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

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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.


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