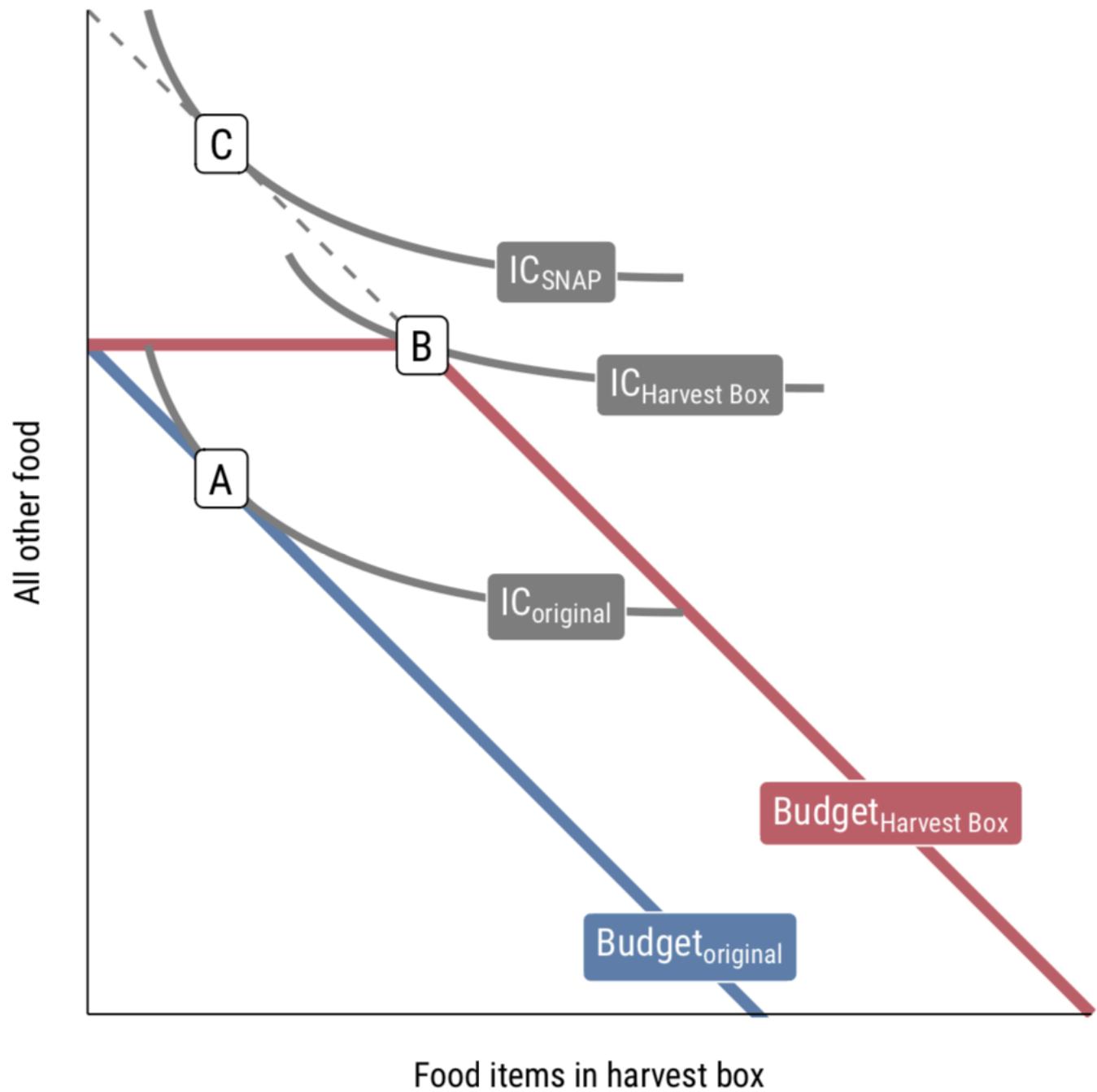
# Trump wants to slash food stamps and replace them with a 'Blue Apron-type program'



