Moral Hazard with a Dual Risk-Averse Agent

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Abstract: This paper studies a stylized moral hazard problem in which a single agent is protected by limited liability and exhibits dual risk aversion (DRA) in the sense of Yaari (1987). Assuming two-sided monotonicity of the wage schedule and certain regularity conditions, I first show that, for a specific class of DRA preferences, optimal contracts must feature a bang-bang slope: an optimal wage schedule is almost everywhere either flat or has slope one. I then focus on two representative DRA preferences within this class, both of which have natural interpretations as the agent's pessimistic beliefs. In these cases, the optimal wage schedule necessarily takes the form of either a debt contract (flat at the bottom and with a slope of one above a threshold) or a capped-bonus contract (with a slope of one up to a cap and flat above, possibly also flat at the bottom). These results highlight how the agent's form of DRA shapes the structure of optimal contracts.