

Lecture 4: Performance Pay

Compensation in Organizations

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Discussion: Hartzell, Parsons and Yermack
(2010)

The Principal-Agent Model

Players

- ▶ There is a firm (the principal) who is risk neutral (exponential utility with parameter $r = 0$).
- ▶ There is a worker (the agent) who is risk averse (exponential utility with parameter $r \geq 0$).

Actions

- ▶ Firm chooses a linear wage which depends on effort ($w(e)$) or output ($w(y)$)
- ▶ After seeing the wage, the worker either accepts or rejects the job.
- ▶ If they accept, worker chooses effort e at an increasing, convex cost $c(e)$

The Principal-Agent Model

Output

- ▶ Output is effort (e) plus noise/luck (ϵ): $y = e + \epsilon$ where $\epsilon \sim N(0, \sigma^2)$
- ▶ This implies output is normal with mean e and variance σ^2

Payoffs

- ▶ If accepted, firm's payoff π is expected output minus expected wages: $E[y - w|e]$
- ▶ If accepted, worker's payoff is expected utility of the wage minus effort cost: $E[u(w) - c(e)|e]$
- ▶ If rejected, worker has “outside option” of \bar{u} and firm has “outside option” of 0.¹

1. We will assume throughout that the firm prefers to hire the worker ex-ante.

Timing

See the board!

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Recap: Effort-Based Pay

Performance-Based Pay

Recap: Effort-Based Pay

- ▶ Suppose the firm can pay based on the worker's effort.
- ▶ Then wage is a linear function of effort: $w(e) = \alpha + \beta e$
- ▶ We now go to the board to solve!

Recap: Effort-Based Pay

Theorem 1

When wages depend directly on effort, effort is e^ which solves $c'(e^*) = 1$ and $\beta^* = 1, \alpha^* = \bar{u} + c(e^*) - 1$*

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Recap: Effort-Based Pay

Performance-Based Pay

Performance-Based Pay

- ▶ Suppose the firm can pay based ONLY on output y
- ▶ Then wage is a linear function of output: $w(y) = \alpha + \beta y$
- ▶ We now go to the board to solve!

Performance-Based Pay

Theorem 2

When wages depend only on output, effort is e_p which solves

$$c'(e_p) = \frac{1}{1 + r\sigma^2 c''(e_p)}$$

and $\beta_p = c'(e_p)$, $\alpha_p = \bar{u} - \beta_p e_p + r\beta^2 \sigma^2 / 2 + c(e_p)$.

- ▶ Notice that $\frac{1}{1+r\sigma^2 c''(e_p)} < 1$.
- ▶ Therefore we are getting less than surplus maximizing effort: $e_p < e^*$
- ▶ Performance pay generates inefficiency relative to effort based pay!

Performance-Based Pay: Explicit Cost Function

- ▶ Suppose that $c(e) = e^2/2$
- ▶ Let's work it out on the board!

Performance-Based Pay: Explicit Cost Function

- ▶ Suppose that $c(e) = e^2/2$
- ▶ Let's work it out on the board!
- ▶ Under this quadratic effort cost:

$$e_p = \beta_p = \frac{1}{1 + r\sigma^2}$$

$$\alpha_p = \frac{r\sigma^2 - 1}{2} \left(\frac{1}{1 + r\sigma^2} \right)^2 - \bar{u}$$

Interpreting Results

- ▶ β is the average amount of money paid to the worker per unit of effort.
- ▶ β represents the strength of incentives (question: why?)
- ▶ We say incentives are high-powered when β is high (close to 1)
- ▶ Because $\beta = c'(e)$ we have that:

$$\beta_p = c'(e_p) = \frac{1}{1 + r\sigma^2 c''(e_p)}$$

Interpreting Results

- ▶ Because $\beta = c'(e)$ we have that:

$$\beta_p = c'(e_p) = \frac{1}{1 + r\sigma^2 c''(e_p)}$$

- ▶ The strength of incentives rises when:
 - ▶ risk-aversion decreases $\downarrow r$ (question: what if $r = 0$?)
 - ▶ noise/luck becomes less important $\downarrow \sigma^2$ (question: what if $\sigma^2 = 0$?)
 - ▶ the marginal-marginal cost of effort decreases $\downarrow c''(e_p)$
 - ▶ a high $c''(e_p)$ means working one more hour after already working 8 hours is much harder than working one more hour after working 1 hour.