Strategic Framing in Contracts
Contracts under hidden action

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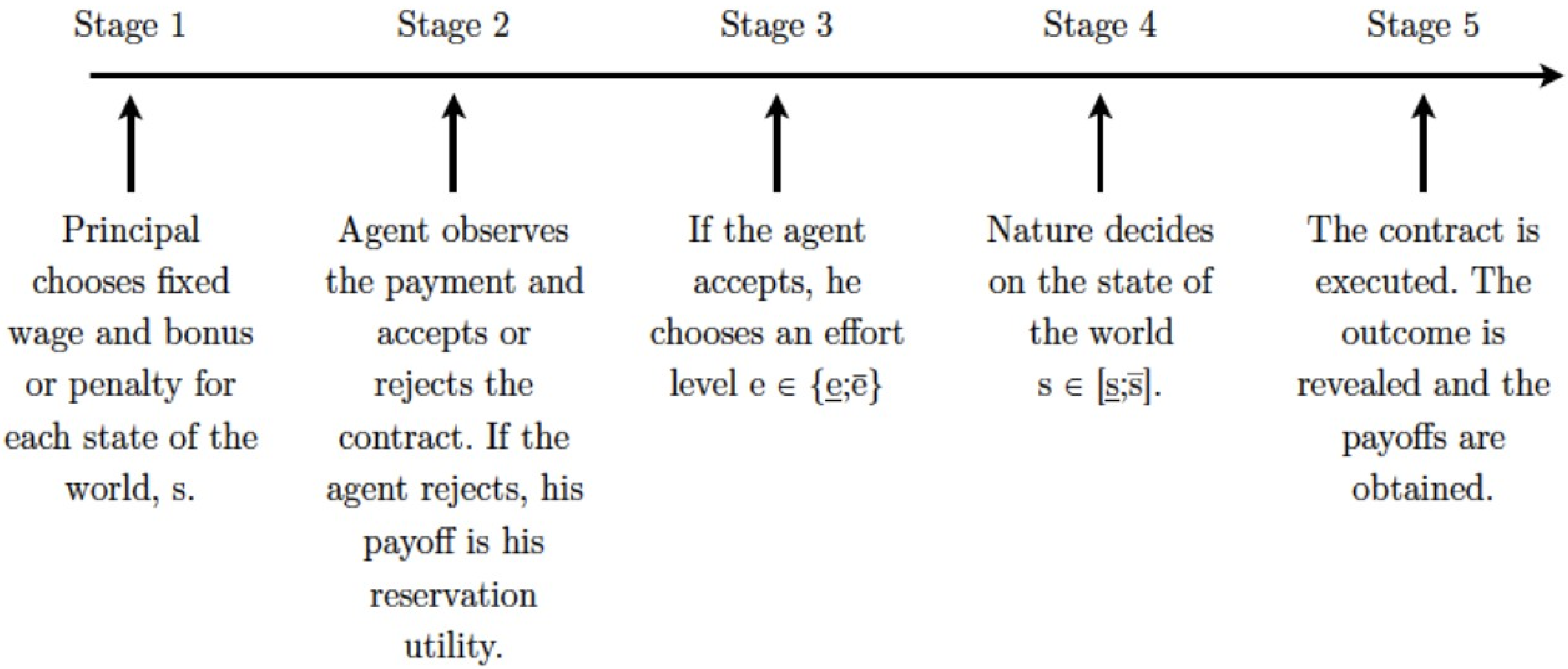
Overview

- Introduction
- The Model (1-4)
- The optimal payment scheme
- Discussion
- Conclusion

