Wealth and the Principal-Agent Matching

Paulo Fagandini
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Paulo Fagandini*
Nova SBE
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Abstract

I study the role the agent’s wealth plays in the principal-agent matching with moral hazard and limited liability. I consider wealth and talent as the agent’s type, and size as the firm’s (principal’s) type. Because utility is not perfectly transferable in this setup, I use generalized increasing differences and find that wealthier agents match with bigger firms, when talent is homogeneous among them, whereas for equally wealthy agents, more talented agents will match with bigger firms. I describe economic conditions over types such that pairs of higher types will write contracts in which the agent obtains more than the information rents, through a higher bonus, increasing the expected surplus. Finally, I provide an example in which wealth is distributed among agents in such a way that it reverses the standard result of positive assortative matching between talent and firm size.

JEL-Classification: D86, D82, C78, J33, M12.
Keywords: Moral Hazard, Asymmetric Information, Matching, Non Transferable Utility.

1 Introduction

Wealth can play a major role in the design of optimal incentives, and therefore in the matching between principals and agents. In order to study the
compensation of these agents, it is fundamental to understand how they will endogenously match with the firms they end up working for, \(^1\) and the specific role that the characteristics of the contracting parties play in it. I propose a model in which risk neutral agents, characterized by their wealth and talent, match with firms (principals), characterized by their size, to perform a task and in the presence of moral hazard. This model allows to study the contracts being signed by the parties, and the implications that wealth brings to the matching for the traditional results of positive assortative matching between talented agents and bigger firms.

Wealth can affect the agent’s behavior, and the optimal contract, in two different ways: through the agent’s risk aversion or through limited liability. While the scarce literature studying the effects in compensation focused on the former (Chade and de Serio, 2014, Thiele and Wambach, 1999), this article concentrates on the latter. Limited liability prevents the principal from selling a high participation in the company to the agent in order to achieve an output closer to the one without information asymmetries. \(^2\) Having this in mind, I raise the question: How do principals and agents match? In particular: Do wealthier agents match with larger firms or the opposite? Can wealth and talent be assigned to agents in such a way that the positive assortative matching of talented agents working in bigger companies does not hold?

Even though the empirical literature studying the matching between principals and agents has focused on the agent’s talent as the main driver, wealth, through limited liability, can play a major role. \(^3\) It is a standard result in the moral hazard literature that under asymmetric information the principal can achieve the first best level of effort with a risk neutral agent that is not cash constrained, allowing the principal to define negative transfers to the agent in case of bad outcomes, or as the traditional interpretation indicates, an up-front cash payment from the agent to the principal. This can be observed for example in the franchise model, or in the cab business. This scenario is not common in the corporate world (see Baker, Jensen, and Murphy (1988)). This can be due to the lack of wealth from the agents to make the transfers, legal or social limitations, or it can be simply interpreted in a different man-

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\(^1\)Ackerberg and Botticini (2002) shows the pervasive effects of neglecting the endogenous matching when studying incentive contracts empirically.

\(^2\)Shetty (1988) studied the effect that limited liability has on the contracts between tenants and landlords.

\(^3\)Dam and Perez-Castrillo (2006), to my knowledge, is the only that explicitly considered the role of wealth in a traditional principal-agent matching setup. However, they consider homogeneous principals, while I allow for heterogeneous principals. I also allow for agents to differ in talent. Legros and Newman (1996) considers a problem of matching agents of the same type with different wealth levels, that get together to form firms between them. Wealth plays an important role in this.
ner, for example as an obligation for the executives to buy shares from the company. Other professions do face these kind of contracts more explicitly. For example, lawyers, when promoted to partners, must buy their partnership with money from their own pockets. Physicians, in some countries, must buy a participation in the clinics where they receive their patients. In general any kind of partnership will involve transfers from the agents to the principal.

As mentioned, in the absence of limited liability the principal can set up a contract that achieves a first best outcome, by selling the firm to the agent for the whole expected surplus leaving the agent without any information rents. This is no longer true once the agent is cash constrained. I focus my study on how this channel affects the matching between agents and principals. In a first stage I study the isolated version of the principal-agent model, finding that the principal’s utility increases in matches with wealthier agents, whereas the agent’s utility increases by working in bigger firms. This suggests that a positive assortative matching is to be expected, that is wealthier agents should work in bigger firms.

Because utility is not perfectly transferable in the principal-agent model, as the sharing of the surplus affects the strength of the incentives, it is necessary to use the concept of generalized increasing differences, introduced by Legros and Newman (2007), in order to analyze the matching. Doing so, requires to study carefully the utility possibility frontier (UPF) that arises from the model. After doing that, I find that there is positive assortative matching (PAM) between principals and agents where the types for principal is the firm size, and the agents’ is their wealth. The same PAM is valid when the agents’ type is their talent: more talented agents work for bigger firms.

Then I describe the contracts that each pair will sign and the expected output they will produce. I also consider gains in efficiency (by generating contracts closer to the first best for some matches) that are generated by the market pressure introduced by competition, that is, the fact that other principals could offer more convenient contracts to my own agent. In particular, I provide conditions under which high-type principals give larger incentives to their agents than what they give in the isolated version of the model. For this market pressure to be effective, though, firms should have similar sizes.

Finally I give an example in which a wealthy agent has lower skills than a poor one, a situation in which generalized increasing differences may not hold anymore, and therefore, neither needs to hold the positive assortative matching between principals and agents when considering talent as the agent’s type. This situation can be less rare as expected, as if talent is similar, the correlation between talent and wealth can be less clear. This situation can also apply to agents in the beginning of their careers. As a consequence, the assumptions made on the correlation between wealth and talent are critical to
claim that, for example, there is positive assortative matching between bigger companies and more talented agents.

In Section 2 I describe and solve the baseline principal-agent model I use in this article, to proceed with the analysis of the utility possibility frontier and the matching analysis in Section 3. In Section 4 I provide an example of a distribution of wealth and talent in which the positive assortative matching does not hold. Finally, in Section 5 I present a discussion on how this model fits the literature, to conclude in Section 6.

2 The Principal-Agent Framework

In this section I develop a slightly modified version of the classical model of moral hazard with risk neutral agents. The modifications I introduce allow to capture the effects of different levels of cash constraint for the agent and the size of the firm in the optimal compensation scheme and welfare allocation, by parameterizing the model in the firm’s size, agent’s wealth, and the agent’s talent.

Both principal and agent are assumed to be risk neutral. I assume that the firm’s output $x$ can have two states, $x \in \{0, \xi\}$, where $\xi \in [0, 1]$ reflects the firm’s size. The agent’s effort $e$ can be chosen between 0 and 1, and affects positively the probability of success — having $x = \xi$ as the outcome — in the following way: $Pr(x = \xi | e) = p(e) = e$. Let $a$ and $b$ be the base wage and the bonus respectively. Although $a$ is paid independently of the outcome, $b$ is paid by the principal only if $x = \xi$ is observed. Effort is costly for the agent, and is represented by the cost function $c(e) = e^2/(2\tau)$. Here $\tau \in (0, 1)$ measures the ability - or talent - of the agent: a higher $\tau$ implies lower effort cost. Assume that the reservation utility for principal and agent are 0 and $u$ respectively. Let $u$ be the maximum between 0 and whatever he can get by working somewhere else. Also assume that the agent has personal wealth $\omega \geq 0$. The agent’s cash constraint is therefore determined by $-\omega$, meaning

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4 See Bolton and Dewatripont (2005), Laffont and Martimort (2002), and Salanié (2005) for examples.

5 Considering $\xi$ as a parameter allows to use it as firm size. For example in Gabaix and Landier (2008), the authors mention that variables such as earnings or capitalization can be considered as firm size, and Bandiera, Guiso, Prat, and Sadun (2015) consider the number of employees as firm size. Given the characteristics of this single-period model, defining size as the earnings in the good state avoids the inclusion of more variables that would needlessly complicate the model.

