SOCIAL DISTANCE AND MONETARY INCENTIVES

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In this paper we experimentally investigate how risk taking varies under different incentive schemes when the investment decisions are made on the behalf of another person. People make risky decisions in many contexts, and often, have to decide for others like spouse, sons, colleagues, employees, customers and shareholders. Those circumstances differ substantially in the level of social distance between the decision maker and the person affected by the choice. In this paper we investigate if –and if so, to which extent- the effectiveness of incentive schemes is affected by the social distance between the decision maker and the passive person. We find that social distance interacts with the decision maker's monetary incentives influencing the decision making process and the ultimate investment in the risky assets.

In a decision task similar to the one in Charness and Gneezy (2010), where both losses and gains are possible but the expected value of the lottery is negative, we study the individual attitude to risk when a subject’s decisions affects: i) herself, ii) an anonymous stranger and, iii) a friend present in the lab. Participants come to the lab with a friend and they make three sets of twelve choices each. The first set of decisions is equal for all players and only has consequences for their own payoff, allowing us to control for the individual's risk attitude. Then, in the second and third set of decisions –depending on being assigned or not to the role of active players - half of our participants also decides on behalf of another passive player. Specifically, in the second set of decisions, the passive subject is an anonymous stranger whose identity is unknown while in the third set of decisions, the passive subjects is a friend of the active subject. Comparing the individual choices made by active subjects in these three domains we are able to isolate the role of other regarding preferences on individual decisions involving risk for themselves and for others controlling also for the social distance between the active and passive players. While social distance is manipulated within subjects, in a between subjects design we vary the monetary incentives of the decision makers. In one treatment, when taking their investment decision in the second and third decisions sets, the monetary incentive of the active players are perfectly aligned with those of the passive ones. This means that participants decide on the behalf of another passive subjects but their earnings are exactly the same. In the second treatment, we modify the monetary incentives of the active players choosing a fixed payment. This design allows us to evaluate the role of monetary incentives when deciding for another person, taking into account the social distance.

We find that when social distance is low (i.e. active player decides for a friend), other regarding preferences affect the decision making process reducing the investment in the risky asset, this reduction is larger in case monetary incentives of the active player are perfectly aligned to the ones of the passive player compared to the case in which active player is

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rewarded with a fixed amount. In contrast, when social distance is large (i.e. active player decides for an anonymous stranger), the role of other regarding preferences is attenuated and, in case of a fixed payment scheme, the active player tends to invest other’s money in a more risky manner than his own money. Overall, female subjects are less sensitive than male subjects to changes in monetary incentives. This finding may be driven by different level of other regarding preferences across gender.

In general, theoretical literature does not provide any suggestion/model about how people behave when taking risk for others. Yet, in distributional game characterized by the absence of any risk (typically dictator game, ultimatum game and public good game), previous studies show that people care about others' payoff exhibiting other regarding preferences (Fehr and Schmidt, 1999; Charness and Rabin, 2002; and Andreoni, 1990). However, it is less clear if other regarding preferences affect decision making in risky environments and how they interact with monetary incentives. Few recent works consider risk-taking decisions on behalf of others providing mixed evidence (Chakravarty et al., 2011; Daruvala, 2007; Eriksen and Kvaloy, 2010). Regarding the role of monetary incentives, since Jensen and Meckling (1976), seminal paper, a large theoretical and empirical literature has studied the relation between compensation scheme and risk taking among workers, CEOs and top executives (see, e.g., Ju, Leland, and Senbet, 2002; Bloom and Milkovich, 1997; Chevalier and Ellison, 1995; Coles, Daniel, and Naveen, 2006). The present research contributes to the previous literature analyzing the reasoning and the forces driving decisions on behalf of others in a risky context by proposing a framework which includes both other regarding preferences and monetary incentives.

Our paper speaks to any contractually-regulated relationship involving risky decisions: the desired level of risk may be induced more easily considering not only monetary incentives but also other elements affecting the decision making, such as other regarding preferences and social distance between the counterparties. However, it fits particularly well relationship between mutual fund managers and customers. During the recent crisis institutional investors have been accused of taking excessive risk positions. Our results suggest that those detrimental investment behaviours may be mitigate by making the relationship between managers and customers somehow less anonymous, in a such a way that managers care about their customers’ money and not only to their remunerations.