

Firms and labor II

MPA 612: Public Management Economics

February 7, 2018

Fill out your reading report on Learning Suite!

UNITED STATES GOVERNMENT CONTRACT NOTICE TO EMPLOYEES

It is a violation of the Public Contracts Act and the Regulations issued thereunder to fail to post this Notice in a conspicuous place where all employees can read it.



This firm is engaged on a Government contract subject to the provisions of the Walsh-Healey Public Contracts Act* and has agreed to comply with the provisions of the act

An employee who works on this Government contract is subject to the act and

**MUST BE PAID TIME AND ONE-HALF
FOR ALL HOURS OVER**

8 IN ANY DAY OR
40 IN ANY WEEK

Even though the employee did not work all his time during the week on the contract

If a minimum wage is called for by this contract the minimum rate of pay must be paid

The Department of Labor is authorized to recover for employees any sums which are due to them for overtime and for payment of less than the applicable minimum wage. * * * No children (boys under 16 and girls under 18) or convict labor may be employed on this contract. Employment of such children and

of convict labor renders employers liable to the United States in liquidated damages in the sum of \$10 a day for each employee so employed * * * This contract must be performed in Factories, Buildings, or Shops which are safe, sanitary, and not dangerous to the health or safety of employees.

* Public, No. 846, 74th Congress.—An Act to provide conditions for the purchase of supplies and the making of contracts by the United States, and for other purposes. (49 Stat. 2036. U. S. Code, Title 41, secs. 35-45.)



Complaints and inquiries should be addressed to
L. METCALFE WALLING, Administrator
DIVISION OF PUBLIC CONTRACTS
WASHINGTON, D. C.

Current events

Plan for today

Asymmetric information

Employees (continued)

Labor discipline

Outsourcing

Asymmetric information

Adverse selection

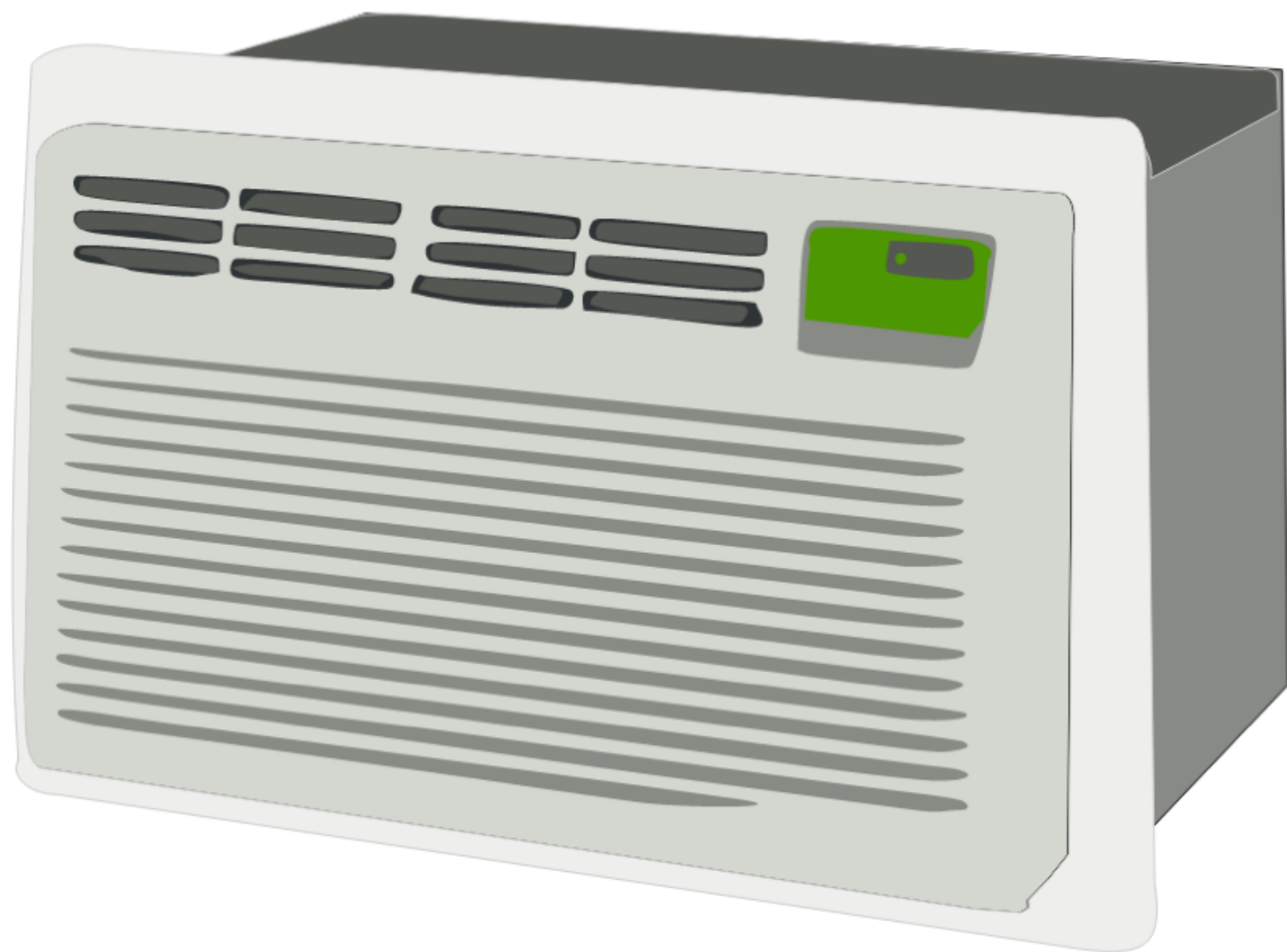
Hidden knowledge

Fix with screening

Moral hazard

Hidden action

Fix with monitoring







Employees

Asymmetric information and incomplete contracts

Contract offer

I offer the following contract proposal to the expert

Fixed payment

(between -\$700 and \$700)

Expert's return share

(between 0% and 100%, in multiples of 10%)

Expert decision

You just received a contract offer! You have to make two decisions now.

First, **decide whether to accept or reject the contract**.

Second, if you accept the contract, **choose your work effort**.