6 The parameterization of the model in the other variables makes the constraint for effort, to be lower than 1, not binding.

7 By the nature of the problem, I consider the reservation utility for the agent to be the minimum change in utility he is willing to accept. Note that if the reservation utility $u$ is included in the participation constraint, for the risk neutrality, it can be canceled out.
that the principal can never set wages such that the agent transfers more than \( \omega \) to her.

First, the principal makes a take-it-or-leave-it offer to the agent, specifying the base wage and the bonus for success; the agent accepts or rejects the offer; conditional on accepting it, he decides how much effort to exert. Finally the outcome is realized and the principal makes the transfer to the agent.

The maximization problem of the principal is given by:

\[
\max_{e,a,b} -a + p(e)[\xi - b] \\
\text{s.t. } a + p(e)b - c(e) \geq \pi \\
e \in \arg \max_{\hat{e}} \{a + p(\hat{e})b - c(\hat{e})\} \\
a \geq -\omega
\]

Equation (PC) is the participation constraint that ensures that the agent will accept the contract proposed by the principal.\(^8\) Equation (IC) represents the incentive compatibility constraint that ensures that the agent will choose endogenously what the principal has chosen as optimal effort, and finally (CC) represents the cash constraint. Usually in the literature (CC) is represented as \( a \geq 0 \) to model a cash-constrained agent, or in other words, a situation with limited liability. In this article, instead, we allow for different levels of wealth.

The solution to this problem depends on the value that \( \omega \) takes. In fact, it is well known in the moral hazard literature that if \( \omega \) is high enough (and this will be shown in the model as well), the principal can achieve first best effort with a contract that is equivalent to selling up-front the outcome to the agent.\(^9\) Doing so, he can extract the whole expected surplus, minus \( \pi \).

When solving the problem not all the constraints are going to be binding. If the (CC) is too severe, then the (PC) is not binding. Conversely if the agent has large wealth, and/or a high reservation utility, one finds that only the (PC) is binding. There are intermediate cases in which both constraints are binding, and the solution is given by the system of equations provided by the constraints of the problem. Because this model is quite standard in the literature I leave its detailed derivation for Appendix A and directly present the main results in Table 1. The utility of the principal is represented by \( v \), whereas the agent’s utility is represented by \( u \).

\(^8\)The participation constraint would be indeed \( \omega + a + p(e)b - c(e) \geq \pi + \omega \), as the agent’s utility depends on his own wealth and on his outside option, but \( \omega \) cancels out on both sides.

\(^9\)First best refers to the situation in which there is no asymmetry of information between the agent and the principal.
binding constraint variable

\[
\omega + \bar{u} < \frac{\xi^2 \tau}{8} \quad \frac{\xi^2 \tau}{8} \leq \omega + \bar{u} \leq \frac{\xi^2 \tau}{2} \quad \frac{\xi^2 \tau}{2} < \omega + \bar{u}
\]

<table>
<thead>
<tr>
<th>Variable</th>
<th>(CC)</th>
<th>(CC) and (PC)</th>
<th>(PC)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(e)</td>
<td>(\frac{\xi^2 \tau}{2})</td>
<td>(\sqrt{(\pi + \omega)^2 \tau})</td>
<td>(\xi \tau)</td>
</tr>
<tr>
<td>(a)</td>
<td>(-\omega)</td>
<td>(-\omega)</td>
<td>(\bar{u} - \frac{\xi^2 \tau}{2})</td>
</tr>
<tr>
<td>(b)</td>
<td>(\frac{\xi^2 \tau}{8})</td>
<td>(\frac{\sqrt{(\pi + \omega)^2 \tau}}{\tau})</td>
<td>(\xi)</td>
</tr>
<tr>
<td>(E[u])</td>
<td>(-\omega + \frac{\xi^2 \tau}{8})</td>
<td>(\bar{u} + \omega)</td>
<td>(\bar{u} + \omega)</td>
</tr>
<tr>
<td>(E[\Delta u])</td>
<td>(\omega + \frac{\xi^2 \tau}{8})</td>
<td>(\xi \sqrt{(\pi + \omega)^2 \tau} - 2\bar{u} - \omega)</td>
<td>(\frac{\xi^2 \tau}{2} - \bar{u})</td>
</tr>
<tr>
<td>(E[v])</td>
<td>(\frac{3 \xi^2 \tau}{8})</td>
<td>(\xi \sqrt{(\pi + \omega)^2 \tau} - \bar{u} - \omega)</td>
<td>(\frac{\xi^2 \tau}{2})</td>
</tr>
<tr>
<td>(\Delta \text{Surplus})</td>
<td>(\frac{\xi^2 \tau}{8})</td>
<td>(\xi \sqrt{(\pi + \omega)^2 \tau} - \bar{u} - \omega)</td>
<td>(\frac{\xi^2 \tau}{2})</td>
</tr>
</tbody>
</table>

Table 1: Solution to problem in (1). \(\Delta u\) and \(\Delta \text{Surplus}\) represent the induced changes in both variables.

It can be immediately observed that when only (PC) is binding the first best can be implemented, by selling the firm to the agent at his reservation utility minus the expected surplus, and letting him keep the whole outcome \((b = \xi)\). The agent receives utility \(\bar{u}\) and the implemented optimal level of effort is \(\xi \tau\). When only the (CC) is binding, the agent obtains information rents, defined as whatever the agent obtains above his reservation utility. The optimal effort is reduced to half when compared to the first best and the surplus has dropped by 25%. What happens in between? The agent gets utility \(\bar{u}\) as the (PC) is binding, and also \(a = -\omega\), as the (CC) is binding. Note that a lower value of \(\omega\) implies an increase in the fixed wage that would lead the agent to increase his utility; nevertheless, a decrease in \(\omega\) leads also to a decrease in the bonus and the implemented effort, keeping the agent at his reservation utility level. The principal, though, is strictly worse off, as less is being produced and she keeps a share of a smaller surplus.

The conclusions of this simple principal-agent model can be summarized as:

1. The higher the agent’s wealth, the larger has to be the firm for him to be considered cash-constrained.
2. If cash-constrained, the agent’s information rents decrease with his personal wealth.
3. The bigger the firm, the larger the set of agents that are to be considered cash-constrained.
4. The larger the firm the (weakly) higher the bonus for the agent and the expected utility for principal and agent, however the bonus is (weakly) lower as a share of the firm’s profits.
5. If the agent is not cash constrained the firm is indifferent as to the level of agent’s wealth and the outcome is first best.

Baker and Hall (2004) finds, in an empirical work, that the size of the bonus for the agent is smaller, as a percentage of the firm, the bigger the firm. This is consistent with point 4. The model predicts that when the agent is cash constrained, the bonus $b$ is linear or constant on the firm’s size, and therefore there is a decreasing relationship between the share of profits the agent is keeping and the size of the firm.

We haven’t focused on the comparative statics of $\tau$. However it is worth mentioning that the results are in line with the findings in the literature (Gabaix and Landier, 2008) in the sense that more talent leads to greater compensation.

Two results are to be learned from this. First an agent would always like to work for a firm in which he is cash constrained, as he can extract more surplus. A good way to do that is to work in a big company, as this makes him more cash-constrained, for a given $\omega$, and also increases his expected utility, as he is getting a share of a bigger surplus. On the other hand, a firm would like to hire wealthy agents (or less cash-constrained or even better an agent that is not cash-constrained at all), as then the principal can keep most or all of the surplus. For the principal, how wealthy the agents needs to be for her to be able to keep the whole surplus, depends on the size of the firm: the smaller the firm, the less wealthy the agent needs to be, and therefore smaller firms would be indifferent between less and more wealthy agents, as long as both could buy the firm. The agent, however, will always look for bigger firms to work for. This result is consistent with the findings of Dam and Perez-Castrillo (2006).

