Commitment and Competition*

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Abstract

Two core principles of economics are that welfare can be enhanced with stronger commitment to individual arrangements (contracts) and with more competition. However, in the presence of search frictions, commitment may deter entry with consequent reduction in the reallocation of human resources. We study these tradeoffs when there are different degrees of commitment in a model with on-the-job search. Since the degree of commitment depends on the organizational structure of a firm, we contrast the equilibrium of an industry where firms are organized in the form of partnerships with the equilibrium where firms are public companies. We show that in the equilibrium with public companies there is more investment in high return but uncertain activities (risk-taking), higher productivity (value added per employee) and greater income dispersion (inequality). These predictions are consistent with the observed evolution of the financial sector where the switch from partnerships to public companies has been especially important in the decades that preceded the 21st Century financial crisis.

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