

George Mailath (July 27th) Theory

The title of the paper is "The Curse of Long Horizons", coauthored with V. Bhaskar.

Abstract:

We study a model of dynamic moral hazard with symmetric ex ante uncertainty about the difficulty of the job. Over time, both the principal and agent update their beliefs about the difficulty of the job as they observe output. As usual, effort is private and so incentives must be provided for the agent to exert effort. Moreover, the agent may have an additional incentive to shirk when the principal expects the agent to exert effort, because by shirking, the agent causes the principal to have incorrect beliefs. We show that this possibility can result in the effort incentive efficient contract needing incentives that become increasingly high powered as the length of the relationship increases. We show that this can imply that it is never optimal to always induce effort in very long relationships.