3 The Utility Possibility Frontier and the Matching

In this section we will study assortative matching between principals and agents. In a broad sense we have assortative matching when the matching between economic agents is determined by their types. For example, in our case, a result of positive assortative matching (PAM) implies that wealthier agents match with bigger firms. Negative assortative matching (NAM) means exactly the opposite, i.e., that wealthier agents work in smaller firms. It is useful to remind the reader at this point that I have defined $\pi$ as the maximum between 0 and the agent’s outside option. Now the outside market option is going to be an input in the utility possibility frontier (UPF), and describes how much utility the agent is obtaining with a particular contract.
In the previous section, I provide arguments suggesting that PAM is a reasonable matching outcome to expect when the agent’s type is wealth. When the agent’s type is talent, it is considered standard in the literature that more talented agents match with higher types of principals. Consistently with the assumption in the previous section, that the principal makes a take-it-or-leave-it offer to the agent, I assume here that there are more agents than principals.

It can be shown that the surplus of a match is supermodular, in the above model, in the principal and agent’s types, which quite often is enough to have PAM in a matching problem with transferable utility. However, in the principal-agent setup, utility is not perfectly transferable. In a contract, the principal can find many ways to transfer utility to the agent, and the case of perfectly transferable utility would be simply a money transfer to the agent (a higher fixed wage $a$). This is not an optimal alternative for the principal. She will instead set a higher bonus $b$, incentivizing the agent to exert a higher level of effort, and thus increasing the surplus. The transfer of utility to the agent is financed in part by giving up a share of the surplus, but also by the increase of it, so the utility loss for the principal is lower than the gains in utility for the agent.

Legros and Newman (2007) [LN henceforward] introduced a methodology to address the matching problem when utility is not perfectly transferable. They consider a match between individuals type $R$ and $S$. Let $s > s'$ and $r > r'$ be two different types within each category, and the outcome be a match between an individual from $R$ with another individual from $S$. They argue that $r$ is going to match with $s$ if $r$ can outbid $r'$ for $s$. In particular, they introduce the concept of generalized increasing differences (GID) which relies on the utility possibility frontier (UPF) in order to determine the matching between individuals. The UPF describes the combinations of utilities $u$ and $v$ that are Pareto efficient. For the sake of consistency I will use the same notation for the UPF, outlined in the following definition:

**Definition 1.** Let $\theta = (\omega, \tau)$ be the agent’s type, and $\xi$ be the principal’s type. The utility possibility frontier is described by the following functions:

- Let $\phi(\xi, \theta, u)$ be the maximum utility that a principal type $\xi$ can obtain when matching with an agent of type $\theta$, and this agent gets utility $u$.

- Let $\psi(\theta, \xi, v)$ be the maximum utility that an agent type $\theta$ can obtain when matching with a principal of type $\xi$, and this principal gets utility $v$.

Thus, $\phi$ and $\psi$ represent the UPF from the points of view of the principal

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10That is, neither principal nor agent can have higher utility without the other being worse off.
and agent respectively, and for a bijective UPF and given types, one is the inverse of the other, with respect to utility levels.

The main result in LN - that GID implies PAM - intuitively states that the low type principal, for any level of utility he can get by matching with the high type agent, will provide a certain utility level for each type of agent (high or low type). In order for the high type principal to keep the high type agent, she should be able to outbid the other principal, that is, to provide at least as much utility to the high type agent as he would receive from the low type principal. This will only occur if the principal gets more utility by providing that utility to the high type agent than what she would get by giving the low type agent what he gets from the low type principal. By doing this the high type principal can outbid the low type principal and PAM will arise as the market outcome.

In the model with only one principal and one agent, developed in section 3, it has been highlighted that, for the optimal contract, there are 3 possible situations: only (CC) is binding, only (PC) is binding, or both (CC) and (PC) are binding. The (IC) is always binding. From table 1, we can write down an analogous table for the UPF (Table 2).

<table>
<thead>
<tr>
<th></th>
<th>CC</th>
<th>PC &amp; CC</th>
<th>PC</th>
</tr>
</thead>
<tbody>
<tr>
<td>(E[\Delta u] = \psi(\omega, \xi, v))</td>
<td>(\frac{\xi^2}{8} - \omega)</td>
<td>(u)</td>
<td>(u)</td>
</tr>
<tr>
<td>(E[v] = \phi(\xi, \omega, u))</td>
<td>(\omega + \frac{\xi^2\tau}{4})</td>
<td>(\xi\sqrt{(u + \omega)^2\tau - 2u - \omega})</td>
<td>(\frac{\xi^2\tau}{2} - u)</td>
</tr>
</tbody>
</table>

Table 2: Utility Possibility Frontier.

The situation when only the (CC) is binding represents a single point on the UPF. This happens because the agent is getting a fixed rent, and the (PC) is not binding. If we want to move to the right along the UPF we need to give higher utility to the agent, and then the (PC) starts binding. The (CC) is binding until the unconditional transfer \(a\) implied by when only (PC) is binding exceeds \(-\omega\) (in other words, (CC) stops binding), leading to:

\[
\overline{\pi} - \frac{\xi^2\tau}{2} \geq -\omega
\]

(2)

or when looking at the UPF, when \(u \geq \frac{\xi^2\tau}{2} - \omega\). For all the values of \(u \in [\frac{\xi^2\tau}{8} - \omega, \frac{\xi^2\tau}{2} - \omega]\), both constraints are binding. Of course the case can appear in which \(\frac{\xi^2\tau}{8} \leq \omega\), or even \(\frac{\xi^2\tau}{2} \leq \omega\), nevertheless, as mentioned earlier, I assume that the agent cannot obtain negative expected utility, and therefore \(\overline{\pi} \geq 0\). In particular for the UPF I assume that \(\overline{\pi} = 0\).

What is different to the usual UPFs is that this UPF’s domain varies with \(\omega, \tau\) and \(\xi\). For example, when \(\omega\) is small, it considers values of \(u\) that
are strictly positive. This represents a small variation with respect to LN’s UPF, as they assume that its domain is between 0 and some upper bound for both individuals. On the other hand, a bigger company, or a more talented agent increases the expected value of the company, making an agent cash constrained, and therefore creating information rents. To address this fact, I define the following correspondences:

**Definition 2.** Given the UPF, define:

- \( u_\theta(\xi) := \max\{0, \frac{\xi^2 - \omega}{8}\} \) as the minimum level of utility that an agent of type \( \theta \) can get from a match with a principal of type \( \xi \).
- \( V_\xi(\theta) := [0, \phi(\xi, \theta, u_\theta(\xi))] \) as the feasible utility levels that an optimal contract can give to a principal whose firm has size \( \xi \) contracting with an agent of type \( \theta \). By definition, \( V_\xi(\theta) \) is also the domain of \( \psi(\theta, \xi, \cdot) \).
- \( U_\xi(\theta) := [u_\theta(\xi), \frac{\xi^2}{2}] \) as the set of feasible utility levels that an optimal contract can give to an agent of type \( \theta \) working for a firm of size \( \xi \). By definition, \( U_\xi(\theta) \) is also the domain of \( \phi(\xi, \theta, \cdot) \).

In Figure 1 I draw the UPF for different levels of \( \omega \). The upper dotted line represents the surplus in the first best, whereas the lower dotted line represents the surplus when only the (CC) binds. Both lines have a slope of \(-1\). In Figure 2 I repeat the same exercise but changing the value of \( \tau \) instead.