White House budget director Mick Mulvaney explained on Feb. 12 how the Trump administration hopes to save money on food aid. (The Washington Post)

When announcing the program, Secretary of Agriculture Sonny Perdue stated that “It maintains the same level of food value as SNAP participants currently receive, provides states flexibility in administering the program, and is responsible to the taxpayers.” In response, Kathy Fisher, policy director at Philadelphia’s Coalition Against Hunger stated “We know SNAP works now, when people can choose what they need. How they would distribute foods to people with specialized diets, or [to people in] rural areas ... It’s very expensive and very complicated.”





# Firms

# What do firms do?

Provide legal shielding for owners

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

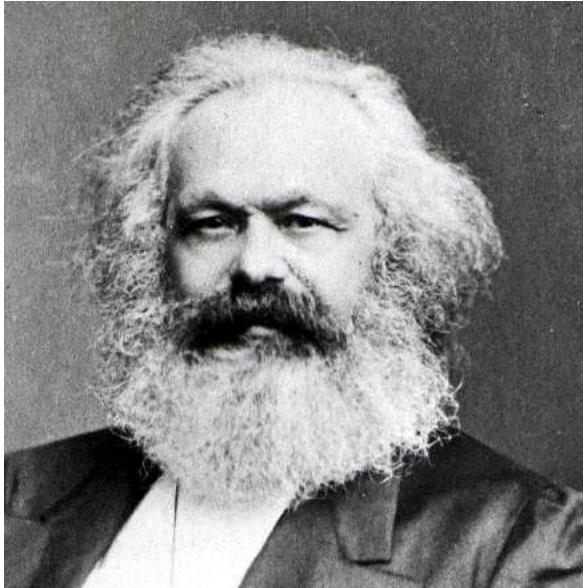
## In firms

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"

