How to design contracts so they make people do what you want

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Category

Strategy & Leadership

Key topics

Strategy

How can you get people to honour their commitments? The smart way is to make a contract self-enforcing

Getting people to keep their promises can be hard. This is true in many business relationships, where suppliers can have an incentive to cut corners or to deliver a substandard product, but it is also true in other areas of life. How can you persuade your roommate to take out the trash, or vacuum?

Is there a way to encourage people to do what they say they will do? Of course, contracts are one answer, but they are only a part of the answer. However well they are written, contracts are always incomplete. The obvious solution – hire more expensive lawyers to draw up more complicated documents – doesn't always work because it is impossible to cover every contingency. Moreover, many dimensions of people's behaviour or performance are hard to contract on and enforcing contracts all the time through legal systems can be very costly. People will always say they will do the best they can, but that is hard to quantify, and it is not always possible to measure the quality of someone’s work.

However, there are ways of writing contracts in such a way that they can become self-enforcing.

Franchises, contracts and moral hazard issues

One area where this can be seen and empirically tested is franchising. Franchising is an increasingly attractive strategy, especially to big service companies (such as food and hotel chains) because it allows them to expand very quickly into new territories where they have no experience. It also represents a relatively cheap way of expanding, as franchisees bear many of the costs and risks associated with investment. In return, franchisees benefit from the brand’s reputation and business expertise. But franchising has at its heart a promise: the franchisee agrees to provide a service that will uphold the franchisor’s reputation.

> People hate losing money more than they like the prospect of making it

However, franchising can generate moral hazard issues because the interests of the agent (the franchisee) and the principal (the franchisor) are often misaligned when it comes to daily business operations. The franchisee might be tempted to deliver a cheap, substandard product and thus free-ride on the brand’s name. The franchisor might tell the franchisee to upgrade the TVs or carpets in a hotel, but that will cut the franchisee’s profits, so they might be disinclined to do it.

Because many franchise businesses are in service industries, operating across large geographical areas, it can be very hard for a franchisor/head office to constantly monitor the quality of service franchisees are offering – and the further an outlet is from headquarters, the more expensive it is to monitor. Some businesses might be able to use cameras or other technology to keep an eye on operations, but that is not always possible: in the hotel industry, for example, it could violate customers’ privacy.

So how can the franchisor ensure the franchisee keeps their promise to do a good job? Well, a principal can make a contract self-enforcing by adding specific requirements to the contract (or tweaking ones that are already there) to ensure the losses associated with having the business deal terminated are greater than the profits to be made by cutting corners.

In our paper "An Empirical Analysis of Self-Enforcement Mechanisms: Evidence from Hotel Franchising", forthcoming in the journal *Management Science*, Giorgo Sertsios and I tested this hypothesis. We looked at data from over 5,500 franchised hotels in the US. We found (controlling for other hotel and market characteristics) that the further away a franchised hotel was from the franchisor's headquarters, the more likely it was to be larger than average, to be of a higher quality and to generate higher revenues.

> However well they are written, contracts are always incomplete

However, we also found that this 'revenue premium' was itself largely explained by the size and quality – tier requirements specified by the franchisor in the franchise contract. In other words, the franchisees further away from the franchisors, which were also more difficult to monitor (and thus could shirk more easily), were asked to operate hotels that could potentially generate more money (or extra rents) for franchisees. As a result, even faraway franchisees had a big incentive to obey the franchisor's standards. In this way, hotel franchisors very cleverly aligned franchisees' incentives to ensure they delivered.

Much broader business applications

In itself, that is an interesting finding. But it is even more important because the idea to make the contract self-enforcing to safeguard good behaviour can be generalised to other business situations. At the simplest level, you can contract to pay somebody after they have completed the work, rather than before. Already such a small trick changes people's incentives and behaviour.

There are many other applications. A franchisor could, for example, give a franchisee the exclusive rights to run their restaurants in a given region, allowing them to earn higher potential profits. Such a vision of higher profits should induce higher effort and better quality while discouraging misbehaviour. Similarly, a contract with a supplier could ask them to invest in a technology that will take a long time to recoup its costs, meaning they will be incentivised not to lose the contract before they have made back their investment.

A car dealership might require a dealer/distributor only sell cars over a certain price-point, not only to ensure customers perceive the brand as 'high valued', but also so dealers can earn extra money and be motivated to put in higher efforts and offer better service to clients.

> There are ways of writing contracts in such a way that they can become self-enforcing

On a macroeconomic level, companies operating in a foreign market where they worry the government might nationalise their business can borrow money from that government, so the administration would directly suffer if it confiscated the business’s property and the company was thus unable to repay the loan.

When it comes to drawing up contracts in general, the principal can improve the self-enforceability by introducing requirements that mean it is more worthwhile for the agent to comply than not. After all, behavioural economics tells us people hate losing money more than they like the prospect of making it. If the conditions of a contract make use of these economic intuitions, then a principal might be able to enforce the terms of a contract even without constantly controlling its business partners or racking up legal fees.

If you can use the same principle with your flatmate, you might even end up with a tidier apartment, too.

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