The Relationship Between Uncertainty and Incentives in Optimal Linear Contracts

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Abstract

Much of the work on agency theory predicts that there is a negative trade-off between the level of uncertainty and the optimal strength of linear incentives. However, this relationship is not empirically supported. In this paper, to examine the relationship between uncertainty and incentives in optimal linear contract, we study a principal-agent relationship in which the agent is risk-averse and has the specific knowledge about the consequences of his actions. We show that uncertainty does not affect the incentive strength in optimal linear contract when the principal can use not only an output measure but also input measures to evaluate the agent's performance.

Keywords: Uncertainty and incentive; Risk-averse agents; Specific knouledge

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