Proposed payment terms

The owner's proposed fixed payment for me: _____

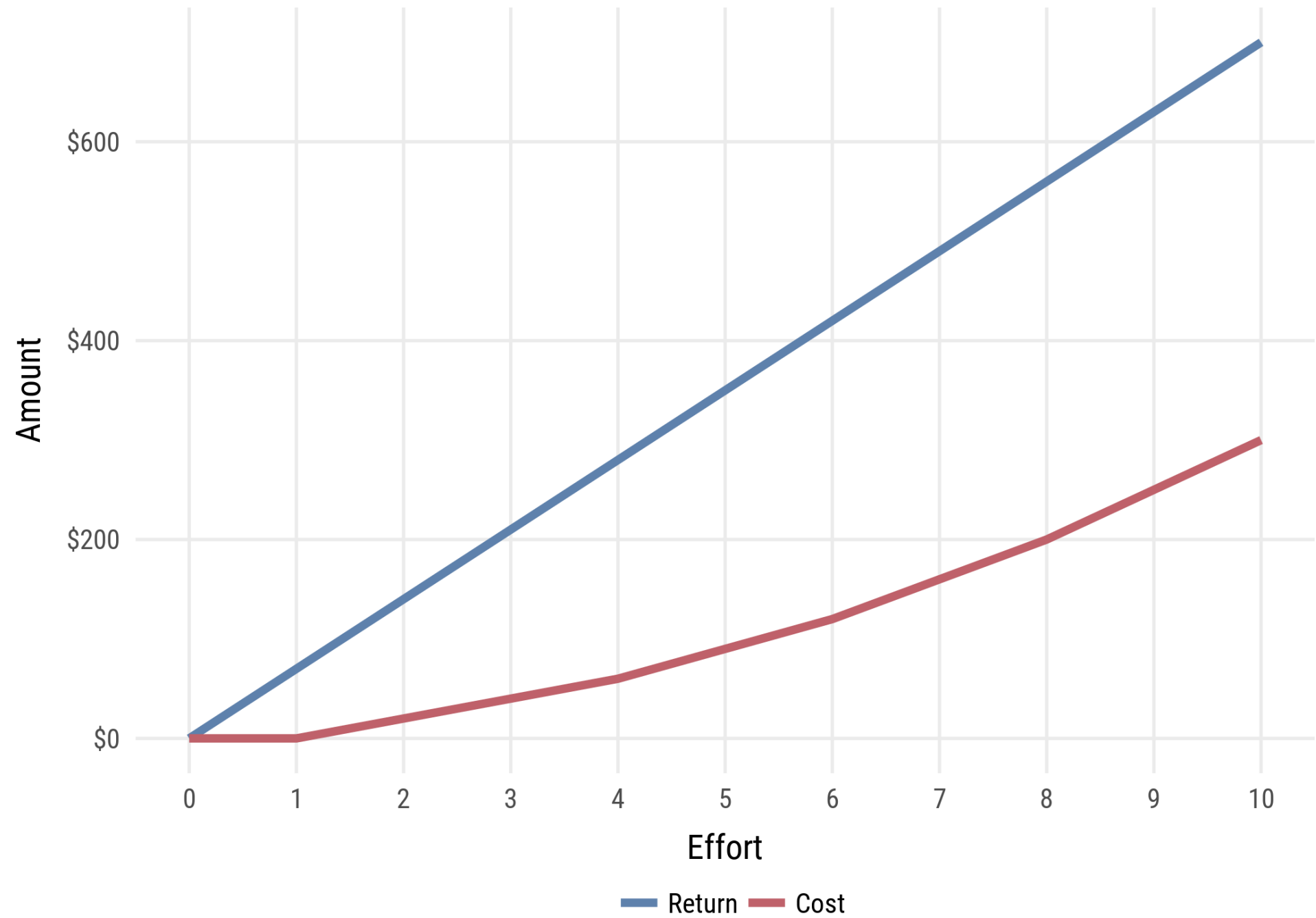
The owner's proposed return share for me: _____

I accept this offer

Yes No

Work effort

(only if you accept offer; between 0 and 10)



Optimal solution

Marginal benefit = marginal cost

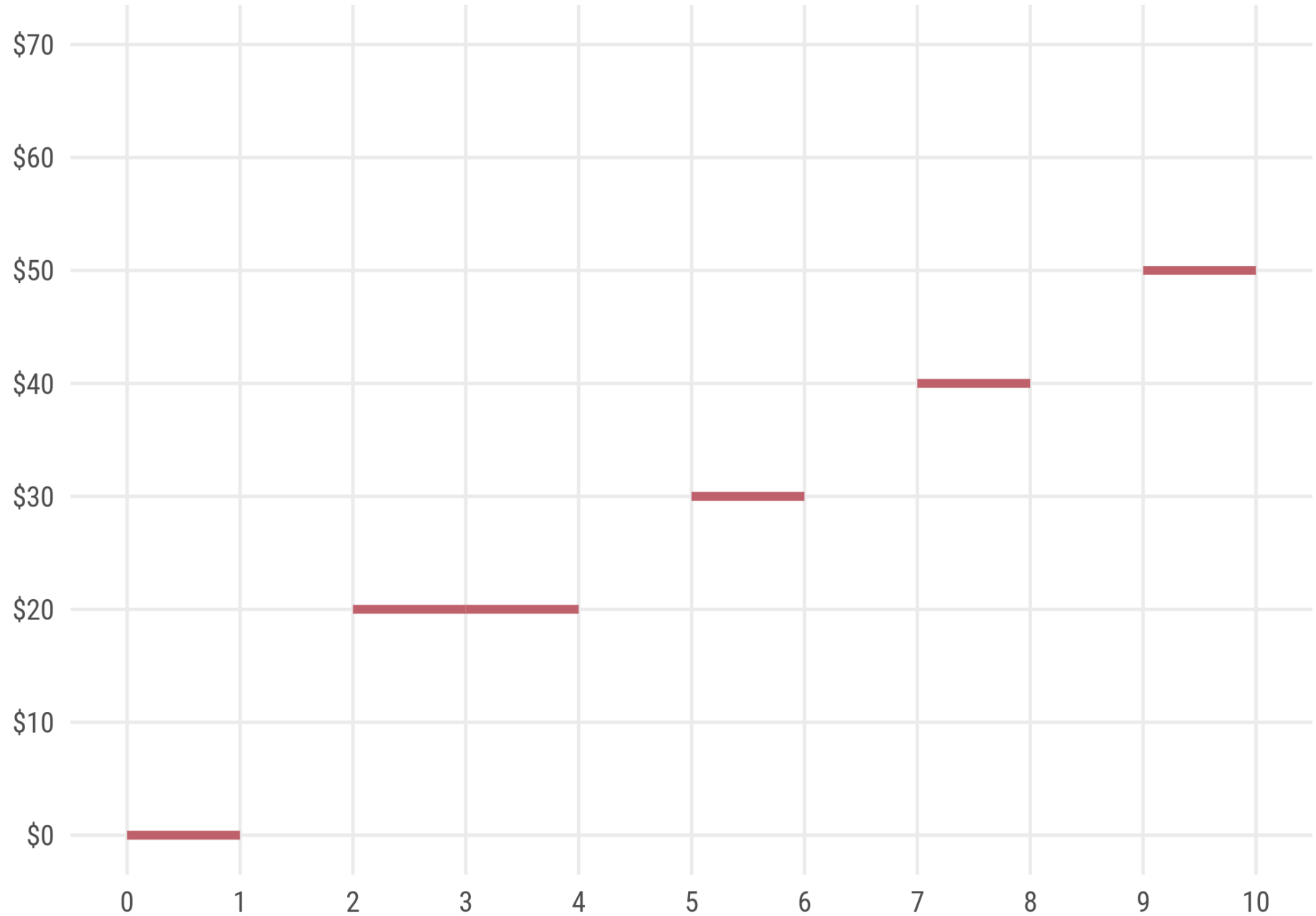
Effort	Return	Cost	Marginal return	Marginal cost
0	0	0		
1	70	0	70	0
2	140	20	70	20
3	210	40	70	20
4	280	60	70	20
5	350	90	70	30
6	420	120	70	30
7	490	160	70	40
8	560	200	70	40
9	630	250	70	50
10	700	300	70	50

