Overconfidence, Competition, and Market Efficiency*

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Abstract: In a labor market with moral hazard, adverse selection, and overconfident workers, I compare the equilibrium contracts and efficiency of perfectly competitive markets and monopsonistic markets. Screening workers according to their productivity (type) requires both competitive firms and a monopsonist to distort the contract offered to less productive workers, and these distortions may offset others that arise due to overconfidence. In each market structure, the overall effect on efficiency depends on the type-distribution of the labor force and/or the relative degree of overconfidence of the different types of the worker. I provide sufficient conditions for a monopsonistic market to be more efficient than a competitive market, but also that overconfident workers prefer to be employed in competitive markets, where their overconfidence harms them the most.

Keywords: Optimal Contracts, Overconfidence, Social Welfare

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