New Economic School
Research Project for 2007-2008

Topics in Microeconomics: Knowledge, Incentives, Corporate Governance

Project leaders:
Anton Suvorov (asuvorov@nes.ru)
Sergey Stepanov (sergeystepan@gmail.com)

Students are free to elaborate on one of the topics described below or come up with their own project with a related theme.

1. **Overconfidence and learning.** Many empirical studies have shown that most people are prone to at least some form of *overconfidence* (*better than average bias* implying overestimation of own'sachievements or possessment of desirable traits, *miscalibration* implying excessive certitude in the precision of own's knowledge, *illusion of control* making people overstimate their influence on the environment, etc.). Overonfidence may not only help people enjoy higher self-esteem for purely hedonic reasons (Kőszegi (2006)), but may also be instrumental, allowing people to mitigate their own self-control problems (Bénabou and Tirole (2002)) or, in the context of an organization, allowing leaders to commit to a stable course of action thus motivating the followers (Van den Steen (2005)). There are several costs associated with overconfidenvce, though: for example, it may lead to stubborn persistence when facing difficult tasks (Bénabou and Tirole (2002)) or to eronneous financial decisions (Kőszegi (2006)). An interesting issue is how overconfidence interacts with learning (incentives to acquire new information), in particular in the context of an organization.

2. **Incentives of researchers, screening intrinsic motivation.** How should the incentives of researchers be structured, how financing should be allocated between projects? One of the problems that exist in Russia now is to create proper incentives for the research activity. One issue is to attract young talented people into the domain of scientific, in particular, basic research, and give them proper incentives to pursue a research career. However, given the high mobility of the young and well-educated, Russian science has to compete here both with the private sector and with the foreign research institutions. A

related question concerns the provision of incentives to those who have chosen a research career (in particular, one has to take into account the difficulties related to the measurement of a researcher's output). Is there scope for tenure-track/tenure contracts that are widespread in the West (see e.g. Carmichael (1988), McPherson and Schapiro (1999))?

Also, research (as well as, say, education, art or medicine) is the domain where intrinsic incentives are highly significant. However, some recent research by both psychologists and economists (see, e.g., Bénabou and Tirole (2003, 2005), Fehr and Falk (2002), Frey (1997)) has shown that under some circumstances extrinsic (often, explicit monetary) incentives can crowd out intrinsic motivation. One has to take this effect into account when designing contracts for academics (also, taking into account the agents' intrinsic motivation when sorting them via employment contracts is important, see Besley and Ghatak (2005)). Another interesting venue for research is investigation of how to screen the employees' intrinsic motivation: indeed, intrinsic motivation, as important as it is, is hardly observable and one can easily come up with diffent motives to misrepresent it. What mechanisms allow to limit the scope for such misleading self-presentation of the employees'?

3. **Why hire external consultants?** One topic could develop the following idea. People within the organization tend to overestimate the quality of most existing practices since they are informative about their ability and people prefer to think well of themselves. An external evaluator has no such bias. However, this same bias that prevents the incumbent managers to see the needed or desirable changes in the organization will make them fight the suggestions made by external consultants. However, committing to accept a consultant's suggestions may be easier than making a cognitive effort and arriving at unbiased thinking. Reputation for efficiency, in turn, may prevent the consutant from acting like a "yes man" (Prendergast (1993)) and withdrawing from criticism.

4. **Information dissemination and knowledge economy.** An important aspect of the knowledge economy concerns the dissemination of information in the society. Presumably, for the effective functioning of such economy, for the creation of the environment supporting creativity and originality, the free circulation of information is crucial. On the other hand, many sociological surveys indicate that the majority of people in the Russian society value the freedom of speech much less that material well-being or security. Does this mean that Russia is far from state of a modern knowledge economy and is unlikely to reach it soon? More generally, what drives the demand for the free dissemination information – why the freedom of speech proliferates in some countries and is more or less

restrained in others?[1]

Some recent papers investigate various supply-side aspects: for example, Baron (2006) shows that journalists' career concerns, that drive them to publish extreme news, may results in persistent media bias; Besley and Prat (2005) show that information unfavorable to some strong interest groups can be suppressed via media capture, etc. Mullainathan and Shleifer (2005) show that a confirmation bias in the readers' preferences with respect to information (which makes them happier if the news confirms their private beliefs rather than when it dissents with them) results in the biased news being communicated by competing media firms. Some further research, in particular, investigating when the "confirmation bias" emerges on the aggregate level, would be interesting to pursue (see also Gentzkow and Shapiro (2006)).

5. **To fire or not to fire: turnover of subordinates.** Why are prime ministers changed more often in some countries than in others? Why is turnover of soccer players higher in one team than in another one? The idea of this project is to link firing/keeping decisions of a principal in an organization with the market/his superior/voters beliefs about the principal's abilities. When a principal takes a decision whether to fire or keep a subordinate (agent) he is concerned with three things: (1) how good or bad the agent is, given the observed signals about the agent's talent; (2) if he fires the agent, will he manage to find a better one? (3) Most interestingly, what the market/people/his own principal will think about him after (some) signals about the agent's talent are publicly revealed and the principal's firing/keeping decision is observed.

