Information Economics, Fall 2014
Case Study 1

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1 Rules

Note 1. For this case study, each team can have ***at most three*** students. Your teammates are those who work with you on lecture problems.

Note 2. The report is due at ***9:00 am, October 13, 2014***. Please submit a ***hard copy*** into the instructor's mail box on the first floor of the Management Building II. As each team only needs to submit one copy, please indicate the names and student IDs of all team members on the first page. Submissions between 9:00 am and 10:00 am on the due date will get 20% off as a penalty. Submissions later than 10:00 am of the due date are not accepted.

2 Article

Narayanan, V.G. and A. Raman (2000), "Aligning incentives for supply chain efficiency," *Harvard Business School Background Note.*[1]

3 Tasks

Write a report with at most six pages (i.e., three double-sided sheets) to address the following questions:[2]

1. Explain in your own words what incentive misalignment is in an decentralized system. Using examples is typically helpful.
2. Provide an example that describes a principal-agent relationship with misaligned incentives. Clearly indicate why incentives are misaligned and how the players behave under the misaligned incentive scheme.
3. Consider an individual who tries to rent a car from a car rental company. When the company decides the daily rental and insurance fees, what hidden information privately observed by the renter is relevant? What hidden action privately determined by the renter is relevant? What may the rental company do to alleviate information asymmetry?
4. Many salespeople are incentivized with sales commissions, i.e., the more sales revenue they generate, the more bonuses they receive. How does this compensation scheme alleviate moral hazard? How does this compensation scheme alleviate adverse selection? If this is so good, why salespeople still earn some fixed salaries that do not depend on the sales outcome?
5. How does the company Li & Fung help align incentives in a supply chain? Describe this with your own words.
6. Consider the supply chain (channel) pricing game with a manufacturer and a retailer. According to the definition of contractibility in this article, is a retailer's retail price contractible? Why or why not?

[1] The web page of this article: https://cb.hbsp.harvard.edu/cbmp/product/600110-PDF-ENG.

[2] The book *Freaoknomics*, especially Chapter 2, is helpful for almost all the problems above. You may even use the examples provided there to answer Question 2.