Review of the Book *Incentives, Cooperation and Risk Sharing: Economic and Psychological Perspectives on Employment Contracts*

Ronald G. Ehrenberg
Cornell University, rge2@cornell.edu

Follow this and additional works at: http://digitalcommons.ilr.cornell.edu/articles

Part of the Labor Economics Commons, and the Labor Relations Commons

Thank you for downloading an article from DigitalCommons@ILR.
Support this valuable resource today!
Review of the Book *Incentives, Cooperation and Risk Sharing: Economic and Psychological Perspectives on Employment Contracts*

**Abstract**

[Excerpt] The current volume, which grew out of a two-day conference held at New York University in 1984, is an excellent introduction to compensation policy research and practice. A unique aspect of the volume is its interdisciplinary orientation; the contributors include academic economists and industrial psychologists, as well as practicing compensation and personnel and human resource specialists. A very readable introductory essay by the editor provides general discussion of analytical issues in compensation policy research and whets the reader’s appetite for the papers that follow.

**Keywords**

compensation policy, incentives, contracts, risk sharing

**Disciplines**

Labor Economics | Labor Relations

**Comments**

**Suggested Citation**


**Required Publisher Statement**

© Cornell University. Reprinted with permission. All rights reserved.
and an attempt to integrate these game-theoretic models into Leibenstein's framework would have improved the book significantly. What Leibenstein deems to be non-maximizing conventions such as peer group pressure or fixed-wage contracts may actually be optimizing behavior in the face of informational constraints.

Leibenstein implies that a source of U.S. inefficiency is the hierarchical organization of firms. Although there may be gains from specialization within a firm, he argues that there are significant costs associated with hierarchies as well. For example, there are problems in coordinating activities across units, potential conflicts between managers' self-interest and the company's interest, and factionalism.

A less rigid hierarchical structure within the Japanese firm, according to Leibenstein, is one of the reasons that Japanese firms apparently perform more successfully than firms in the United States. For example, there are fewer distinctions between workers and managers in Japan. Further, he argues that several other aspects of Japanese employment systems are particularly advantageous: the lifetime employment ideal; the small number of job boundaries; and flexible compensation. He also argues, however, that the Japanese management system is not wholly responsible for Japanese success; also playing an important part are cultural values, such as loyalty.

It would have been helpful if more attention had been paid to the difficult question of the degree to which the Japanese management system is exportable. In my opinion, results from game theory suggest that at least some of the benefits of the Japanese system may be transferable. Specifically, game theorists have shown that under some circumstances, cooperation in repeated prisoner's dilemma games (the situation that Leibenstein believes characterizes much of industry) is more likely the longer the participants' time horizons and the lower their discount rates (Friedman, above). Such is the case when there are short-term gains to both sides from noncooperative behavior, but longer-term losses. Long time horizons appear to be a major characteristic of Japanese workers and firms, and it is conceivable that time horizons in other countries could be affected by the policies of their governments.

As my discussion of game theory and allusion to efficiency wage and implicit contract theories suggest, many of the phenomena that Leibenstein labels as non-maximizing are consistent with maximizing models of behavior. Of course, the existence of such theories does not prove that conventions, inertia, and the like are the result of optimizing choices. But even if these theories receive empirical confirmation, Leibenstein is to be commended for pointing us toward a subject that has received insufficient attention from economists—the internal workings of firms. Further, his discussion of the problems of coordination and incentives suggests the important general implication that cost minimization may be a very difficult goal for any firm to achieve.

Lawrence M. Kahn
Professor of Economics and Labor and Industrial Relations
University of Illinois, Urbana-Champaign


A recent Industrial Relations Research Association volume paper that George Milkovich and I co-authored concluded that although various theories exist about the effects of compensation policies and why these policies might vary across firms, there is little empirical evidence either on the determinants of compensation policies or on whether these policies have desired incentive effects at the individual, corporate, or macroeconomic level. In the last few years, however, compensation policies and their effects have begun to attract the attention of many industrial relations researchers, and a forthcoming special issue of the Industrial and Labor Relations Review will be devoted to this topic.

