Contract Theory

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CCER, Peking University

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1 Course Grade

Your grade will be based on your solutions to problems that I will hand out intermittently through the course.

2 Goals

The objectives of this course are: (1) to familiarize you with the literature on contract theory; (2) to acquaint you with the relevant tools for solving contracting problems where private information is important; (3) to generate research topics.

3 Reading List

This list is not comprehensive, but there is more material here than I will be able to discuss in detail in class. I will be selective in what I lecture on, but I will not precommit more than two days in advance.

1. Principal-Agent Models

Holmstrom, B. 1979. "Moral Hazard and Observability," *Bell Journal of Economics* 10, 74-91.

Holmstrom, B. 1982. "Moral Hazard in Teams," *Bell Journal of Economics* , 324-340.

Grossman and Hart 1983 "An Analysis of the Principal-Agent Problem," *Econometrica* 51, 7-45.

Sappington, D. 1983. "Limited Liability Contracts Between Principal and Agent," *Journal of Economic Theory* 29, 1-21.

2. Adverse Selection Models

Akerlof, G. 1970. "The Market for 'Lemons': Qualitative Uncertainty and the Market Mechanism," *Quarterly Journal of Economics* 89, 488-500.

Rothschild, M. and Stiglitz, J. 1976 "Equilibrium in Competitive Insurance Markets," *Quarterly Journal of Economics* 90, 629-649.

Wang, C. and Williamson, S. 1998 "Adverse Selection in Credit Markets With Costly Screening," *Canadian Journal of Economics* Vol. 31, No.3, 573-595.

3. Costly State Verification Models

Townsend, R. 1979. "Optimal Contracts and Competitive Markets With Costly State Verification," *Journal of Economic Theory* 21, 265, 293.

Mookherjee, D. and Png. I. 1989. "Optimal Auditing, Insurance, and Redistribution," *Quarterly Journal of Economics* 104, 399-416.

4. Dynamic Contracts

Green, E. 1987. "Lending and Smoothing of Uninsurable Income," in E. Prescott and N. Wallace, eds., *Contractual Arrangements for Intertemporal Trade* University of Minnesota Press.

Spear, S. and Srivastava, S. 1987. "On Repeated Moral Hazard With Discounting," *Review of Economic Studies* 54, 599-617.

Thomas, J. and Worrall, T. 1990. "Income Fluctuations and Asymmetric Information: An Example of the Repeated Principal-Agent Problem," *Journal of Economic Theory* 51, 367-390.

Atkeson, A. and Lucas, R. 1992. "On Efficient Distribution With Private Information," *Review of Economic Studies* 59, 427-453.

Wang, C. 1995. "Dynamic Insurance between Two Risk Averse Agents with Bilateral Asymmetric Information," *Review of Economic Studies* 62, 577-595.

Wang, C. (1997) "Incentives, CEO compensation, and shareholder wealth in a dynamic agency model," *Journal of Economic Theory*, 76, 72-105.

Wang, C. 2000. "Dynamic Costly State Verification," working paper, GSIA, Carnegie Mellon University.

Spear, S. and C. Wang 2002. "When to Fire a CEO: Transience and Ergodicity in Long-term Contracts," *GSIA Working Paper* 2002-E5.