Consider the relationship between an absentee landlord and a tenant farmer given in class.

The landlord objective function is given by:
Max \( \Pi = PQ(e) – w \)

The tenant’s objective function is given by:
Max \( U = U(w, e) = w – 1.5e \)

The production function is given by:
\( Q = \alpha + \beta e \)

\( \alpha \) is a normally distributed random variable with mean \( \mu_\alpha \) and standard deviation \( \sigma_\alpha \).

Assume that high effort is socially optimal (i.e. the value of increased productivity offsets the disutility of effort).

1. Would a flat wage (i.e. the wage rate is a fixed amount per annum) be incentive compatible? Explain your answer without doing any calculations.

2. Would a contract where the farmer pays a fixed rent on the land be incentive compatible?

3. In the real world share contracts whereby both the landlord and farmer receive a share of output \((0 < b < 1)\) are commonly used in preference to either wage or rental contracts in which either the landlord or farmer keeps the output and pays the other party a fixed fee. Why does this make economic sense?

Questions 4 – 12 are drawn from the article Canice Prendergast, “The Provision of Incentives in Firms”.

4. Explain the tradeoff between risk and incentives. Why would firms not use incentive contracts if output is variable? Relate you answer back to the farmer-landlord example from lecture.

5. What is the multi-tasking problem? Why are firms less likely to use schemes that tie pay to output in the presence of multi-tasking?

6. Why do firms use subjective performance evaluations? What are some of the problems associated with subjective performance evaluations?

7. What is relative performance evaluation? Why do firms prefer to use relative performance evaluation rather some absolute measures of performance?
8. Describe some of the empirical tests of the basic agency model. What are the general conclusions of these tests?

9. Why would employees wait until the last minute to fill their targets? Does the evidence suggest that this occurs?

10. What other productivity-decreasing responses to incentives have been identified by researchers?

11. What is a tournament? What is deferred compensation? What is an efficiency wage?

12. What are some of the incentive problems associated with team production? What are the best ways of compensating workers where there is team production?