

Issues in Microeconomics I:
Information Economics

Term I, 2008

Kyiv School of Economics

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Course description:

So far, you have been studying microeconomics under ideal conditions: that information is perfect, markets are complete, and that there is no market transaction costs. Micro-economic literature in the late 1960's began focusing on the importance of information and initiated the relaxation of the Arrow-Debreu-Hahn assumptions. That relaxation allows microeconomics to explain a much broader scope of relationships among economic and social agents in the real world. This course focuses on incentives that guide the economic activities in a world of imperfect information and incomplete markets. Those incentives are created by contracts (both implicit and institutional) among the agents such as employer-employee, buyer and seller, tenant and landlord, bank and lender, etc.

The course builds on concepts of agency (principal-agent), asymmetric information, and high exclusion costs of certain types of information. The concepts of transaction costs, hidden information, hidden action, signaling, screening, optimum contract, segmentation induced by differential information, pooling and separating equilibrium, and hierarchical internal organizations will also be explored and formalized.

Course objectives: Having successfully completed this course, the student will:

1. Become familiar with the current and classic literature on the subject;
2. Understand assumptions, strengths and weaknesses of different economic theories under asymmetric information;
3. Be able to use appropriate information economics concepts;
4. Develop skills in using information economics' analytic tools, and be able to apply them in analysis of real world situations when information is asymmetric.

Textbook:

- Inés Macho-Stadler and David Pérez-Castrillo. (*MSPC*) *An Introduction to the Economics of Information: Incentives and Contracts* (New York: Oxford University Press, 2nd edition, 2001).
- Mas-Colell, Whinston, and Green. (MWG) *Microeconomic Theory* (1995) Ch. 13, 14
- Yujiro Hayami and Keijuro Otsuka. *The Economics of Contract Choice: An Agrarian Perspective* (Oxford University Press, 1993) Ch.1-5.
- Debraj Ray. *Development Economics* (Princeton University Press, 1998) Ch.12, 14, 15.

Optional Reading:

- Jean-Jacques Laffont and David Martimort. *The Theory of Incentives – The Principal-Agent Model*.

Copies of the readings that are not available through JSTOR will be made available to the students.

Grading:

Assignments:	30%
Midterm:	30%
Final Exam:	<u>40%</u>
Total	100%

Students can earn up to 10% worth of bonus points for class participation.

Tentative Topics Outline**Part 1. Theoretical Concepts****I. An Introduction to the Problems of Asymmetric Information**

Review of Arrow-Debreu assumptions about information and implications
Consequences of asymmetric information for contract design and exchange

MSPC, Ch. 1

Sappington, D.E. (1991). "Incentives in Principal-Agent Relationships," *The Journal of Economic Perspectives*, vol. 5, No.2, pp. 45-66.

Stiglitz, J. (2000). "The Contributions of the Economics of Information to 20th Century Economics," *QJE*, Nov.

II. Simple "principal-agent" model

MSPC, Chs. 2

Hayami&Otsuka, Ch.2

III. The Problem of Moral Hazard

MSPC, Ch. 3

Holmstrom, B. (1979) "Moral Hazard and Observability," *The Bell Journal of Economics*, vol. 10, No. 3, pp. 74-91.

Arnott, R.J. and J.E. Stiglitz. (1988). "The Basic Analytics of Moral Hazard," *The Scandinavian Journal of Economics*, vol. 90, No. 3, pp. 383-413.

Holmstrom, B. (1982) "Moral Hazard in Teams," *The Bell Journal of Economics*, vol. 13, No. 2, pp. 324-40.

Hyde, C.E. and J.A. Vercammen. (1997). "Costly Yield Verification, Moral Hazard, and Crop Insurance Contract Form," *Journal of Agricultural Economics*, vol. 48, No. 3, pp. 393-407.

Lambert, R.A. (1983). "Long-Term Contracts and Moral Hazard," *The Bell Journal of Economics*, vol. 14, No. 3, pp. 441-52.

IV. The Problem of Adverse Selection

MSPC, Ch. 4

Akerlof, G.A. (1970). "The Market for "Lemons": Quality Uncertainty and the Market Mechanism," *The Quarterly Journal of Economics*, vol. 84, No. 3, pp. 488-500.

V. Signalling and Screening

MSPC, Ch. 5

Milde, H. and J.G. Riley. (1988). "Signaling in credit markets," *The Quarterly Journal of Economics*, vol.103, No. 1, pp. 1001-29.

Wolpin, K.I. (1977). "Education and Screening," *The American Economic Review*, vol. 67, No. 5, pp. 949-58.

VII. Contract Choice

Hayami&Otsuka, Ch.3-5.

VIII. Repeated interactions and Institutional Outcomes

Grief, A. (1993). "Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition", *The American Economic Review*, vol. 83, No. 3, pp. 525-48.

