

Agency Theory and Efficiency Wage Theory

Agency Theory

The framework applied is the principal agent problem:

- Deals with the problem of designing an efficient contract between the principal and the agent when there are incentives to cheat
- Problems rise with asymmetric information
- Eliciting a "truth-telling" contract to ensure incentive compatibility
- Examples of such contracts are: collective agreements or implicit contracts

Economics of Superstars

- Small differences in the skill input of certain individuals may get magnified incredibly in the value of marginal product of the service consumed by the public or co-workers in certain circumstances (ex. concert, TV show)
- A small positive effect on each person can accumulate into a large total effect when the number of affected persons in the organization is large (ex. executives, talented individuals)

Agency Theory and Efficiency Wage Theory

Efficiency Wage Theory

- Wages affect productivity
- Wages are being paid according to value of marginal product of labour
- Emphasizes that subsistence wage is necessary for basic levels of nutrition, reproduction, and higher productivity
- The result of higher wages is efficiency gains, especially if queues for jobs form

Salaries as Tournament Prizes

Promotion on the basis of being the best (of several executives with seemingly equal ability), results in a huge increase in the salary

- Treated as prize of winning a contest
- Based on capability
- Increases the incentive to perform
- Important to senior persons who have few promotional opportunities left
- But,
- Discourages cooperative behaviour
- Fosters corruption and sabotage

Efficient Pay Equality, Teams, and Employee Cooperation

Inequality of pay is necessary to provide an incentive to perform well

Too much inequality is not efficient since it:

- Discourages cooperative behaviour and teamwork
- Encourages sabotage

Solution:

- Different pay incentive schemes for different levels within an organization
- Higher-level managers' bonuses on the basis of group output
- Separate business units
- External promotion
- Human resources policies to encourage cooperative behaviour

Efficient Pay Equality, Teams, and Employee Cooperation

Piece Rates

Workers are paid on the basis of the output they produce

Benefits:

- Workers producing more output
- Systems attracting good workers
- Save on the cost of monitoring

Drawbacks:

- Harder to monitor output of an individual
- Costly
- Harder to sustain the system if the individual does not have a large degree of control over the output
- Quality?

Efficient Pay Equality, Teams, and Employee Cooperation

Up-or-Out Rules

- Under such rules employees are evaluated usually at a specified point in their career and either promoted or terminated (e.g. tenure at universities)
- No messy dismissal involved & avoids disgruntled employees
- Appears to be inefficient practice that causes loss of workers with lower productivity

Solution

- Using junior non-promoted slots to evaluate new candidate

Efficient Pay Equality, Teams, and Employee Cooperation

Executive Compensation

- Executive pay has increased relative to the average pay of workers
- Executive compensation consists of a base salary and stock options
- Often not linked to performance
- Shareholders (principles) often don't understand the complex compensation packages of executives (agents)
- Compensation process involves the board of directors who has an incentive to award high executive salaries because they too are executives

Deferred Wages

Wages above an individual's productivity:

- Senior employees
- Wages rise with seniority independently of productivity
- Wage increase and pension accrual for each additional year of work

Characteristics:

- Exist only if there is a long-term commitment on the part of the firm to continue the contracted arrangements

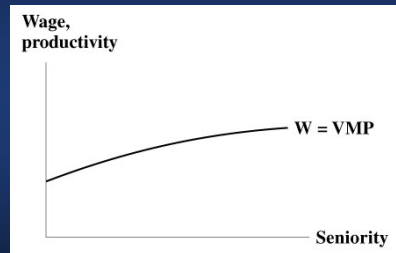
Efficiency rationale:

- Increases work honesty and effort
- Reduces the need for constant everyday monitoring
- Reduces unwanted turnover
- Reduces fixed hiring and training costs
- Discourages bad workers

Wage Productivity Profiles

Spot Market:

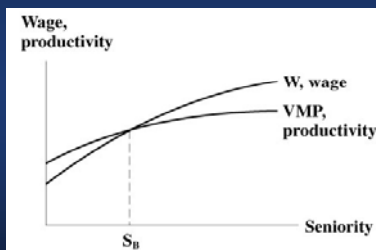
Wages are equal to productivity at each and every level of seniority



