Lecture 17: Up or Out

Compensation in Organizations

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Discussion: MacLeod and Urquiola (2021)

Definition 1

An up or out contract consists of an initial period of employment followed by an evaluation after which the worker is either promoted or terminated.

What are some occupations where up or out is used?

Up or Out in the Wild

- Law firms: Cravath system says you must achieve partner in 10 years or leave.
- Management consulting: Bain, BCG, Mckinsey
- Military (until recently): discharged if passed over for rank promotion twice.
- Universities: tenure-track assistant professors

Tenure as Up or Out

- Tenure is a unique form of up or out.
- If you receive tenure, you receive some form of additional job security.
- This can be viewed as a form of compensation!
- Recall that if people are risk averse, lowering the variance of pay improves their utility.

Tenure at Research Universities

- Six year period as a tenure-track assistant professor
- During this period, the AP does research and teaches
- At the end, they submit a packet documenting their accomplishments
- Publication record is usually the main metric of success
- The department votes, the college and dean also sign off on tenure decision
- If given tenure, promoted to associate professor and typically not subject to termination except in extreme circumstances
- If not, AP is terminated (all or nothing).

What are some benefits of tenure in the academic setting?

Academic Freedom

- After tenure, tenure may promote academic freedom.
- For example, a professor can study a topic or provide an answer that is controversial.
- But before tenure, the need to get department support could weaken academic freedom.
- For example, a professor may only study topics which interest a large number of colleagues.
- There are many professions where truth is important, but where up or out/tenure is not used.

Riskier Projects

- Brogaard, Engelberg, and Van Wesep (2018) study economists after tenure.
- They find total publications and "home run publications" fall.
- No evidence that economists try for riskier projects after tenure is granted.

Selecting and Sorting

- Industry pays (much) better for some academic disciplines at the PhD level.
- For example, consulting offers for econ PhDs are often more than 2x an assistant professor salary
- Tenure allows universities to compete for talent without higher salaries
- It also sorts people: up or out is only attractive if you think you have a chance at moving up!

What are some costs of tenure in the academic setting?

High to Low Powered Incentives

- Prior to tenure, professors face high powered incentives.
- Produce research or lose your job!
- But after, they face low powered incentives.
- So there is incentive to reduce effort after tenure.

Why Up or Out?

- We will review two prominent theories for why up or out contracts exist.
- Both have to do with encouraging the worker to work hard/invest:
  1. Kahn and Huberman (1988): firm-specific human capital
  2. Waldman (1990): general human capital, known only to the firm
- We will only verbally discuss the logic of these theories.
- You are not responsible for understanding the derivations or the model setup.

Kahn and Huberman (1988): firm-specific human capital

- Suppose there is a worker who can invest (at a cost) to increase their productivity at a particular firm only.
- This increase in productivity is random: sometimes investing increases productivity sometimes not.
- Further, suppose this investment is observed only by the worker, and output only by the firm.
- How can the firm get the worker to invest?
- Problem: the investment does not increase the worker's market wage.
- Discussion: Why?

Kahn and Huberman (1988): firm-specific human capital

- One option: the firm can offer a high wage for high productivity.
- But output is not seen by a court.
- So when it comes time to pay, the firm can just claim the worker had low output.
- The worker knows this, and so will not invest!
- There are two key issues:
  1. The benefits of training go to the firm, and the costs are on the worker.
  2. The firm paying the worker to invest/work hard is not credible.

Kahn and Huberman (1988)

- One solution is an up or out contract.
- If output is high “promote” and pay a higher wage.
- If output is low, terminate.
- The firm does not want to claim output is low when it is not.
- This is because it has to then fire the employee, and get 0.
- So up or out compensates the worker for hard work, and is credible for the firm!

General vs. Firm-Specific Human Capital

- In Kahn and Huberman (1988), investing in human capital only improves productivity at one firm.
- This is called firm-specific human capital.
- Because the worker incurs the cost and does not directly benefit this causes problems.
- But many jobs do not have firm-specific human capital.
- Example: most professors have discipline-specific knowledge that can be used at any university.

General vs. Firm-Specific Human Capital

- Skills that can be used anywhere are called general human capital.
- They raise productivity at any workplace.
- As a consequence they raise a workers wage.
- In this case the worker bares the cost but gets the benefit.
- Issue: we still see up or out among professions with only general human capital!

Waldman (1990): Result

- Keep almost everything the same as Kahn and Huberman (1988).
- Except: now investment increases productivity at many firms.
- Allow firms to make offers and counteroffers to the worker.
- Result: firms offer up or out contracts that get workers to invest.
- This is surprising: firms pay workers to invest even though their skills can be stolen by other firms!

Waldman (1990): The Logic

- Investment either increases productivity or does not.
- The firm currently employing the worker observes which case happens.
- The firm retains if productivity is high (up) and terminates if not (out).
- Other firms do not see productivity.
- But they do see whether the worker is retained or terminated.
- And they know the termination decision was made with full knowledge of the worker's productivity!

Waldman (1990): Retention As a Signal

- When other firms see a worker is retained, they know that productivity is high.
- They try to lure the worker away with high wage offers.
- To keep the worker, the original firm must counteroffer.
- The counteroffer must be equal to the worker's high productivity (why?)

Waldman (1990): Retention As a Signal

- When other firms see a worker is terminated, they know that productivity is low.
- They make offers to the worker.
- The equilibrium wage offer is exactly the worker's low productivity (low wage).
- The original firm is not tempted to try to hire the worker back because the wage is equal to productivity.

Waldman (1990): Incentives to Invest/Work Hard

- The worker invests in their human capital (or works hard) initially.
- They do this for the chance of being retained (up) rather than being terminated (out)
- The fact that the firm terminates the worker makes up or out contracts credible.

Waldman (1990) and Academics

- The model we verbally walked through explains why up or out might be used even with general human capital.
- This gives a reason why up or out is used for academics and lawyers who often have general human capital.
- It also explains why tenure does not usually come with a large pay increase.
- Instead, professors often go out and get counteroffers from other universities even when they make tenure!
- Salary then increases to match these counteroffers.
- This is especially true at state universities (why?).