Summary

“Contractual Relationships in the Absence of Formal Enforcement: Experimental Evidence from Germany and Kenya”

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This dissertation consists of three experimental studies that aim at contributing to a better understanding of behavior within contractual relationships—in particular, if information asymmetries, incentive issues and a lack of formal institutions make exchange more difficult and risky. Opportunistic behavior, but also the sheer potential of opportunism, may lead to inefficiencies in value chains and severe welfare losses, making this a highly relevant topic. To improve market institutions and make value chains more efficient, we need to gain better knowledge of how individuals in bilateral trade relations and different contexts actually behave and interact.

The first study is dedicated to the issue of contract agriculture and breach. Contracts may be subject to strategic default, particularly if public enforcement institutions are weak. In a lab experiment, we study behavior in a contract farming game without third-party enforcement but with an external spot market as outside option. Two players, farmer and company, may conclude a contract but also breach it by side-selling or arbitrary payment reductions. We examine if and how relational contracts and personal, voluntary communication can support private-order enforcement. Moreover, we investigate whether company players offer price premiums to extend the contract’s self-enforcing range. We find mixed evidence for our private ordering hypothesis. Although breach can be reduced by relational contracts, direct bargaining communication does not additionally improve the outcome. Price premiums are offered if other enforcement mechanisms are absent, but turn out to be only an “allurement”. Most subjects are not willing to sacrifice short-term gains in favor of a well-functioning relationship that (as we show) would be beneficial for both contract parties in the long run.

The second study deals with contract flexibility, which can be expedient for economic exchange in environments with high ambiguity and risk, but may also encourage opportunistic behavior. We run a modified investment game, including the choice between two different contract designs and asymmetric information about the realized surplus (hidden knowledge). We examine if Nairobi slum dwellers choose flexible over rigid contracts when interacting in risky environments and whether preferences for contract flexibility are sensitive to the exogenous probability of experiencing a negative shock. We find that most interaction is realized through flexible agreements. Principals offer more flexibility if the likelihood of a shock is high, relative to the low-risk environment. Agents are somewhat more reluctant to sign rigid agreements when facing the threat of a bad state. While agents and the overall efficiency benefit from higher flexibility, principals always do better by opting for a rigid contract.

The third study examines the link between inequity aversion and opportunism. Even though many informal settlements exhibit vibrant economic activity, behavioral patterns and preferences of slum dwellers are not well understood. We run a lab-in-the-field experiment again with subjects from the Kibera slum in Nairobi, Kenya. In a simple principal–agent game with hidden action, we study if rejection rates and post-contractual opportunism increase when a contracting party can observe large (disadvantageous) differences in profit from trade. Along the lines of inequity aversion theory, we argue that the feeling of being treated unfairly in an exchange relationship may trigger uncooperative responses. Our results do not confirm this and rather show a very high compliance rate in general. Rejections and opportunistic behavior are not reinforced by profit asymmetries. Yet, we do find significant gender effects. Experimental and survey outcomes jointly suggest a low level of inequity aversion among Nairobi slum dwellers.