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Biased supervision☆

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ABSTRACT

Organizations can use subjective performance pay when verifiable performance measures are imperfect. However, this gives supervisors the power to direct employees toward tasks that mainly benefit the supervisor rather than the organization. We cast a principal–supervisor–agent model in a multitask setting, where the supervisor has an intrinsic preference toward specific tasks and may receive soft information on the agent's efforts. We show that subjective performance pay based on evaluation by a biased supervisor has the same distorting effect on the agent's effort allocation across tasks as incentive pay based on an incongruent performance measure. Combining incongruent performance measures with biased supervision can mitigate, but does not always eliminate this distortion. We apply our results to the choice between specialist and generalist middle managers, where a trade-off between monitoring ability and bias arises.

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1. Introduction

In many organizations, middle managers' assessment of employees' performance is an important determinant of bonus pay and career prospects.[1] If verifiable performance measures are imperfect, subjective performance evaluation may provide a more accurate assessment of employees' performance, thereby providing better incentives for employees. On the other hand, subjective performance evaluation can be manipulated, weakening the link between actual and reported performance. Furthermore, their role in determining pay and promotion opportunities gives managers (more) power over their subordinates. Earlier work has shown that performance pay based on middle managers' evaluations can be prone to favoritism (Prendergast and Topel, 1996; Bol, 2011; Dur and Tichem, 2015), collusion (Tirole, 1986; Vafaï, 2010; Thiele, 2013), extortion (Laffont, 1990; Vafaï, 2002, 2010), and a lack of incentives or ability to monitor (Gibbs et al., 2004; Bol, 2011; Kamphorst and Swank, 2015).

In this paper, we study subjective performance pay in a principal–supervisor–agent model, where the supervisor uses her discretionary power to pull the agent toward tasks that benefit the supervisor more than the organization. The agent

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[1] For instance, Eccles and Crane (1988), Gibbs (1995), and Bol (2011) document the use of subjective performance evaluation in (financial) service firms, Breuer et al. (2013) in a large call-center, Gibbs et al. (2004) in car-dealerships, Woods (2012) in an internal audit firm, and Medoff and Abraham (1980) in manufacturing firms.

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exerts effort on multiple tasks, which is unobserved by the principal. Depending on her monitoring ability, the supervisor may receive soft information on the agent's efforts. The supervisor provides a report on the agent's performance to the principal, which can be used in determining the agent's incentive pay. Crucially, we assume that the supervisor has an intrinsic preference for particular tasks exerted by the agent. This makes that she overemphasizes these tasks when providing directions to the agent. Anticipating that not living up to the supervisor's expectations results in a bad evaluation, the agent works toward the supervisor's goals. As a consequence, akin to the standard multitasking model (Holmström and Milgrom, 1991; Baker, 1992, 2002), we show that the principal optimally sets weaker subjective performance pay when the supervisor's preferences are less aligned, as well as when the supervisor has lower ability.[2]

This changes when the principal has access to a verifiable, but possibly incongruent, performance measure. To structure ideas, consider a salesman of a local store owned by a retail chain. The store's manager is an active member of the local community, so that she cares a lot about her store's reputation for providing good service. The salesman contributes to long-run store performance through sales effort and service effort. The latter does not contribute directly to short-run sales, but increases the reputation of the local store, which has long-run benefits to the retail chain. The manager monitors the salesman's efforts, but the chain's headquarters only observes sales. If headquarters uses the salesman's sales figures to provide incentive pay, he will focus disproportionately on sales at the expense of service. Alternatively, headquarters could relate the salesman's pay to his performance evaluation as provided by the store manager. However, in evaluating performance, the manager will put too much emphasis on service provision, inducing the salesman to exert suboptimally low sales effort. Combining verifiable sales figures with subjective performance evaluation in the salesman's bonus plan brings several advantages. First, sales targets constrain the store manager in emphasizing service at the expense of sales. Second, the use of subjective performance evaluation allows the manager to pull the salesman away from the disproportionate focus on sales induced by sales targets. Third, the sales figures provide additional information on the salesman's efforts, allowing for better monitoring.[3]

We show that by offering bonus pay conditional on achieving both a performance target and a favorable subjective evaluation, the principal may mitigate the distortion that arises when using either objective or subjective performance pay exclusively. This relates to the literature on contracting with multiple incongruent performance measures (Feltham and Xie, 1994; Datar et al., 2001; Budde, 2007), where it has been shown that full congruence can be achieved if the number of verifiable measures meets or exceeds the number of tasks. Even when all measures are biased toward the same task, congruence is feasible by placing a negative weight on the most biased measure. In contrast, we show that this does not hold when some measures are subjectively determined. Placing a negative weight on the subjective evaluation is ineffective. If a good evaluation would have a negative effect on the agent's compensation, the supervisor could still direct the agent toward the tasks she considers important by threatening to provide a good evaluation unless the agent follows her directions. Hence, congruence is not feasible when the supervisor is more biased than the verifiable performance measure.

When the verifiable performance measure and the supervisor are biased toward different tasks, the principal implement non-distorted efforts, unless either the supervisor's monitoring ability is low or the performance measure is unreliable. We model the latter as the probability with which the agent can ex post costlessly manipulate measured performance.[4] If this probability is too high, the supervisor ignores the principal's performance target and induces her most preferred effort allocation. Similarly, if the supervisor's ability is too low, the agent ignores her instructions and meets the performance target at lowest effort cost by working purely toward measured performance. To prevent these outcomes, the principal must allow for some bias in effort allocation and optimally reduces the agent's incentive pay.

The key assumption of our model is that the supervisor has intrinsic preferences over the agent's tasks, which may differ from the principal's relative valuation of these tasks. Such preferences could be driven by private benefits, by career concerns, or by professional norms. The supervisor may overemphasize providing input into her own work, or overemphasize tasks that benefit the supervisor's unit at the expense of activities that benefit other units. Alternatively, the supervisor may intrinsically consider particular tasks more important, as in e.g. Akerlof and Kranton (2005) and Prendergast (2007). In Guth and MacMillan (1986), middle managers admit to making decisions that are not aligned with corporate strategy and goals, in order to protect their self-interest. Burgelman (1994) argues that in the 1980s, Intel had to change corporate strategy after middle managers made resource allocation decisions that went against the initial strategy. Our analysis shows that misaligned middle management may, but need not be detrimental for firm performance, depending on the available performance measures.

Supervisor's biased preferences over tasks differ from interpersonal preferences such as altruism, spite or favoritism, as in Prendergast and Topel (1996), Giebe and Gurtler (2012), and Dur and Tichem (2015). Typically, interpersonal preferences

[2] Supervisors can also use their power to affect (the behavior of) employees in ways that are not directly linked to employees' tasks at work, e.g. by engaging in bullying, extortion, (sexual) harassment, etc. Our interest lies with supervisors' incentives to provide misaligned directions regarding employees' efforts at work.

[3] Manthei and Sliwka (2014) provide a subset of local managers of a retail bank, who previously allocated bonus pay based on subjective assessment, with individual sales data of their employees. This increased both employees' sales activities and profit.

[4] Examples of manipulation of performance information abound. Nagin et al. (2002) study monitoring of call-center agents who can falsely report sales. Alternatively, employees may be able to influence the timing of sales around target commencement dates, as documented by Asch (1990), Oyer (1998), Courty and Marschke (2004), and Larkin (2014). In the accounting literature, manipulation of information is an important theme, ranging from earnings management to accounting fraud (see e.g. Holthausen et al., 1995; Efendi et al., 2007; Goldman and Slezak, 2006).

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