LECTURE 10.5

INFORMATIVENESS PRINCIPLE

AND GROUP INCENTIVE PAY

INFORMATIVENESS PRINCIPLE

The informativeness principle states that all signals that are informative about agent effort should be included in a contract.

- In designing compensation contracts, theory suggests that it is productive to include all performance indicators that provide additional information about the employee's effort assuming that such indicators can be included at low cost. Doing so reduces the cost of inefficient risk bearing and generally leads to a more efficient effort choice.

So far in this week's lectures we have assumed that the only measure of the employees performance is output – this is clearly not the case.

For example, it may be useful to use information about the performance of co-workers, i.e. to include measures of relative performance.

What might have been the benefits of doing so in the case of DuPont? How might it have been implemented in the DuPont case?

GROUP INCENTIVE PAY

Payoffs can be tied to performance of teams, business unit, firm .

Performance can be measured by stock prices, accounting earnings or business unit costs

Why use this approach?

- Difficulty measuring individual performance
- Group pay may encourage cooperation and teamwork
- Performance monitoring can be encouraged among team members.
- Retention valued workers and it may increase the amount of firm specific investment by employees if it discourages quits
- Reduction in contracting costs by matching compensation with team performance – it may be the case that when an individual's performance is correlated with the that of the team, this type of remuneration automatically adjusts and helps retain staff who may be faced with external offers.

What might be some of the difficulties associated with such an approach?

- Free riding
- Limited incentives – witness the experience of DuPont