

Vague by Design: Performance Evaluation and Learning from Wages

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Abstract

We study a dynamic principal-agent setting in which both sides learn about the importance of effort. The quality of the agent's output is not observed directly. Instead, the principal jointly designs an evaluation technology and a wage schedule. More precise performance evaluation reduces current agency costs but promotes learning, which is shown to increase future agency costs. As a result, the optimal evaluation technology is imprecise. When output is coarse, the optimal evaluation is tough: a bad performance is always sanctioned, but a good one is not always recognized. When output is fine grained, the optimal evaluation features a base wage for bad and moderate performance, and tailored bonuses for high performance.