UNIVERSITY OF SOUTHERN CALIFORNIA
MARSHALL SCHOOL OF BUSINESS

GSBA 612
Spring 2013

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SELECTED ISSUES IN ECONOMIC THEORY II

COURSE DESCRIPTION

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This syllabus describes a doctoral course in microeconomics, focusing on agency problems, incentives and governance within and across organizations. The course is divided into three basic modules: (1) contracting theory, (2) executive compensation, and (3) the theory of the firm. Although all three modules include theory and evidence, the first part of the course is primarily theoretical and covers several topics normally covered in a contracting course. But this is not a standard course in contract theory. Instead, the theories are chosen because of their existing and potential applications in accounting, corporate finance, and organizations. The second part of the course combines both theory and evidence relating to top-managerial incentives and corporate performance. The third part offers an introduction to organizational economics and the theory of the firm.

PREREQUISITES

At least one semester of graduate-level price theory (presumably GSBA 602). That is, I presume a decent background in the basics of utility maximization under uncertainty, statistical decision theory, risk aversion, moral hazard, adverse selection, and signaling. Please see me if you have any questions or concerns about the required background.

GRADING

The course grade will be based on weekly assignments, a midterm examination, the research project, and a final examination. The weights for the final grade are:

Weekly Assignments	25%
Class Participation	10%
Midterm Exam (February 26th)	25%
Final Exam (May 9th, 2pm-4pm)	40%

Students are expected to read papers prior to class and will also be asked to present readings and their answers to homework assignments throughout the semester.

OFFICE HOURS

I am easily accessible via e-mail (kjmurphy@usc.edu) and will be happy to schedule appointments on an individual basis. In addition, I am generally available after class and – based on student course schedules – can "negotiate" a mutually acceptable time for established office hours during the week.

SYLLABUS

Session 1 — *January 15*
NEO-CLASSICAL LABOR SUPPLY AND INTRODUCTION TO CONTRACTING
The Labor-Leisure Trade-off
The Economics of Contracting (Introduction)

Session 2 — *January 22*
OPTIMAL PIECE RATES
Optimal Contracts under Risk Neutrality
Linear Incentive Contracts under Risk Aversion
Application: CEO Pay and Pay-Performance Sensitivities

Session 3 — *January 29*
NON-LINEAR CONTRACTS AND THE INFORMATIVENESS PRINCIPLE
Non-Linear Incentive Contracts
(Un)Informativeness Principle

Session 4 — *February 5*
MULTI-TASKING AND DISINCENTIVE CONTRACTS
Multi-task Incentive Contracts
Distorted Performance Measures

Session 5 — *February 12*
MULTI-AGENT CONTRACTS
Multi-agent agency problems
Team production
Relative Performance Evaluation

Session 6 — *February 19*
IMPLICIT (AND RELATIONAL) CONTRACTS AND CAREER CONCERNS
Subjective performance measures and discretionary bonuses
Career concerns

Session 7 — *February 26*
MIDTERM

Session 8 — **NEO-CLASSICAL LABOR DEMAND AND MATCHING**
March 5
The Classic Labor Demand Model
Optimal Assignment of Workers to Firms (or Positions)
The Economics of Superstars
General, Firm-Specific, and Managerial Capital

Session 9 — **SEARCH, SCREENING, AND LEARNING**
March 12
Wage Dynamics with Uncertain Ability
Self-Selection Contracts

Session 10 — **EXECUTIVE COMPENSATION**
March 26
Grant-date vs. Realized Pay
The "Cost" vs. the "Value" of Incentive Compensation
Measuring CEO Incentives (and Disincentives)

Session 11 — **THEORIES OF EXECUTIVE COMPENSATION**
April 2
Managerial Power
Efficient Contracting
Perceived Costs

Session 12 — **EXPLAINING CEO PAY**
April 9
A Brief History of CEO Pay
The (Unmodeled) Role of Government Intervention
Towards a General Theory of Executive Compensation

Session 13 — **THE CLASSIC THEORY OF THE FIRM**
April 16
The Nature of the Firm
Transaction-Costs Economics
Vertical Integration

Session 14 — **THE FORMALIZIBLE THEORY OF THE FIRM**
April 23

Session 15 — **INFORMATION AND AUTHORITY IN ORGANIZATIONS**
April 30

May 9th — **FINAL EXAMINATION**
2:00 - 4:00pm

PRELIMINARY READING LIST

The purpose of this reading list is to give you a fairly broad exposure to at least the classic (if not the most recent) papers in the major topics we'll be covering. There is no expectation that you will read all of these during the semester.

