Microeconomics
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Exercise Set 7
October 18, 2006
(due Oct. 25)

Describe a principal-agent situation involving moral hazard that you have experienced, preferably in your work. It is not necessary to formulate a mathematical model. However, you should clearly identify:

1. The principal and the agent, and their respective goals, including their attitudes towards risk.

2. The agent's action variable(s), including the "hidden" action(s).

3. The outcome of the agent's action(s).

4. The stochastic variables that affect the outcome but are not observable by the principal. (Are these observable by the agent?)

5. The policy that determines the agent's compensation.

6. The dynamics of the interaction(s) between the principal and the agent. (I.e., is it a one-stage or a repeated game?)

7. Sources of inefficiency in the situation (if any), and how efficiency might be improved.