Incentive Pay

- This chapter analyzes the employment contracts that arise to tackle the problems of incomplete information and worker shirking

- **Incentive pay** – a compensation package designed to elicit particular levels of effort from the worker, as yet another tool it can use to increase its profits

Piece Rates and Time Rates

- **Piece rate**
  - Compensates the worker according to some measure of the worker's output
- **Time rate**
  - the compensation of time-rate workers depends only on the number of hours the worker allocates to the job and has nothing to do with the number of units the worker produces, at least in the short run

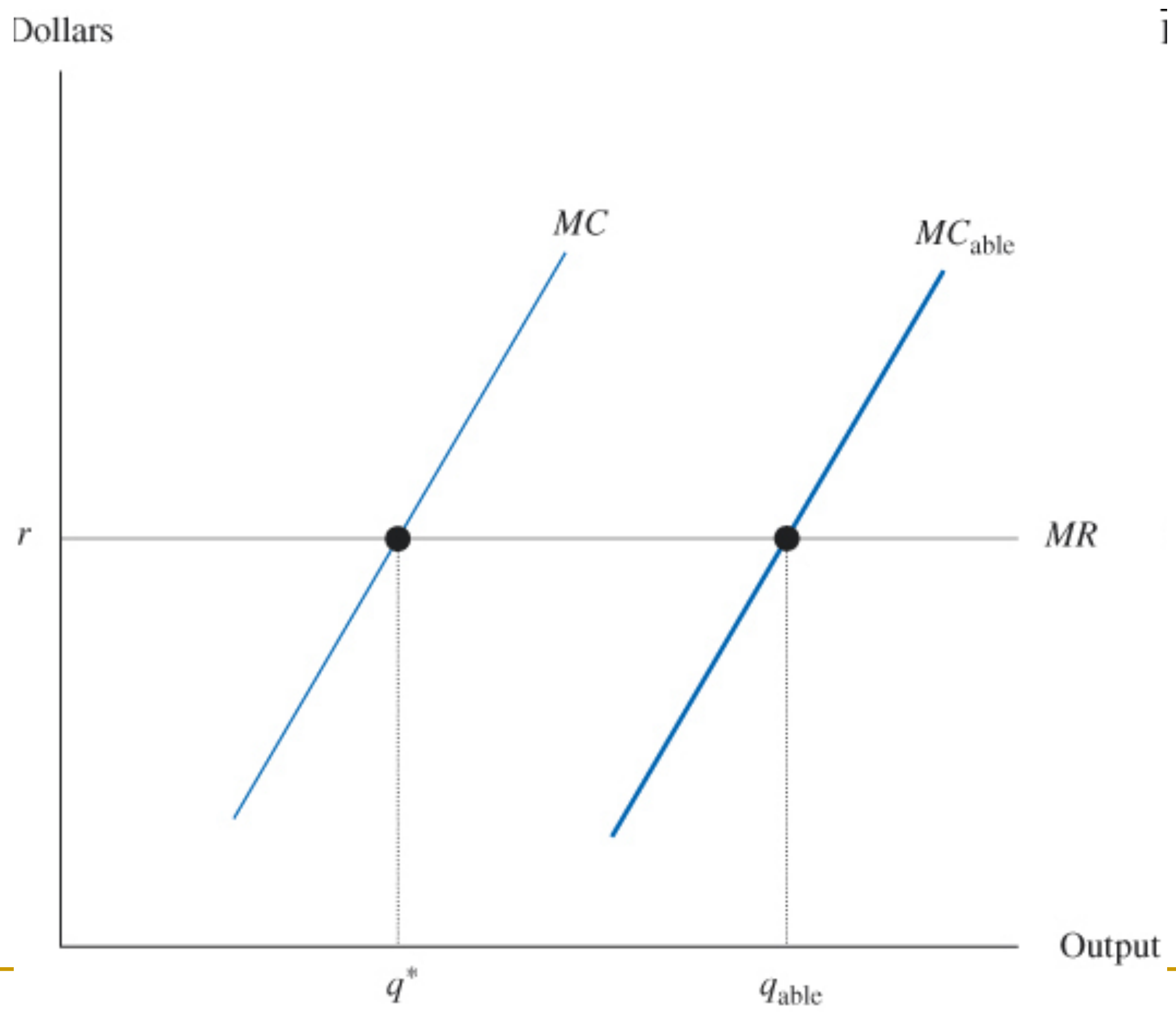
Should a firm offer piece rates or time rates?

