Pay for Performance and Beyond

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The Principal-Agent Problem

• Employer-Employee, Client-Lawyer, Board-CEO, etc.

• Two difficulties
  – Preferences not aligned
  – Performance imperfectly measured

• Incentive
  – Contracted pay based on *measured* outcome
First best and second best

Total surplus: P’s Benefit – A’s Cost – Risk cost

First best cases:
  – agent’s choice verifiable => fixed wage
  – agent risk neutral => rental agreement

Second best:
  – balance incentives against risk
Informativeness Principle

- What information is valuable for incentive contracting?
  - Anything that is informative about the agent’s choice of action (Holmstrom 79, Shavell 79)
  - Information that is not informative should be excluded

- Old accounting principle: pay should only depend on variables that the agent can control

- Relative Performance Evaluation and Controllability
Lessons from informativeness

Pros:
- Reveals exactly how model “thinks”
- Explains puzzles about basic P-A model

Cons:
- Incentive contract oversensitive to information
- Model of limited use for predicting optimal shape of incentive contract (Grossman-Hart 83)
Why are contracts linear? (H-M 87)

Marris’ example: punishing very rare failures very severely approximates first-best

Dynamic version: invites gaming

Linear scheme (commission) optimal because it provides constant incentive pressure and avoids gaming (robust)
Linear model with one task

Stronger incentive (higher commission) when

• Performance measure more precise (less risk)
• Agent less risk averse
• Value of agent’s effort higher
• Agent’s responsiveness to incentive higher

First three “obvious” – last one the key
Multitasking (H-M 91, Baker 92)

- Many tasks changes the game

- Challenging when easy to measure and hard to measure tasks compete for agent’s attention
  - Quantity versus quality

- Related cases
  - Measures are misaligned with objective
  - Measures can be easily manipulated
Scandals: “you get what you pay for”

- Wells Fargo – fake performance
- BP and oil Gulf spill – excessive output incentives at the expense of safety
- Enron – conflicting incentives between main firm and subsidiaries
- Teachers – teaching to the test
Lessons from multitasking

• Two ways to provide incentives for task
  – Pay more for that task
  – Pay less for competing (substitute) tasks

• Low powered incentives
  – Low or no incentive may be best incentive when an important task hard to measure
  – Highly controllable task may not be incentivized
Alternative incentives within firm

• Job design
  – Define tasks (Google – 20% freedom)
  – Split up easy-to-measure tasks and hard-to-measure tasks

• Bureaucratic rules and constraints
  – Work in the office rather than at home
  – Can’t work for other companies

• Authority, career paths, supervision, recruiting, accounting...

Key driver: Employee’s want to be appreciated
Employment vs Contracting

- **Freedom**
  - Low
  - High

- **Incentive Power**
  - Low
  - High

- **Contrasts**
  - Many constraints → Low-powered incentives → Strong input monitoring → Few constraints
  - High-powered incentives → Strong output monitoring → Few constraints
Two roles of firm boundaries

• External role (Grossman-Hart-Moore)
  – Assets strategic chips in market

• Internal role (Jensen 80, Holmstrom 99)
  – Assets empower firms to set *rules of the game* and restructure incentives (a firm is no democracy)
  – Firm coordinates the use of incentives (especially on production side)
Concluding remarks

• There is a lot beyond pay-for-performance

• Multitasking relevant regardless of which instruments are being used (Dewatripont-Jewitt-Tirole 99)

• Desire to be appreciated may also lead to pandering and influence costs (Holmstrom 82, Milgrom-Roberts 92)

• How will the changing nature of work affect incentives?
Thank You!