HOW DO INFORMAL AGREEMENTS AND REVISION SHAPE CONTRACTUAL REFERENCE POINTS?

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Abstract
The notion of contracts as reference points provides the basis for a deeper understanding of important phenomena such as the employment contract, vertical integration, firm scope, authority and delegation. Previous experiments lend support to this notion but they ignore realistic aspects of trading relationships such as informal agreements and ex post renegotiation or revision. Here we show that the central behavioral mechanism underlying contractual reference points is robust to such considerations. Our data reveal that informal agreements can mitigate the trade-off between rigidity and flexibility but they do not fully resolve the problem of misaligned reference points. Our experiments also show that contract revision is a more nuanced process than the previous literature has recognized. We find, for example, that it is sometimes better for parties to write a simple (rigid) contract and then revise it ex post if needed, rather than to anticipate and include future contingencies in a (flexible) contract from the outset. (JEL: C90, D03, D86)

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