- Competitive firms choose whichever system is most profitable

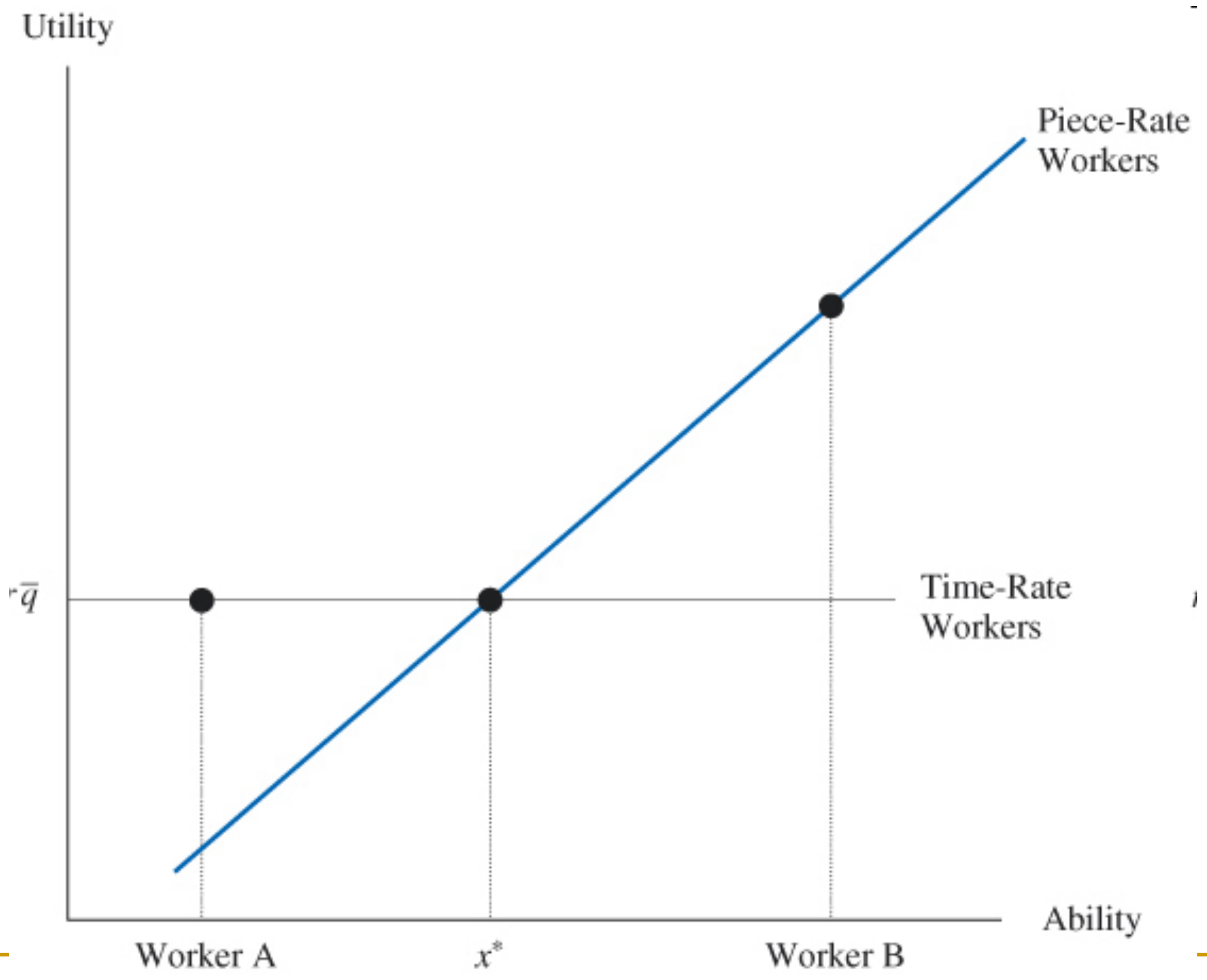
- Firms with high monitoring costs, opts for time rates

- Firms with low monitoring costs choose piece rates

How much effort do workers allocate to their jobs?
The Allocation of Work Effort by Piece-Rate Workers