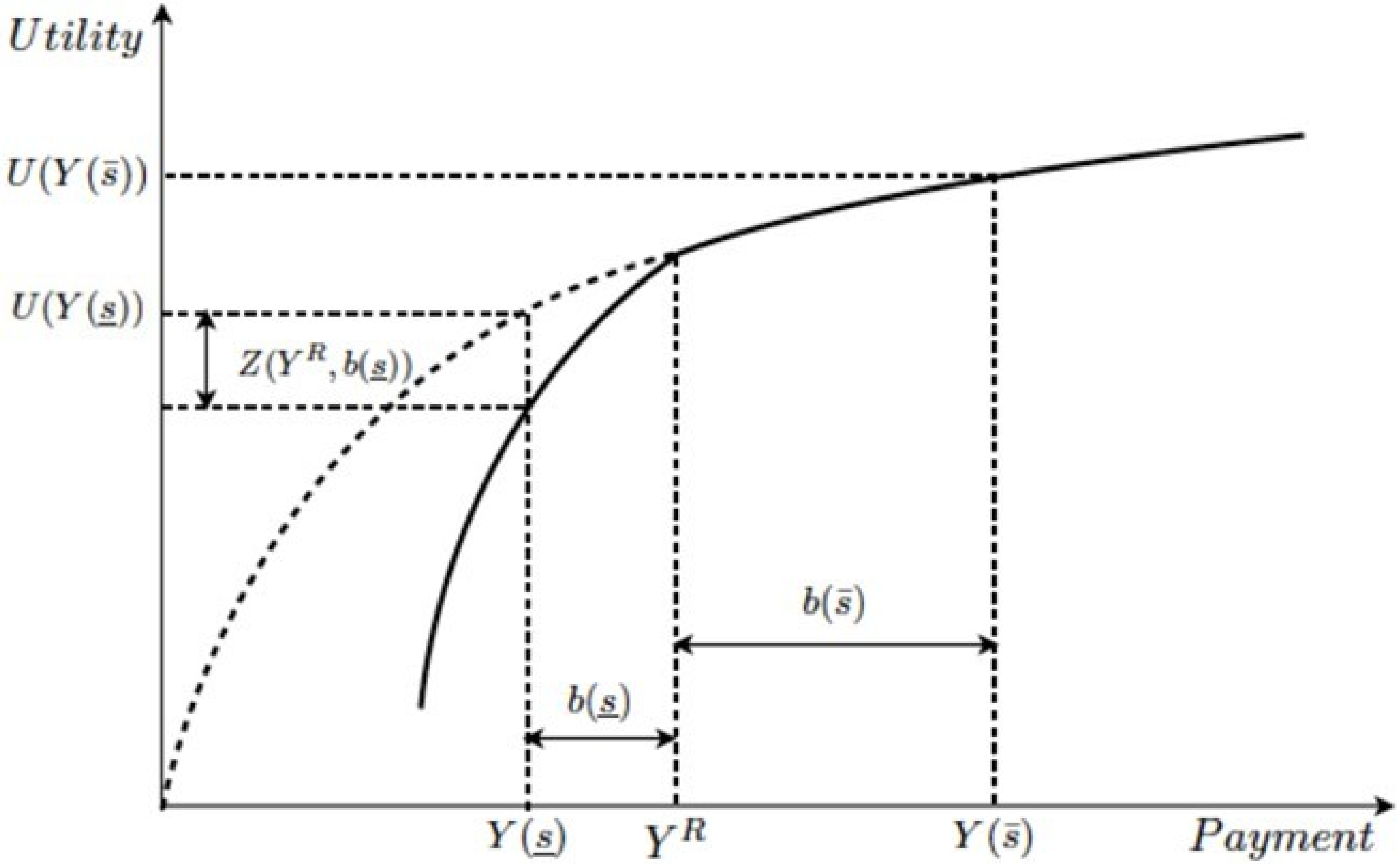
Introduction

- Importance of payment schemes as incentive device
- Prospect theory as an alternative basis for EUT
- Strategic Framing of an exogenous reference income
- Basing analysis on De Meza and Webb (2007)
    - Penalties still possible in their analysis