Marginal amounts

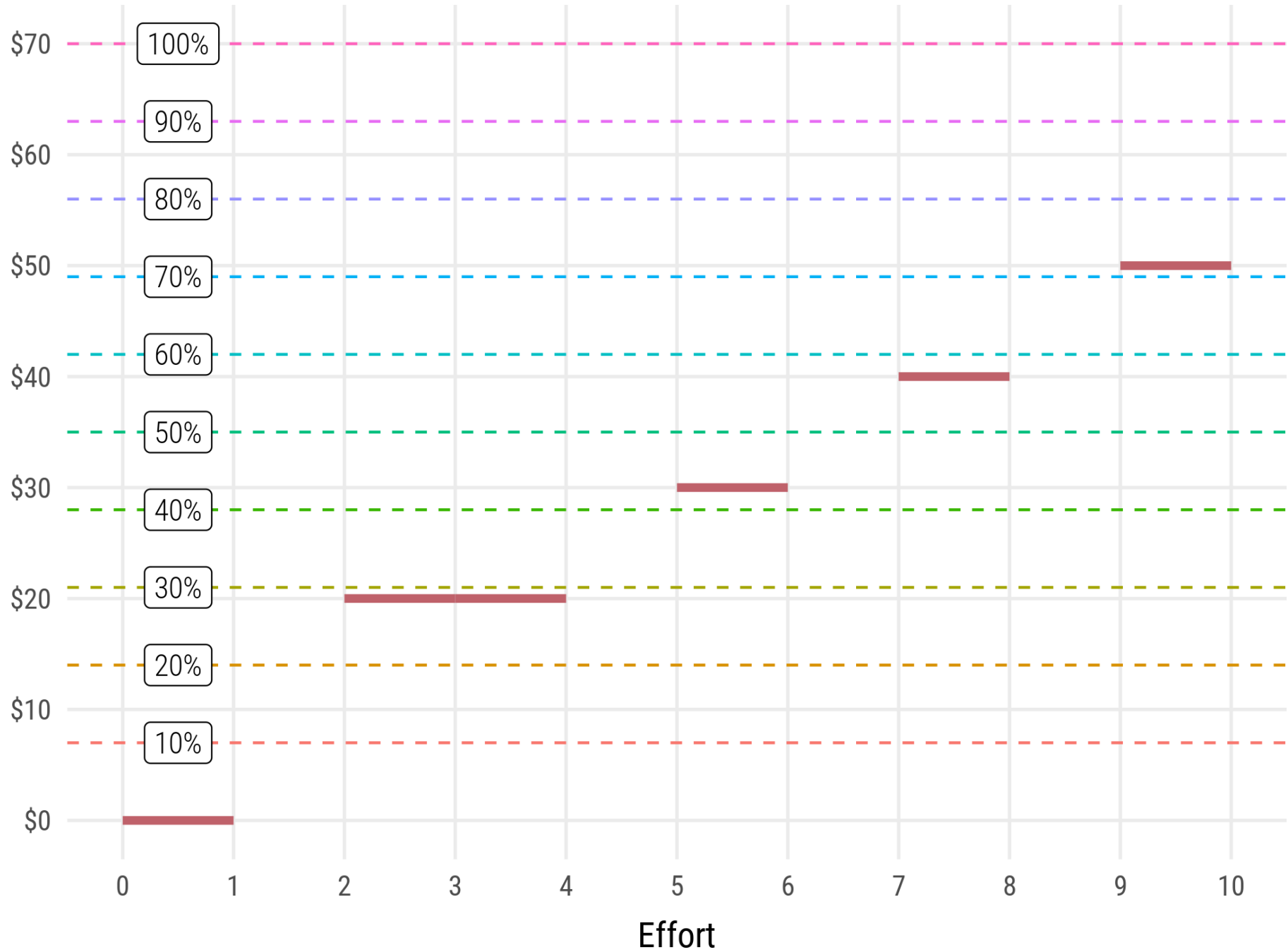
\$70
\$60
\$50
\$40
\$30
\$20
\$10
\$0

0 1 2 3 4 5 6 7 8 9 10

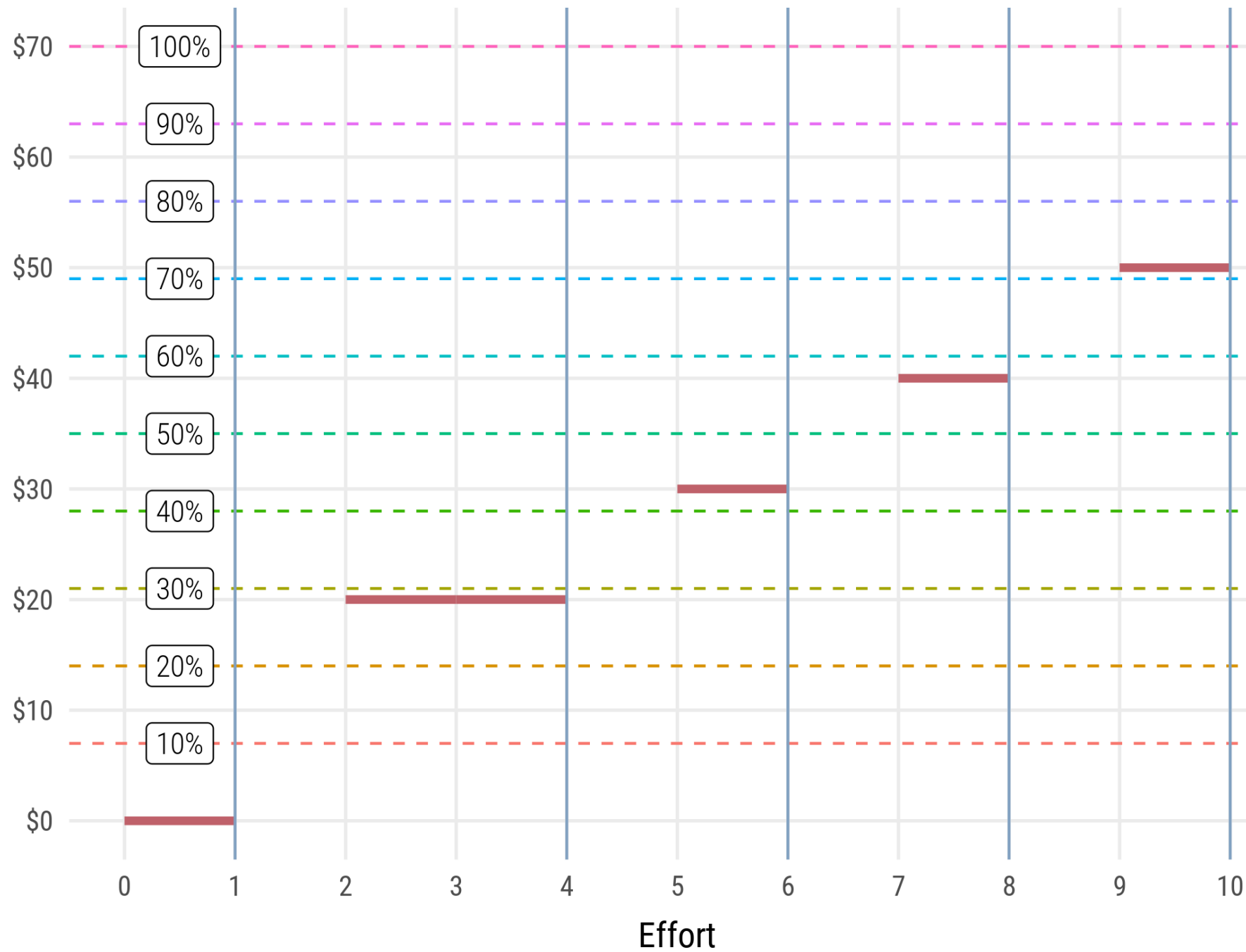
