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)

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

Dymamic 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

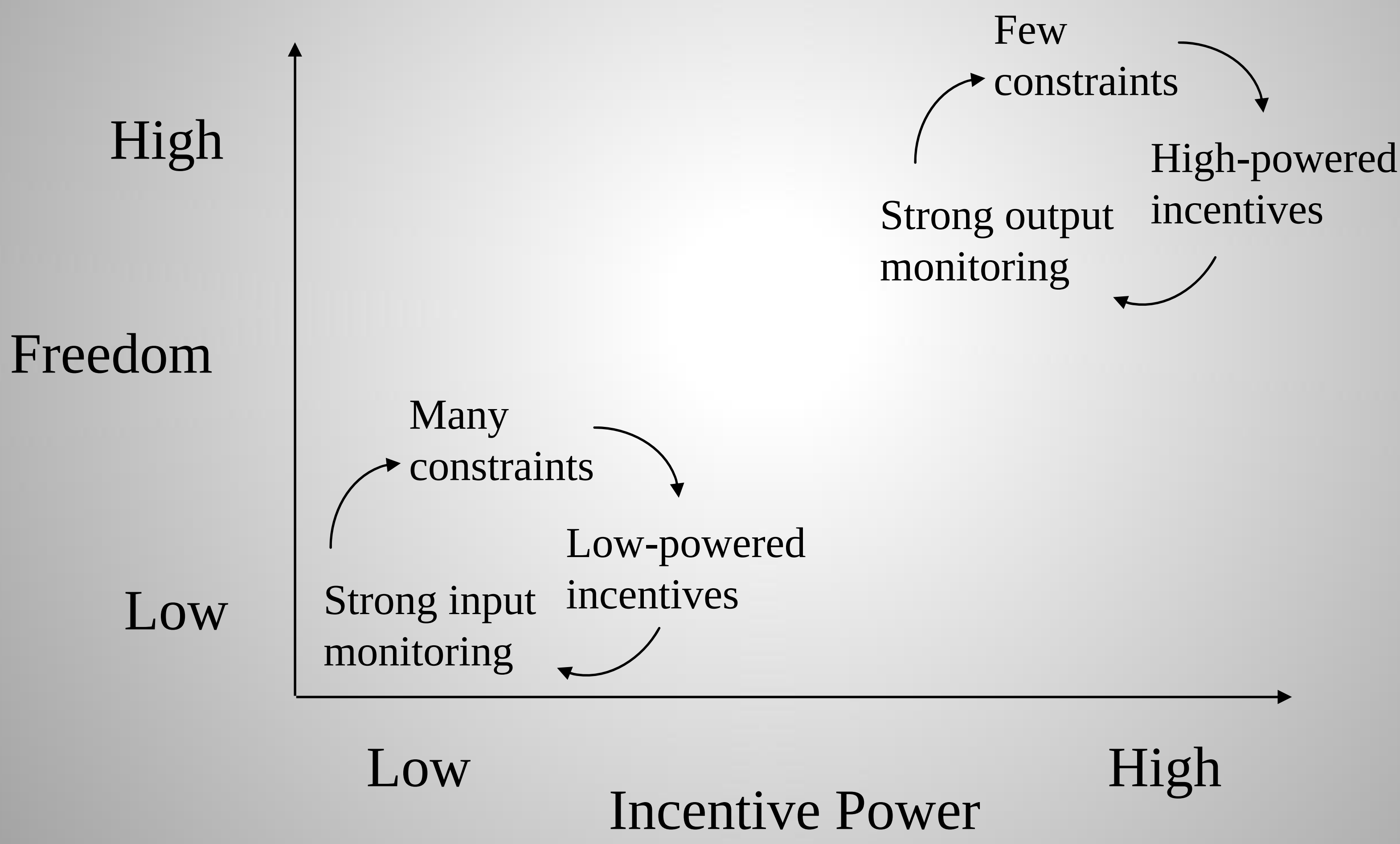
- Two ways to provide incentives for task
  - Pay more for that task
  - Pay less for competing (substitute) tasks
- Low powered incentives
  - Low or no incentive may be best incentive when an important task hard to measure
  - Highly controllable task may not be incentivized

