LECTURE 10.0

INCENTIVE COMPENSATION

INCENTIVE SCHEMES GONE WRONG

Consider the experience of DuPont's Fibres Division in the late 1980s (as told in Brickley et al).

- Placed up to 6 percent of annual pay into an 'at-risk pool' for around 20,000 employees.
- Then, if profits beat forecasts, a bonus of multiples of the at risk pool was paid. Otherwise, the pool was lost.
- In 1990 real earnings growth of >4% had to be attained to have bonus paid

The plan was abandoned less than two years into its three year schedule when employees were faced with the entire loss of the 'at risk pool'

- The Gulf War of 1990 did not help with matters, nor did general economic conditions.

LESSONS FROM THE DUPONT EXPERIENCE

Possibility 1: Incentive plans often don’t work.

Possibility 2: The scheme was simply poorly designed.

What problems might have characterised the DuPont plan?

- A weak relationship between effort and reward (including dilution among the many employees)? People might freeride.
- External factors beyond the control of any individual likely impacted on the probability the bonus was paid?

OUTLINE

10.0 Incentive compensation

10.1 The basic incentive problem

10.2 Incentives from ownership

10.3 Optimal risk sharing

10.4 The principal-agent model

10.5 Informativeness principle and group incentive pay

10.6 Multi-tasking

10.7 Incentive schemes

READING

Chapter 15, “Incentive Compensation” in Brickley, Smith and Zimmerman (2016) Managerial Economics and Organizational Architecture (6th ed)

Chapter 8, “Incentives” in Mcafee (2002) *Competitive Solutions* (Section on multitasking on p195-199. Link is to electronic version in library)

Reading or link to electronic version in library is in Canvas.