Signaling via Contracting: The Timing of Offers by an Informed Principal

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This Version: October 30, 2026

Abstract

This paper studies the timing of contract offers when a principal learns an agent's ability before the agent himself, and both the agent's productivity and his outside option depend on that ability. The principal can either make an exploding offer before the agent learns his ability, or wait until the information becomes public. Because the offer itself conveys the principal's private information, the agent's belief affects both his effort and the rent he demands. I characterize the principal-optimal equilibrium outcomes and show that pooling at the earlier date is optimal if the agent's outside option is sufficiently sensitive to his ability. As a consequence, the principal's profit can increase, even discontinuously, in the outside option of a high-ability agent. Implications for unraveling in entry-level labor markets are also discussed.