ABSTRACT

CFEM workshop:
New Trends in Mechanism Design III
August 17-19, 2015
University of Copenhagen, Denmark

Title: Competitive Search Equilibrium and Moral Hazard

Benoit Julien and Guillaume Roger

Principals seek to enter a productive relationship with agents by posting general incentive contracts. A contract must solve both the ex post moral hazard in production and the ex ante competitive search problem (participation). Menus of contracts do not help hence (single) contract posting is optimal; the optimal contract is characterized and includes compensatory transfers to agents who meet a principal but fail to contract. To generate rents to attract agents, principals distort both the transfer function and the productive action. This implies lower welfare; the allocation is Pareto optimal conditional on the action but not constrained efficient precisely because of this trade off. A planner is immune to principal competition and so implements the standard solution instead. The loss of efficiency is severe: no instrument can correct the market allocation. We also establish a connection between the meeting technology and the set of feasible contracts, and recover an augmented conditional Hosios condition for a subset of (suboptimal) contracts..