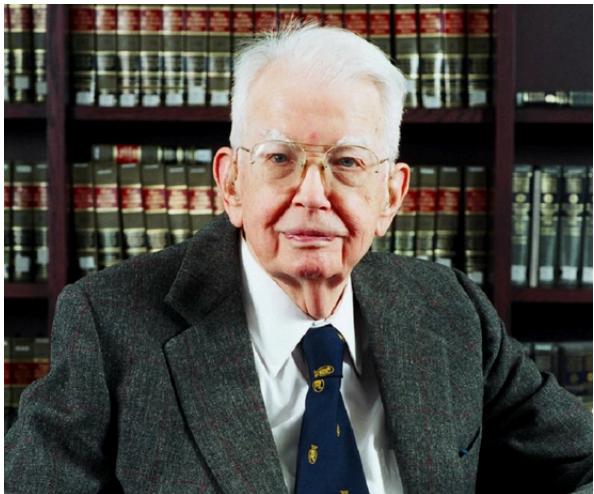
# Consequences of authority



“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.**

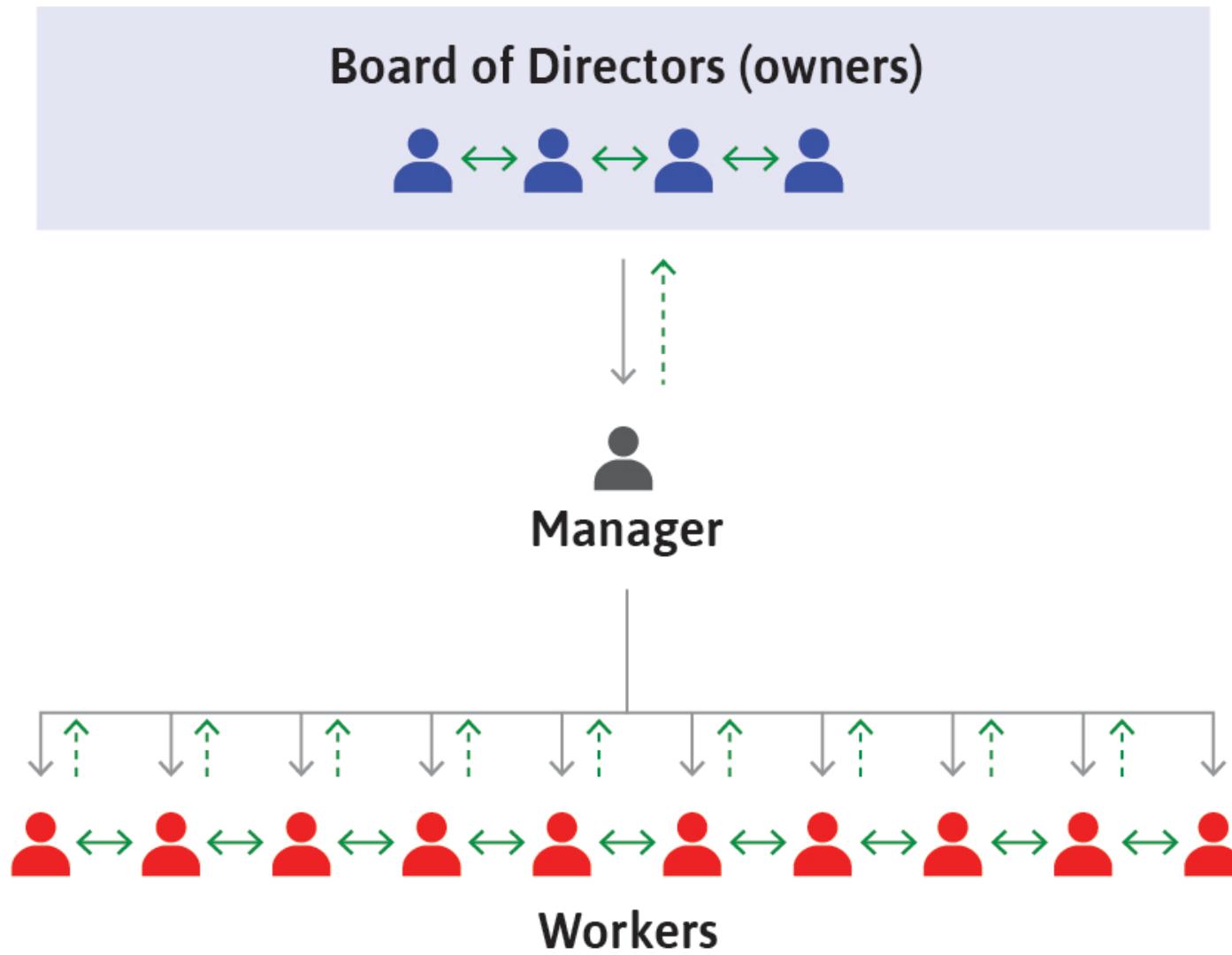
**“The firm in a capitalist economy is a miniature, privately owned, centrally planned economy.”**