The left and right solid points rest over the second and first best surplus respectively. Specifically the left dot represents the contract in a second best when only the CC is binding, whereas the right dot represents the principal giving away the firm for free to the agent. The solid line represents sections of the UPF when the principal has sold the firm to the agent in exchange of some fixed fee. The dashed line represents the UPF when both constraints, CC and PC, are binding.

By increasing the agent’s wealth, the UPF expands upward until it reaches the first best surplus. As the utility for the agent increases, the principal implements the contract indicated by the system of the three constraints CC, PC, and IC. At the same time, the higher the utility for the agent, the more relevant the PC becomes compared to the CC, and therefore the solution gets closer to the first best outcome. Here, the principal is selling cheaper a share in the outcome and therefore the agent, for the same price, is obtaining more of the outcome, hence exerting more effort. If the agent has some wealth, the principal will decide, once the agent is receiving a high amount of utility, just to sell the whole firm for whatever wealth the agent has. By moving along the UPF to the right, the principal will sell the firm cheaper, increasing the utility received by the agent.

As the agent gets wealthier, the principal selling the firm to the agent happens sooner in the UPF, that is, for lower values of \( \Delta u \). In the extreme
Figure 1: UPF for different levels of $\omega$.

(a) $\omega = 0$

(b) $\omega \in [0, \frac{\xi^2\tau}{8}]$

(c) $\omega \in \left[\frac{\xi^2\tau}{8}, \frac{\xi^2\tau}{2}\right]$  

(d) $\omega \in \left[\frac{\xi^2\tau}{2}, \infty\right)$

Figure 2: UPF for different levels of $\tau$.

(a) $\tau \in \left[0, \frac{2\omega}{\xi^2}\right]$

(b) $\tau \in \left[\frac{2\omega}{\xi^2}, \frac{8\omega}{\xi^2}\right]$

(c) $\tau \in \left[\frac{8\omega}{\xi^2}, \infty\right)$
case when the agent has enough wealth to pay the whole surplus, the principal will be able to write the first best contract and extract the whole surplus.

On the other hand, when the agent has a fixed amount of wealth, increasing his talent will cause the value of the firm, in first and second best outcomes, to increase. This of course is good for both (the share he is receiving increases, and the share of the principal increases as well), however there is a caveat. The more valuable the firm is, the relative wealth, that is the amount of wealth the agent has compared to the value of the firm ($\xi$), is decreasing, and therefore the agent with more talent is relatively more affected by the CC than a less talented agent. We can observe in Figure 2 how by increasing the level of $\tau$ the agent moves from a situation in which he is unaffected by the cash constraint, and therefore a first best outcome is always achieved, to another in which he is considerably cash constrained, up to a point where information rents are created. Let us start with a benchmark result.

**Fact 1.** If talent is homogeneous among the agents, and they are wealthy enough such that they are not cash constrained for any firm, then nothing can be said about how firms and agents are going to match.

**Proof.** If the poorest agent is rich enough to buy the biggest firm, the principal will always set up a first best contract, and therefore will sell the firm exactly at its surplus. For the agents, then, all the firms represent the same utility, that is zero, and therefore are indifferent between them. For this reason, any kind of matching can arise. \hfill $\Box$

Fact 1 represents the simplest case, in which always first best contracts are written and the principals are able to extract the whole surplus of their firms. Putting this case out of the way, we can study more interesting situations.

In order to look for GID or PAM in this model, I will refer to Corollary 1 in LN, where they use the assumption that $\phi$ is twice differentiable to obtain PAM, by looking at the signs of its second derivatives. There is a caveat though: in our model $\phi$ is not twice differentiable. In Appendix B I discuss that for LN’s corollary, it is enough for PAM that $\phi$ is differentiable in $\xi$, and that this derivative is increasing in $u$ and the agent’s type. These conditions establish that the gains of a principal by matching with a higher type counterpart are greater (a supermodularity condition) than when matching with lower type counterparts, plus that for higher values of utility given to the agent along the UPF, these gains also increase. This will ensure that the high type principal can outbid the low type principal for the high type agent.

**Lemma 1.** The UPF described by $\phi(\xi, \theta, u)$ is:

- Continuous and strictly decreasing in $u$ for $u \in U_\xi(\theta)$.
- Differentiable in $u$ for $u \in \text{int}(U_\xi(\theta))$. 

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Differentiable in $\xi$.

Proof. To prove continuity it is enough to verify that $\phi(\xi, \theta, \xi^2\tau/8 - \omega) = \omega + \xi^2\tau/4$ and that $\phi(\xi, \theta, \xi^2\tau/2 - \omega) = \omega$. Both are verified using simple algebra.

Every piece of the UPF is differentiable in $u$. Therefore, it is sufficient to verify that the derivatives coincide when the function changes its functional form. At the first best surplus (and therefore in that section of the UPF) the UPF has slope $-1$. The derivative of the UPF when PC and CC are binding is $(\xi\sqrt{2\tau(u + \omega)})/(2(u + \omega)) - 2$. After replacing $u = \xi^2\tau/2 - \omega$ we obtain $-1$, and then the UPF is differentiable in the interior of $U^\xi(\theta)$. The part of the UPF in which only the CC is binding is a point, and lies in the minimum value of utility the agent can get from the matching, and therefore does not belong to the interior of $U^\xi(\theta)$.

Finally, as the function is continuous and every piece of it is strictly decreasing in $u$, the UPF is decreasing in $u$.

Now analyzing $\partial \phi/\partial \xi$, we need to study again its intervals. $\phi$ written as a function of $\xi$ is:

$$
\phi(\xi, \theta, u) = \begin{cases} 
\xi^2\tau - \pi & \text{if } \xi \leq \sqrt{\frac{2(\pi + \omega)}{\tau}} \\
\xi\sqrt{(\pi + \omega)2\tau} - 2\pi - \omega & \text{if } \sqrt{\frac{2(\pi + \omega)}{\tau}} < \xi \leq \sqrt{\frac{8(\pi + \omega)}{\tau}} \\
\xi^2\tau + \omega & \text{if } \xi > \sqrt{\frac{8(\pi + \omega)}{\tau}}
\end{cases}
$$

Using simple algebra it can be shown that this function is continuous in $\xi$. Moreover, taking the derivatives in each piece, and replacing the boundaries of each piece of the function, it can also be verified to be differentiable in $\xi$.

Lemma 1 is instrumental in the construction of the proof of the final proposition. It says that the UPF is well behaved and follows a standard principle: The more utility is given to the agent, the less utility the principal will obtain.

Lemma 2. $\partial \phi/\partial \xi$ is continuous and increasing in $\tau$, $\omega$, and $u$.

For the proof of Lemma 2 please refer to Appendix B. This is the first stone to build up the supermodularity type of characteristics for $\phi$ in order to obtain PAM. Further, it is necessary that $\phi$ does not decrease in the agent’s type, nor $\psi$ decrease in the principal’s type. This is formalized in the following lemma,

Lemma 3. $\phi(\xi, \theta, u)$ and $\psi(\theta, \xi, v)$ are type increasing, that is:

- $\phi$ is non decreasing in $\omega$ and $\tau$. 

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• \( \psi \) is non decreasing in \( \xi \).

*Proof.* From Table 1 it can be seen that, at least piece-wise, both \( \phi \) and \( \psi \) are non decreasing in \( \omega \) or \( \tau \) the former, and \( \xi \) the latter. Continuity of \( \phi \) and \( \psi \) in each of the relevant variables, which is easily shown, is sufficient then to obtain the type increasing property.