The "*more* important" readings are marked with an "*" and will be posted on Blackboard.

The "*most* important" will be designated on the weekly assignments; these will typically involve readings directly applicable to the following or preceding lecture.

1. NEO-CLASSICAL LABOR SUPPLY AND INTRODUCTION TO CONTRACTING

*Baker, George P., Michael C. Jensen and Kevin J. Murphy, 1988. Compensation and Incentives: Practice vs. Theory, *Journal of Finance*, 43(3), 593-616.

*Becker, Gary S. and George J. Stigler, 1974. Law Enforcement, Malfeasance, and Compensation of Enforcers, *Journal of Legal Studies*, 3(1), 1-18.

Lazear, Edward P., 1979. Why Is There Mandatory Retirement? *Journal of Political Economy*, 87(6), 1261-1284.

Prendergast, Canice, 1999. The Provision of Incentives in Firms, *Journal of Economic Literature*, 37(1), 7-63.

2. OPTIMAL PIECE RATES

*Garen, John E. 1994. Executive Compensation and Principal-Agent Theory. *Journal of Political Economy*. 102(6) (December), 1175-1199.

*Haubrich, Joseph G., 1994. Risk Aversion, Performance Pay, and the Principal-Agent Problem, *Journal of Political Economy*, 102(2), 258-76.

*Jensen, Michael C. and Kevin J. Murphy, 1990. Performance Pay and Top Management Incentives, *Journal of Political Economy*, 98(2), 225-265.

*Lazear, Edward P. and Sherwin Rosen, 1981. Rank-Order Tournaments as Optimum Labor Contracts, *Journal of Political Economy*, 89(5), 841-864.

*Lazear, Edward P., 1986. Salaries and Piece Rates, *Journal of Business*, 59(3) (July), pp. 405-431.

*Murphy, Kevin J., 1985. Corporate Performance And Managerial Remuneration - An Empirical Analysis, *Journal of Accounting & Economics*, 7(1-3), 11-42.

*Prendergast, Canice, 2002. The Tenuous Trade-off between Risk and Incentives, *Journal of Political Economy*, 110(5), 1071-1102.

*Zábojník, Ján, 1996. Pay-performance Sensitivity and Production Uncertainty, *Economic Letters*, 53(3), 291-296

Aggarwal, Rajesh K. and Andrew A. Samwick, 1999. The Other Side of the Tradeoff: The Impact of Risk on Executive Compensation, *Journal of Political Economy*, 107(1), 65-105.

Coughlan, Anne T. and Ronald M. Schmidt, 1985, Executive Compensation, Management Turnover, and Firm Performance: An Empirical Investigation, *Journal of Accounting and Economics*, 7(1-3), 43-66.

Gibbons, Robert, 1987. Piece-rate Incentive Schemes, *Journal of Labor Economics*, 5(4:1), 413-429.

3. NON-LINEAR CONTRACTS AND THE (UN)INFORMATIVENESS PRINCIPLE

*Hart, Oliver D. and Bengt Holmstrom, 1987. The Theory of Contracts. In T. Bewley (ed.), *Advances in Economic Theory*, Fifth World Congress, University Press, Cambridge.

*Holmstrom, Bengt, 1979. Moral Hazard and Observability, *The Bell Journal of Economics*, 10(1), 74-91.

*Rogerson, William P. 1985. The First-Order Approach to Principal-Agent Problems. *Econometrica* 53(6), 1357-1367.

