The Agent's Private Information and the Principal's Subjective Information

Kazumi Hori

Abstract

This paper characterizes the optimal contract when a principal has unverifiable subjective information that is correlated with an agent's private information. We find that the principal's subjective information alleviates the initial information asymmetry only if the correlation is sufficiently high. The first-best outcome for the principal is not feasible unless the principal's information and the agent's cost are perfectly correlated.

Keywords: adverse selection, unknown cost, subjective information, correlation.

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