CENTRO DE ECONOMÍA APLICADA

Abstract

We extend the dynamic moral hazard principal-agent model to allow for an agent who is loss averse and whose reference updates according to the previous period's consumption. Under full commitment and when the agent has no ac- cess to credit markets, the optimal payment scheme can have ô °²at segments at the reference level. This property implies that there is a positive probability of observing constant wages over time, even though the scheme has memory. More- over, the model predicts a ô °°status quo biasô °± whenever the agent is allowed to borrow or save after the outcome is realized -a preference for consuming his full allocation ex-post-. This result in turn implies that unlike the canonical model, the optimal contract may be implemented even when the agent has access to a savings technology. We also show that although the optimal contract scheme is renegotiation-proof, it cannot be implemented by a sequence of spot contracts. However, when the agent has access to the credit market and the principal can monitor his savings, the long-term optimal contract is spot contractible.