Effort

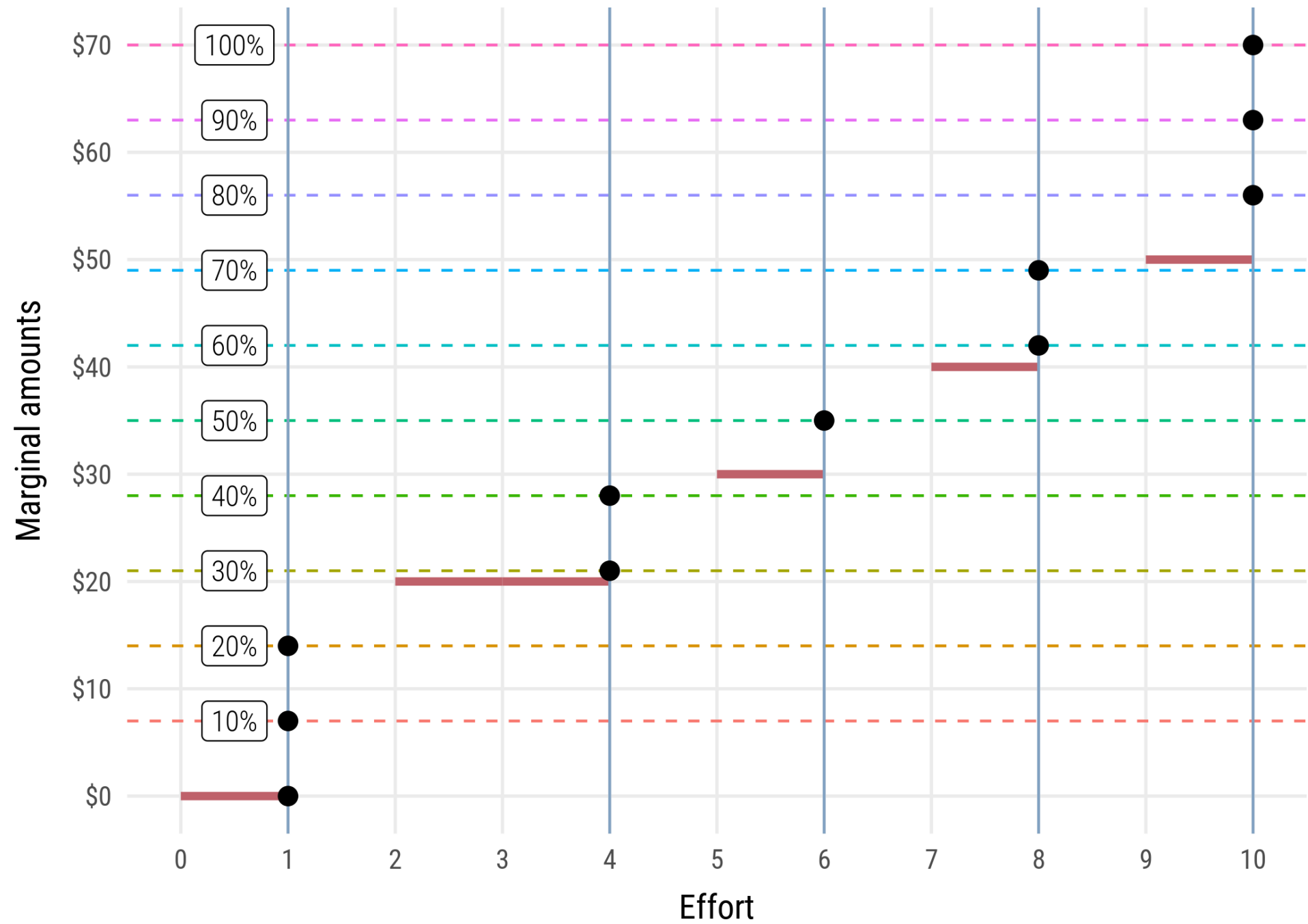


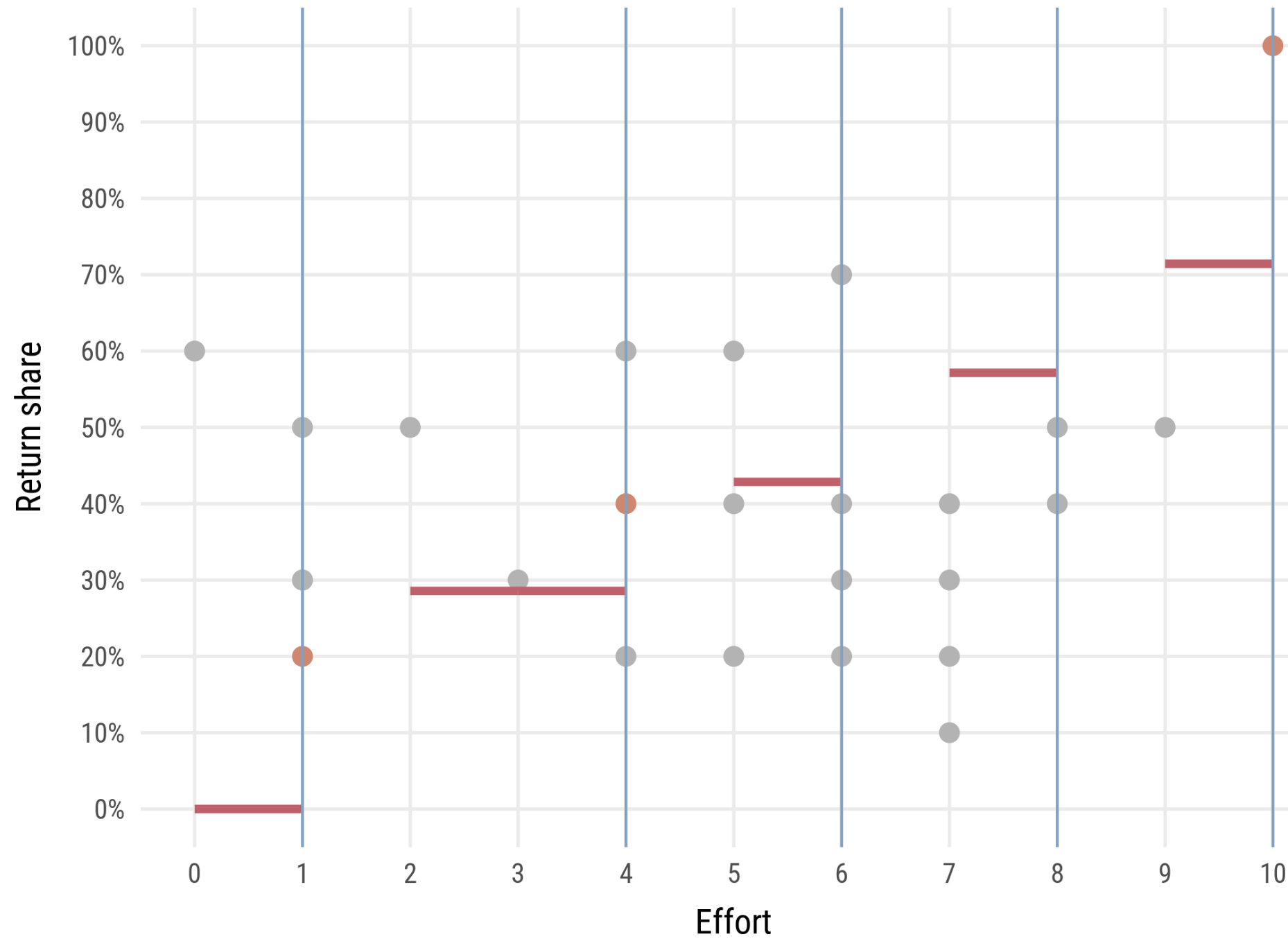
Marginal amounts



Marginal amounts







Labor contracts are inherently incomplete

Tasks based on unknown future

Tasks difficult to measure

But workers still work! Why?

