

## **Lecture 10. Payment Scheme and Reward to Human Capital**

### **1. Problems associated with the orthodox theory**

Some puzzles:

Why are CEOs of big corporations paid so much higher than other employees?

Why do some firms link pay to job tenure?

Why do large firms pay more?

- The marginal productivity of a worker is often costly to observe and/or it may take time to observe. This creates a problem of monitoring worker effort for firms (agency problem). The case arises when the following situations prevail:
  - a. the job entails team production
  - b. there are long delays in observing output
  - c. the job entails numerous and varied tasks so that creating an output index is difficult
- Employment contracts are often incomplete (worker tasks cannot be fully specified in advance) and/or implicit (they are normally a set of informal understandings that are too vague to be legally enforceable).

### **2. New theories on human capital and pay**

Employers respond to this agency problem and incomplete contract problem by creating various compensation policies to motivate employees. In particular, pay is often used as a tool to motivate workers rather than simply to reward productivity/human capital.

(1) Performance-related pay:

- individual performance-related pay
- group performance-related pay
- merit pay
- profit sharing schemes

## share option schemes

Performance-related pay is used when output level is easy to quantify. However, they may induce some short-term behaviour that undermines the long-term development of a firm.

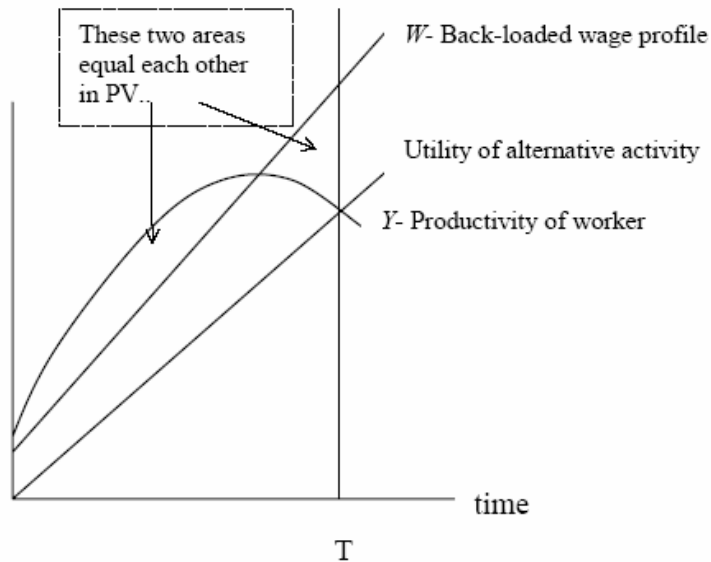
### (2) Tournament

Promotion to the best performer is used to induce effort and prevent shirking.

### (3) efficiency wage

Wages are paid above the market level to induce more effort. Efficiency wage can be viewed as both “carrots” and “sticks” to induce effort and punish shirking. It may have implications on persistent unemployment rate and industry and firm wage differentials.

### (4) deferred compensation



Under a “back-loaded” wage profile you underpay the worker at the beginning of her career and over pay her in the later part. The present value (areas under the curves  $W$  and  $Y$ ) are the same either if you pay the worker her productivity each period or if you pay her a back-loaded wage profile up to time  $T$ . If the worker gets paid her productivity each period she will want to retire at time  $T$ . The problem is that under  $W$  the worker will not want to retire at time  $T$  (she is making more money then she values the alternative use of time), hence you need Mandatory Retirement.

## 3. Implications for human capital investment

People with the same productivity/human capital may be paid differently by different employers for doing the similar jobs. The labour market is segregated by “good” jobs and “bad” jobs with “good” jobs reward productivity more highly than “bad” jobs.

- people are willing to invest in those human capital that enables them to get “good” jobs.
- “good” jobs are also those with more on-the-job training opportunities. People will invest those human capitals to make them more trainable rather than train themselves for jobs.

Readings:

Ch. 11 of Ehrenberg and Smith

Belfield, C. and Wei, Xiangdong. “[Employer Size-Wage Effects: Evidence from Matched Employer-Employee Survey Data in the UK](#)”, 36(3):185-193, February 2004, *Applied Economics*.