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



Proposal power

Enforcement power

Centralize

Implementation power

Decentralize

# Asymmetric information

# Asymmetric information

## Adverse selection

Hidden knowledge

Lemons

Insurance

Death spirals

## Moral hazard

Hidden action

Repairs

Crime prevention

Reaching exact incentives

# Asymmetric information

## Adverse selection

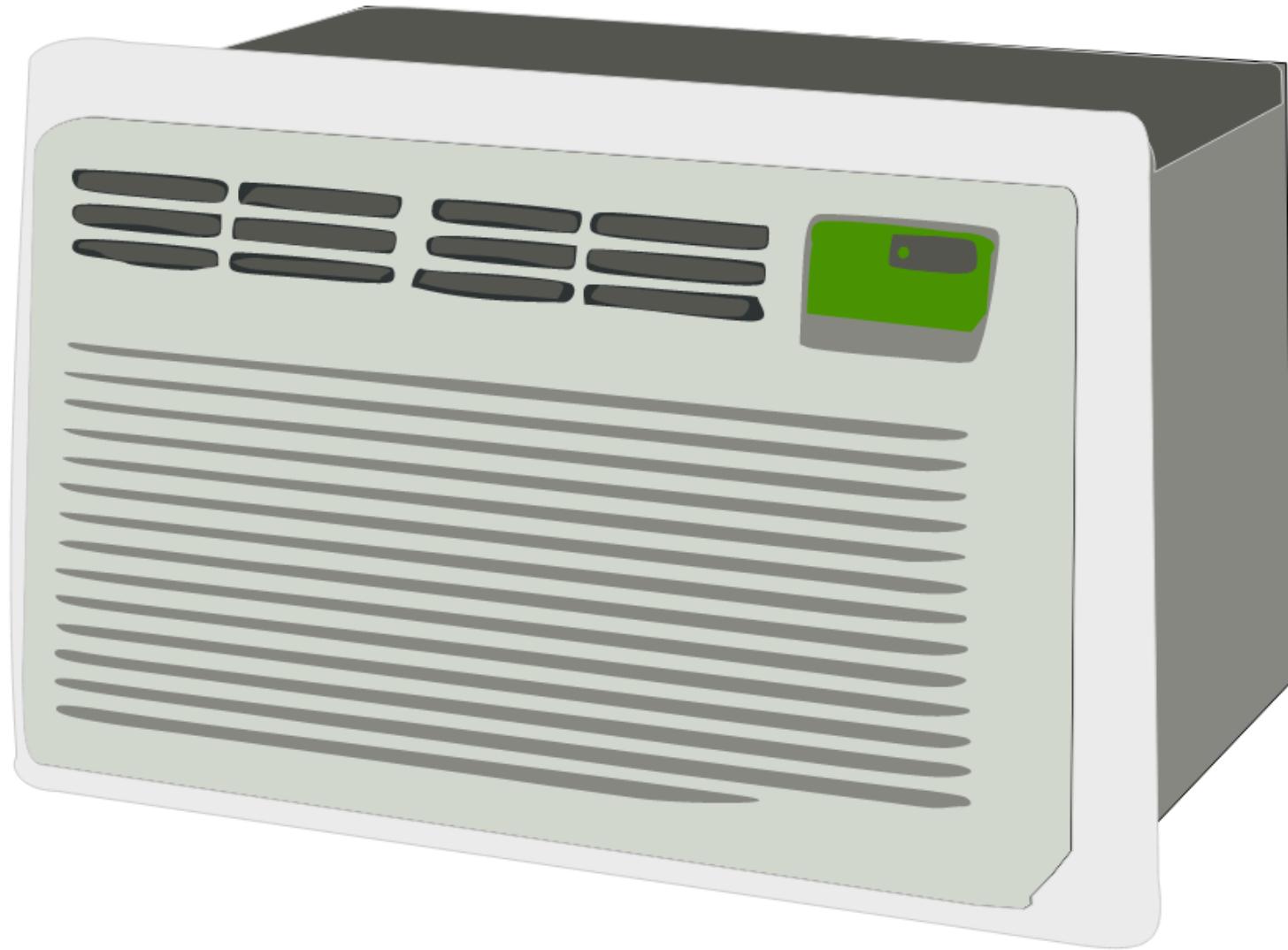
Fix with screening

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

## Moral hazard

Fix with monitoring

I have insurance so I'll take up skydiving



# 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**

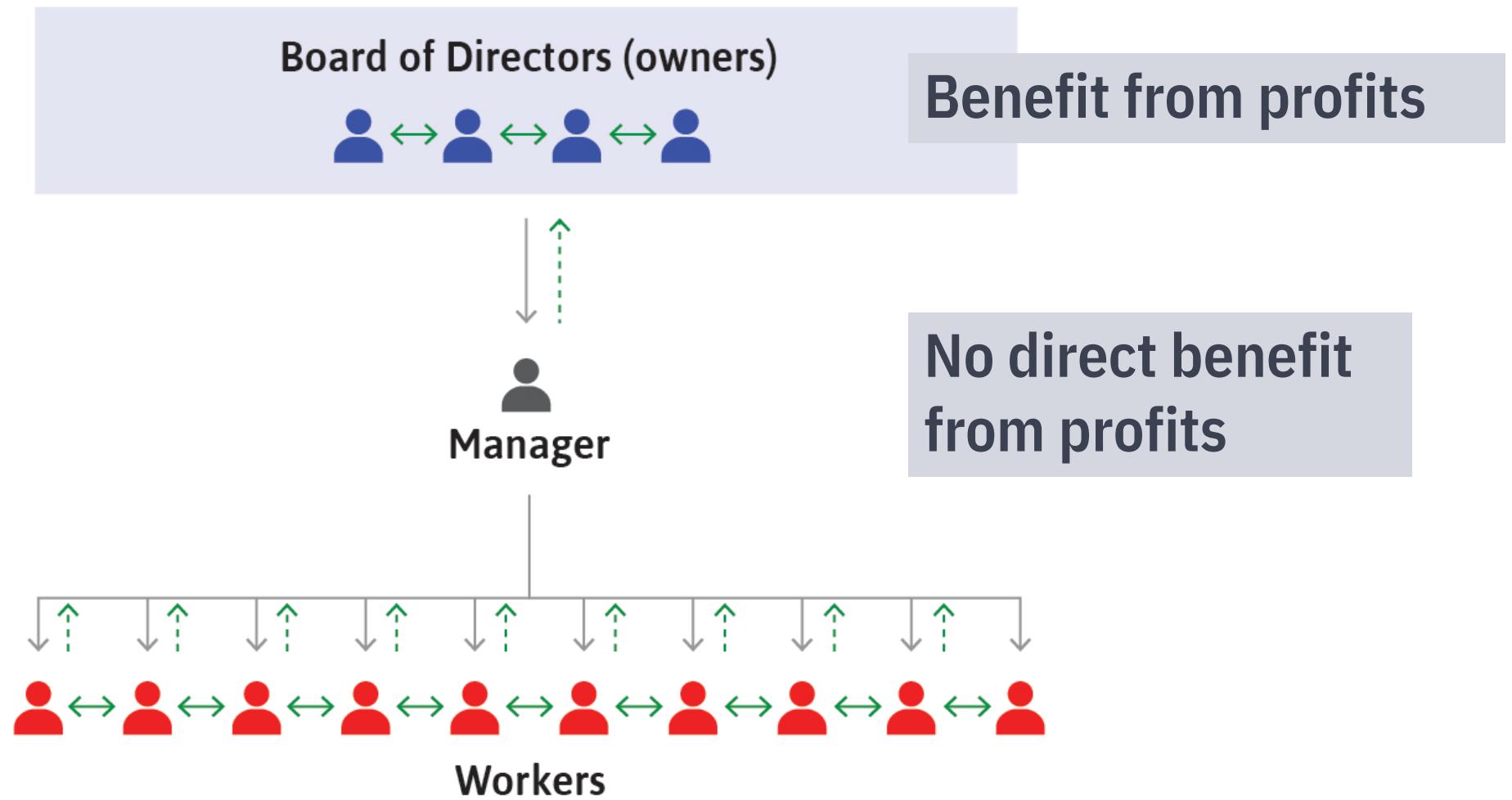
Principal lacks information to make sure agent does it