   The crucial element of the story is that more able principals can choose better agents – this is why the principal's firing/keeping decision together with the agent's publicly observable measures of performance matter for the evaluation of the principal's abilities.

   The research question is: what is the optimal turnover policy of a principal, depending on his ability and environment? By environment we mean anything that affects the principal's incentives to appear talented. Depending on a specific application it can be e.g. political regime, market conditions, or a structure of the organization in which the principal works. Students are welcome to collect data/stories on turnovers in various organizations (e.g. turnover of prime ministers in different countries, players in sport teams) – such empirical work would be a great complement to a theoretical model.

   The above considerations can be interacted with the moral hazard on the part of agent: when choosing effort she may take into account the principal's concerns with trying to

[1] Note, that more precise public information is not always good for the society – see, for example, Morris and Shin (2002).

appear more able. There are also issues of matching: e.g. will talented people agree to work for unable principals?

The key references are Holmström (1999), Dewatripont et al (1999a, 1999b), Gibbons and Murphy (1992), Bolton and Dewatripont (2005), ch. 10.5

6. **Managing information about talent to motivate people**. In the career concerns models (e.g. Holmström (1999)) agents are induced to work hard by the motivation that better performance makes the market think they are more talented, which leads to a greater likelihood of getting a better job, being promoted/not fired or offered a higher wage.

   However, once it becomes known she is good, an agent loses her motivation. The agent will also lose motivation if she knows that the principal/market receives additional signals about her talent that are unrelated to her effort. Thus, two related questions arise. Shall a principal use all his information about an agent's talent when a decision about keeping/firing/promoting her has to be taken? Is it always good to let an agent know what you think about her?

   The model should build on the mentioned papers to explore the following tradeoff. On the one hand, revealing information about the agent's talent and using it for taking decisions about an agent is valuable from both the ex-ante (providing career concerns incentives) and the ex-post (selecting better people) perspectives. On the other hand, the above considerations suggest that excessive use of such information may destroy incentives.

   The model should examine when each of the effects is more important and, if the negative effect dominates, what kind of commitment mechanisms could preclude the excessive use of information (e.g. delegating decisions concerning the agent to someone less informed, or setting decision rules that are based only on verifiable information about the agent's performance). Optimal timing of revelation of the principal's beliefs about an agent (e.g. timing of promotion decisions) would be another application of the model. The key references are the same as in the previous topic.

7. **Length of relationships and collusion.** Are long-term relationships better than short-term ones for preventing collusion between agents at the expense of other agents? Arthur Andersen colluded with the Enron's management to conceal Enron's accounting manipulations. Huge losses incurred by thousands of Enron shareholders could be avoided if Arthur Andersen refused to collude. This and other similar scandals raised the issue of mandatory rotation of audit firms. The rationale for mandatory rotation is that a long-lasting relationship between an auditor and a firm's management can gradually result in

collusive behavior.

The idea of the project is to consider situations where a "controlling" party (e.g. management) can benefit himself at the expense of another party (e.g. shareholders), and there is a monitor (e.g. auditor or "outside" director on the board of directors) who can either report the controlling party's misbehavior or collude with him in exchange for a bribe or favor. Long-term relationships can indeed lead to establishing sustained collusive behavior. However, they can kill the mere incentive to collude the first time as the monitor understands that he will be "trapped" by the controlling party after the first collusion: the controlling party will subsequently misbehave ignoring the monitor, as the monitor, having colluded once, will be afraid of reporting subsequent misbehavior. Under short-term relationships, on the other hand, the monitor is not concerned with being "trapped". Thus, the benefit of mandating rotation of monitors after a short period is not obvious.

The model should examine the above tradeoff and analyze the following questions:

(1) In the absence of mandatory restrictions, what length of the monitor's contract would parties choose voluntarily?

(2) When are mandatory restrictions on the length of relationship beneficial?

The most relevant general references are Tirole (1986), Tirole (1992), Martimort (1999) and Bolton and Dewatripont (2005), ch. 8. Papers that deal specifically with collusion in the corporate governance context are Maug (2002) and Dessi (2005).

8. **Multiple blockholders. Protection of minority shareholders vs. costly fights for control.** Some corporations with concentrated ownership have several large shareholders (blockholders), each of them having a non-trivial power in the firm. In Russia, examples of such companies would be those in which Alfa Group has a large stake (like Vimpelcom). Empirical papers do not provide conclusive evidence on the effect of such structures on a firm's performance, while theory on the topic is scarce. Balance of power and competition for votes of other shareholders reduces the chances of opportunism by any single blockholder, thereby protecting small shareholders (Block and Hege (2001), Bennedsen and Wolfenzon (2000), Gomes and Novaes (2005)). On the other hand, multiple blockholders can engage in wasteful struggles for control, which we often observe in Russia. Additionally, conflicts between them may lead to inefficient deadlocks (Gomes and Novaes (2005)), like in the ongoing conflict between Alfa and Telenor in Vimpelcom.