Norms

Feelings of responsibility

Calling

Public service motivation

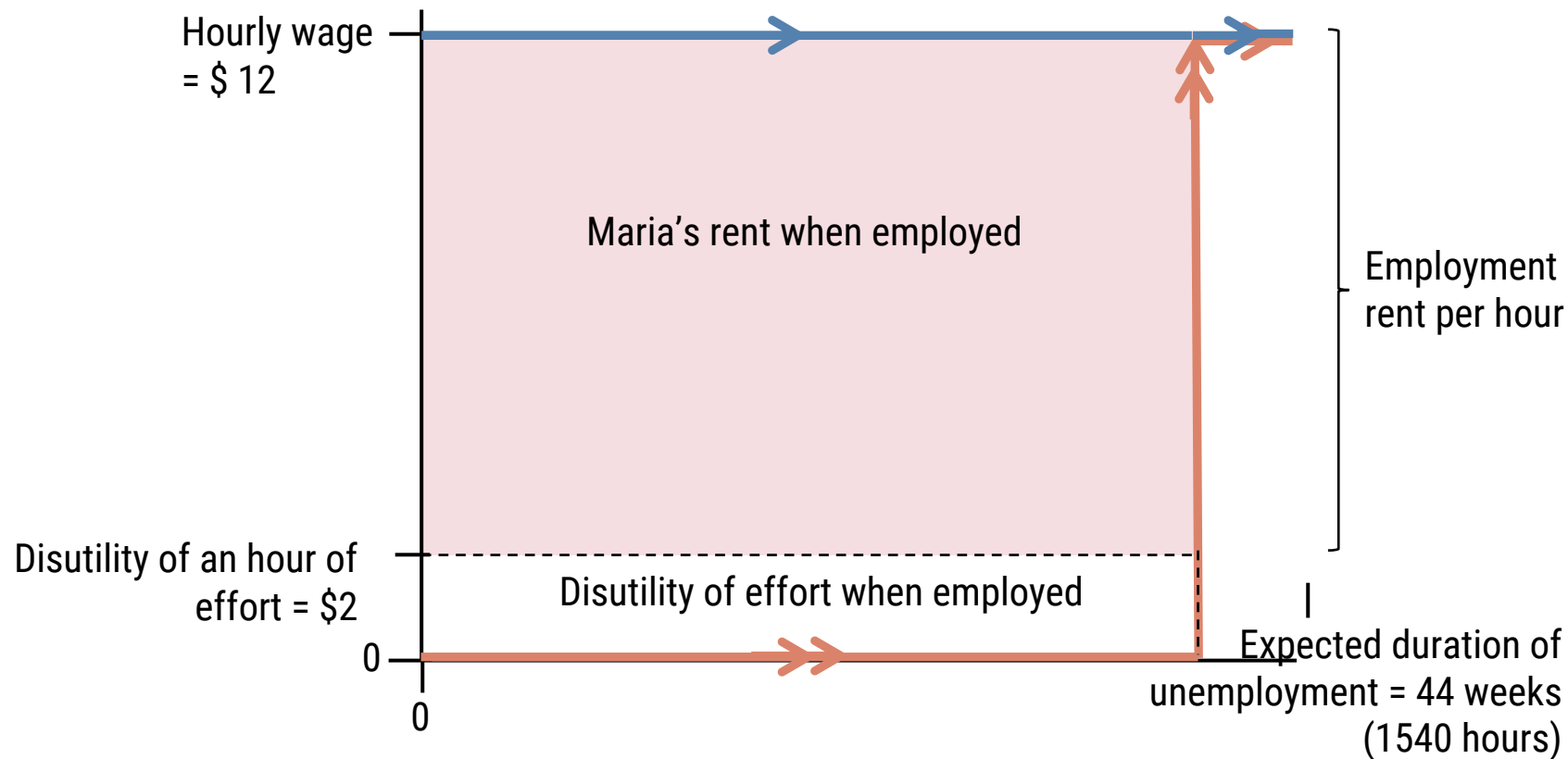
Fear of being fired

Economic rents

Payment or benefit received above and beyond what you would have received from your next best alternative

Employment rent = wage – reservation wage – disutility of effort

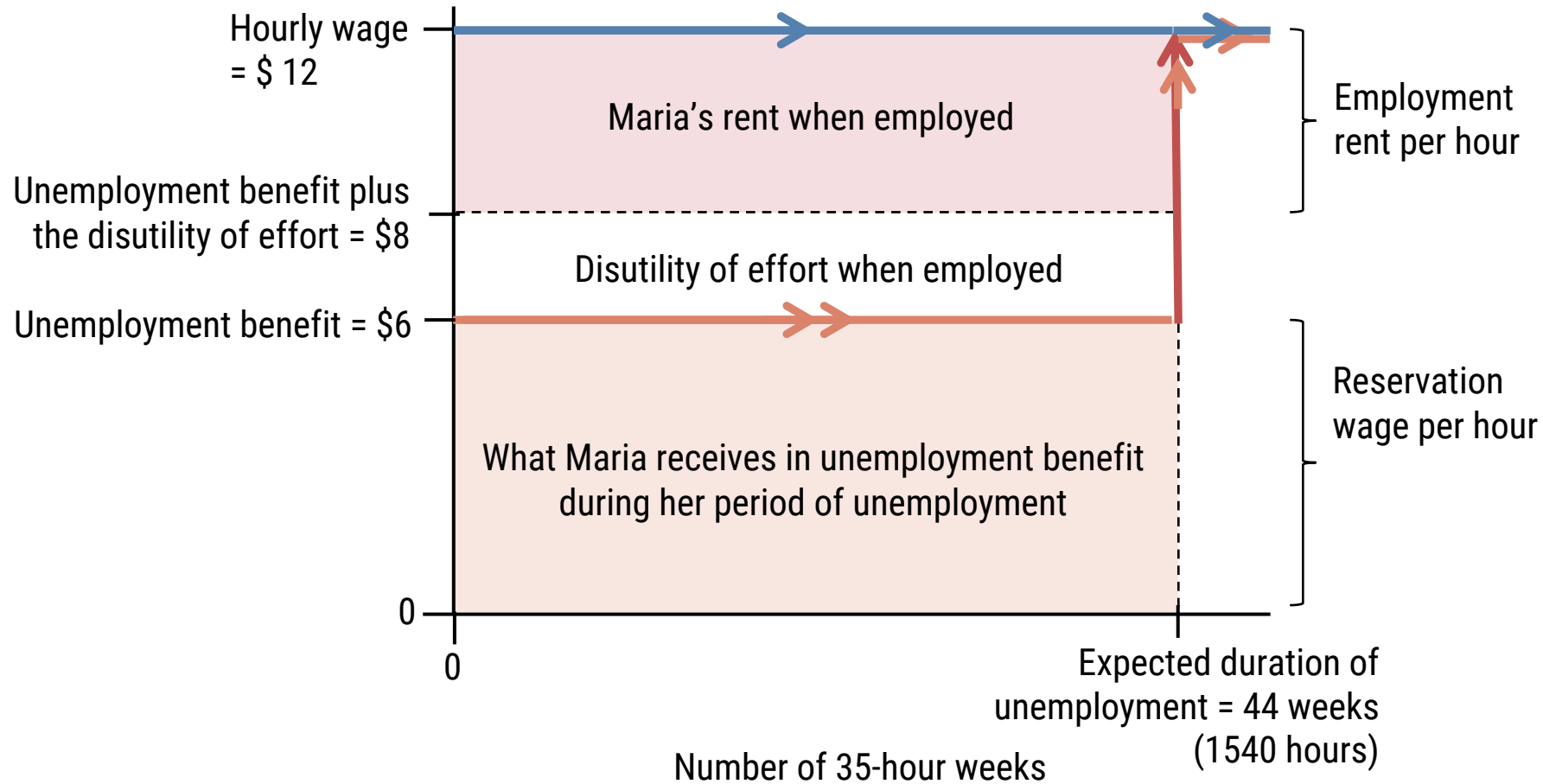
- = What Maria gets should she not lose her job today
- = What Maria gets should she lose her job today



Rent per hour ×
expected lost
hours of work

\$10/hour × 1,540
hours = \$15,400

- = What Maria gets should she not lose her job today
→ = What Maria gets should she lose her job today



$$\begin{aligned} &\$4/\text{hour} \times 1,540 \\ &\text{hours} = \$6,160 \end{aligned}$$

Labor discipline

How much should you work? How much should you pay people?

