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# Tournaments as a Response to Ambiguity Aversion in Incentive Contracts <sup>☆</sup>

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## Abstract

We study a principal-agent problem with multiple identical agents, where the action-dependent stochastic relationship between actions and output is perceived to be ambiguous, and agents are ambiguity averse. We argue that ambiguity, and particularly ambiguity aversion, make it more attractive for the principal to choose a tournament. If agents are risk neutral, but ambiguity averse, we show that the set of optimal incentive schemes contains a tournament. Moreover, if ambiguity is rich enough, all optimal incentive schemes must be such that realized output levels affect only the distribution of wages across agents and not the total wages paid out, as it is true for tournaments. When agents are both risk averse and ambiguity averse, tournaments need not be optimal, but ambiguity and ambiguity aversion still favor, in many cases, the use of tournaments or tournament-like schemes over e.g. incentive schemes that only depend on each agent's own output level.

*Keywords:* Ambiguity aversion, Incentive contracts, Tournaments

*JEL:* D81, D86, M52

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## 1. Introduction

In principal-agent problems with multiple agents, a variety of incentive contracts can be observed. Sometimes the compensation of the agents is solely based on their own performance. Often, however, the relative performance of an agent in comparison to the other agents also determines compensation. One example of this are tournaments, in which the payment awarded to an agent depends only on the rank of her output contribution. In the context of wages in firms it

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