   The goal of the project is to improve on the existing literature by developing a model that would endogenize the emergence of structures with multiple blockholders and their behavior as a function of legal environment and firm-specific characteristics. Based on

Gomes and Novaes (2005) and Radaev and Stepanov (2006) the model is supposed to incorporate a fight for control between blockholders under asymmetric information.

Selected References

Baron D. (2006) "Persistent Media Bias", Journal of Public Economics, Vol. 90, Issue 1/2, pp.1-36.

Bénabou R. and J. Tirole (2002) "Self-Confidence and Personal Motivation", Quarterly Journal of Economics, 117(3), 871-915.

Bénabou R. and J. Tirole (2003) "Intrinsic and Extrinsic Motivation", Review of Economic Studies, 70(3), 489-520.

Bénabou R. and J. Tirole (2005) "Incentives and Prosocial Behavior", American Economic review, forthcoming.

Bennedsen, M., and D. Wolfenzon (2000) “The Balance of Power in Closely Held Corporations”, Journal of Financial Economics 58, 113-139.

Besley T. and M. Ghatak (2005) "Competition and Incentives with Motivated Agents", American Economic review, forthcoming.

Besley T. and A. Prat (2005) "Handcuffs for the Grabbing Hand?: Media Capture and Government Accountability", American Economic review, forthcoming.

Bloch, F., and U. Hege (2001) “Multiple Shareholders and Control Contests”, unpublished manuscript.

Bolton P. and M. Dewatripont (2005) Contract Theory, MIT Press.

Carmichael (1988) "Incentives in Academics: Why Is There Tenure?", Journal of Political Economy, 96(3), 453-472.

Dasgupta P. and P. David (1994) "Towards a New Economics of Science", Research Policy 23, 487-521.

David P. and D. Foray (2001) "Economic Fundamentals of the Knowledge Society", Policy Futures In Education (an E-journal).

Dessi R. (2005) "Start-up Finance, Monitoring and Collusion", The RAND Journal of Economics, vol. 36, n. 2, p. 255-274.

Dewatripont M., I. Jewitt, and J.Tirole (1999) “The Economics of Career Concerns: Part I: Comparing Information Structures” Review of Economic Studies, 66 (1): 183-198

Dewatripont, M., I. Jewitt, and J. Tirole. "The Economics of Career Concerns, Part II: Application to Missions and Accountability of Government Agencies." Review of Economic Studies, v. 66, 1999, pp. 199-217.

Fehr and Falk (2002) “Psychological Foundations of Incentives”, European Economic Review, 46: 687-724.

Frey, B. (1997) *Not Just For The Money - An Economic Theory Of Personal Motivation,* Edward Elgar, Cheltenham.

Gentzkow M. and J. Shapiro (2006) "Media Bias and Reputation", Journal of Political Economy, 114(2).

Gibbons R. and K. J. Murphy (1992) "Optimal Incentive Contracts in the Presence of Career Concerns: Theory and Evidence," The Journal of Political Economy, Vol. 100, No. 3, 468-505.

Gomes, A., and W. Novaes (2005) “Sharing control versus monitoring as a corporate governance mechanism”, PIER Working paper, University of Pennsylvania Law School.

Holmström B. (1999) "Managerial Incentive Problems: A Dynamic Perspective." The Review of Economic Studies, Vol. 66, No. 1, 169-182.

Kőszegi B. (2006) “Ego Utility, Overconfidence, and Task Choice”, Journal of the European Economic Association, 4(4), pp. 673-707

Martimort D. (1999) "The Life Cycle of Regulatory Agencies: Dynamic Capture and Transaction Costs." The Review of Economic Studies, Vol. 66, No. 4, 929-947.

Maug E. (2002) "Insider Trading Legislation and Corporate Governance." European Economic Review, Vol. 46, pp. 1569-1597.

McPherson M. and M. Schapiro (1999) "Tenure Issues in Higher Education", Journal of Economic Perspectives, Vol. 13, No. 1, pp. 85-98

Morris S. and H. Shin (2002) "Social Value of Public Information", American Economic Review, December 2002.

Mullainathan S. and A. Shleifer (2005) "The Market for News", American Economic Review, September, 2005.

Scotchmer S. (2004) *Innovation and Incentives*, MIT Press.

Radaev A. and S. Stepanov (2006) "Agency Problems and Multiple Large Shareholders", NES working paper

Tirole J. (1986) "Hierarchies and Bureaucracies: On the Role of Collusion in Organizations", The Journal of Law, Economics, and Organization, 2, 181-214.

Tirole J. (1992) "Collusion and the Theory of Organizations", Advances in Economic Theory: Proceedings of the Sixth World Congress of the Econometric Society, Jean-Jacques Laffont (eds.), series Econometric Society Monographs, vol. 1 & 2, Cambridge University Press, 1992.

Van den Steen E. (2004) "Organizational Beliefs and Managerial Vision", Journal of Law, Economics, and Organization, 21 (1), 256-283 .