The current volume, which grew out of a two-day conference held at New York University in 1984, is an excellent introduction to compensation policy research and practice. A unique aspect of the volume is its interdisciplinary orientation; the contributors include academic economists and industrial psychologists, as well as practicing compensation and personnel and human resource specialists. A very readable introductory essay by the editor provides general discussion of analytical issues in compensation policy research and whets the reader's appetite for the papers that follow.

The volume is divided neatly into four parts. In the first, nontechnical discussions of economic models of incentives and risk sharing
and of supervision are presented by Joseph Stiglitz and Guillermo Calvo, respectively. Both authors provide excellent summaries of their work and trace the implications of their respective models for firms' compensation policies. A paper by Edward Lawler III also appears in this section and deals with conceptual issues relating to pay systems from the perspective of an industrial psychologist.

The second part of the book summarizes what we know about the effects of incentive systems. Richard Guzzo and Raymond Katzell review research by psychologists, and John Kendrick reviews research on profit-sharing and gain-sharing. Although these two chapters introduce the reader to the literature, they unfortunately are quite uncritical and fail to point out substantial methodological weaknesses in many of the reviewed studies. Andrew Weiss reports some of his own research on the effects of individual wage incentives, group incentives, and seniority-based incentive systems in the section's third paper. The section concludes with a reprinted paper by practitioners Jude Rich and John Larson that discusses why some long-term executive incentive compensation systems fail to have intended effects.

The third part of the book examines issues in the design of incentive compensation systems. A paper by a practitioner (Sarah Armstrong) dealing with the actual experiences of one large firm is usefully paired with a nontechnical paper by an economic theorist (Bengt Holmstrom) that deals with the design of executive compensation systems from a theoretical perspective.

The volume's final section focuses on macroeconomic issues. Economists John Taylor, Martin Weitzman, and Clive Bull deal, respectively, with the structure of labor contracts in the United States, macroeconomic aspects of profit sharing, and evidence of the current flexibility of wages over the business cycle.

Incentives, Cooperation and Risk Sharing should be of interest to a wide spectrum of the ILR Review's readers. It is an excellent introduction to issues relating to incentive effects of compensation systems, and the editor and authors obviously have gone to great lengths to make it very accessible to nonspecialists. In spite of the shortcomings I have noted in a few of its essays, it is well worth reading.

Ronald G. Ehrenberg
Irving M. Ives Professor of Industrial and Labor Relations and Economics
Cornell University


Team work is a management "buzz" word of the 1980s, along with organizational culture and flexibility. This book is a blueprint for the use of teams as a basis of organization. Tjosvold relies on a review of social psychology research to understand how teams function and to argue that they are a superior basis for structuring the management process of an organization. The material reviewed focuses on expectancy theories of motivation and group process research.

The fundamental premise is that cooperation provides far better motivation for employees than does competition. Tjosvold argues that cooperation functions best in group situations, and that the result of team-based cooperation is greater productivity, more innovation, and integration of individuals into the organization by acceptance of group goals. Organizations must be restructured to abandon hierarchy, make power a positive force, and channel group conflict to reach sound solutions to managerial problems. In such a system, status differences should be reduced and employees at all levels brought together in production and human resource policy teams.

Tjosvold reviews important issues, such as the use of power in team work situations, and does so without the use of academic jargon or excessive text citations. The style reflects his intention of reaching managers as well as academics and management educators. The purpose of reaching both audiences, however, results in the usual ambivalent presentation. Is this research, or a "how to" book for managers? Tjosvold's strong advocacy of team work leads him to cite research selectively and to weight the book heavily with normative material. Each chapter, for example, contains sections giving summary advice to managers ("Guides to Action" and "Steps to . . . "). Diagrams illustrating the flow of teamwork processes are confusing.

It is difficult to think of a sound use for this book. Tjosvold's aim of summarizing academic research to provide a basis for practical application is commendable; translating academic work for application is a crucial task. The book's partially academic style, however, makes it unlikely reading for the popular management market. Furthermore, the material is presented in such a simplified form that researchers will not find it useful and would probably argue with several of the principle