Optimally Coarse Contracts

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Abstract :
We study a principal-agent model with imperfectly contractible actions and a cost of determining what is contractible. If contractibility costs satisfy a monotonicity property---implied by any arbitrarily small difficulty in distinguishing actions when writing the contract---then optimal contracts are necessarily coarse, specifying finitely many actions out of a continuum. By contrast, costs of enforcing a contract affect allocations but yield complete contracts. We provide first-order conditions that describe the structure of optimally incomplete contracts. Applying these results, the model rationalizes discrete pay grades in employment contracts. The presence of private information about productivity coarsens the optimal pay scale.