

Time-Inconsistent Preferences & Contract Law

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I. INTRODUCTION

- In this presentation, I relax the standard assumption that contract parties have time-consistent preferences and analyze the extent to which self-control problems due to time-*inconsistent* preferences can systematically affect the decisions and actions of contract parties. I then develop various doctrinal and theoretical implications from relaxing the time-consistency assumption.
- Contracts comprise a series of intertemporal choices: one or more parties make promises about future actions and when the time to act arrives, they either follow through or breach. A party's long-term preference—at the time of making a promise—will either be confirmed or disavowed when the time to perform arrives.
 - In deciding whether to make a promise, a party will make a cost-benefit analysis, discounting exponentially to account for *future* costs or rewards; and, generally, the party will make the promise if the (discounted) rewards exceed the costs.
 - Suppose that the time to perform has arrived and nothing has changed—i.e., the party has not received any new information that would lead her to re-value the costs and rewards associated with performing. In such an instance, a party with time-consistent preferences (by definition) will necessarily follow through and perform as planned.
 - A party with time-inconsistent preferences, on the other hand, will—at the allotted time of performance—give greater weight to any *immediate* cost or immediate rewards (while still discounting in the same manner as before any future costs and rewards). This can lead a time-inconsistent party to reach a different result when making this new cost-benefit analysis. If the extra weight the party gives to immediate costs and rewards is sufficiently great, the party will have *short-term* preferences that are different from her original long-term preferences and may, thus, act in ways that conflict with the long-term preferences that she had at the time that she made the promise.
 - A caveat: this presentation summarizes the arguments that I set forth in three separate papers dealing with self-control problems in contract formation, performance, and breach/damages contexts; the presentation will not provide a detailed examination of the empirical and theoretical framework that underpins the general conclusions that I reach.
- My general claim is that even very low-levels of self-control problems due to time-inconsistent preferences can lead contracting parties to systematically take, or fail to take contract actions that they otherwise had a long-term preference to take (or not take).

- More generally, the parties may take a contract action later than they otherwise wanted (from a long-term perspective), and may never take an action that they had intended to take; or
- Parties may take certain actions—e.g., acting opportunistically—sooner and more often than they had intended from a long-term perspective.
- Contract parties generally make contract decisions along two dimensions—they choose: (1) *what* action to take; and (2) *when* to take it. I will primarily focus on the effect of time-inconsistent preferences on the decision of parties and courts regarding:
 - Optimal level of reliance—how much to rely and when to rely.
 - Opportunistic actions—how much opportunism to engage in and when to act opportunistically
 - Incomplete contracts—when to adopt provisions; renegotiation; default rules; relational contracts
 - Acquiring information—how much and when.
 - Optimal time to breach—a party may repeatedly procrastinate following through with “efficient breach” action
- The arguments I develop in these three papers have important consequence for legal scholars and policymakers, since addressing time-inconsistent preferences requires different, sometimes counter-intuitive solutions.

Time-Inconsistent Preferences: Evidence: Economics, Psychology

- Standard Assumption in Law & Economics and Rational Choice Theory is that people have time-consistent preferences.
- Nonetheless there is a large body of empirical evidence showing that people exhibit preferences for immediate gratification that lead them to behave in a time-inconsistent manner—i.e., the pull of immediate gratification can lead people to systematically act in ways that contradict their long-term preferences.
 - More recently, also evidence from brain-imaging studies.
- “Smoking guns” that supports claim: a time-consistent person will never adopt a commitment device, since she has no self-control problems, but people routinely:
 - Join health clubs, go to weight-loss spas
 - Purchase homes to prevent over-consumption early in life
 - Retirement accounts with penalties for withdrawals serve similar purposes

Procrastinate: immediate costs & delayed rewards

- Never do today, what you can do tomorrow...” For example, enroll in retirement account; start exercising; diet; writing novel; having children
- Short-term cost-benefit analysis—compare:
 - Benefit from avoiding *immediate cost*, against
 - Loss from procrastinating one period

