The Theory of the Firm

Microeconomics with Endogenous Entrepreneurs, Firms, Markets, and Organizations

Daniel F. Spulber
Northwestern University
# Contents

*Preface and Acknowledgments*  

<table>
<thead>
<tr>
<th>Introduction</th>
<th>1</th>
</tr>
</thead>
</table>

## PART I. THE THEORY OF THE FIRM

### 1 The Consumer

| 1.1 The Intermediation Hypothesis and the Scope of the Firm | 12 |
| 1.2 Consumer Characteristics | 26 |
| 1.3 Consumer Cooperation and Transaction Benefits | 28 |
| 1.4 Consumer Coordination and Transaction Costs | 35 |
| 1.5 Consumer Organizations and the Separation Criterion | 40 |
| 1.6 Conclusions | 61 |

### 2 The Firm

| 2.1 The Separation Criterion | 64 |
| 2.2 Firms Create and Manage Markets | 76 |
| 2.3 Firms Create and Manage Organizations | 88 |
| 2.4 The Development of the Firm | 102 |
| 2.5 The Social, Legal, and Political Context of the Firm | 117 |
| 2.6 Conclusions | 123 |

### 3 The Separation of Consumer Objectives and Firm Objectives

| 3.1 The Neoclassical Separation Theorem | 127 |
| 3.2 The Separation Theorem with Price-Setting Firms | 132 |
| 3.3 The Fisher Separation Theorem | 136 |
| 3.4 The Fisher Separation Theorem with Price-Setting Firms | 142 |
| 3.5 Conclusions | 147 |
PART II. THE ENTREPRENEUR IN EQUILIBRIUM

4 The Entrepreneur
4.1 A Dynamic Theory of the Entrepreneur
4.2 The Entrepreneur’s Decisions and the Foundational Shift
4.3 Type I Competition: Competition among Entrepreneurs
4.4 Type II Competition: Competition between Entrepreneurs and Consumer Organizations
4.5 Type III Competition: Competition between Entrepreneurs and Established Firms
4.6 The Classical Theory of the Entrepreneur
4.7 Conclusions

5 Competition among Entrepreneurs
5.1 Set-Up Costs
5.2 Investment
5.3 Time Preferences
5.4 Risky Projects
5.5 Risk Aversion
5.6 Endowments and Incentives for Effort
5.7 Conclusions

PART III. HUMAN CAPITAL, FINANCIAL CAPITAL, AND THE ORGANIZATION OF THE FIRM

6 Human Capital and the Organization of the Firm
6.1 The Worker Cooperative versus the Firm
6.2 Hiring Workers with Diverse Abilities
6.3 Hiring with Moral Hazard in Teams
6.4 Market Contracts versus Organizational Contracts
6.5 Hiring by the Firm versus a Cooperative with Open Membership
6.6 Conclusions

7 Financial Capital and the Organization of the Firm
7.1 The Basic Model
7.2 The Corporation in Equilibrium
7.3 The Partnership in Equilibrium
7.4 Market Equilibrium and Organizational Form
7.5 Conclusions
Contents

PART IV. INTERMEDIATION BY THE FIRM

8 The Firm as Intermediary in the Pure-Exchange Economy 295
  8.1 The Firm and Money 296
  8.2 The Firm and the Absence of a Double Coincidence of Wants 302
  8.3 The Firm and Market Clearing 308
  8.4 The Firm and Time 310
  8.5 The Firm and Distance 315
  8.6 The Firm and Risk 322
  8.7 Conclusions 328

9 The Firm versus Free Riding 329
  9.1 The Firm and Economies of Scale 331
  9.2 The Firm and Public Goods 347
  9.3 The Firm and Common-Property Resources 355
  9.4 Conclusions 362

PART V. MARKET MAKING BY THE FIRM

10 The Firm Creates Markets 367
  10.1 Market Making and Matchmaking by the Firm: Overview 368
  10.2 Market Making by the Firm versus Consumer Search 380
  10.3 Matchmaking by the Firm versus Consumer Search 388
  10.4 Competition between Market-Making Firms 391
  10.5 Competition between Market-Making Firms: Characterization of Equilibrium 404
  10.6 Conclusions 415

11 The Firm in the Market for Contracts 417
  11.1 Contracts and Incentives to Invest: Firms Create Markets 419
  11.2 Moral Hazard: Firm Management of Tournaments versus Bilateral Agency Contracts 440
  11.3 Adverse Selection: The Firm Monitors Performance 447
  11.4 Adverse Selection: The Firm Certifies Quality 451
  11.5 Conclusions 456

12 Conclusion 458
  12.1 The Firm 458
  12.2 The Entrepreneur 460