Why do owners pay people?

Employers can't directly
measure effort

So they take advantage of the fact that work is afraid
of losing job and they **increase the cost of job loss**

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

Employer chooses a wage

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

Worker chooses level of effort

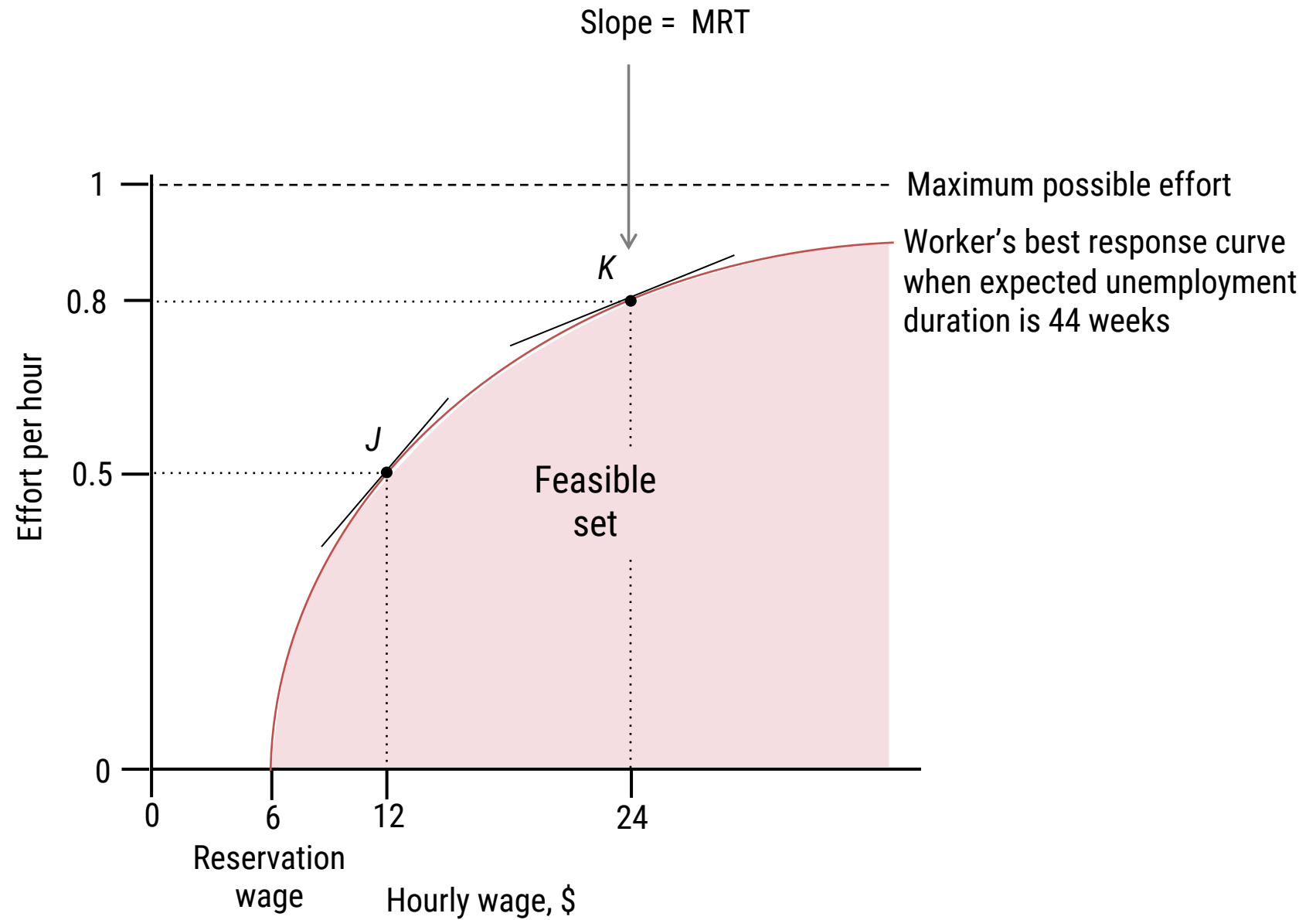
Worker considers costs of losing job if they don't work hard enough