Preponderate: immediate rewards & delayed costs

- Grab reward today, consume now....Pay the consequences tomorrow.
 - Over-consumption in present—under-save for retirement
 - Drug, alcohol, nicotine addictions
- Short-term cost-benefit—compare:
 - Benefit from *immediate reward*, against

- Loss from increased costs in future periods due to acting too soon

II. TIME-INCONSISTENT PREFERENCES AND UNDER-RELIANCE

- A principal goal of contract law is to protect and therefore encourage reliance investments—e.g., Section 90 of the Restatement and expectation damages.
 - Reliance risks are an obvious cause of inefficient under-reliance.
- I begin by assuming a “best-case” reliance scenario—buyer reliance decision:
 - No reliance risk—i.e., reliance reward is guaranteed
 - Reliance reward greatly exceeds reliance costs
 - Only cost: immediate effort of making reliance investment
- However, I show that in a world with *no reliance risks*, time-inconsistent preferences can lead buyer to engage in inefficient under-reliance.
 - From a long-term perspective, time-consistent and time-inconsistent buyers will make the same intertemporal choices regarding the optimal level *and* time of reliance. The time-consistent buyer always follows through and relies at the allotted time.
 - However, under very plausible assumptions, the time-inconsistent buyer will have an incentive to repeatedly procrastinate and will thus:
 - Rely later than the optimal time to rely; and
 - *May never* make this otherwise value-maximizing reliance investment.
 - This is true notwithstanding the time-inconsistent buyer’s long-term preference to act in the same period as the time-consistent buyer
- Various positive implications—e.g., cannot, without more evidence/explanation, claim that observed under-reliance due to risk or exponential discounting
- Normative implications:
 - Welfare losses each period buyer procrastinates, buyer *and* seller incur small welfare loss that in the aggregate it can be very large
 - Identifying these time-inconsistent sources of under-reliance has important consequences for the choice of legal rules and contract incentives
 - Incentives for time-consistent buyers different—need to change long-term preferences—e.g., increase expected reliance reward
 - For time-inconsistent buyers will also need to change short-term incentives that motivate procrastination—e.g., reduce immediate cost to buyer of making reliance investment; or increase cost to buyer of each one period delay in making reliance investment
 - For example, make salient the higher future costs
 - Deadlines backed by penalties

III. THE “NIBBLING OPPORTUNIST”

- The standard assumption in the law and economics literature is that parties will act opportunistically if given the chance.
 - Contract law is thus explained in part as providing a series of disincentives to parties tempted to act opportunistically.
 - Non-legal constraints such as reputational concerns are also seen as providing additional disincentives to parties.

- The *time-consistent* model predicts that a party will act opportunistically only if the expected benefits of doing so exceed the expected costs.
 - However, real-world actors are often observed taking opportunistic actions that can potentially have large effects on their reputations, and, that at first glance, appear puzzling.
- Many opportunistic actions provide immediate rewards and produce delayed expected costs, such as loss of reputation, if the opportunism comes to light.
 - The *time-inconsistent* model that I develop predicts that parties will have an incentive to over-indulge in taking opportunistic actions, particularly opportunistic actions that produce small losses, but are repeated over time.
 - Such *nibbling opportunism* will occur when the immediate reward from acting opportunistically exceed the increase in (discounted) future costs associated with acting opportunistically in that period—i.e., the increase in expected reputational loss.
 - Parties are thus more likely to over-indulge taking opportunistic actions in contexts in which they have repeated occasions to act opportunistically, and the increase in expected delayed reputational loss is sufficiently low.

