Discussion of Fong and Li (2009): Relational Contracts, Limited Liability, and Employment Dynamics

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Disclaimer: Second round of comments!
Objective of the paper

- Characterize employment dynamics under relational contracting with moral hazard and limited liability

- Study comparative statics with respect to level of surplus and commitment

- Relate results to empirical findings
Main idea

- Assume parties are risk neutral and output is verifiable.
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  Pareto-optimal frontier with LL ($w_t \geq \underline{w}$):
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  Pareto-optimal frontier \textit{with LL} \((w_t \geq w)\):
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- Principal can always gain from lowering $u$ below $u_e$.
  \[ \Rightarrow \text{Optimal contract (for principal) always inefficient:} \]
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- Principal can always gain from lowering $u$ below $u_e$

  $\Rightarrow$ Optimal contract (for principal) always inefficient:

  - Probation phase: Pay $w$, increase (decrease) probability of tenure if high (low) output

  - Tenure phase: Pay $w$ if low output, $w + k$ if high output

  - Termination phase: Receive outside options
Main idea

- Principal faces tradeoff between maximizing total surplus and minimizing rent to agent

- Principal can always gain from lowering $u$ below $u_e$

  $\Rightarrow$ Optimal contract (for principal) always inefficient:

  - Probation phase: Pay $w$, increase (decrease) probability of tenure if high (low) output
    $\rightarrow$ give incentives through increased job security
  
  - Tenure phase: Pay $w$ if low output, $w + k$ if high output
    $\rightarrow$ give incentives through bonus payment

  - Termination phase: Receive outside options
Other results

- If non-verifiable output but “high surplus”, same results as with verifiable output.
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- If non-verifiable output and "low surplus", cannot achieve first-best, so always use termination to give incentives. Still, two phases: (1) no bonus - high termination; (2) bonus - low termination
Other results

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- If non-verifiable output and “low surplus”, cannot achieve first-best, so always use termination to give incentives. Still, two phases: (1) no bonus - high termination; (2) bonus - low termination

- Compared to “low surplus” case, commitment / “high surplus” gives: more job security, higher average pay, steeper earning profile, higher sensitivity of pay to performance
My comments

- What really drives the results – both theoretical and empirical
- Other issues overlooked by the paper
My comments: What really drives the theoretical results?

- Paper: Under relational contracts, higher surplus $\Rightarrow$ more job security, higher average pay, steeper earning profile, higher bonus/wage

- But need relational contracting for this prediction?
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\[ P's \text{ expected payoff in tenure phase: } \pi_y - c - (u_e + pk) \]
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- Paper: Under relational contracts, higher surplus $\Rightarrow$ more job security, higher average pay, steeper earning profile, higher bonus/wage.

- But need relational contracting for this prediction? If $y$ increases, less termination

$\Rightarrow$ if $e_H > e_L > 0$, more likely to give $k_H > k_L$ in tenure phase.
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- But what’s higher surplus?
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- But what’s higher surplus?
My comments: What really drives the empirical results?

- Probation period
  - Nice job with Ford’s example!

- Sensitivity of pay to performance increasing over time
  - Career concerns? Learning about principal types?

- Average pay and bonus-wage ratio increasing with surplus
  - Standard relational contracts with many effort levels?

- Probability of termination decreasing with surplus
  - Relational contracts under private monitoring?
My comments: What issues have been overlooked?

- Comparative statics on wage floor and policy implications
- Role of bargaining power structure
- Path dependency
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- Comparative statics on wage floor and policy implications
- Role of bargaining power structure
- Path dependency $\rightarrow$ especially since Bob is organizing this conference! :-}
Thank you!