The Model (1) - Timeline



The Model (2) - Utility



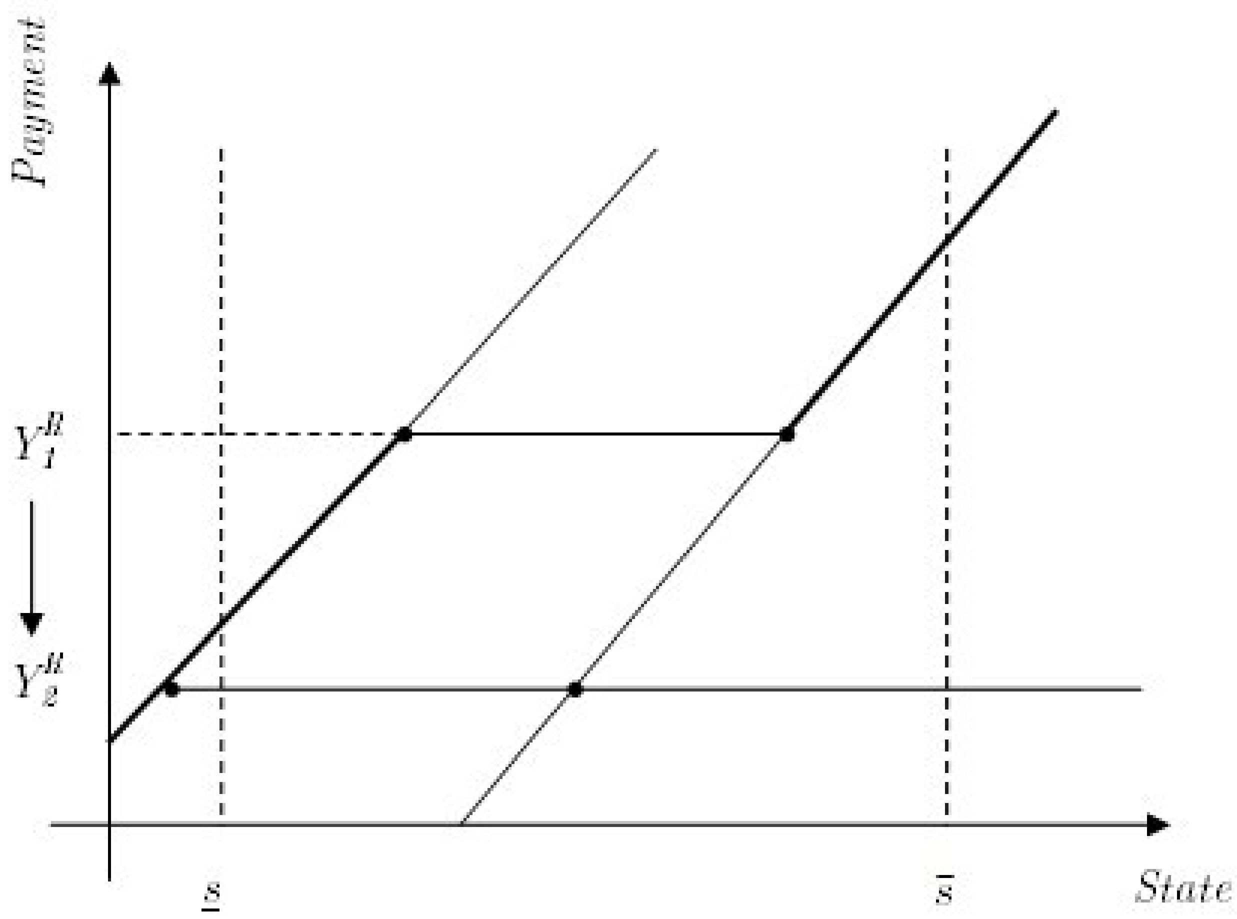
The Model (3)

- Lagrange minimization of costs with participation and incentive compatibility constraint w.r.t. two variables
- The kink in the utility function results from different evaluation of gains and losses
- For different levels of reference income, which are the optimal payments?
- Which of these payment schemes is optimal?

The Model (4) - Intuition

- Principal (risk-neutral) has the goal to pay as little as possible for the required effort level
- The risk-averse agent wants to avoid loss payments
- By moving one of the payments into the loss region by increasing the reference wage, the principal has to compensate in the gains region by increasing some bonus payment
- There is always a flat region in the payment scheme at the reference income (the kink)

The optimal payment scheme



Endogenous reference point

Technique:

IC to determine the personal equilibria, there are three

PC to determine for which personal equilibria he will participate

Which of these payments is cost-minimizing?

Framing

Areas for future research

- Assumption of the reference income crucial
  - Exogenous reference income = base wage
- Incorporation of other anomalies
  - Risk seeking in the domain of losses
  - Weighting function
  - Peer comparison
  - Multi-period models
- Observability of performance output
- Optimal effort level

Conclusion

- Framing payments as gains is optimal – Reference wage plus bonus
- Endogenous reference income (expectations according to Köszegi & Rabin, 2006)
- Experiments conducted to test for theoretical outcomes

Thank you for your Attention!