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The role of verifiability and privacy in the strategic provision of performance feedback: Theory and experimental evidence ☆

Seda Ertac [a,*], Levent Koçkesen [a], Duygu Ozdemir [b]

[a] *Koç University, Turkey*
[b] *University of Essex, United Kingdom*

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ABSTRACT

We theoretically and experimentally analyze the role of verifiability and privacy in strategic performance feedback using a "one principal–two agent" context with real effort. We confirm the theoretical prediction that information transmission occurs only in verifiable feedback mechanisms and private–verifiable feedback is the most informative mechanism. Yet, subjects also exhibit some behavior that cannot be explained by our baseline model, such as telling the truth even when this will definitely hurt them, interpreting "no feedback" more optimistically than they should, and being influenced by feedback given to the other agent. We show that a model with individual-specific lying costs and naive agents can account for some, but not all, of these findings. We conclude that although agents do take into account the principal's strategic behavior to form beliefs in a Bayesian fashion, they are overly optimistic and interpret positive feedback to the other agent more pessimistically than they should.

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1. Introduction

This paper provides a theoretical and experimental study of the role of verifiability and privacy in the strategic communication of interim performance information. Performance feedback (also known as performance review or performance appraisal) is one of the most commonly used management practices. Almost every organization, be it a major corporation, a small company, a high school, or a hospital uses some form of performance feedback.[1] Although it is considered an indispensable part of any organization, performance feedback has also been the object of a heated debate. Employees usually

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* Corresponding author at: Department of Economics, Koç University, Rumelifeneri Yolu Sariyer, Istanbul 34450, Turkey.
E-mail address: sertac@ku.edu.tr (S. Ertac).

[1] One source estimates that "97.2% of U.S. companies have performance appraisals, as do 91% of companies worldwide" (see "Should Performance Reviews Be Fired?"). Also see evidence cited in Murphy and Cleveland (1991).

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dread it and many business experts and consultants are fierce opponents. One of the most critical voices, Samuel Culbert, states that "[i]t's a negative to corporate performance, an obstacle to straight-talk relationships, and a prime cause of low morale at work." (Culbert, 2008).

Ideally, performance feedback gives an unbiased report on past performance and provides guidance regarding how to improve future performance. This aspect, i.e., accuracy or unbiased communication, has been regarded as a crucial aspect of performance feedback. In practice, however, the accuracy of feedback may be tainted due to various biases that arise from the evaluator's self-interest. In particular, supervisors may be vague in their assessments or avoid giving negative feedback to their subordinates for strategic reasons.[2] Forced ranking systems may overcome this deficiency but they cause problems of their own, potentially undermining employee confidence and motivation.

Clearly, there are various pros and cons of performance feedback along a multitude of dimensions, but its effectiveness as a tool of communication seems to be one of the most contentious aspects. In this paper we focus on precisely this aspect. In a setting where feedback is given strategically by a supervisor, we theoretically and experimentally analyze how subordinates interpret the feedback they receive in forming an opinion of themselves and whether feedback communicates the actual performance information in a truthful manner.

In our experiment there is a supervisor (called principal) and two subordinates (called agents) who work for (potentially) two periods. In each period agents perform a real effort task and succeed if their performance is greater than a randomly determined threshold, which plays the role of chance or other unpredictable exogenous factors such as market conditions and organizational standards. The principal, and only the principal, observes the first-period performance (i.e., success or failure) of the agents and then decides whether and what type of feedback to provide to the agents. The agents observe the feedback (or lack thereof), update their beliefs about their likelihood of succeeding in the second period, and choose whether to perform the task again in the second period or not.[3]

The agents receive monetary payoff from their performances in the two periods, while the principal receives a payoff only from the agents' second-period performances. In addition, the principal's payoff depends on the minimum of the two agents' performances. That is, the principal obtains an extra payoff only if both agents end up performing in the second-period task. This captures "weakest-link" type performance settings, where it is important that every agent achieve a certain level of performance. With such a payoff function, the principal prefers both agents to have a high perceived likelihood of success in the second-period task, i.e., to have high self-confidence. This also makes feedback a strategic choice: if the first-period performance is positively correlated with second-period performance, then the principal has an incentive to get the agents to believe that they succeeded in the first period task.[4]

We analyze the effectiveness of performance feedback mechanisms along two dimensions: (1) verifiability of the feedback; (2) privacy of the feedback. Our baseline scenario is truthful private feedback, in which each agent privately and truthfully learns whether he succeeded in the first period task or not. In the verifiable feedback case, the principal has to reveal the true performance or reveal no information at all, while in unverifiable feedback, she may lie about performance without incurring any monetary cost. The feedback may be private, in which case each agent receives feedback only about his own performance, or public, in which case both agents observe the feedback on each agent's performance. Therefore, in addition to the baseline scenario, we have four different treatments: (1) private–verifiable; (2) public–verifiable; (3) private–unverifiable; (4) public–unverifiable.

In reality, some performance measures are indeed objective and hence verifiable, while others are subjective and unverifiable. For example, a supervisor may have access to evaluations – by higher ranking administrators, co-workers, customers, or students – that can be reproduced if needed. Similarly, sales or productivity figures, customer ratings, exam grades of students, and long-term mortality rates after surgeries are all objectively measurable and verifiable performance measures. Subjective or judgmental evaluations by supervisors, on the other hand, are by their very nature unverifiable, i.e., cheap talk. Likewise, feedback is sometimes provided in a private manner, as in many performance review interviews, while in other cases it is public, as in 'employee of the month' types of feedback. The question of whether feedback should be provided publicly is especially relevant for contexts where it is important to preserve the "morale" of all agents. Given that most organizations have some freedom in determining their feedback mechanisms along the lines we consider, our results can have significant policy implications for firms and for educational settings.

In Section 4 we analyze a theoretical model and derive several predictions. Our main prediction is that information transmission occurs only in verifiable feedback mechanisms and private–verifiable feedback is the most informative feedback mechanism. Section 5.1 presents strong evidence in support of this prediction. We therefore conclude that, if effective

[2] See Schraeder et al. (2007) for a summary of research in psychology, management, and organizational behavior. Culbert (2008) claims that "any critique [involved in performance review] is as much an expression of the evaluator's self-interests as it is a subordinate's attributes or imperfections." Longenecker et al. (1987) report (interview) evidence that the main concern of the executives in performance appraisals is not accuracy but rather to motivate and reward subordinates. Accordingly, they systematically inflate the ratings in order to increase performance. In the Forbes article titled "Ten Biggest Mistakes Bosses Make In Performance Reviews," the number 1 item is 'Too vague,' number 2 is 'Everything's perfect – until it's not and you're fired,' while number 8 is 'Not being truthful with employees about their performance' (Jackson, 2012).

[3] More precisely, subjects state the probability with which they believe they will succeed in the second-period task, which is elicited using a Becker–De Groot–Marschak type procedure.

[4] The experiment is designed so that the likelihood of success for each agent is independent of the likelihood of success for the other agent. This implies that the performance of the other agent is not informative about the likelihood of own success. Furthermore, feedback has no direct payoff consequences, which lets us isolate the communication phase involved in the feedback process from other strategic considerations.

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