Grossman, Sanford J. and Oliver D. Hart, 1983. An Analysis of the Principal-Agent Problem, *Econometrica*, 51(1), 7-45.

Mirrlees, James A., 1974. Notes on Welfare Economics, Information, and Uncertainty, in M. Balch, D. McFadden, and S. Wu, eds, *Essays on Economic Behavior Under Uncertainty*, North Holland, Amsterdam.

Mirrlees, James A., 1976. The Optimal Structure of Incentives and Authority within an Organization, *Bell Journal of Economics*, 7(1), 105-131.

Ross, Stephen A., 1973. The Economic Theory of Agency: The Principal's Problem, *American Economic Review*, 63(2), 134-39.

Accounting vs. Stock-Price Performance Measures: Theory and Evidence

*Banker, Rajiv D. and Srikant. M. Datar, 1989. Sensitivity, Precision, and Linear Aggregation of Signals for Performance Evaluation, *Journal of Accounting Research*, 27(1), 21-39.

*Lambert, R. and D. Larcker, 1988. An Analysis of the Use of Accounting and Market Measures of Performance in Executive Compensation Contracts, *Journal of Accounting Research*, 25(Supplement), 85-129.

Datar, Srikant, Susan Cohen Kulp and Richard A. Lambert, 2001. Balancing Performance Measures, *Journal of Accounting Research* 39(1), 75-92.

Non-linearities and performance benchmarks

*Healy, Paul M., 1985. The Effect of Bonus Schemes on Accounting Decisions, *Journal of Accounting and Economics*, 7(1-3), 85-112

*Murphy, Kevin J. and Michael C. Jensen, CEO Bonus Plans and How to Fix Them, Working Paper (November 2011).

*Murphy, Kevin J., 2001. Performance Standards in Incentive Contracts, *Journal of Accounting and Economics*, 30(3), 245-278

*Oyer, Paul, 1998. Fiscal Year Ends and Nonlinear Incentive Contracts: The Effect on Business Seasonality, *Quarterly Journal of Economics*, 113(1), 149-85.

Gaver, Jennifer, Kenneth M. Gaver and Jeffrey R. Austin, 1995. Additional Evidence on Bonus Plans and Income Management, Journal of Accounting and Economics, *Journal of Accounting and Economics*, 19(1), 3-28.

Holthausen, Richard, David Larcker and Richard G. Sloan, 1995. Annual Bonus Schemes and the Manipulation of Earnings, *Journal of Accounting and Economics*, 19(1), 29-74.

Jensen, Michael C., 2003. Paying People to Lie: The Truth About the Budgeting Process. *European Financial Management*, 9(3), 379-40.

4. MULTI-TASKING AND DISINCENTIVE CONTRACTS

*Baker, George P., 1992. Incentive Contracts and Performance Measurement, *Journal of Political Economy* 100(3), 598-614

*Baker, George P., 2002. Distortion and Risk in Optimal Incentive Contracts, *Journal of Human Resources*, 37(4), 728-751.

*Feltham, Gerald A. and Jim Xie, 1994. Performance Measure Congruity and Diversity in Multi-Task Principal/Agent Relations. *Accounting Review* 69(3), 429-453.

*Holmstrom, Bengt, and Paul Milgrom, 1991. Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design, *Journal of Law, Economics, and Organization*, 7(Special issue), 24-52.

*Kerr, Steven, 1975. On the Folly of Rewarding A, While Hoping for B. *Academy of Management Journal*, 18(4), 769-783.

Courty, Pascal, and Gerald Marschke, 2004. An Empirical Investigation of Gaming Responses to Explicit Performance Incentives, *Journal of Labor Economics*, 22(1), 23-56.

Dechow, Patricia M and Richard G. Sloan, 1991. Executive Incentives and the Horizon Problem - An Empirical Investigation, *Journal of Accounting and Economics*, 14(1), 51-89.

