



Economic Theory, Decision Theory and Experimental Economics
Seminar

Relational Contracts with Subjective Peer Evaluations

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Tuesday, 20th November 2012
12:45pm Room 3-E4-SR03 Via Röntgen 1 Milano

Abstract

We analyze the optimal use of peer evaluations in the provision of incentives within a team, and its interplay with relational contracts. We consider an environment in which the firm pays a discretionary bonus based on a publicly observed team output but may further sharpen incentives by using privately reported peer evaluations. We characterize the optimal contract, and show that peer evaluations can help sustain relational contracts. Peer evaluations are used when the firm is less patient and the associated level of surplus destruction is small. Moreover, peer evaluation affects a worker's pay only when the public output is at its lowest level and the co-worker sends the worst report. Noticeably, a worker's report does not affect his own pay, as the provision of effort incentives cannot be decoupled from the incentive for truthful reporting of peer performance. To induce the workers both to put in effort and to report truthfully, the firm may find it optimal to neglect signals that are informative of the worker's effort.