

To Each According To...?
*Markets, Tournaments, and the Matching
Problem With Borrowing Constraints**

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Abstract

We compare the performance of markets and tournaments as allocative mechanisms in an economy with borrowing constraints. The model consists of a continuum of individuals who differ in their initial wealth and ability level (e.g. students) and that are to be assigned to a continuum of investment opportunities or inputs of different productivity (e.g. schools of different qualities). With perfect capital markets both mechanisms achieve the efficient allocation, though markets generate higher aggregate consumption because of the waste associated with the production of signals under tournaments. When borrowing constraints are present, however, tournaments dominate markets in terms of aggregate output and, for sufficiently powerful signaling technologies, also in terms of aggregate consumption.

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