



ELSEVIER

European Economic Review 46 (2002) 725–733

EUROPEAN
ECONOMIC
REVIEW

www.elsevier.com/locate/econbase

Incomplete Contracts

On indescribable contingencies and incomplete contracts[☆]

Eric Maskin^{*}

*Institute for Advanced Study and Princeton University, School of Social Science, Einstein Drive,
Princeton, NJ 08540, USA*

Abstract

I examine the theoretical foundations underlying the incomplete contracts literature. A common justification for the assumption that contracts are not fully contingent on the state of nature is to point out that some aspects of the state may be unforeseen or indescribable to the contracting partners at the time the contract is written. I argue, however, that as long as risk-averse parties can foresee the probabilities of their possible payoffs, then the fact that they cannot describe the possible physical states does not matter; even with renegotiation, the parties can attain the same welfare as when full description is possible. © 2002 Elsevier Science B.V. All rights reserved.

JEL classification: L14

Keywords: Incomplete contracts; Unforeseen contingencies; Implementation theory

1. Introduction

The literature on incomplete contracts (see Hart (1995) and Tirole (1999) for surveys) has provided significant insight into how assignment of ownership of productive assets bears on economic outcomes. In this short paper I do not intend to quarrel with any of the literature's conceptual accomplishments, which I regard as valuable and interesting. Nevertheless, I wish to take issue with some of the theoretical foundations underlying this line of work.

The points that I will make are not new; most have been made in one form or another in Maskin and Tirole (1999) or Maskin and Moore (1999).¹ However, it is

[☆] This paper is based on a talk given at the European Economic Association 2001 meeting in Lausanne.

^{*} Tel.: 609/734-8309; fax: 609/951-4457.

E-mail address: maskin@ias.edu (E. Maskin).

¹ The latter paper is not concerned with incomplete contracts per se, but develops techniques that I use in the mechanism of Section 4.

fair to say that the discussion so far has taken place at a rather technical level. Herein, I will try to present some of the main ideas in a reasonably informal way.

2. Incomplete contracts

If I am to criticize the incomplete contracts literature, I must first say what an incomplete contract is. Rather than attempting a precise definition – although such attempts have been made – I will consider a contract to be “incomplete” if it is not as fully contingent on the “state of the world” (the resolution of uncertainty about the future) as the parties to the contract might like it to be.²

Imagine, for example, that two agents plan to trade at some time in the future. Before this happens, they must know the characteristics of the good to be exchanged. Suppose that these characteristics are still undetermined at the time the parties negotiate their contract. Then different states of the world will correspond to different characteristic specifications. And if the terms of trade in the contract do not depend on the state, the contract might reasonably be called “incomplete”.

The literature offers three main reasons for contractual incompleteness:

- (1) Some aspects of the state of the world may not be *common knowledge* or commonly observable; in particular, whoever is responsible for enforcing the contract (e.g., the court) may not be able to ascertain these aspects (in which case, we say that the aspects are “unverifiable”);
- (2) Some aspects of the state may be *unforeseen* or *indescribable* by the parties in advance (perhaps because there is simply too vast a range of possibilities to think about);
- (3) Even if certain aspects are foreseen, writing them into a contract may be too costly.

Let me put aside reason (3) right away. This is not to deny that it has validity, but only that we have not yet discovered a widely accepted principle for gauging the cost of specifying contingencies (see, however, the interesting work by Anderlini and Felli (1994) and MacLeod (1995)). This issue seems intimately related to that of “bounded rationality”, a topic that I touch on in the conclusion.

As for reason (2), I will argue that, for a broad range of models used in the incomplete contracts literature, unforeseeability or indescribability “does not matter”. More specifically, I will illustrate why the following theorem (sometimes called the Irrelevance Theorem and stated here rather loosely) holds:

Theorem 1. *If parties can assign a probability distribution to their possible future payoffs, then the fact that they cannot describe the possible physical states (e.g., the possible characteristics of the good to be traded) in advance is irrelevant to welfare. That is, the parties can devise a contract that leaves them no worse off than were they able to describe the physical states ex ante.*

I should stress that, this theorem does not imply that the parties can do as well as though they had fully contingent contracts, because reason (1) for incompleteness may

² This definition is so broad that it covers many contracts in the literature that are not normally considered “incomplete”, e.g., insurance contracts with adverse selection. But for my purposes, I need not refine it further.

متن کامل مقاله

دریافت فوری ←

ISIArticles

مرجع مقالات تخصصی ایران

- ✓ امکان دانلود نسخه تمام متن مقالات انگلیسی
- ✓ امکان دانلود نسخه ترجمه شده مقالات
- ✓ پذیرش سفارش ترجمه تخصصی
- ✓ امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
- ✓ امکان دانلود رایگان ۲ صفحه اول هر مقاله
- ✓ امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
- ✓ دانلود فوری مقاله پس از پرداخت آنلاین
- ✓ پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات