

Three Essays on Incentive Design

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Abstract

We present three distinct works on the subject of incentive design. The first focuses on a fundamental aspect of all principal-agent models, the participation constraint. We endogenise the constraint, allowing the agent to influence his outside option, albeit at some detriment to the project he is contracted to work upon. We compare the optimal contract to the literature on the supposed trade-off between risk and incentives. We find support for the Prendergast (2002) observation of a positive relationship between the two variables and offer an explanation through the use of said influence activities. The second contribution introduces another principal-agent framework for models with both adverse selection and moral hazard, with the novel inclusion of limited liability. Described in a target-setting environment, the findings are related to and support the use of tenure contracts in academia. This is justified by the fact that pooling equilibria maximise the value to the principal and fully separating equilibria are implemented with non-monotonic wage structures. Finally, in opposition to conventional literature, those of low type make rent gains over and above their reservation utility, while the high types break even. The final chapter studies organisational design and allocation of control. We offer conditions whereby firms would wish to integrate, or profit-share, with another, given varying degrees of control allocation. We show that integration comes at a lower cost for the decision-making firm when control is contractible as opposed to transferable. Also we show that the level of incompatibility between firms, unrelated to financial gain, can affect the integration decision.

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