Work and Grow Rich: The Dynamic Effects of Performance Pay Contracts

Christos Makridis*

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Abstract

This paper studies the rise of performance pay contracts and their aggregate effects on the labor market. First, using the Panel Study of Income Dynamics and National Longitudinal Survey of Youth, I document three patterns: (i) the share of performance pay workers grew from 15% in 1970 to 50% by 2000, (ii) performance pay workers experience higher earnings levels and growth rates and work longer hours, and (iii) invest more in their on-the-job human capital. These differences persist even when comparing similar jobs in the same establishment using the National Compensation Survey. Second, I build a dynamic Roy model with heterogeneity in performance pay, time-varying probabilities of receiving performance pay, and human capital accumulation. The model is calibrated using simulated method of moments on the NLSY79. Third, I use my model to gauge the role of incentives, the contribution of performance pay to rising earnings inequality, and evaluate a recently proposed counterfactual 73% marginal tax rate.

JEL: H2, J21, J22, J31.

*MIT Sloan School of Management, 245 First St, Room E94-1521 Cambridge, MA 02142-1347, www.christosmakridis.com, makridis@mit.edu. The paper reflects my views only, rather than any affiliated individuals / organizations or the United States. Thank you to David Autor, Patrick Bayer, Gabriel Carroll, Richard Freeman, George-Levi Gayle, Rocio Madera Holgado, Caroline Hoxby, Ellen McGrattan, Alvin Murphy, Paul Oyer, Elena Pastorino, Richard Rogerson, Kathryn Shaw, and V. Kerry Smith for suggestions and feedback, as well as audiences at Stanford University, Arizona State University, George Mason University (and the Institute of Humane Studies), Rutgers, the 2015 Society of Labor Economists, the 2017 AEA Meetings, the 2017 Western Economics Association. I am also especially grateful to Peter Arcidiacono, Edward Lazear, and my PhD advisers (Nicholas Bloom, Mark Duggan, and Luigi Pistaferri) for helping me refine the essence of the idea, as well as the Bureau Labor Statistics (especially Maury Gittleman) for their accommodations with the NCS micro-data. Finally, I thank Alexandros Theloudis for suggestions with the Panel Study of Income Dynamics, Veronica Bassagoda for careful help in the assembly of the National Longitudinal Survey of Youth.