"The Ratchet Effect Implies no Learning: Dynamic Contracting without Commitment"

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Abstract

We study an infinitely repeated principal-agent model under adverse-selection and short-term contracts. Due to her lack of commitment, the principal changes the terms of trade and offers a more demanding contract when she learns that the agent has a high productivity. The limit allocation, as the parties become more patient, depends only on the principal's prior on the agent being productive at the beginning of the relationship. When the initial prior is low, the ratchet effect implies that the allocation converges to a pooling one. When the initial prior is high, the principal excludes the inefficient type in the first period of the relationship.