Lemma 3 shows that the surplus increases when increasing \( \omega, \tau, \) or \( \xi, \) formalizing what can be observed in figures 1, 2, and 3 in which the UPF shifts upward when increasing any of those parameters. This implies that for any level of \( u \) that is feasible, the principal obtains at least as much utility with a richer, or more talented agent.

\[ \xi' < \xi, \omega \in [0, \tilde{\xi} \frac{\xi'}{b}] \text{ with } \tilde{\xi} \in \{\xi', \xi\} \]

**Figure 3:** \( \xi' < \xi, \omega \in [0, \tilde{\xi} \frac{\xi'}{b}] \) with \( \tilde{\xi} \in \{\xi', \xi\} \)

\[ \Delta u|\omega \]

**Proposition 1.** The economy with principals and agents with moral hazard satisfies generalized increasing differences in \((\xi, \omega)\) and \((\xi, \tau)\), which implies that:

- For equally talented agents, larger firms will match with wealthier agents.
  
- For equally wealthy agents, larger firms will match with more talented agents.

*Proof.* Given that the function \( \phi \) is differentiable in \( \xi \) (Lemma 1), the fact that Lemma 2 ensures that \( \partial \phi/\partial \xi \) is non decreasing in \( \tau, \omega, \) and \( u \), and that Lemma 3 shows that \( \phi \) and \( \psi \) are type increasing, Corollary 1 in (Legros and Newman, 2007, p.1097) can be applied, as the requirements for its proof are satisfied, and therefore PAM is obtained for both matches. For a detailed proof refer to Appendix B.
Additional results with discrete types

Wealthier agents will work in bigger firms, and more talented agents will also work in bigger firms. However, what is the equilibrium going to look like? Finding how principals and agents will construct their contracts is not simple, as an equilibrium would imply that everyone is maximizing their expected utility by matching with their partner, and no other principal steals the agent of another one. This means not only that the match is stable, which is implied by GID, but that the contracts signed by each party can be clearly identified. The conclusions of GID can be applied to a continuum of firms and agents, as well as for a discrete set of them. For simplicity, I will focus in what is left of this article on working with the discrete case.

Proposition 2. Let \( \theta = (\omega, \tau) \) and \( \theta' = (\omega', \tau') \) be the types of two consecutive agents such that \( \omega' \leq \omega \) and \( \tau' \leq \tau \). One coordinate (\( \tau \) or \( \omega \)) is equal among all the agents, whereas the other (\( \omega \) or \( \tau \)) is strictly larger. Let \( \xi' < \xi \) be the sizes of two consecutive firms. The equilibrium outcome must satisfy:

- If \((\theta', \xi')\) represents the match of the lowest matching types, agent and principal will obtain:
  \[
  u^* = u_{\theta'}(\xi') \\
  v^* = \phi(\xi', \theta', u^*)
  \]

- Otherwise, let \( \tilde{v} \) be the utility of the low type principal. The high type match will obtain:
  \[
  u^* = \max \{ \psi(\theta, \xi', \tilde{v}) , u_{\theta}(\xi) \} \\
  v^* = \phi(\xi, \theta, u^*)
  \]

Proof. The first part of the proposition is trivial, as by GID no principal would want to outbid the lowest type principal for the lowest type agent, and therefore there are no incentives for the lowest type principal to provide more utility than the minimum possible, that is \( u_{\theta'}(\xi') \).

For the second part, assume that \( u^* = \psi(\theta, \xi', \tilde{v}) \). Note that if the high type principal were to offer less than \( u^* \), say \( u^* - 2\epsilon \), then the low type principal could offer \( u^* - \epsilon \) and be strictly better off because the UFP is strictly increasing in \( \theta \). By offering higher utility to the high type agent, she outbids the high type principal for the high type agent. If \( u^* = u_{\theta}(\xi) \), the same reasoning applies, as it is sufficient that the high type principal offers enough utility to the agent to avoid the outbidding from the low type principal.
In a 2 by 2 world, that is two principals and two or more agents, the low type match will write down a second best contract as if they were in an isolated situation, whereas the high type match will write down a contract that provides the agent at least as much utility as the high type agent would obtain with the low type principal, when this principal is getting his second best utility when matching with the low type agent, that is, when the low type principal is unable to outbid the high type principal for the high type agent.

**Proposition 3.** Consider consecutive matches of firms of size $\xi' < \xi$, and agents with types $\theta' < \theta$, such that only $\omega$ or $\tau$ is equal for all the agents, and for every match, the agents are cash constrained for both firms.

If difference in wealth or talent is large enough, i.e. if:

- $\omega - \omega' > \tau \left(2\xi'^4 + \frac{(\xi^2 - \xi'^2)}{4} - \xi'^2\sqrt{\xi^2 - \xi'^2 + 4\xi'^2}\right)$, when the agents’ type is wealth.
- $\tau' / \tau < 2 - \frac{\xi^2}{2\xi'^2}$, when the agents’ type is talent.

Then the high type match will write a contract with stronger incentives than the contract it would write out of the market, and therefore closer to the first best output.

**Proof.** Let $\xi' < \xi$, $\omega' \leq \omega$ and $\tau' \leq \tau$ with only one of these two last inequalities being strict. Let $v'$ represent the utility the low type principal obtains by matching with the low type agent, and assume both agents are cash constrained for both firms. From Proposition 2 we can write the maximum utility the high type agent could get from the low type principal:

$$u = \frac{1}{4} \left(-2(\omega' + \omega) + \xi'^2\frac{\tau + \Delta\tau}{2} + \xi'\sqrt{\tau(\xi'^2\Delta\tau + 4\Delta\omega)}\right).$$

(3)

where $\Delta\omega = \omega - \omega'$ and $\Delta\tau = \tau - \tau'$. If the contract of the high type match is equivalent to the one they would write out of the market, then the high type agent would receive $\xi^2\tau/8 - \omega$. The conditions in the proposition come from comparing the utility level in (3) against this last expression. □

Proposition 3 states the conditions such that the competitive pressure imposed by the market makes the high type match write a contract that provides incentives in which the outcome is closer to the first best, compared to the expected outcome in the one-to-one version of the model, reflecting the efficiency brought by competition into this economy. The first part of Proposition 3 says that when the agents’ type is wealth, then the more talented they are, and the more different in size are the firms, how much different wealth between high and low type agents needs to be, in order for the competitive pressure
to be enough to motivate the high type principal to strengthen the incentives for the high type agent. Note that a bigger firm makes the agent more cash constrained, increasing the information rents, and therefore decreasing the need of more compensation to avoid outbidding from the low type principal (as part of this cost is already covered by the higher information rents). This explains, then, the necessary increase in the wealth of the high type agent compared to the low type to have a contract that provides him more than the information rents.

The second part of Proposition 3 says that when the agents’ type is talent, and the size of the smaller firm is less than half of the size of the big one, then for any relationship of talent between the agents, there is no competition enough to make the high type principal to provide extra incentives to the high type agent. However if \( \xi' \geq (\sqrt{2}/2)\xi \), then for any pair of \( \tau' \) and \( \tau \) the contract written by the high types is going to give the high type agent more information rents than what he would obtain with the high type principal in the absence of market pressure.

The conclusions of Propositions 3 and 4 go in line with the literature, in the sense that market pressure (competitive factors) can increase the difference in expected compensation among the agents more than the difference in the information rents created by the firm size. This would explain why concentrated distributions in talent, for example, can lead to dispersed distributions of compensation as found by Terviö (2008).

4 Wealth, Talent and the Matching

I have shown that the economy described in this work satisfies positive assortative matching when the agent’s type is either talent or wealth. This suggests that if talent and wealth are positively correlated, that is, more talented agents have higher amounts of wealth, indeed positive assortative matching will arise. However, there are situations in which this does not necessarily happen. In particular, for young agents, their wealth is not correlated with their talent but maybe their cash constraint is influenced by their networks or their family wealth, so the question that remains is: Does positive assortative matching with respect to talent holds for all joint distributions of the agents’ talent and wealth?

