Discussion of Li and Matouschek (2011):
The Burden of Past Promises

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Objective of the paper

- Study the conflict that arises when workers cannot observe whether firms are complying with their promises
- Characterize optimal relational contract and how profits and effort evolve over time
- Relate results to business examples
Motivation

- **Lincoln Electric:**
  - Company suffers losses but borrows money to honor promised payment

- **First Boston:**
  - Bank pays low bonuses, promises higher bonuses for next year

- Tradeoff between costs of conflict if fail to honor promise and benefits of flexibility if adjust payments to current conditions
Model

- Risk neutral firm and worker can trade at $t = 0, 1, 2, \ldots$
The mechanism

- Efficiency dictates that firm pay effort-contingent bonus to worker only when cost is low

- But cost of payment is firm’s private information ⇒ firm is tempted to report a high cost in every period

⇒ Need to punish firm when reports a high cost: future promised bonus increases and effort goes down
Resulting dynamics

No-shock bonus

Effort
My comments

- Rich analysis with nice insights on the dynamics of payments, effort, and firm profits
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- What is the main message of the paper? What is the main contribution to the literature?

- Many cases, variations, and possible benchmarks make it hard to pin down main contribution
Relative to symmetric information

- Literature (e.g., Ray 2002): Dynamics driven by division of surplus; converge to stationary contract
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- If the principal keeps all the surplus
Relative to symmetric information

- Literature (e.g., Ray 2002): Dynamics driven by division of surplus; converge to stationary contract
- If the agent keeps some surplus: backloading
Relative to symmetric information

- Literature (e.g., Ray 2002): Dynamics driven by division of surplus; converge to stationary contract

- This paper: Dynamics driven by principal’s truthful reporting constraint ⇒ persist over time
Relative to full contracting

- T-review contract: increase future no-shock bonus if shock today; pay large penalty if shock in $T$ consecutive periods

- Ability to commit to arbitrarily large payments allows to approach first best (as $T \to \infty$)
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![Graph showing fluctuating effort over time with no shock bonus]
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- This paper: constraint may not only reduce effort, but also cause effort to fluctuate over time
Relative to private information

- Literature on repeated games with private monitoring: conflicts arise in equilibrium (e.g., Levin 2003, MacLeod 2003 in principal-agent setting)

- Yared (2010): periods of peace marked by escalating demands; bound on demands means that failure to make concessions eventually leads to temporary war
Relative to private information

- This paper: no need to impose joint punishments; curvature of payoff frontier then gives optimal punishments over time

⇒ Can provide tight characterization in a rich and relevant principal-agent environment
Moving forward

- Main comparative statics?
- Larger shocks? More frequent shocks? Continuum of shocks?
- Effects of discounting? Outside options? Bargaining powers?
Thank you!