Sorting of workers in Piece Rate and Time Rate Jobs

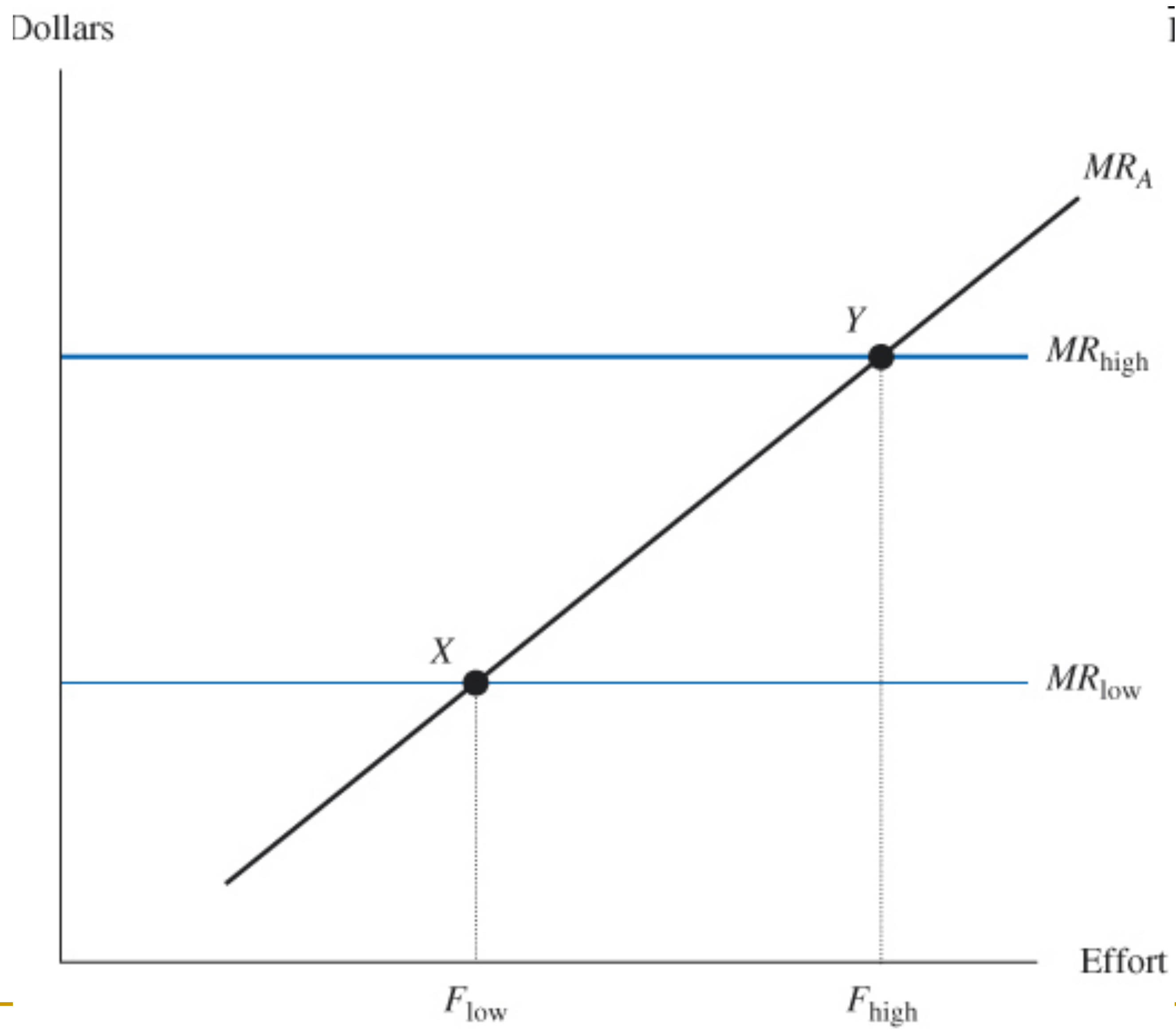


- **Profit sharing**
  - Bonus
  - Redistributes part of a firm’s profits back to the workers
  - Suffer from the incentive problems that afflict all team efforts
- **Free-riding problem**
  - A single worker does not have much incentive to allocate effort to her job and will instead depend on the “kindness of others”

Tournaments

- Some firms **award promotions on the basis of the relative ranking of the workers.**
- A tournament might be used when it is cheaper **to observe the relative ranking of a worker** than the absolute level of the worker's productivity.
- Workers allocate more effort to the firm when the prize spread between winners and losers in the tournament is very large. A large prize spread, however, also creates incentives for workers to sabotage the efforts of other players or to quit along the way.