5. MULTI-AGENT CONTRACTS

Relative Performance Evaluation: Theory and Evidence

*Antle, Rick and Abbie Smith, 1986. An Empirical Investigation of the Relative Performance Evaluation of Corporate Executives, Journal of Accounting Research, 24(1), 1-39.

*Gibbons, Robert and Kevin J. Murphy, 1990. Relative Performance Evaluation for Chief Executive Officers, Industrial and Labor Relations Review, 43(3), 30S-51S.

Aggarwal, Rajesh K. and Andrew A. Samwick, 1997. Executive Compensation, Strategic Competition, and Relative Performance Evaluation: Theory and Evidence, Journal of Finance, 54(6), 1999-2043.

Janakiraman, Surya N., Richard A. Lambert and David F. Larcker, 1992. An Empirical Investigation of the Relative Performance Evaluation Hypothesis, Journal of Accounting Research, 30(1), 53-69.

Lazear, Edward, 1989. Pay Equality and Industrial Politics, Journal of Political Economy, 97(3), 561-80.

Rajgopal, Shivaram, Terry J. Shevlin and Valentina Zamora, 2006. CEOs' Outside Employment Opportunities and the Lack of Relative Performance Evaluation in Compensation Contracts, Journal of Finance, 61(4), 1813-1844.

Sloan, Richard, 1993. Accounting Earnings and Top Executive Compensation, Journal of Accounting and Economics, 16(1-2-3), 55-100.

Rewarding Group Performance

*Hall, Brian J., and Kevin J. Murphy, 2003, The Trouble with Stock Options, *Journal of Economic Perspectives* 17, 49-70.

*Holmstrom, Bengt, 1982. Moral Hazard in Teams, Bell Journal of Economics, 13(2), 324-340.

*Oyer, Paul and Scott Schaefer, 2005. Why Do Some Firms Give Stock Options to All Employees?: An empirical Examination of Alternative Theories, Journal of Financial Economics, 76(1), 99-133

*Oyer, Paul, 2004. Why Do Firms Use Incentives that Have No Incentive Effects? Journal of Finance, 59(4), 1619-1649

Kandel, Eugene and Edward P. Lazear, 1992. Peer Pressure and Partnership, Journal of Political Economy, 100(4), 801-17.

6. IMPLICIT (AND RELATIONAL) CONTRACTS AND CAREER CONCERNS

Subjective Performance Measures and Relational Contracts

*Baker, George P., Robert Gibbons and Kevin J. Murphy, 1994. Subjective Performance Measures in Optimal Incentive Contracts, *Quarterly Journal of Economics*, 109(4), 1125-1156.

*Bull, Clive, 1987. The Existence of Self-Enforcing Implicit Contracts, *Quarterly Journal of Economics*, 102(1), 147-59.

*Klein, Benjamin and Keith Leffler, 1980. The Role of Market Forces in Assuring Contractual Performance, Journal of Political Economy, Vol. 89, pp. 615-641

*Murphy, Kevin J. and Paul Oyer, 2004. Discretion in Executive Incentive Contracts, USC Working Paper.

*Prendergast, Canice and Robert H. Topel. 1996. Favoritism in Organizations. *Journal of Political Economy*, Vol. 104, No. 5., pp. 958-978.

Bushman, Robert M., R. J. Indjejikian and Abbie Smith, 1996. CEO Compensation: The Role of Individual Performance Evaluation, *Journal of Accounting and Economics*, 21(2), 161-193.

Levin, Jonathan, 2003. Relational Incentive Contracts, *American Economic Review*, 93, pp. 835-857.

MacLeod, W. Bentley and James M. Malcomson, 1998. Motivation and Markets, *American Economic Review*, 88(3), 388-411.

Career Concerns

*Fama, E., 1980. Agency Problems and the Theory of the Firm, *Journal of Political Economy*, 88(2), 288-307.

*Gibbons, Robert, and Kevin J. Murphy, 1992. Optimal Incentive Contracts in the Presence of Career Concerns: Theory and Evidence, Journal of Political Economy, 100(3), 468-505.

