Reference: Microeconomics for managers, ch19.

1. There are examples of moral hazard, situations in which the actions of one party affects the welfare of others, where the interests of the parties diverge to some extent, and the actions chosen by the first party are not completely controllable.

2. A variety of incentives can work on individuals and groups. In this note, we focus on direct financial incentives.

3. A basic trade-off: risk sharing versus motivation:
   There are two simple solutions to problems of incentives.
   a) The first is to determine what choice of action is desirable and fix this contractually.
   - The problem is that often the desired "inputs" cannot be adequately measured or monitored or, if they can be, cannot be made part of an enforceable contract.
   b) The second potential simple solution is to construct an arrangement that puts the onus entirely on the party choosing the action.
   - The problem with these is that they imply no risk sharing between the parties involved.

4. A fundamental trade-off concerning incentives involves the confluence of three factors:
   1. The desired actions cannot be specified contractually.
   2. Even if the desired actions are taken, there is uncertainty about the consequences.
   3. The economic benefits of risk sharing among the parties.

5. The trick is to balance risk sharing and motivation.
   An Example: Salesperson Compensation
   -You (risk neutral) employ a salesperson. If the person makes the sale, you will earn a profit of $60,000. If the person does not make the sale, you earn $0. The person must decide on a level of effort to devote to selling for you. He can kill himself (where his disutility of effort is 40), he can work hard (where his disutility of effort is 20), he can try but not hard (where his disutility of effort is 10), or he can loaf (where his disutility of effort is 0). His level of effort affects the probability that

he makes the sale. If he kills himself, he will make the sale with probability 0.5 . If he works hard, he will make the sale with probability 0.4. If he tries but not hard, he will make the sale with probability 0.25. And if he loafs, he will make the sale with probability 0.05. If he is paid a wage of w, his utility is

$$\sqrt{w} \text{ – disutility of effort.}$$

The person's best alternative utility level is 100.
a) Suppose you can contractually fix the level of effort. What do you do?
b) Suppose you cannot fix the salesperson's level of effort. What do you do?

6. What is more important is the qualitative insight generated by hunting for the answer heuristically: See p459.