

BS3391 – Further Topics in Microeconomics

Lecture 11 – Revision 2

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Outline

- Revision of two topics (questions 3 and 4 of mock exam paper)
 - Principal-Agent Problem (designing contracts)
 - Outsourcing vs Integration (incomplete contracts)
- Final advice

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TOPIC 3 – Designing Contracts

- Topic was covered in lectures 8 & 9
- What is principal agent problem? To what extent is it relevant for employment decisions?
- Designing optimal contracts!
 - Effort vs output measures
 - Linear and non-linear contracts
- How do these contracts work? **Participation** and **Incentive** constraints
- What are the limitations of such contracts?
- Possible extensions:
 - Fairness
 - Uncertainty (requires Expected Utility Model)

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Mock paper question:

“Using a numerical example, critically discuss how a principal could design a linear compensation contract that fulfils both the incentive and participation constraint for a risk neutral employee.”

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Potential answer

- How can you introduce this question? Is the question of relevance in the real world?
- Introduce the concept of linear contract – explain its components!
- Come up with numerical example and state assumptions
- EXPLAIN your mathematical calculations! Provide intuition
- What is the minimum you have to offer that the expert is willing to accept offer? (PC)
- Are you providing sufficient incentive for the expert to exert optimal amount of effort? (IC)
- You could add a diagram to support your argument
- Limitations? Extensions of the model? Real world examples of sectors where we can find linear compensation contracts?

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TOPIC 4 – Outsourcing and Integration

- Topic was covered in lectures 10 & 11
- Why outsourcing? See Abraham and Taylor
- Why integration? Transaction costs and incomplete contracts
- What are the key features of incomplete contracts? What causes hold-up problem?
- Main model: Navaretti and Venables
 - Show formally the impact of incomplete contracts on profits
 - Identify determinants of profits
- Further models of fragmentation

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Mock paper question

“Use the incomplete-contracts model by Navaretti and Venables (2004) to explain under what circumstance firms will be better off outsourcing rather than producing intermediate inputs in-house. Evaluate the impact of a shift in bargaining power between two firms.”

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Potential answer

- How can you introduce this question? Is the question of relevance in the real world?
- The Navaretti & Venables model is the foundation of this question – you will have to use the formal model!
- State assumptions
- Start with a “baseline” scenario, then explain the impact of incomplete contracts on profits
- Don’t just state equations and conclude, explain what is the story behind the equations
- Explain importance of bargaining power by making reference to equations and/or diagrams
- What are the limitations of this model? Are there any extensions? Is the outcome similar to what you can observe in the real world?

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Top Advice

- The MOCK EXAM paper is still the best guide for the ACTUAL EXAM.
- The questions in the actual exam will have a similar layout and structure but WILL NOT BE identical
- You will have to use the models, theories and concepts we have covered in the module for answering the question. You may add further reading if it is related to the content we have covered.

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Further advice

- Each answer = 50% of exam marks
- A few lines will not be enough for you to evidence sufficient understanding – you can write up to 1000 words!
- Avoid using bullet points, write a coherent and structured explanation
- Communication is important!!
- Write in a way that allows you to communicate effectively economic concepts and principles and your argument

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Essay advice

- All essays should have a beginning/i.e. an introduction
- All essays must have a middle/main body
 - Logical development of ideas/argument
- Clear explanation and application of economic concepts, theories and techniques
- Diagrams should be included to help clarify and support the explanation and application of the theory.
 - Should be clearly/correctly drawn and labelled – use a **ruler!!**
 - Use labels in your written explanations

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Further Essay Advice

- The material must be relevant and applied to the particular question
 - Avoid a brain dump
 - Do not answer the question you wish we had asked!!
 - Are you applying knowledge/theory to the question?
- All essays should have an end/conclusion
 - Pull your arguments together and show how you have answered the exam question
 - Must be longer than one sentence
 - Good conclusions can really make a difference to your mark

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Top top top advice!!!

- Do not only provide definitions!!! I don't want to read a "shopping list"
- **Practice to draw diagrams in advance (and how to explain them)**
- Diagrams or numerical examples have to be used as a tool for answering the question!!! Do not just provide a general explanation of the models.
- Communications is an important part: your arguments and explanations have to be clearly structured and accurate.
- Excellent answers are expected to provide evidence of further reading.
- Find your **Kn A C!!!**