IV. TIME-INCONSISTENT PREFERENCES AND INCOMPLETE CONTRACTING

- I also show that under certain conditions, contract parties will have an incentive to repeatedly procrastinate adopting contract provisions that are value maximizing.
- All other things being equal, compared to time-consistent parties, time-inconsistent parties will not adopt contract provisions any sooner, but may:
 - Adopt contract provision later than the optimal period, and
 - May never adopt otherwise value-maximizing provisions and, therefore, leave their contracts more incomplete.
- Some contracts may therefore be incomplete not because parties intended to leave the existing gap, but because notwithstanding the parties' long-term preferences not to leave the gap, they procrastinated addressing the contractual gap for one period too many—until conflict and litigation ensued.
 - This implies, that any attempt to provide these time-inconsistent parties with incentives to make their contracts more complete requires policymakers to change the short-term incentives—e.g., by reducing the immediate costs of adopting contract provisions or increasing the incremental loss each period that parties procrastinate adopting contract provisions.
 - It also implies that, the mere fact that parties rarely opt out of a default rule does not necessarily mean they had a preference to be governed by that rule; they may have actually had a long-term preference to opt out, but repeatedly procrastinated following through. Thus, when we evaluate a default rule, the fact that parties rarely opt out of the rule, by itself, may provide us with little information regarding the true long-term preferences of parties.
 - There is an additional implication: the very existence of a default rule (or standard forms) may, under certain conditions, increase the propensity of parties to procrastinate adopting value-maximizing contract provisions. This can have implications for the debate on the relative value of majoritarian and minoritarian default rules, such as penalty-default rules.

- More generally, time-inconsistent preferences provide an intuitive explanation of path-dependence. Individuals contemplating whether or not to opt out of or change an institutional framework may decide that the benefits of doing so exceed the costs and yet repeatedly procrastinate doing so. Path-dependence can thus occur in instances where *all* of the individuals in a group prefer to change an institution, but in each period face sufficiently high immediate costs to cause them to procrastinate.
 - This does not mean that they will necessarily procrastinate indefinitely. However, one would expect that institutional changes will be slower in contexts in which the immediate costs of changing the institution are high.
 - For example, time-inconsistent preferences can delay the emergence of standardized forms, or delay the modification of inefficient forms.
- ***Procrastination in Acquisition of Information:*** A contract party may repeatedly procrastinate acquiring the information even though it otherwise fully intends to acquire it. (Acquiring information usually requires incurring an immediate cost, while the rewards from acquiring the information are often delayed). Procrastination in acquiring information can increase the level of contract incompleteness, since it can lead parties to fail to identify relevant contractual hazards.
 - A party may also procrastinate acquiring transactional information about *herself*, such as information about her own skills and ability to perform the contract. Importantly, a party's procrastination in acquiring this type of information can lead to lower level of precaution than optimal. For example, a party may enter into contracts incorrectly believing that they had the ability to follow through as promised.

V. OTHER LEGAL CONTEXTS

- This work part of a larger project, a book: SELF-CONTROL PROBLEMS & THE LAW, in which, I argue that time-inconsistent preferences can help explain a number of theoretical and doctrinal issues in a variety of legal areas:
- The barriers necessary to prevent *entry* into a variety of contexts are lower than predicted by models that assume time-consistent preferences—i.e., the immediate costs of those barriers may lead potential entrants to repeatedly procrastinate entering.
 - Antitrust—barriers to entry; collective action problems in various legal contexts, such as corporate law; repeated PD-games and reputation
 - Lobbyists can provide sufficiently high immediate costs to cause legislators to procrastinate adopting legislation
- Low *exit*-barriers can lead to repeated procrastination in exiting various contexts:
 - Hate groups; marriage; spousal abuse situations; efficient breach contexts;
 - Defection from cartels, collusion—antitrust
- Parties with long-term “other-regarding” preferences may repeatedly preponderate, acting as if they had “prisoner’s dilemma” preferences. Since the latter is what outsiders would observe, it can lead to mistaken policy decisions
 - Tragedy of the commons—environmental law
- Corporate Governance: Board of directors—repeatedly procrastinate disciplining managers; corporate officers may repeatedly preponderate—nibbling opportunists.
- Opting into & ratifying international treaties