



Business Economics II

Session VII: Performance evaluation and compensation



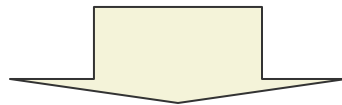
Plan

- Performance evaluation:
 - Objective and subjective
- How to establish evaluation standards?
- Group (team) performance evaluation
- Elements of the compensation system
- Internal labor markets
 - Compensation
- Compensation packages



Objective evaluation

Based on the measurement of performance through using a set of quantitative indicators that are easily verifiable



Need to use performance indicators that must be defined



Advantages and disadvantages

- Advantages
 - Less uncertainty: everybody knows what is expected of them
 - The system is highly objective
- Disadvantages
 - Inflexibility
 - Difficult to find adequate performance measurement
 - Unbalanced effort is possible (when several tasks are pursued)
 - Time consuming and costs attached to measuring



Dysfunctions of the objective evaluation

- ❖ Moscow taxis: evaluation in terms of km traveled = taxis end up on roundabouts
- ❖ Moscow lamp factory: evaluation in terms of tonnage of output = the lamps end up falling off the ceilings
- ❖ During the Vietnam war, McNamara set enemy casualties as an efficiency indicator = this led to massive killings



Subjective evaluation

- Advantages:
 - Flexibility
 - A broader performance evaluation
- Opposed by
 - Employees: because it is not “fair”
 - Management: because the management would have to get “soft”



Subjective evaluation: problems and solutions

- Difficulty in measuring performance in a “just manner”
 - Solution: use of standard questionnaires
- Influence costs: “politicking”
 - Solution: rotation of evaluators
- Shirking among supervisors
 - Solution: Hold supervisors accountable for future performance
 - Forced distributions



Performance standards

- Need to define “high” and “low” output
 - Not always a 1:1 correspondence between effort exerted and output

- Consider the following case

$$y = 5e + \varepsilon$$

- Where: e = effort; ε = error (zero expected value)
- Usual problem: e is not observable, we only observe y
 - How do we know whether a low y is due to the unfavorable circumstances or due lack of effort?



Absolute evaluation

- Fixing a target for performance in absolute terms
- **Example:** in some departments, contracted researchers have to publish a number of articles in scientific journals in six years if they don't want to lose their job
- Key: how is this target set?
 - Quality?



Solution: learn from experience

- Past performance as a predictor for present performance
- Big incentive problem: the *ratchet effect*
 - Any increase in production confers only a temporary increase in incentive while requiring a permanent greater expenditure of work,
- Solution:
 - Policy is not changed unless a new process is introduced
 - Job rotation (Can destroy job-specific human capital)



Relative performance evaluation

- Compare the performance of the worker to the performance of the other worker or group of workers
 - Many universities





Within-company comparison

- Comparison within the company, problems:
 - The possibility of collective fraud
 - Destructive competition
 - Incentives to join the worst teams



Between-company comparison

- Comparison with other companies
 - Rankings <http://rankings.ft.com/pdf/global-mba-rankings.pdf>
 - Traders <http://www.prnewswire.co.uk/cgi/news/release?id=158036>
- Generates new problems:
 - Different conditions (comparing “apples with oranges”)
 - The difficulty of obtaining the information





Why evaluate groups?

- We may be interested in promoting cooperation among group members
- We may be interested in mutual control
- It may be difficult to measure individual output
- To perform and function well, the group cannot be very big



Internal labor markets

- Neoclassical model: no long term contracts
- Empirical evidence: many employees work for the same company for decades
- Many companies use “internal labor markets”
 - External access leads to only basic jobs
- The promotion system plays a crucial role



Why are there long-term contracts?

- The need to invest in specific human capital
- A tool to motivate employees
- Allows to observe the type of the worker: uncertainty is eliminated



Problems

- Endogamy
 - strong anti-competitiveness device
- Not always the best person is contracted
- The companies have to contract an external person when the necessity of specific training is little



Compensation in the internal labor markets

- Salary: the entire discounted flow of salaries to be collected during the employment

$$w = \sum_{t=0}^T \frac{w_t}{(1+r)^t}$$



Compensation in the internal labor markets

- Three ways of making the system flexible:
 - Efficiency salaries
 - Bonus for seniority
 - Relate salary increases to promotions
- Tournaments
 - Investment banking, GE
 - Drug dealers
 - <http://www.youtube.com/watch?v=5UGC2nLnaes>



Efficiency wages

- If difficult to monitor workers' actions
 - Pay them above the market level
- Why?
 - The cost of losing the job increases
- If the time horizon is increased, workers will tend to tell the truth
 - Higher opportunity cost



Deferred compensation

- Idea: as seniority increases, increase the salary at a pace which is superior to the pace of productivity growth
- It implies that initially the worker has to be paid below his/her productivity
- The system is good to retain workers:
 - if they leave early, they leave “losing”.
- At a particular time, the company has high incentives to fire the most senior workers – “pre-jubilaciones”

BBVA





Promotions

- Promotions allow one to raise to the higher levels of the organizational chart
- The workers compete (*tournament, horse race*)
- Aimed at choosing the person whose development is most advanced in relative terms
- Peter's principle: people is promoted up to the level of their **incompetence**



Cash and in-kind payments

- A typical American employee earns only 75% of his salary in cash
 - The rest
 - Contributions to the pension fund
 - Medical insurance
 - Free education
 - Meals at reduced prices
 - Subsidized entertainment programs, etc.
- Reasons: tax, to differentiate employees, ...
 - Car at Procter & Gamble
 - Office space
 - Business class flights...
 - Reasons: tax, signaling...



Differences among employees

- Human capital
 - General knowledge
 - Professional experience
 - Special talents
- Who is investing in human capital?
 - If it is general: employee
 - If it is specific: the company



The case of Spain

- In theory, social security is financed by:
 - The worker (cuota obrera): 4,80%
 - The company (cuota patronal): 28,80%
- In addition, companies have to provide a month of vacation time and pay two months of salary