The Allocation of Effort in a Tournament



- Tournaments exist because they elicit the right amount of effort when it is difficult to measure a worker’s actual productivity, but is easier to contrast the productivity of one worker with that of another

- Recommended reading on compensation of CEOs

Worker Incentives and Delayed Compensation

- Worker shirking – firms want to offer compensation packages that discourage workers from misbehaving

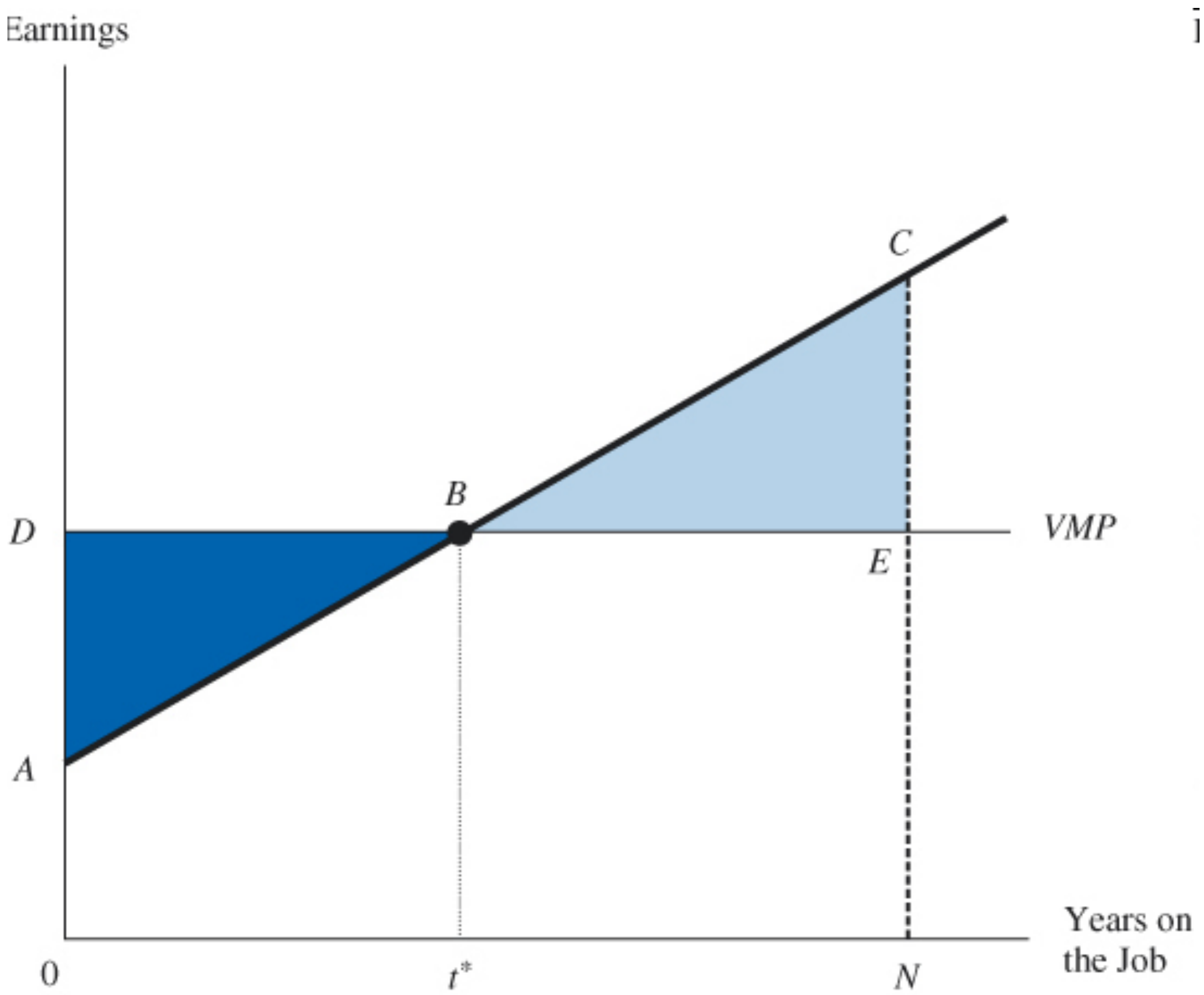
- The worker's effort and output are hard to observe, and it is very expensive for the firm to monitor the worker constantly

Worker Incentives and Delayed Compensation

- The firm can set up a contract where the worker will voluntarily produce the right level of output (VMP) even if the firm cannot constantly monitor the worker

- Suppose the firm offered the worker a contract under which the wage during the initial years on the job was low her value of marginal product but the wage in the later years was above her value of marginal product

The worker is indifferent between a constant wage and upward-sloping age-earnings profile



An upward sloping age-earnings profile, therefore, elicits more effort from the worker and discourage shirking

- The worker would be indifferent between the delayed-compensation contract given by the age-earnings profile AC and a contract that paid VMP in each time period if the two earnings stream had the same present value

- The relative low wage that the worker would receive initially is compensated by the high wage that the worker would eventually earn