The corporate finance literature (Terviö, 2008) considered positive assortative matching between agents and principals when considering talent and size as their types. I exploit the model introduced in this article to analyze the impact that wealth can have on the matching between principals and agents. In other words, are there distributions of wealth and talent among agents

\[\text{11Because the agents are risk neutral, this is equivalent to gains in expected utility.}\]
that could compromise the PAM with respect to talent? Can wealthier but poorly talented agents match with big firms at the same time that talented and poorer agents end up working in small firms?

In Figure 4 we observe a graphical representation of the UPF to look for GID or GDD, following Legros and Newman (2007). In detail, we compare four possible matches: In the upper half of each vertical axis we consider the big firm matching with the agents, whereas in the bottom half we consider the small firm matching with the agents. The left half considers the poor but talented agent matching with the firms, whereas the right half considers the wealthier but not so skilled agent matching also with the firms as well. Each axis represents the utilities of each actor, and the curves are the UPF derived from each matching. For simplicity I assume that the poor agent has $\omega = 0$, whereas the rich agent has $\omega > 1$, which ensures that he is cash unconstrained with any firm. We observe (Figure 4a) that when having a poor but skilled agent against a rich but less capable agent we might no longer have PAM with respect to talent and firm size. This happens when the difference in their talent is below some threshold ($\tau - \tau' < \tau$). Furthermore, if we start assuming a level $\bar{\tau}$ as reservation profits for the firms, then we can even end up with negative assortative matching when considering firm size and agent talent, if rich agents have poor skills and poor agents are talented. Conversely, if the difference in talent between the two agents is sufficiently high (Figure 4b), then the effect of the limited liability becomes irrelevant, and positive assortative matching between talent and firm size arises.

Note that where the UPF intersects the horizontal axis (the agent’s change in utility) only changes with $\tau$ and $\xi$, whereas $\omega$ is crucial to determine where the UPF reaches the maximum value for $\phi$ (the principal’s utility). Because of this, if we analyze the matching between both of the agents, $(\omega,\tau')$ and $(\omega',\tau)$, with a firm of a given size, then the poorer agent will always have the bottom of his UPF to the right of the UPF generated by the matching of the wealthier one. However, if the difference in talent is small, the poorer agent’s UPF will reach a lower maximum (the isolated second best contract outcome) on the vertical axis than the UPF of the wealthier agent (the first best outcome, of a slightly smaller outcome because of the lower talent). This crossing of the UPFs is critical, as the firms prefer one agent or the other, depending on how much utility they will have to provide to the agent in order to make the matching stable. The UPFs will cross if and only if the difference in talent is low enough.

$^{12}$LN define generalized decreasing differences (GDD) as a sufficient condition for negative assortative matching (NAM), where the lower type principal can outbid the high type principal for the high type agent.
5 Discussion

The model studied in this paper provides a simple framework to study the implications of the matching between principals and agents, when we consider, besides talent, the wealth owned by the agents. Doing that, on the one side we obtain predictions for future empirical work, with a model that considers the effects of endogenous matching. On the other, the model replicates some empirical findings in the literature of executive compensation. In this section I will expand on these two points.

Dam and Perez-Castrillo (2006) takes the principal-agent model, with moral hazard, into the matching framework. They conclude that market conditions, such as competition for jobs or competition for workers, are critical to determine the market outcome. A key similarity with this work is the consideration of wealth as the agent’s type, the consideration of non-
perfectly-transferable utility between principal and agents, and the introduction of the effects of wealth through the limited liability channel. A key difference, though, is that they consider homogeneous principals while I let principals to differ in the size of their projects. I also let the agents have their talent as another type. These differences allow to consider a much wider range of scenarios, and instead of answering who is working (or who is hiring), they allow to answer the question of who is working where. Letting talent be part of the model, allows to contrast the conclusions with a wider set of empirical literature, and check if there are crossed implications, as the agent’s could have a multidimensional type.

Earlier, Legros and Newman (1996) set up a general equilibrium model in which agents with different levels of wealth get together to form a firm. They find that wealth plays a crucial role in defining the type of firms that are going to be formed, in particular in the presence of moral hazard (when monitoring costs are nontrivial).13 In this article, instead of studying firm formation, I try to model the environment in which empirical compensation studies are based on, such as, firms hiring executives. I do so, by letting the market to be two-sided, differentiating firms from agents. Furthermore, in the model presented in this article, agents are endowed with talent as well. Both articles share, though, characteristics such as risk neutrality and wealth playing a crucial role in the matching of agents through the limited liability channel.

The empirical literature on compensation, has started to incorporate some degrees of matching and moral hazard. Of particular relevance are the works of Gabaix and Landier (2008) and Terviö (2008), which provide interesting conclusions relating the variables that might drive the matching between executives and firms. Gabaix and Landier (2008) present a model of CEO and firms matching, based on the distribution of the CEOs’ talent. They assume that compensation is based on talent, while firms and CEOs are differentiated between them in size and talent respectively. Their main theoretical contribution is how compensation on talent reacts to the talent distribution, reaching the conclusion (supported by their data) that even highly similar talented CEOs can show big differences in their wages. They also conclude that bigger firms lead to higher wages in equilibrium. Terviö (2008) on the other hand, develops a matching model that tries to obtain the distribution of CEO’s ability from the known distribution of pay and firm’s market value. The author concludes, among other important insights, that the wide differ-

13This market is closer to the one presented in Lucas (1978), in which the market is one-sided, and economic agents might assume different roles in the resulting organizations. In a more recent work Eeckhout and Kircher (2018) expands this matching concept by allowing the firm to choose endogenously how many and how skilled are those workers.
ences in compensation for a small distribution of CEO’s ability is given by firms characteristics. It happens as well that competitive factors are crucial to explain the huge differences in compensation levels among managers. Again, Terviö (2008) neglects moral hazard problems, and neglect any impact wealth might have on the the design of incentives. An important lesson though is the effects competition has in the level of wages. The model introduced in this article provides a theoretical ground for these findings. The more similar the agents and firms, the latter needs to pay more to keep the high type agents, otherwise, smaller firms could outbid the bigger ones for them. This competitive effect generates efficiency gains, which reflects in higher expected surplus.

Edmans, Gabaix, and Landier (2009) expands the framework of Gabaix and Landier (2008), by incorporating the agency problems within a competitive assignment model. They conclude that the compensation, as a share of the firm, is decreasing in firm size, and they evaluate the effectiveness of incentive compensation, a result that can also be replicated in the model introduced in this article. Moreover, in their conclusions they raise a question that relates directly with this article: Are CEO incentives increasing in wealth? They refer to this problem and the impossibility to solve, at least empirically, given that there is no information on absolute wealth for the CEO, and it is only possible to obtain the wealth inside the firm, in terms of stocks and options. This is one of the things that Baker and Hall (2004) tried to address. They were trying to investigate the relationship between CEO’s compensation with the firm’s size. To do this they developed a single and multitask agency problem, and find the optimal compensation scheme for the CEO. They later estimate their model focusing on understanding how the marginal effect of a manager depends on the firm’s size. An interesting finding is that the CEO’s bonus decreases, as a share of the company, with the firm’s size. They do not use a matching model as the previous article, nevertheless this result is confirmed by the model presented in here. The authors use wealth to determine the risk aversion only, given a firm size, and later make three assumptions that allow them to proxy wealth in three different ways: first they assume that wealth is proportional to total annual compensation, later they assume that wealth is the CEO’s holding in the firm (options plus stock), and finally they assume that CEOs of big firms aren’t richer nor poorer than CEOs of smaller firms. For us, this is not the case, as the agent’s wealth is key to determine 1) if the agent is cash constrained, and 2) if it is cash constrained, how much information rents can the agent extract.
6 Conclusions

The model developed here allows to understand some implications of the traditional moral hazard framework on the matching between principals and agents. In particular I focus on the effect of the agent’s wealth on his relationship with firms of different size. I show that, with risk neutral principals and agents, wealth makes the agent cash constrained for a lower amount of firms (the smaller ones), and further, if he is not cash constrained, his information rents decrease with his wealth, and increasingly so in the firm’s size. Another result is that the size of the firm, measured in earnings, increases both: agent and principal’s utility and compensation. Therefore a first conclusion is that the agent would prefer to work in big firms, for which he would be cash constrained and therefore able to extract information rents. On the other hand, firms prefer to hire wealthier agents, as this would allow them to reduce the information rents the agent can extract from the surplus. This is true only as long as the agent is cash constrained. This will happen for higher levels of wealth, the higher size of the firm, or conversely, for a given size of the firm, for lower levels of wealth. If the firm is small, the principal can do just fine with poorer agents, as less wealth from their side is required to keep them from being cash constrained.

