Essays on the Economic Theory of Managerial Incentives

Fabio Feriozzi

Paying for Observable Luck  In this essay I present a simple hidden action model in which the agent has explicit contractual incentives but also implicit incentives created by the possibility of bankruptcy. An observable exogenous shock affects the agent’s performance and determines the probability of liquidation. Furthermore, after signing the contract, but before choosing his action, the agent observes a private signal on the future shock. The observation of a bad signal strengthens the agent’s implicit incentive and reduces the conflict of interest with the principal. If the agent had no private information, the principal could completely filter out the observable luck. However, when the agent has private information, the contract optimally adjusts explicit to implicit incentives. As a result, observable luck is not completely removed from the agent compensation schedule. The model explains recent empirical evidence of asymmetric benchmarking in managerial compensation: managers appear to be insulated from bad luck but not from good luck. The result obtains in a model that shares most of the assumptions typically made in the empirical literature. In particular, asymmetric benchmarking arises even though the managerial productivity and the exogenous shock are independent.

Career Concerns and Competitive Pressure  In the second essay I use a duopoly model to study the effects of increased competitive pressure on the implicit incentives provided by career concerns. By building a good reputation managers are able to capture on the labor market part of the profits that they produce in excess with respect to less talented managers. Therefore, increased competition has an ambiguous effect: it raises the reputational concerns to the extent that it makes to hire a good manager more valuable.

Career Concerns and the Market for Corporate Control  In the third essay I introduce the threat of hostile takeovers in a model in which managers have career concerns that emerge from the managerial labor market. A successful takeover may free those firms whose CEOs succeeded to get entrenched then allowing them to participate on the demand side of the managerial labor market. This effect sharpens incentives but is important only for firms with weak governance systems. A raider who manages to takeover a firm could however bring his own management team then subtracting the company from the labor market. This second mechanism reduces incentives and is predominant when good governance standards are diffused in the corporate world. The model predicts that if good governance standards are widespread, anti takeover provisions strengthen the competitive position of CEOs in the labor market and increase the value of their compensation packages. These findings are consistent with the upsurge of managerial compensation observed during the 1990s.