SELECTED ISSUES IN ECONOMIC THEORY II

COURSE DESCRIPTION

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 (kimurphy@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  NEO-CLASSICAL LABOR SUPPLY AND INTRODUCTION TO CONTRACTING  
January 15  
The Labor-Leisure Trade-off  
The Economics of Contracting (Introduction)

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

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

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

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

Session 6  IMPlicit (AND RELATIONAL) CONTRACTS AND CAREER CONCERns  
February 19  
Subjective performance measures and discretionary bonuses  
Career concerns

Session 7  MIDTERM  
February 26
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 FORMALIZABLE THEORY OF THE FIRM**  
*April 23*  

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

**May 9**  
**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**


2. **Optimal Piece Rates**


3. **Non-Linear Contracts and the (Un)Informativeness Principle**


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


**Non-linearities and performance benchmarks**


**4. Multi-Tasking and Disincentive Contracts**


5. **MULTI-AGENT CONTRACTS**

**Relative Performance Evaluation: Theory and Evidence**


Rewarding Group Performance


6. **Implicit (and Relational) Contracts and Career Concerns**

Subjective Performance Measures and Relational Contracts


Career Concerns


7. Neo-Classical Labor Demand and Matching


8. Search, Screening, and Learning


9. **Midterm**

10. **Executive Compensation**


* 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**


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


*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


14. THE (FORMALIZABLE) THEORY OF THE FIRM


### 15. INFORMATION AND AUTHORITY IN ORGANIZATIONS