In order to tackle the question of how principals and agents match, I adapt the techniques developed in Legros and Newman (2007) and use generalized increasing differences to obtain endogenous positive assortative matching between principals and agents when considering the firm’s size and the agent’s wealth or talent. I also describe conditions on the parameter space to describe the contract associated to each match, and its efficiency. In particular I find that when types are closer, the market pressure is higher and makes the high type match to set up a contract that creates a higher surplus than that which could be obtained in a 1 to 1 situation. I also find that the lowest type will always write a contract that is equivalent to an outside the market outcome, when principals retain the bargaining power.

Finally I provide an example in which a poor agent with high talent, and a wealthy agent with poor talent, match with firms of different size. I find that if the difference in talent is small, then there will be no positive assortative matching with respect to talent and firm size. However, if the difference between the agents’ talent is sufficiently high, PAM is maintained. Considering that wealth is not necessarily perfectly correlated with talent in a sample with similar agents, this can be an issue for empirical considerations. In particular, given that Ackerberg and Botticini (2002) has already shown the negative impact that neglecting the matching considerations can have on empirical results.
References


## A Derivation of the Partial Model

In this Appendix I provide the detailed steps to arrive from the maximization problem of the principal in (1) to the results shown in Table 1.

Given the simplifying assumptions in the model, it is possible to solve the problem by using the first order approach (as the agent’s problem has a unique solution),\(^{14}\) the optimal \(e\) for the agent, given a pair of \(a\) and \(b\) is given by the following condition:

\[
p'(e)b = c'(e) \quad \text{or,} \quad b = \frac{c'(e)}{p'(e)}
\]  

Equation (4) implies that \(e = b\tau\). As expected, the amount of effort exerted by the agent is increasing in the distance between the wage in the good and bad state (in other words, the size of the bonus), as well as in the level of his ability. We can replace then the first order condition (4) into the other equations of the principal’s problem eliminating the variable \(b\) from it. The new problem for the principal is:

\[
\max_{e,a} -a + e[\xi - c'(e)]
\]

\[\text{s.t.} \quad a + ec'(e) - c(e) \geq \pi \quad \text{(PC.2)} \]

\[a \geq -\omega \quad \text{(CC.2)}
\]

This reduced problem has a particular advantage. Besides having less variables to consider, it allow us to put the attention in the cash constraint for the agent. In particular we are interested on how affected are the incentives when

\(^{14}\)Grossman and Hart (1983) show how, under certain conditions, satisfied in this model, it can be solved in two stages, first the agent’s problem, given the wages, and later the principal’s problem.
(CC.2) is relevant for the principal’s optimization. This will be the case as long as (CC.2) is binding. We will proceed assuming that the agent is not cash constrained, and solve the optimal compensation scheme. This is equivalent to think that \( \omega \) is big enough such that the \( a \) obtained by maximizing subject to (PC.2) is higher than \(-\omega\). Later we will solve the problem considering the opposite case, to finalize with the case in which both are binding.

Let \( \omega \) be such that (CC.2) is not binding. From the new participation constraint we obtain the minimum \( a \) that would make the agent sign the contract. This \( a \) is given by:

\[
a = \overline{u} + c(e) - ec'(e) = \overline{u} - c(e)
\]

The optimal \( a \) depends positively on the agent’s reservation utility but negatively on effort. This is the most direct way in which we can observe how the cash constraint (that forbids at some point decreasing \( a \) no matter the level of \( e \)) impedes the principal to achieve an efficient outcome. The optimal level for \( a \) can be replaced in the objective function for the principal’s maximization problem described in (5) to end up with the following problem:

\[
\max_e -\overline{u} + e\xi - c(e)
\]

Whose first order condition with respect to \( e \) is \( \xi = c'(e) \). This implies that the marginal benefit of \( e \) should be equal to its marginal cost, which is exactly the optimality condition in a first best situation. The solution should satisfy \( e^* = \tau\xi \). It should not be surprising to find that for higher values of the output in the good state, the higher the contracted effort, as it happens with the agent’s talent.

The wages set by the principal are \( a = \overline{u} - \frac{\xi^2}{\tau} \) and \( b = \xi \). As stated previously, the principal charges the expected surplus of the operation whereas letting the agent keep the whole good outcome of the firm.

The expected utility for agent and principal are \( \overline{u} + \omega \) and \( \frac{\xi^2}{\tau} - \overline{u} (= -a) \) respectively. This shows also that the agent, when not cash constrained, is unable to extract any information rents from the principal. This result is widely known in the moral hazard literature. The principal therefore keeps the whole surplus of the project, and she only needs to satisfy the agent’s reservation utility. This is equivalent to a first best outcome, when the principal has full knowledge of the agent’s actions.

To obtain these results, it is important to recall that we have assumed that equation (CC.2) is not binding. Having an expression for \( a \) from the participation constraint (CC.2), we can find a condition that indicates if either
the participation constraint (PC.2) or the cash constraint (CC.2) is binding. For equation (CC.2) not to be binding it must hold that:

$$\bar{u} - \frac{\xi^2 \tau}{2} > -\omega$$

(6)

From equation (6) we obtain already some conclusions. The higher the agent’s reservation utility ($\bar{u}$) and the agent’s wealth ($\omega$), the less likely the cash constraint (CC) is going to be binding. In the opposite direction, the larger the size of the firm ($\xi$), the more likely the cash constraint is to be binding.

Assume now that equation (CC.2) is binding. That implies immediately that $a = -\omega$, and given that equation (IC) hasn’t changed, $b = c'(e)$. Replacing that in the objective function, now the principal optimizes:

$$\max_e -\omega + e[\xi - c'(e)]$$

That yields as solution $e^* = \frac{\xi^2 \tau}{2}$. It is direct to see how the optimal effort has diminished. The optimal compensation scheme is now given by $a = -\omega$ and $b = \frac{\xi}{2}$. The expected utility for the agent and the principal are $\frac{\xi^2 \tau}{8}$ and $\omega + \frac{\xi^2 \tau}{4}$ respectively.

An interesting result is that the agent’s expected utility is decreasing in $\omega$ and increasing in $\xi$. Remember that the higher $\omega$, the less possibilities has the agent to extract information rents from the principal. Looking to the principal, $\tilde{u}_p$ is increasing in both $\omega$ and $\xi$.

