

Managing Reputation in a Principal-Agent Problem

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Abstract

In a repeated interaction, one not only tries to maximize his/her current payoffs but also considers the future implications of the decision. Reputation concerns arise when there is incomplete information regarding the preferences of the counterparts. We analyze the finitely repeated interaction between an agent and a short-term or a long-term principal. We show that if there is a sufficiently high probability that the agent is a biased type, then the short-term principal does not hire the agent in the initial periods. It leads to a loss of surplus, which can be avoided by varying the periods' relative stakes. The agent sets the relative stakes to start the career path with larger stakes, and the stakes decrease gradually. On the other hand, the long-term principal or the social planner allocates the stakes so that the interaction starts small. We can also show that if the agent interacts with a long-term principal, she starts small if her reputation is sufficiently low. The findings highlight the optimal design of a career path under different conditions.

Keywords: Reputation, Repeated Games, Gradualism.

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