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Uncertainty, Efficiency and Incentive Compatibility:

Ambiguity solves the conflict between efficiency and incentive compatibility*

Luciano De Castro† Nicholas C. Yannelis‡

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Abstract

A fundamental fact of modern economics is the conflict between efficiency and incentive compatibility, that is, the fact that some Pareto optimal (efficient) allocations are not incentive compatible. This conflict has generated a huge literature, which almost always assumes that individuals are expected utility maximizers. What happens if they have other kind of preferences? Is there any preference where this conflict does not exist? Can we characterize those preferences? We show that in an economy where individuals have complete, transitive, continuous and monotonic preferences, every efficient allocation is incentive compatible if and only if individuals have maximin preferences.

Keywords: Asymmetric information, ambiguity aversion, Incentive compatibility, mechanism design, first-best, second-best.

JEL Codes: D50, D81, D82.

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