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

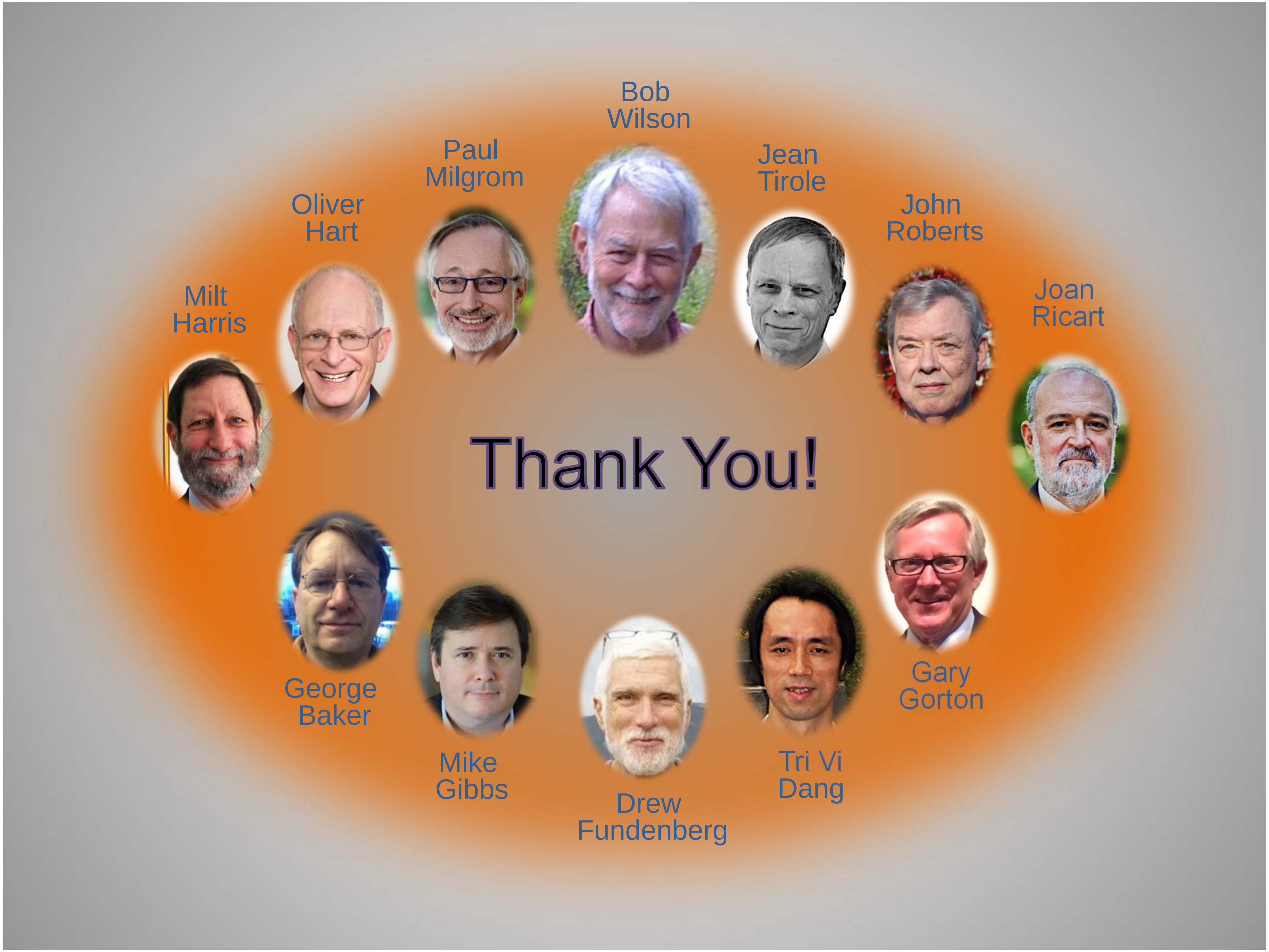


Two roles of firm boundaries

- 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?


Bob Wilson
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Thank You!
George Baker
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Mike Gibbs
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