

Summary

This paper studies delegation between firm owners and firm managers in a framework with uncertainty over the demand function. Incentive contracts determine managers' compensation as a convex combination of sales and profits.

The main contribution of the paper is to apply the concept of supply function equilibrium to the managerial incentive analysis in Fershtman and Judd (1987). Under the notion of supply function equilibrium (Klemperer and Meyer, 1989), rather than committing to a quantity or a price, agents commit to a decision rule that relates the quantity produced to the price the market will bear.

The author focuses on the particular case of two firms (each of them with an owner and a manager) selling a homogeneous good, a linear demand with a stochastic component, and quadratic production costs. In contrast with previous literature, the author argues that in this framework managers' decisions may be strategic complements, which has implications for the contract between owners and managers.

Main comments

I am not convinced about the contribution and the validity of the results:

1) The author assumes for simplicity that owners and managers are "equally ill informed" about demand. This is an important difference from the delegation literature, which assumes that managers learn about the stochastic demand after the incentive contract stage but before choosing their competition strategy. Delegation contracts make sense when the firm owners have a greater degree of uncertainty on the state of the market than managers. For instance, Fershtman and Judd (1987) argue that owners' "uncertainty is necessary to make the use of linear contracts in profits and sales reasonable and superior to contracts which yield the usual oligopoly outcomes."

2) The author is not very transparent about the assumptions made or their potential limitations. For instance, how sensitive is the main result to the assumptions on quadratic production costs? Also, what assumptions do they make in line with Klemperer and Meyer (1989) to address the problem of multiplicity of supply function equilibria?

3) The main driving force of the results was already brought up by Laussel (AER, 1992) "Strategic Commercial Policy Revisited: A Supply-Function Equilibrium Model." This paper already shows how in a supply function equilibrium with a linear demand, there is strategic complementarity between the supply functions' slopes. Although the application is not the same, the paper also studies the implications for strategic competition.

Other comments

- The paper could be better written. In particular, many paragraphs seem repetitive and others lack more explanation.
- The term "aggressiveness" is used in a confusing way and sometimes incorrectly. With similar assumptions, Laussel argues that the complementarity between supply functions' slopes induces the rival firm to behave less aggressively.
- Very confusing similar notation for sales and for the supply function.