*Holmstrom, Bengt, 1982. Managerial Incentive Problems--A Dynamic Perspective, Republished in *Review of Economic Studies*, 1999, 66 (1), 169-182.

7. NEO-CLASSICAL LABOR DEMAND AND MATCHING

*Rosen, Sherwin, 1981, The Economics of Superstars *American Economic Review*, Dec. 1981.

*Rosen, Sherwin, 1982, Authority, Control, and the Distribution of Earnings, *Bell Journal of Economics*, 13(2), 311-323.

*Roy, A. D., 1951. Some Thoughts on the Distribution of Earnings, *Oxford Economic Papers*.

Jovanovic, Boyan. 1979. Job Matching and the Theory of Turnover *Journal of Political Economy*, October 1979.

MacDonald, G. The Economics of Rising Stars, *American Economic Review* 78 (March 1988): 155-66.

8. SEARCH, SCREENING, AND LEARNING

*Harris, M. and B. Holmstrom, 1982. A Theory of Wage Dynamics *Review of Economic Studies*. July 1982; 49(3): 315-33

*Murphy, Kevin J., 1986. Incentives, Learning, and Compensation: a Theoretical and Empirical Investigation of Managerial Labor Contracts, Rand Journal of Economics, 17(1), 59-76.

*Rogerson, Richard; Robert Shimer, and Randall Wright, 2005. Search-Theoretic Models of the Labor Market: A Survey *Journal of Economic Literature*. (December) 43(4): 959-88.

*Salop, Joanne and Steven Salop, 1976. Self-Selection and Turnover in the Labor Market, Quarterly Journal of Economics, 90(4) (November), pp. 619-627.

9. MIDTERM

10. EXECUTIVE COMPENSATION

*Baker, George P, and Brian Hall, 2004. CEO Incentives and Firm Size, *Journal of Labor Economics* 22, 767-798

*Fernandes, Nuno, Miguel A. Ferreira, Pedro Matos and Kevin J. Murphy, 2013. Are US CEOs Paid More? New International Evidence. *Review of Financial Studies* (forthcoming).

*Frydman, Carola, and Raven E. Saks, 2010. Executive Compensation: A New View from a Long-Term Perspective, 1936-2005, *Review of Financial Studies* 23, 2099-2138.

*Hall, Brian J., and Kevin J. Murphy, 2002. Stock Options for Undiversified Executives, *Journal of Accounting and Economics* 33, 3-42.

*Murphy, Kevin J., 2013. Executive Compensation: Where we are, and how we got there, Chapter 4 in George Constantinides, Milton Harris, and René Stulz (eds.), *Handbook of the Economics of Finance*. Elsevier Science North Holland (forthcoming), Section 2.

11. THEORIES OF EXECUTIVE COMPENSATION

*Bebchuk, Lucian A., Jesse M. Fried, and David I. Walker, 2002. Managerial Power and Rent Extraction in the Design of Executive Compensation, *University of Chicago Law Review* 69, 751-846. http://papers.ssrn.com/abstract=316590

*Bebchuk, Lucian Arye, and Jesse M. Fried, 2003. Executive Compensation as an Agency Problem, *Journal of Economic Perspectives* 17, 71+.

*Edmans, Alex, and Xavier Gabaix, 2009. Is CEO Pay Really Inefficient? A Survey of New Optimal Contracting Theories, *European Financial Management* 15.

*Frydman, Carola, and Dirk Jenter, 2010. CEO Compensation, *Annual Review of Financial Economics* 2, 75-102.

*Gabaix, Xavier, and Augustin Landier, 2008. Why has CEO Pay Increased So Much?, *Quarterly Journal of Economics* 123, 49-100.

*Murphy, Kevin J., 2002. Explaining Executive Compensation: Managerial Power vs. the Perceived Cost of Stock Options, *University of Chicago Law Review* 69, 847-869.

*Murphy, Kevin J., and Jan Zábojník, 2008. Managerial Capital and the Market for CEOs.

