Chapter 11
PAY AND PRODUCTIVITY:
WAGE DETERMINATION WITHIN THE FIRM

Answer questions 2, 4, and 6 in the textbook.

1a. Describe the advantages and disadvantages of "piece rate" pay from the employer perspective.
b. Explain how a worker’s risk aversion would affect their preference for piece rate pay instead of time based pay.
c. Explain how a worker’s ability or skills would affect their preference for piece rate pay instead of time based pay.

2. Describe the Meijer pay scheme for cashiers discussed in class and point out some of its advantages and disadvantages.

3a. Explain why paying CEOs on the basis of relative performance might make sense. What could explain companies' unwillingness to set pay this way?
b. Describe why compensating a CEO with stock options can lead to risk taking. How could the compensation scheme be altered to reduce such risk taking behavior?

4. Why is the incentive effect of a profit sharing plan less effective at larger firms?

5a. What is an "efficiency wage premium"?
b. Explain how payment of efficiency wage premiums could be used to:
   i. reduce turnover
   ii. reduce shirking
   iii. reduce employee theft
   iv. reduce monitoring costs.
c. Explain why a company that pays efficiency wage premia may discriminate against older workers when hiring.
d. Using a isocost and isoquant diagram, demonstrate how a reduction in the cost of monitoring will impact the mix of efficiency wage premia and monitoring.
e. Given your answer to d, how would a reduction in the cost of monitoring worker output impact employer preferences for hiring younger workers?

6a. Explain why a firm would prefer to use deferred pay instead of an efficiency wage premium to reduce turnover.
b. What prevents firms from firing workers once they reach the point in their career where their wage exceeds their marginal revenue product?
c. In some states, "employment at will" laws are in force which allow firms to fire workers without any justification required. In other states, firms cannot dismiss workers without justification (“just cause” laws). Would workers in “employment at will” states be more or less willing to accept a deferred pay package? Why?
7. Explain why the disincentive for "cheating" at work drops with age when the firm has an efficiency wage package.

8. Suppose that a firm has a sales force of 10 employees and each receives a 10% commission on their own sales. The average sales person receives commissions of $5,000 per month. There are, however, systematic fluctuations in sales across the workers in which sales randomly rise and fall over time. At the same time, in any given month, some workers sell more than others, so there is also variation across workers at a given point in time.

The firm is considering switching to a new compensation scheme that includes some tournament aspects. It will cut its commission from 10% to 5% and use the proceeds of the reduced commission to create tournament prizes. If sales remain constant, the reduction of the commission to 5% would generate $25,000 of prize money. The firm will distribute this among the top 5 sales people with prizes of $10,000; $7,000; $5,000; $2,000; and $1,000.

a. Consider the effect of this switch in compensation structure on total compensation. First, assume that all workers have an equal chance of winning the tournament. Suppose sales fluctuate sharply from month to month across all workers (e.g. Sales = $10,000 in half the months and sales=$90,000 in the other half). Will the new structure lead to more or less variation in compensation across months? Given your answer, will risk-averse sales people prefer the new structure or the old?

b. Suppose that some sales people consistently have lower sales than other sales people. How does the tournament structure affect the willingness of the most and least able sales people to take risky strategies in their sales tactics?