CHAPTER 11 - PAY AND PRODUCTIVITY

This chapter explores in detail the relationship between compensation and productivity. It begins with a discussion of the employment contract, which is largely implicit and legally unenforceable. How this contract can be made self-enforcing within the context of asymmetric information is the principal focus of this section.

After discussion of some general issues relevant to worker motivation, we turn (in sequence) to an analysis of how motivation is affected by the basis of pay, the *level* of pay, and the *sequencing of* pay. Thus, we discuss in turn issues related to piece rates, commissions, profit sharing, and hourly pay (including merit pay); efficiency wages; and deferred payment schemes, promotion tournaments and the issue of "career concerns. " The chapter ends with a short section on two puzzles: why earnings increase with tenure and why they increase with firm size.

List of Major Concepts

1. Productivity varies across workers and over time for a given worker, and it involves taking the initiative in a myriad of hard-to-observe ways that advance the employer's interests.

2. Contracts can be both formal and implicit, with the latter being incompletely specified and hence legally unenforceable.

3. For an implicit contract to be self-enforcing, the parties can rely on signals that they are contracting with the "right kind" of person; alternatively, they can structure the contract so that the other party derives more from honest continuation of the employment relationship than from reneging on their promises.

4. Dividing a "surplus" between marginal revenue product and the alternative wage is critical to a self-enforcing employment contract; this surplus can be created by labor investments of one sort or other.

5. Workers can be motivated to be highly productive by close supervision or by having their earnings tied to their performance; the latter method requires that the measures of their performance be correlated with their effort and the employer's objectives.

6. Because of group considerations, motivation techniques must take account of the perceptions of fairness and issues of group loyalty.

7. Compensation schemes are jointly chosen by employer and employee.

8. Schemes that tie pay to individual productivity must take account of worker risk aversion, but they are useful in eliciting signals about worker characteristics.

9. Output is not normally one-dimensional, and if pay is based on objectively-measured aspects of output ("quantity"), workers will put forth little effort to increase output along the other (subjective, or "quality") dimensions.

10. Group incentive schemes run the risk of creating "free rider" problems.

11. Time-based pay with merit increases can be based on either absolute or relative output; absolute measures do not correlate as closely with individual effort, but relative measures can induce counterproductive behaviors among employees.

12. Employees who feel generously treated by their employers may put forth greater effort; hence, by increasing their wages employers can increase the productivity of their workers (the efficiency wage).

13. Efficiency wages are most effective when the employer-employee tenure is expected to be long.

14. With long expected tenures, the sequencing of pay is also an option; this option promises handsome future rewards for current effort.

15. One scheme involves a period of underpayment followed by later overpayment, which has both signaling value in obtaining future-oriented, hard-working employees and offers incentives for current workers to put forth effort.

16. Promotion tournaments also have signaling and incentive value.

17. Employee "career concerns" (which can involve future payoffs with *other employers)* can both distort and enhance efforts with one's current employer.

18. Concepts in this chapter contribute to the cluster of hypotheses that seek to explain why wages rise with tenure and why large firms pay higher wages.

19. As firms increase in size it becomes increasingly costly to monitor worker effort, and one way to cope with this monitoring problem is to pay higher wages. The higher labor costs associated with greater firm size suggests that the labor supply curve to a firm may be upward sloping, and this may explain monopsonistic behavior among firms in the labor market.