Abstract

In this paper we test experimentally the empirical relevance of the behavioral forces suggested by Hart and Moore (2008). Our evidence confirms the model’s prediction that there is a trade-off between rigidity and flexibility in a trading environment with incomplete contracts and ex ante uncertainty about the state of nature. Our findings support the hypothesis that a contract constitutes a reference point for a trading relationship. It appears that a party’s ex post performance depends on whether he gets what he feels entitled to relative to outcomes permitted by the contract. Flexible contracts allow for adjustments of terms, such that trade is always feasible. However, since flexible contracts allow for many outcomes, discrepancies between expected and realized payoffs are likely. It seems that parties are often disappointed by the realized outcome, because the contract allowed for better terms. As a consequence flexible contracts cause a significant amount of shading. In rigid contracts, in contrast, the fixed terms of the contract imply that trade cannot occur in all states. But since outcomes are pinned down from the beginning, the trading parties know exactly what to expect and so there is not much room for disappointment. Accordingly, when trade takes place shading is much less frequent in rigid contracts than in flexible contracts.

Keywords: Contracts, Reference Points, Experiment

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