Exam

Incentives in Organizations and Innovation

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Choose **either** question Question I **or** Question II.

Question I

A risk neutral principal hires an agent. The agent's reservation utility is equal to 0. The agent's output is given by: $q = e + \varepsilon$. The principal cannot observe the agent's effort e. The expected value of random variable ε is equal to 0. The variance equals 2. The agent's wage is given by: $w = \alpha q + \beta$. His or her expected utility is: $EU = E[w] - 0{,}25e^2 - Var[w]$.

(I.a) Identify the participation constraint and the incentive compatibility constraint.

(I.b) Identify the profit maximizing values of α and β. How much effort does the agent exert?

Question II

How do economists explain a crowding out of intrinsic motivation? Is there empirical evidence of a crowding out effect?

Please note: If you answer both questions, we will only consider Question I.