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

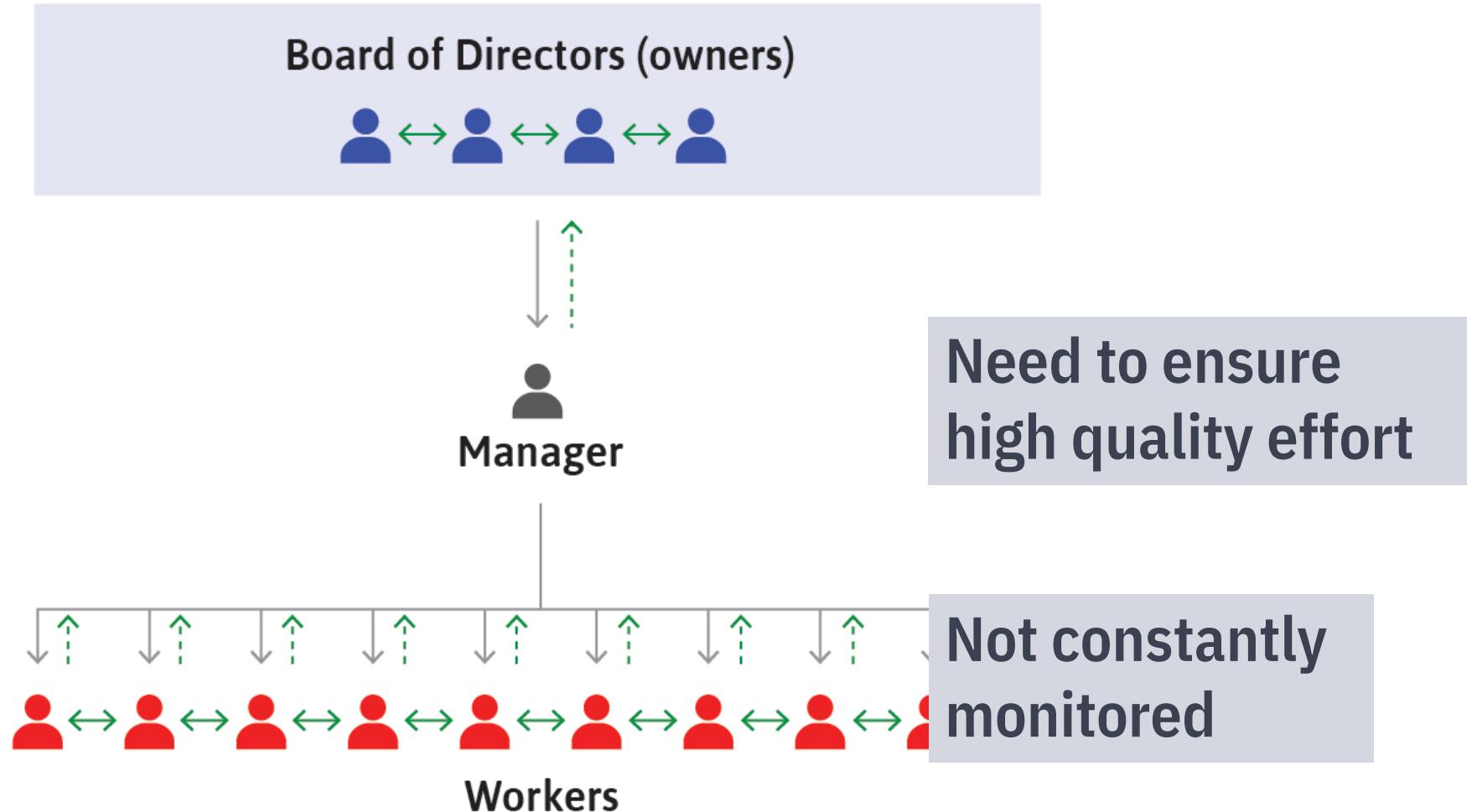


<b>Principal</b>	<b>Agent</b>	<b>Action that is hidden and not covered in the contract</b>
Employer	Employee	Quality and quantity of work
Banker	Borrower	Repayment of loan, prudent conduct
Owner	Manager	Maximization of owners' profits
Landlord	Tenant	Care of the apartment
Insurance company	Insured	Prudent 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/MPP jobs?

# But workers still work! Why?

Norms

Feelings of responsibility

Calling

Public service motivation

**For economists:  
fear of being fired**

# 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

<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

**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

# Involuntary unemployment

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

4.5–6%