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The Effect of Performance-Based Incentive Contracts on System 1 and System 2 Processing in Affective Decision Contexts: fMRI and Behavioral Evidence

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ABSTRACT

Managers may rely on emotional reactions to a setting to the detriment of economic considerations (“System 1 processing”), resulting in decisions that are costly for firms. While economic theory prescribes performance-based incentives to align goals and induce effort, psychology theory suggests that the salience of emotions is difficult to overcome without also inducing more deliberate consideration of both emotional and economic factors (“System 2 processing”). We link these perspectives by investigating whether performance-based incentives mitigate the costly influence of emotion by inducing more System 2 processing. Using functional magnetic resonance imaging and traditional experiments, we investigate managers' brain activity and choices under fixed wage and performance-based contracts. Under both, brain regions associated with System 1 processing are more active when emotion is present. Relative to fixed wage contracts, performance-based contracts induce System 2 processing in emotional contexts beyond that observed absent emotion, and decrease the proportion of economically costly choices.

Data Availability: *Contact the authors.*

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