

We invite you to our departmental seminar which will take place on :

Date: 16/06/2015

Time: 14:00-15:15

Place: Recanati building room 408

Speaker: Ron Kaniel (University of Rochester)

Title: Relative Pay for Non-Relative Performance: Keeping up with the Joneses with Optimal Contracts

Abstract:

We consider a multi-agent contracting setting when agents derive utility based in part on their pay relative to their peers. Because agents' productivity is affected by common as well as idiosyncratic shocks, it is optimal to base pay on the agent's performance relative to a benchmark of his peers. But when agents have "keeping up with the Joneses" (KUJ) preferences and care about how their pay compares to that of others, relative performance evaluation also increases the agent's perceived risk. We show that when a single principal (or social planner) can commit to a public contract, the optimal contract hedges the risk of the agent's relative wage without sacrificing efficiency. While output is unchanged, however, hedging makes the contracts *appear* inefficient in the sense that performance is inadequately benchmarked. We also show that when there are multiple principals, or the principal is unable to commit, efficiency is undermined. In particular, KUJ effects induce agents to be more productive, but average wages increase even more, reducing firm profits. Finally, we show that when principals manage teams, distortions are reduced if compensation contracts are disclosed within teams when KUJ effects are weak, but kept secret when KUJ effects are sufficiently strong. We also demonstrate that a number of typical comparative statics in the contracting environment are overturned when agents have relative wealth concerns.