Competition without Commitment

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Whereas reputational mechanisms have received most attention as a way to deal with time-inconsistency problems, we identify competition as an alternative mechanism that is able to implement efficient outcomes in the presence of commitment problems. In particular, we characterize equilibria in competitive markets with moral hazard and two-sided lack of commitment.
After agents have chosen a hidden effort and the need to provide incentives has vanished, firms can modify their contracts and agents can switch firms.
We show that equilibrium contracts without commitment are identical to those with full commitment if the latter involve no cross-subsidization between individuals who choose different effort levels. Otherwise, less effort and lower-powered incentive contracts are implemented by equilibria without commitment compared to those with full commitment. Moreover, we compare competitive equilibria without commitment to the equilibria that a government with the same informational and commitment constraints can achieve. Competitive markets implement allocations that are Pareto superior to and induce strictly more effort than those attained by a utilitarian social planner.
These results extend to governments concerned about a large class of more general welfare criteria, and they do not depend on the details of the market game.