

## APPLIED ECONOMICS FOR MANAGERS SESSION 17—

### I. REVIEW: STRATEGIC ISSUES INSIDE THE FIRM

#### A. PRINCIPAL/AGENT PROBLEMS

##### 1. SUPPLIERS/INPUTS HAVE PRIVATE INFORMATION

a. ADVERSE SELECTION—CHIP SUPPLIERS

b. MORAL HAZARD—LEGAL SERVICES

##### 2. EXAMPLE:

TOTAL BENEFIT OF LEGAL SERVICES:  $TB = 600L - L^2$

AVERAGE BENEFIT OF LEGAL SERVICES:  $AB = 600 - L$

MARGINAL BENEFIT OF LEGAL SERVICES:  $MB = 600 - 2L$

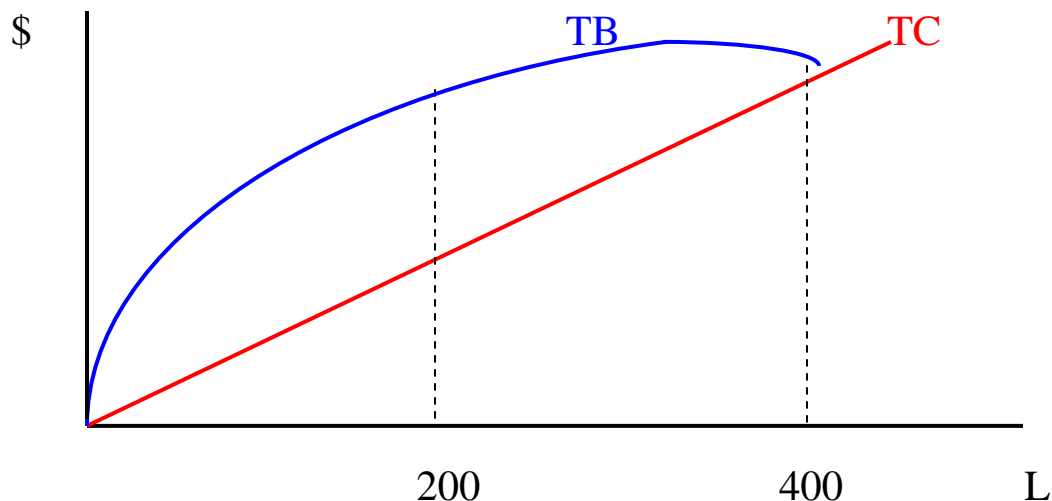
LAW FIRM: FEE OF \$200 PER HOUR, GOAL IS TO MAXIMIZE BILLABLE HOURS

IF CHOICE OF QUANTITY OF LEGAL SERVICES IS LEFT TO LAW FIRM: MAXIMIZE BILLABLE HOURS SUBJECT TO CONSTRAINT THAT TOTAL BENEFITS  $\geq$  TOTAL COST

$$600L - L^2 = 200L \Rightarrow 400 = L$$

FIRM MAXIMIZATION OF NET BENEFITS:  $MB = MC = 200$

$$\Rightarrow 600 - 2L = 200 \Rightarrow L = 200$$



LAW GROUP'S EXPLOITATION OF ASYMMETRIC INFORMATION CAN HURT THE FIRM

**B. COORDINATION PROBLEMS**

1. COMPLEMENTARY INPUTS OR TEAMS
2. MULTIPLE NASH EQUILIBRIA

**C. TIME-CONSISTENCY AND FIRM SPECIFIC INVESTMENTS**

**D. ALL OF THE ABOVE ARE ISSUES OF CONTRACT DESIGN—  
CONTRACTS MUST SOLVE**

1. INCENTIVE ISSUES
2. PARTICIPATION CONSTRAINT

**II. WHO'S IN CHARGE? GROUP DECISION MAKING AND  
ECONOMIC OUTCOMES**

**A. FREER TRADE IN FREDONIA**

**B. INDIVIDUAL RATIONALITY VERSUS COLLECTIVE  
IRRATIONALITY**

**C. STRATEGIC VOTING AND VOTE TRADING**