4-2014

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Kevin F. Hallock
University of Richmond, president@richmond.edu

Recommended Citation
Hallock, Kevin F., PhD. 2014. "What have You done for Me Lately?" *Workspan* 57 (4) (04): 12.

4 | 2014
workspan
The Magazine of WorldatWork©

What Have You Done for Me Lately?

Does when we perform well have an impact on our pay?

Cornell University
ILR School
Institute for Compensation Studies

Kevin F. Hallock, Ph.D.
Donald C. Opatrny '74 Chair,
Department of Economics
Cornell University

Joseph R. Rich '80 Professor,
Departments of Economics and HR Studies
Cornell University

Director,
Institute for Compensation Studies,
Cornell University

Board Member,
WorldatWork Society of Certified Professionals

Long ago, I worked in a small organization that (progressively, for the time) sought the input of subordinates, including me, on the performance of our managers. Although I was really young and not thinking this way at the time, I am now convinced that my manager went out of his way to be kind and ingratiate himself with me and fellow subordinates, but only around the time of the annual performance review. Why?

I think the manager may have had an appreciation for the well-known compensation problem of evaluators placing undue weight on the most recent performance. If this manager was particularly kind to us just before we filled out our surveys, maybe we would evaluate him higher.

This has me thinking more about pay for performance incentives and the timing of that performance. Do some occupations or pay plans create incentives to strategically time your best performance? What problems does that create?

Major League Baseball and Performance in a Contract Year

One set of occupations for which there is a lot of anecdotal evidence and volumes of discussion regarding performance timing is professional athletics. In "The Dynamics of Performance Over the Duration of Major League Baseball Long-Term Contracts," (*Journal of Sports Economics*, 10(1), February 2009, 6-21), Anthony C. Krautmann and John L. Solow considered the case of professional baseball players who have contracts for a set number of years. In particular, they examined the performance of players over the entire span of their contracts and investigated (among other issues) the incentive to perform well to land a better next contract versus the disincentive effects of a fixed contract coming to an end. They were careful to control for statistical issues that may cloud the results (such as the chances that a given contract is likely the last one for the player). Among their findings were that players who are less likely to sign an additional contract have a substantial reduction in performance, relative to what is predicted based on their characteristics. In other words, having a contract with an impending end date and no contract renewal worsens the player's performance. Krautmann and Solow, however, also found evidence that players they predict to sign another contract only perform about as well as expected, neither improving nor worsening their predicted performance.

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Executive Pay and the Timing of Performance

Salespeople who have (say, quarterly) bonus opportunities may have the incentive to move sales from one period to the other. For example, if an employee has met his/her quarterly bonus target, he/she may hold back additional sales until the next quarter in hopes of working toward the next quarterly bonus. And that may not be optimal for the organization.

But, what about those at the top of the management pyramid? I wrote a paper with Paul Oyer (Stanford Business School) called "The Timeliness of Performance Information in Determining Executive Compensation," (*Journal of Corporate Finance*, 1999, 5(4), 303-321) for which we studied the relationship between firm performance and CEO pay. Our interest: "Do corporate boards consider smoothly performance throughout the year or do they concentrate more on CEO/firm performance just prior to their compensation decisions?" This is a question directly related to my manager so long ago and to professional athletes.

Based on a sample of a few thousand executives, we found something consistent with the "contract-year performance-shift" idea. That is, we found evidence of a stronger link between CEO pay and the firm's sales revenue in the fourth fiscal quarter than in the other three quarters. In other words, CEOs may have some financial incentive to shift sales closer to the timing of the board's compensation decision. However, questions remain, such as: Is there a good reason for a board to put extra weight on the CEO's most recent performance, or is performance pay creating some net negative outcome for shareholders?

Timing Going Forward

There certainly is plenty of evidence across a set of industries that the timing of performance can have real effects on the compensation of employees. To the extent that this gives employees (athletes, salespeople, executives and others) incentives to shift the timing of effort in ways that may not be in the best interests of the employer, shareholders and other constituents is certainly something worth thinking about if we want to better curb such unwelcome gaming. For me, because annual reviews at Cornell are done around now and I am the chair of a large department, I am now thinking about whether and how this timing of performance issue could be hitting home within my own organization. Are you wondering the same? ws

got a question?

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