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Presentation Title

Contracting with Endogenously Incomplete Commitment: Escape Clauses
(with Thomas P. Tangerås)

Abstract

We consider a mechanism design problem between a principal and a single agent. Contracting costs restrict the number K of contracts that the principal can offer the agent ex ante to a number of I of potential cost types of the agent. Under such restricted contracting, we consider the principal's surplus-maximizing menu of contracts. This involves pooling of cost types, partial participation (some cost types produce zero output), a combination, or both. We ask whether the principal can increase expected surplus by limiting its commitment and allow ex-post contracting under certain circumstances. We call these circumstances escape clauses, and they are specified in the ex-ante contract offer. Ex-post contracting increases flexibility, but it also leads to dynamic inefficiencies in terms of a ratchet effect, causing agents to misrepresent their cost. This inefficiency may dominate the value of flexibility so that pure ex-ante contracting becomes optimal. Whenever contracting is severely restricted, i.e. K = 1, it is optimal for the principal to include an escape clause. We characterize the properties of incentive optimal mechanisms under endogenlusly incomplete commitment.

Keywords

Revelation principle, mechanism design, contract theory, endogenously incomplete commitment, asymmetric information.

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