Wage Productivity Profiles

Deferred Wages Contract Market:

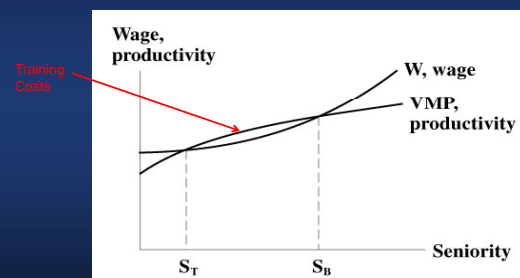
Wages rise more rapidly than productivity reaching a breakeven point and then being above productivity at higher levels



Wage Productivity Profiles

Deferred Wages with Company-Specific Training:

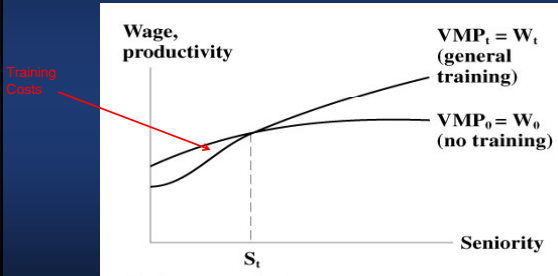
Wages are above individual's productivity during the initial training period (up to S_T), thereafter a deferred wage profile is received



Wage Productivity Profiles

General Training:

Wages are considerably below productivity in the initial general training period up to S_t



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Mandatory Retirement

Rationales:

- To enable deferred wages
- As a result the expected present value of the wage stream is equal to the expected present value of the productivity stream to the firm
- Gives finality to the existing contractual arrangement
- Efficient compensation rule
- Opens up promotion and employment opportunities for younger workers
- Creates a greater degree of certainty about the date of retirement
- For employers: facilitate planning for new staffing requirements, pension obligations, and medical expenditures
- For workers: encourages pre-retirement planning
- Reduces the cost of monitoring of older workers

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Deferred Wages

Do workers also prefer deferred wages?

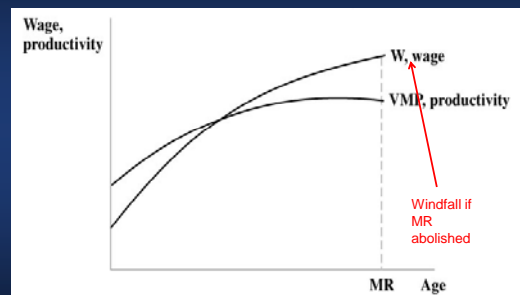
- Researchers observed that workers actually preferred the rising wage profiles
- They regard them as forced saving
- They get satisfaction for anticipating future consumption
- Individuals seemed to give up current wages in return for future wages

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Mandatory Retirement



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Mandatory Retirement

Arguments Against Mandatory Retirement:

- Human rights issues (a form of age discrimination)
- If one is able, wants to continue, and capable of working productively, they will still not be able to do so (efficiency-loss)
- Improving the viability of public and private pensions

Summary

- Agency and Efficient Wage Theories
- Economics of Superstars
- Salaries as Tournament Prizes
- Inequality in Pay
- Up-or-Out Rule: Drawbacks and Resolution
- Piece Rates: Positives and Negatives
- Executive Compensation
- Deferred Wages: Characteristics and Rationale
- Mandatory Retirement: Rationales, Impact, and Causes

Mandatory Retirement

Impact of Banning Mandatory Retirement

Some theoretical predictions:

- Changing the age earning profile to coincide with productivity (higher wages for younger workers and lower wages for older workers)
- Possible changes of deferred wages systems
- "Golden handshakes"
- Possible increase in the monitoring and evaluation of workers since poor employees more costly and avoidance of age-related wrongful dismissal suits
- Reduction in the employment opportunities for younger workers
- Reduction in training
- More difficult forecasting and planning
- Possible redesigning of jobs to accommodate older workers

End of Chapter Thirteen