Comments on
Paying for Performance

A. Bryson, R. Freeman, C. Lucifora, M. Pellizzari and V. Perotin

Pietro Garibaldi

Collegio Carlo Alberto, Università di Torino; and fRDB

Outline

- How broad should the concept be?
- The Basic Story
- The Real Puzzle
- Why so little Pay for Performance?
- Inside Italy
- Pay for Performance and Industrial Relation
- Policy

The Report

- Good Report. It is a must reading as an introduction to Pay For Performance (PFP)
- Very broad in the definition of PFP (section 2)
  - Maybe too broad?
- Good effort to measure the size of PFP across countries (section 3)
- Excellent and extended survery on existing theory and evidence (section 4 and 5)
- Original empirical research (section 6)
- Policy question: should government subsidize PFP? (section 7)

Too broad?

- Within the report PFP include i)wages linked to productivity, ii) incentive group, iiii) profit sharing, iv) financial participation.
- Linking individual wages to productivity is about incentives, price mechanism, labour market analysis
  - Group incentive is a natural extension in a service society
- Financial participation of workers is more about finance than labour (diversified income risk , ownership structure of capital, financial deepening, capital market regulation)
- Critical survey and original empirical research. Empirical survey addresses the risk of "insider econometrics" using privileged personnel data for drawing external validity
  - Does not the report suffers from fire-friend?

The Basic Story

- Two key features of basic market based economic paradigm:
  - price reflects demand and supply and
  - wages should follow marginal productivity (the value of marginal product)
- Linking wages to productivity and performance is the soul of economics: optimal allocation of labour to firms, incentives, theory of value
- Basic contemporary model is the principal agent model with the optimal insurance incentive trade off: with risk averse workrs the optimal contract is a wage not fully linked to productivity (never fully because of risk aversion, but likely substantial)
- Economic Theory would suggest that PFP be widespread
- The report argues that linking wages to productivity is a good thing!
  - Who, among the profession, should ever "dare" disagree with the broad basic idea?

The Real Puzzle

- Approximately 20 percent of workers receive some form of PFP (Is the U.S. data really comparable?)
  - Most of the workers are paid a fixed wage
  - The few paid in a flexible way receive a huge proportion of their wage in a fixed way, independent of performance (Italian public sector!)
- There is apparently no legislative obstacle in any country to pay for performance.
- If anything, PFP is subsidized (section 2)
- The real puzzle is thus why do we observe so little pay for performance in the real world.
  - Why don't firm *just do it?*

Why so little? Level effect

- Output is not easily measured
- Risk aversion is extremely high in real life
- It is less costly to measure input than output.
- When there are may employees,
  - only joint output may be observed
  - relative performance evaluation may be more effective (Why is the report silent on relative performance?).
- A wage independent of output may motivate workers: efficiency wages.
- The firm has other (non-wage-based) tools to motivate workers, particularly career path.
- Unions love equal pay (within and across firms wage flexibility)
- Psychologists say that monetary incentives may reduce workers motivation.