Dufwenberg, M. and M. Lundholm. (1997). "Social Norms and Moral Hazard" – working paper.

Milgrom, P.R., D.C. North and B.R. Weingast. (1990) "The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs," *Economics and Politics*, vol. 2, No. 1, pp.1-23

IX. Transaction cost and structure of the firm

Fama, E.F. (1980). "Agency Problem and the Theory of the Firm," *Journal of Political Economy*, vol.88, No 2, pp. 288-307.

*Jensen, M.C. (1976). "Theory of Firm: Managerial Behavior, Agency Cost and Ownership Structure," *Journal of Financial Economics*, No. 3, pp. 305-60.

Part 2. Applications

X. Credit Markets:

Ray (1998) Ch. 14.2.2.-14.4.

Stiglitz, J., A. Weiss. (1992). "Asymmetric Information in Credit Markets and Its Implications for Macro-Economics," *Oxford Economic Papers*, vol. 44, No. 4, Special Issue on Financial Markets, Institutions and Policy (Oct., 1992), pp. 694-724.

Stiglitz, J. (1990). "Peer Monitoring and Credit Markets," *The World Bank Economic Review*, vol. 4, No. 3, pp. 351-66.

Stiglitz, J., A. Weiss. (1981). "Credit Rationing in Markets with Imperfect Information," *The American Economic Review*, vol. 71, No. 3, pp. 393-410.

Pitt, M.M., Khandker, S.R. (1998). "The Impact of Group-Based Credit Programs on Poor Households in Bangladesh: Does the Gender of Participants Matter?," *The Journal of Political Economy*, vol. 106, No. 5, pp. 958-96.

Bell, C., T.N. Srinivasan, C. Udry. (1997). "Rationing, Spillover, and Interlinking in Credit Markets: The Case of Rural Punjab," *Oxford Economic Papers*, New Series, vol. 49, No. 4, pp. 557-85.

Morduch, J. (1999). "The Microfinance Promise," *Journal of Economic Literature*, vol. 37, No. 4, pp. 1569-1614.

Williamson, S.D. (1987). "Costly Monitoring, Loan Contracts, Credit Rationing," *The Quarterly Journal of Economics*, vol. 102, No. 1, pp. 135-46.

XI. Labor Markets:

Foster, A.D., M.R. Rosenzweig. (1994). "A Test for Moral Hazard in the Labor Market: Contractual Arrangements, Effort, and Health," *The Review of Economics and Statistics*, vol. 76, No. 2, pp. 213-227.

Grossman, S.J. and O.D. Hart. (1981). "Implicit Contracts, Moral Hazard and Unemployment," *The American Economic Review*, vol. 71, No. 2, Papers and Proceedings of the Ninety-Third Annual Meeting of the American Economic Association, pp. 301-07.

Hart, O.D. (1983). "Optimal Labor Contracts under Asymmetric Information: An Introduction," *The Review of Economic Studies*, vol. 50, No. 1, pp. 3-35.

XII. Insurance:

Ray (1998), Ch. 15.3.

Rothschild, M., J. Stiglitz. (1976): "Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information." *Quarterly Journal of Economics*, vol. 90, No.4, pp. 629-49.

Rothschild, M., J. Stiglitz. (1997): "Competition and Insurance Twenty Years Later," *The Geneva Papers on Risk and Insurance Theory*, vol. 22, pp. 73-79.

*Turvey, Z, M. Hoy, and Z. Islam (2002), "The Role of Ex-Ante Regulations in Addressing Problems of Moral Hazard in Agricultural Insurance," *Agricultural Finance Review*, vol. 62, No. 2, pp. 103-16.

Arnott, R. and J. Stiglitz. (1991). Moral Hazard and Nonmarket Institutions: Dysfunctional Crowding Out of Peer Monitoring," *The American Economic Review*, vol. 81, No.1, pp.179-90.

XIII. Program Design and Evaluation:

Kwerel, E. (1977). "To Tell the Truth: Imperfect Information and Optimal Pollution Control," *The Review of Economic Studies*, vol. 44, No. 3, pp. 595-601.

Duflo, E. (2003). "Grandmothers and Granddaughters: Old-Age Pension and Intrahousehold Allocation in South Africa," *The World Bank Economic Review*, vol. 17, No. 1, pp. 1-25.

XIV. Agriculture and Sharecropping:

Ray (1998), Ch. 12.3, Appendix 12.1., 12.2.

Hayami&Otsuka, Ch.1.

Stiglitz, J. (1974). "Incentives and Risk Sharing in Sharecropping," *The Review of Economic Studies*, vol. 41, No. 2, pp. 219-55.

XV. Overview

Stiglitz, J. (2000). "The Contributions of the Economics of Information to 20th Century Economics," *QJE*, Nov.