Firm payoffs: $\text{profit} = \text{worker's output} - \text{wage}$

Worker payoffs: employment rent

Response curve
Optimal effort for
each wage

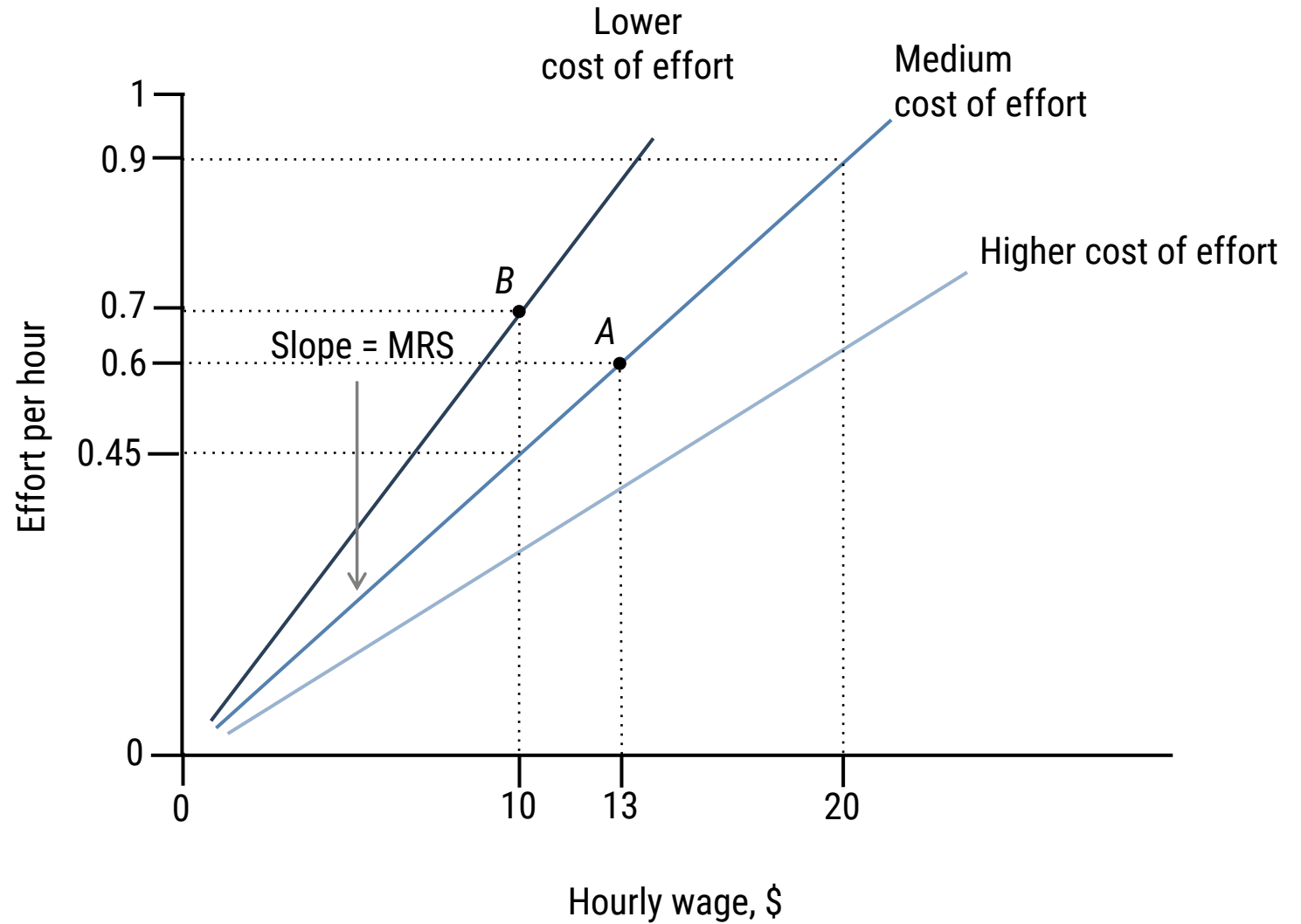
Slope of feasible
frontier = MRT



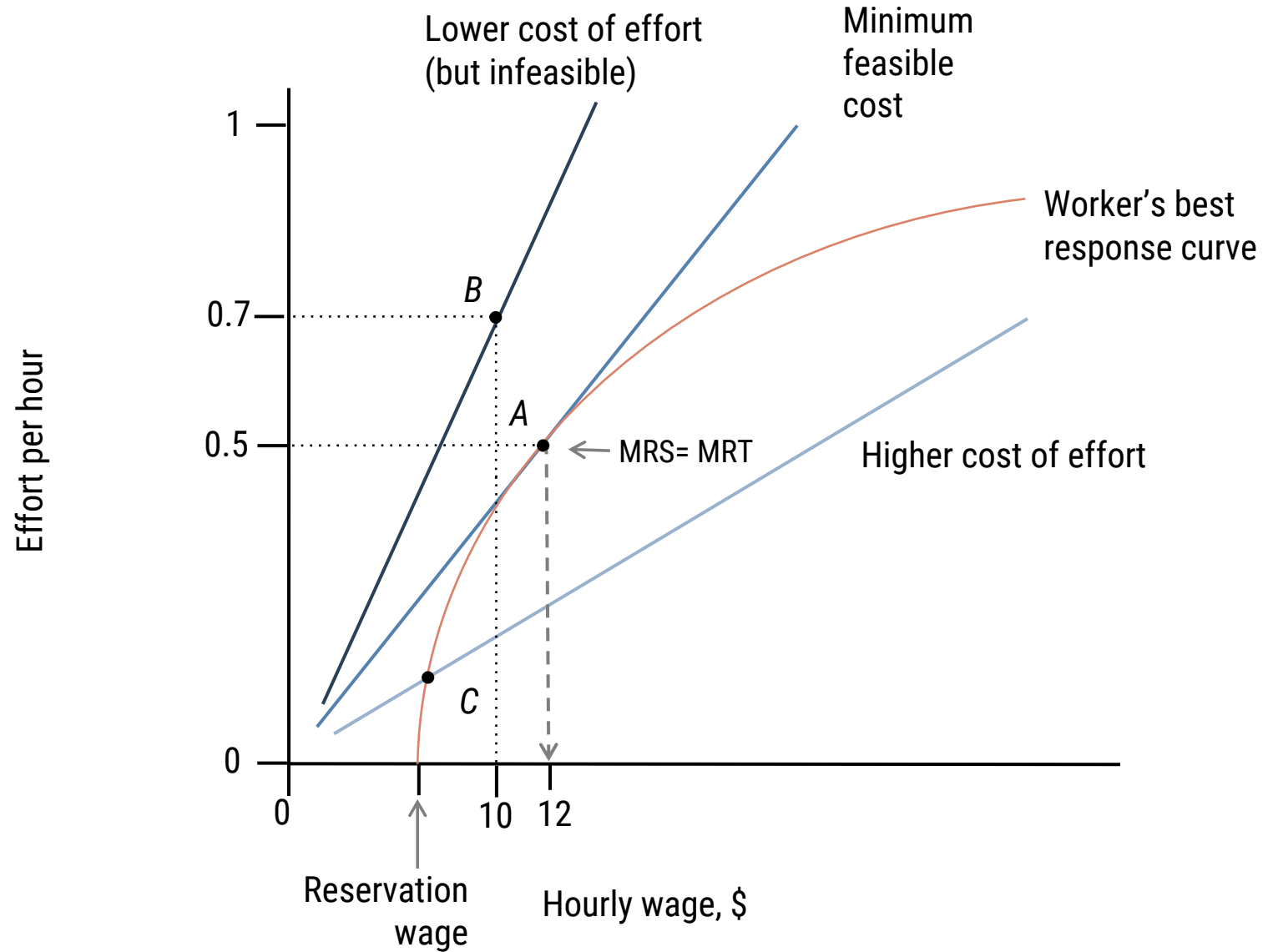
Efficiency unit = unit of effort per dollar = e/w

Cost per unit of effort = w/e

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

When should government privatize stuff?

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

How is outsourcing a principal-agent problem?

Is privatization of government services good?

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 worse 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 contracting

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