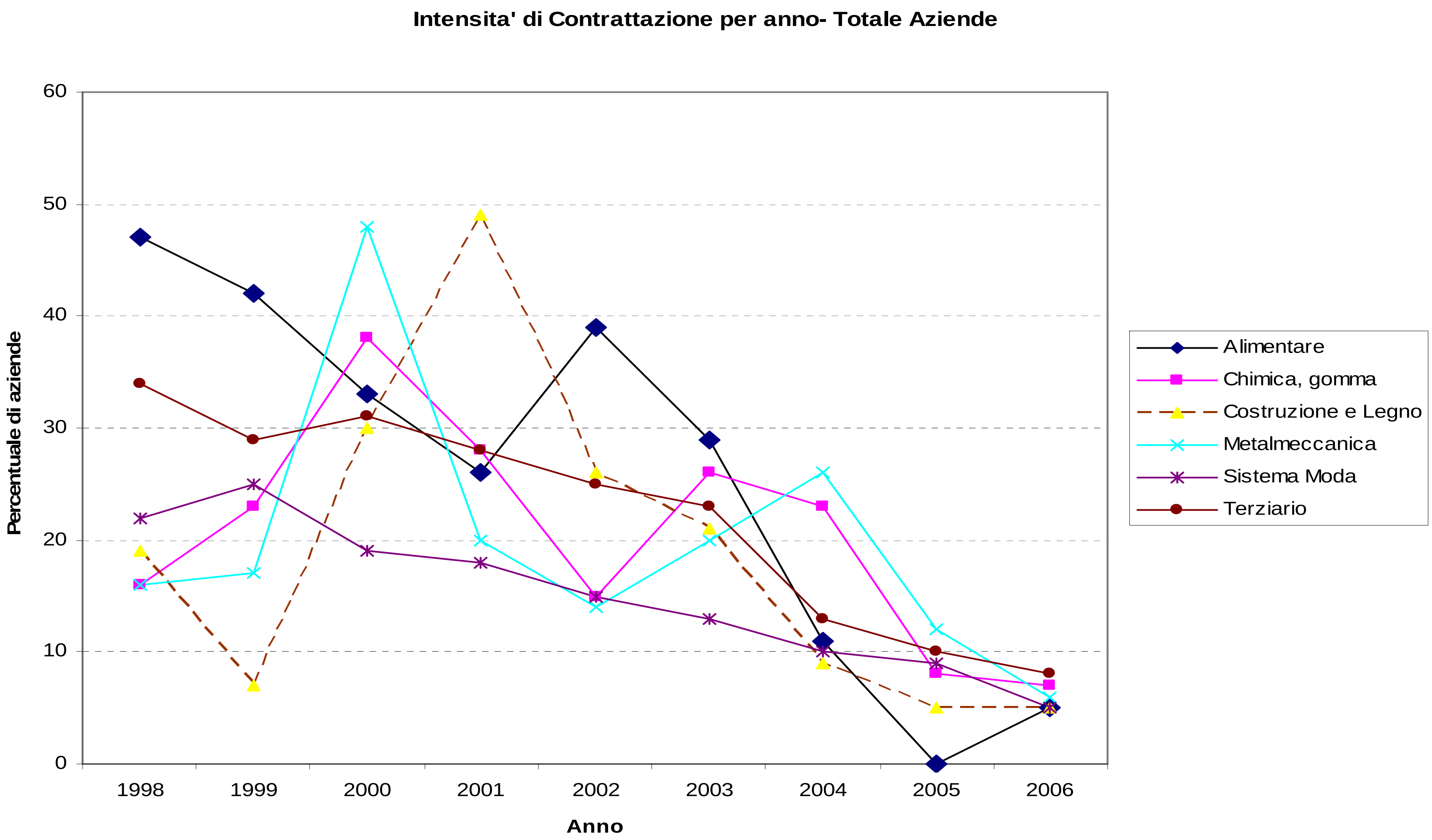
Why so little? Trend

- There is an apparent cross country trend toward more PFP (is it really true?)
- The report identifies a key channel
  - ICT
- How about deunionization? Is not a key driving force? Maybe not.
- Why do not look at what firms do rather than what they declare to be doing.
  - PFP implies wage dispersion both “within” and “between” firms. Maybe the report should look at the dynamics of wage dispersion in firms that declare PFP (e.g. Section on Italian metal industry firms)

Inside Italy

- Original empirical research on the link between PFP and productivity in the metal industry sector
- Since 1993, industrial relation system in Italy features an apparent two tier system (broad national wage agreements with *optional* second tier linking wages to productivity/profits)
- 40 percent of firms in metal industry (Figure 6.2.1 in the report) less than 10 percent across the board
- Two issues
  - Only unionized firms (mainly large firms in Italy) are in a de-facto position to conclude a second tier agreement
  - The second tier "involves only possible wage gain".

Marked Reduction in second tier[12] agreements at the national level



Inside Italy

- Empirical result is striking: adopting the second tier agreement **causes** a 6 percent increase in productivity
- Identification strategy: the 1993 agreement is exogenous, and we can compare firms that adopt PFP after 1995 (treatment) with respect to those that never adopted (control)
- Main problem: since second tier implies a de facto wage gain, shouldn't we see the second tier PFP, ONLY when firms expect a productivity increase
  - Is not this a perfect case of "reverse causality"? Expected productivity gains induce decentralized wage increase, rather than vice-versa
- The puzzle is still why firms that expect productivity gains decide to share in with the workers.
  - Sabotage may be a real issue here (look at 6.2.3)

Industrial Relation in Italy and PFP

- The two tier system in Italy has been "potentially" reformed in January 2009
  - Overall structure of the Two tier system confirmed
  - Centralized wage contract still broad but based on a European core inflation index
  - Centralized wage contract specifies an ex-post wage increase for those workers not covered in the second tier performance.
  - Second tier wage increase with reduced taxation (still true?)
- Should a centralized wage contract "impose" a rule on decentralized link between wage and productivity for those (small) firms without unions or without second tier?
  - Should this be mandatory or voluntary (like an option to be voted in)?

More on Unions?

- Facts we learn:
  - Across countries, unions and pay for performance are apparently not correlated
  - Over time, deunionization may be correlated to the increase in PFP
  - PFP much larger in large firms, where unions ARE present.
  - Unions obsessed with equal pay policy within the firm.
  - Unions presence, by allowing firm level agreement, may facilitate wage differential across firms
- Could it be that unions be an obstacle to PFP *within* firms but may facilitate PFP *across* firms ?

Policy

- Should government subsidize PFP?
- The report is ambiguous but cautious. Difficulties, trade offs: experimentation is advisable.
- The report should "dare more".
- In light of the limited diffusion (if it is so good why don't firms "*just do it*") it is very difficult to advise pro policy intervention.
- Selection of firms is far too important.
- All the g't could and should if it believes in PFP really induce (unlike Italy) it in the public sector, if it believes it is such a good thing!