12. EXPLAINING CEO PAY

*Kaplan, Steven N., 2008, Are U.S. CEOs Overpaid?, *Academy of Management Perspectives*, 1-16.

*Kaplan, Steven N., and Josh Rauh, 2010, Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?, *Review of Financial Studies* 23, 1004-1050.

*Murphy, Kevin J., 2013. Executive Compensation: Where we are, and how we got there, Chapter 4 in George Constantinides, Milton Harris, and René Stulz (eds.), *Handbook of the Economics of Finance*. Elsevier Science North Holland (forthcoming), Sections 3 & 5.

13. THE CLASSIC THEORY OF THE FIRM

*Alchian, Armen and Harold Demsetz, 1972. Production, information costs and economic organization, *American Economic Review*, 62:777-795.

*Coase, Ronald, 1937. The Nature of the Firm, *Economica*, 4:386-405

*Klein, Benjamin, Robert Crawford, and Armen Alchian, 1978. Vertical Integration, Appropriable Rents and the Competitive Contracting Process, *Journal of Law and Economics* 21, 297-326.

*Michael C. Jensen and William H. Meckling. 1976. Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure. *Journal of Financial Economics*, Vol. 3, No. 4: October, pp. 305-360

*Williamson, Oliver, 1971. The Vertical Integration of Production: Market Failure Considerations, *American Economic Review*, 61:112-123

*Williamson, Oliver, 2002. The Theory of the Firm as Governance Structure, *Journal of Economic Perspectives*, 16:171-195

14. THE (FORMALIZABLE) THEORY OF THE FIRM

*Baker, George, Robert Gibbons and Kevin J. Murphy, 2002. Relational contracts and the Theory of the Firm, *Quarterly Journal of Economics*, 117:39-83

*Gibbons, Robert (2005), Four Formal(izable) Theories of the Firm?, *Journal of Economic Behavior and Organization,* 58 (2005): 202-47

*Grossman, Sanford and Oliver Hart, 1986. The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration, *Journal of Political Economy* 94:691-719

Hart, Oliver and John Moore, Property Rights and the Nature of the Firm, 1990. *Journal of Political Economy* 98, 1119-58.

Holmstrom, Bengt and Paul Milgrom, 1994. The Firm as an Incentive System, *American Economic Review*, 84:972-991

Holmstrom, Bengt, 1999. The Firm as a Subeconomy, *Journal of Law, Economics and Organization*, 15(1):74-102

Milgrom, Paul and John Roberts (1988), An Economic approach to influence activities in organizations, *American Journal of Sociology*, 94:S154-S179

Whinston, Michael. (2003), On the transaction cost determinants of vertical integration, *Journal of Law, Economics and Organization*, 19:1-23

15. INFORMATION AND AUTHORITY IN ORGANIZATIONS

*Aghion, Phillip and Jean Tirole. 1997. Formal and Real Authority in Organizations. *Journal of Political Economy* 105:1-29.

*Alonso, R., W. Dessein and N. Matoushek, 2008. When Does Coordination Require Centralization? *American Economic Review*, 98(1):145-79

*Baker, George, Robert Gibbons and Kevin J. Murphy, 1999. Informal Authority in Organizations, *Journal of Law, Economics and Organization*, 15(1):56-73

*Baker, George, Robert Gibbons and Kevin J. Murphy. 2012. Relational Adaptation. USC Working Paper.

*Dessein, W. (2002), Authority and Communication in Organizations, *Review of Economic Studies* 69:811-838

*Garicano, L. (2000), Hierarchies and the organization of knowledge in production, *Journal of Political Economy*, 108:874-904

Alonso, R. and N. Matouschek (2008), Optimal delegation, *Review of Economic Studies*, 75(1):259-293

Bolton, P. and M. Dewatripont, 1994. The Firm as a Communication Network, *Quarterly Journal of Economics,* 109:809-39

Crawford, V. and J. Sobel (1982), Strategic Information Transmission, *Econometrica*, 50:1431-1451

Rantakari, H. (2008), Governing Adaptation, *Review of Economic Studies*, 75:1257–1285