

# Impacts of Contract Time Horizon on Performance and Human Capital Investment

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## Abstract

This paper is motivated by the incentives provided by contracts between a player and team owner in Major League Baseball. Using both theory and data, I analyze how the player's performance changes when the contract term switches from short-term to long-term. I utilize a two-stage, Principal-Agent approach in which the team owner is the principal and the player is the agent. The owner uses the player's first-period output to update her belief about the player's ability. Then the owner adjusts second-period contract in the direction of updated beliefs. The model is then extended to consider the player's incentive to invest depending on the contract term expands and how much his performance improvement affects the owner's profit. Results include that the high-ability player reveals his true type to the owner from his performance. Further, if the player switches his contract from short-term to long-term, then he invests more in his human capital.

*Keywords:* Contract Theory, Major League Baseball, Human Capital Investment

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