

Topics in Management and Applied Microeconomics: Moral Hazard in Organizations

Summer Term 2019

This is an advanced lecture in contract theory, discussing moral-hazard problems in organizations. Students should learn and discuss the main principles and building blocks of those contract-theoretic papers that address problems of asymmetric information arising after contracts have been signed. The course starts with a brief overview about the following topics:

- *Verifiable* performance signal:
 - risk neutral agent (A) + unlimited liability (i.e., no wealth constraints)(UL) → “selling the firm”
 - risk neutral A + competitive markets (i.e., zero-profit condition)
 - risk neutral A + limited liability (LL) → A earns positive rent if his/her outside option is small enough
 - risk averse A + UL + moving support
 - risk averse A + UL + *non*-moving support → risk-incentive trade-off; BUT: discussion starting by Prendergast (JPE 2002)
 - behavioral effects (e.g., inequity aversion, loss aversion, myopic behavior)

- *Unverifiable* performance signal:
 - tournaments (self-commitment effect) (e.g., job-promotion tournaments with wages attached to jobs; bonus pools)
 - burning money (but: renegotiation-proof?)
 - third party (bribing, side contracts?)
 - repeated games/relational contracts (self-enforcing agreements)
 - career concerns (Holmström) (signal jamming)

- Specific topics:
 - multiple agents (e.g., principal-supervisor-agent model + collusion)
 - multiple principals (e.g., cooperatives, middlemen/intermediaries)
 - multitasking → new kind of moral-hazard problem: inefficient allocation of time
 - multiple periods → short-term versus long-term contracts (income smoothing)
 - contract renegotiation
 - job design (specialization, bundling of tasks,....)
 - delegation of authority and decision rights (Aghion and Tirole JPE 1997)

In a next step, I will present own research that deals with following topics:

- On the limits of Holmström's Informativeness Principle
- Peer effects and incentives
- Delegation of project choice and contract renegotiation

The students have to pick at least one of the papers from the following reading list and present it to the audience (alternatively, they can suggest a related paper for presentation or a first draft of an own research idea); a general discussion will follow each presentation:

To refresh basics:

Holmström. B. (2017): Pay for Performance and Beyond, *American Economic Review* 107, 1753–1777.

Specific topics:

Benabou, R. and J. Tirole (2016): Bonus Culture: Competitive Pay, Screening, and Multitasking. *Journal of Political Economy* 124, 305–370.

Deb, J., Li, J. and A. Mukherjee (2016): Relational Contracts with Subjective Peer Evaluations. *RAND Journal of Economics* 47, 3–28.

- DeVaro, J. and O. Gürtler (2016): Strategic Shirking: A Theoretical Analysis of Multitasking and Specialization. *International Economic Review* 57, 507–532.
- Ederer, F., Holden, R. and M. Meyer (2018): Gaming and Strategic Opacity in Incentive Provision. *RAND Journal of Economics* 49, 819–854.
- Englmaier, F., Fahn, M. and M. Schwarz (2018): Long-Term Employment Relations When Agents are Present Biased. CEPR Discussion Paper DP13227, Industrial Organization.
- Fahn, M. and H. Hakenes (forthcoming): Teamwork as a Self-Disciplining Device. *American Economic Journal: Microeconomics*.
- Foschi, M. and L. Santos-Pinto (2017): Subjective Performance Evaluation of Employees with Biased Beliefs. European University Institute. EUI Working Paper ECO 2017/08.
- Goldlücke, S. and P.W. Schmitz (2018): Pollution Claim Settlements Reconsidered: Hidden Information and Bounded Payments. *European Economic Review* 110, 211–222.
- Ishihara, A. (2017): Relational Contracting and Endogenous Formation of Teamwork, *RAND Journal of Economics* 48, 335–357.
- Kaya, A. and G. Vereshchagina (2014): Partnerships versus Corporations: Moral Hazard, Sorting, and Ownership Structure, *American Economic Review* 104, 291–307.
- Koszegi, B. (2014): Behavioral Contract Theory. *Journal of Economic Literature* 52, 1075–1118.
- Miklós-Thal, J. and H. Ullrich (2015): Belief Precision and Effort Incentives in Promotion Contests, *Economic Journal* 125, 1952–1963.
- Mukherjee, A. and L. Vasconcelos (2018): On the Trade-off between Efficiency in Job Assignment and Turnover: The Role of Breakup Fees. *Journal of Law, Economics, and Organization* 34, 230–271.
- Poblete, J. and D. Spulber (2017): Managing Innovation: Optimal Incentive Contracts for Delegated R&D with Double Moral Hazard. *European Economic Review* 95, 38–61.
- Tan, T.Y. (2017): The Extrinsic Motivation of Freedom at Work. Columbia University. Working Paper.

Wu, Y. (2017): Incentive Contracts and the Allocation of Talent. *Economic Journal* 127, 2744–2783.

In addition to the own presentation and the discussion of other presentations, the students have to write either (1) a term paper on a new research idea on moral-hazard in organizations or (2) two research proposals.