Finally there is the situation in which both constraints PC and CC are binding (IC must always be binding with asymmetric information). In this case, we determine the optimal level of effort without having to maximize the principal’s utility, as this level is determined by the system of equations given by the $PC$, $CC$ and $IC$. We obtain that the implemented level of effort is:

$$e = \sqrt{\bar{u} + \omega)2\tau}$$

(7)

Equation (7) implies that $e$ is increasing in $\omega$, $\tau$, and $\bar{u}$. As the participation constraint is binding, the agent is still getting the expected utility $\bar{u}$. However, as $a = -\omega$, $a$ is decreasing in the agent’s wealth, and therefore the effectively paid bonus should increase. As it can be observed, to implement higher levels of effort it is necessary to have higher values of $b$ as well. As consequence the expected bonus increases in $\omega$, compensating the agent for the decrease in his fixed pay $a$ and keeping his utility at $\bar{u}$. Conversely, decreasing the agent’s wealth implies a higher fixed wage $a$, and therefore for the agent to
obtain his reservation utility, a lower bonus is required implementing a lower level of effort. The principal suffers by having to implement lower levels of effort (compared to first best) and paying a higher fixed compensation, decreasing her expected utility (as she is getting lower probability of receiving $\xi$). The principal’s expected utility can be written as:

$$E[u_p|\text{CC and PC binding}] = \xi \sqrt{(\pi + \omega)^2 \tau - 2\pi - \omega}$$

It is very important to recall that when the CC is binding for the agent, the PC must be satisfied, so the agent is always getting $\pi$ or more. This implies that the agent is always at least as good (always weakly better) when he is cash constrained. On the opposite side, the principal is getting all the surplus when the agent is not cash constrained.

## B Proof of Proposition 1

In this Appendix I explore if the conditions which are sufficient to have generalized increasing differences (GID) are satisfied by the principal-agent model developed in the main text. The utility possibility frontier (UPF) generated by the original model is found in Table 2. In this UPF $E[v]$ represents the utility obtained from the principal after signing the contract with the agent. Each column represents the situation in which the agent is cash constrained, but the participation constraint is not binding, when the cash constraint and the participation constraint are both binding, and finally when only the participation constraint is binding. The relation between the variables that define in what situation we are, is given by the base wage determined when the agent is not cash constrained, against his wealth. If the fixed part of the optimal wage, assume an cash unconstrained agent, is lower than his minus wealth, then the agent is not cash constrained. Then, the agent is cash constrained if:

$$\pi - \frac{\xi^2 \tau}{2} < -\omega$$

This implies that the agent is not cash constrained if $\xi \geq \sqrt{\frac{2(\pi + \omega)}{\tau}}$, so $\phi(\xi, \theta, \pi) = \frac{\xi^2 \tau}{2} - \pi$ if $\xi \geq \sqrt{\frac{2(\pi + \omega)}{\tau}}$. Note that this condition is equivalent to $\pi \leq \frac{\xi^2 \tau}{2} - \omega$ when looked from the point of view of $\pi$.

With that, $\phi()$ can be written as:
\[ \phi(\xi, \theta, u) = \begin{cases} 
\xi^2 + \omega & \text{if } \xi \leq \sqrt{\frac{2(\pi + \omega)}{\tau}} \\
\xi \sqrt{(\pi + \omega)2\tau} - 2\pi - \omega & \text{if } \sqrt{\frac{2(\pi + \omega)}{\tau}} < \xi \leq \sqrt{\frac{8(\pi + \omega)}{\tau}} \\
\xi^2 \tau - \pi & \text{if } \xi > \sqrt{\frac{8(\pi + \omega)}{\tau}} 
\end{cases} \]

Which is above written as a function of \( \xi \). This function is continuous in \( \xi \). In order to be differentiable, let’s look at its derivatives:

\[ \frac{\partial \phi}{\partial \xi} = \begin{cases} 
\xi \tau & \text{if } \xi \leq \sqrt{\frac{2(\pi + \omega)}{\tau}} \\
\sqrt{(\pi + \omega)2\tau} \xi & \text{if } \sqrt{\frac{2(\pi + \omega)}{\tau}} < \xi \leq \sqrt{\frac{8(\pi + \omega)}{\tau}} \\
\xi^2 \tau - \pi & \text{if } \xi > \sqrt{\frac{8(\pi + \omega)}{\tau}} 
\end{cases} \]

The derivatives coincide in each interval, and therefore \( \phi \) is differentiable in \( \xi \). It remains to answer if \( \frac{\partial \phi}{\partial \xi} \) is differentiable in \( \pi, \omega, \) and \( \tau \).

B.1 \( \frac{\partial \phi}{\partial \xi} \) for \((\pi + \omega)\)

\[ \frac{\partial \phi}{\partial \xi} = \begin{cases} 
\frac{\xi \tau}{2} & \text{if } \pi + \omega < \frac{\xi^2 \tau}{8} \\
\sqrt{(\pi + \omega)2\tau} & \text{if } \frac{\xi^2 \tau}{8} \leq \pi + \omega < \frac{\xi^2 \tau}{2} \\
\xi \tau & \text{if } \pi + \omega \geq \frac{\xi^2 \tau}{2} 
\end{cases} \]

 Which is continuous in \( \pi + \omega \). Derivatives with respect to \( \pi + \omega \) in each interval are \( \frac{\pi + \omega}{\sqrt{2\tau(\pi + \omega)}} \), and \( 0 \) respectively. Evaluating in the extremes of the interval it gives \( \frac{2}{\xi} \) and \( \frac{1}{\xi} \) respectively. Therefore it is not differentiable in \( \pi + \omega \).

However, it is necessary that \( \frac{\partial \phi}{\partial \xi} \) is increasing in \( \pi \) which it is. As the function is continuous, and increasing in \( \pi \) inside each interval, then \( \frac{\partial \phi}{\partial \xi} \) is increasing in \( \pi + \omega \), which implies that it is increasing in \( \pi \) and \( \omega \).

B.2 \( \frac{\partial \phi}{\partial \xi} \) for \( \tau \)

\[ \frac{\partial \phi}{\partial \xi} = \begin{cases} 
\xi \tau & \text{if } \tau \leq \frac{2(\pi + \omega)}{\xi^2} \\
\sqrt{(\pi + \omega)2\tau} & \text{if } \frac{2(\pi + \omega)}{\xi^2} < \tau \leq \frac{8(\pi + \omega)}{\xi^2} \\
\xi^2 \tau - \pi & \text{if } \tau > \frac{8(\pi + \omega)}{\xi^2} 
\end{cases} \]

Which is continuous in \( \tau \). The derivatives with respect to \( \tau \) are: \( \xi, \frac{\pi + \omega}{\sqrt{2\tau(\pi + \omega)}} \), and \( \frac{\xi}{\tau} \) respectively. All of them positive, and therefore \( \frac{\partial \phi}{\partial \xi} \) is increasing in \( \tau \) in each interval. This added to continuity gives that \( \frac{\partial \phi}{\partial \xi} \) is increasing in \( \tau \).
B.3 GID

The sufficiency conditions expressed in corollary 1 in Legros and Newman (2007, p. 1083) are:

- For GID in $\xi$ and $\omega$,

$$\frac{\partial^2 \phi(\xi, \theta, u)}{\partial \xi \partial \omega} \geq 0 \quad \text{and} \quad \frac{\partial^2 \phi(\xi, \theta, u)}{\partial \xi \partial u} \geq 0$$

- For GID in $\xi$ and $\tau$,

$$\frac{\partial^2 \phi(\xi, \theta, u)}{\partial \xi \partial \tau} \geq 0 \quad \text{and} \quad \frac{\partial^2 \phi(\xi, \theta, u)}{\partial \xi \partial u} \geq 0$$

In their proof, they use $\partial^2 \phi/\partial \xi \partial \omega$ or $\partial^2 \phi/\partial \xi \partial \tau$ to obtain that the derivative of $\phi$ with respect to $\xi$ is increasing in the agent’s type and utility (Legros and Newman, 2007, p.1097). Even though this function is not twice differentiable in the model presented here, we have shown that it is increasing in all the necessary variables and therefore the model in this economy satisfies GID in $\xi, \omega$ and $\xi, \tau$. 