

Seminar/Assignment set 4

1. Assume you are the chairman of the board of a large company. One of your tasks is to design your CEO's remuneration contract. Furthermore, assume that you cannot verify this CEO's provision of effort but you are quite sure you correctly observe total sales of the company (but nothing else). Discuss how this contract depends on how volatile production is in your industry. Does the contract depend on personal characteristics of the CEO? If so, on what?
2. Does the CEO earn a rent in this case? Discuss.
3. Assume now that your adviser points out the availability of industry production statistics, thus providing information on total sales in the industry. Does this change the remuneration contract you offer to your CEO?
4. Discuss potential pitfalls affecting your design and drawbacks of the remuneration contract.
5. Assume now that you are the CEO of a company with a complex production structure. Thus neither workers' effort nor the value of output is verifiable. Effort will only be observed with a probability p . As a CEO you set (determine) worker wages. Do the workers earn a rent in this case? Explain what is meant by a rent.
6. If they earn a rent, how is this affected by changed probability of being detected if one does not provide effort? What is the effect on the rent of an increase in the job destruction rate?
7. Discuss in this case how the wage policy of firms may change during business cycle fluctuations.