

THE SUBOPTIMALITY OF INCENTIVE CONTRACTS IN A CONTRACTING MODEL

by

Jacob Paroush*

and

Jonas Prager**

15 December 1993

ABSTRACT

We take issue with the fundamental privatization theorem of Sappington and Stiglitz, which asserts that a government contracting-out auction can be -- and by implication, should be -- designed to maximize output while simultaneously extracting all contractor rent. We demonstrate through a model that accepts the possibility of contractor deception that welfare can be enhanced by permitting the contractor to retain some of the rent.

* Department of Economics, Bar Ilan University

** Department of Economics, New York University

We wish to acknowledge continuing support of Prager's research on privatization by the C.V. Starr Center for Applied Economics at New York University.