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MORE IS LESS

Why Parties May Deliberately Write Incomplete Contracts

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More Is Less

Why Parties May Deliberately Write Incomplete Contracts

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Abstract: Why are contracts incomplete? Transaction costs and bounded rationality cannot be a total explanation since states of the world are often describable, foreseeable, and yet are not mentioned in a contract. Asymmetric information theories also have limitations. We offer an explanation based on “contracts as reference points”. Including a contingency of the form, “The buyer will require a good in event E ”, has a benefit and a cost. The benefit is that if E occurs there is less to argue about; the cost is that the additional reference point provided by the outcome in E can hinder (re)negotiation in states outside E . We show that if parties agree about a reasonable division of surplus, an incomplete contract is strictly superior to a contingent contract. If parties have different views about the division of surplus, an incomplete contract can be superior if including a contingency would lead to divergent reference points.

This Element also has a video abstract: www.cambridge.org/ELEP_Halonen

Keywords: incomplete contracts, contracts as reference points, renegotiation, shared views, ambiguity

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