Informal labour incentive contracts and product market competition

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This paper studies the dynamic interaction between product market competition and shirking incentives in a context where workers' effort is unverifiable and the probability of the unemployed workers getting a job can depend on their employment histories according to the degree of product market competition. It is shown that efficiency wages paid by each firm can decrease when competition becomes fiercer. With discretionary bonuses, instead, wages are generally uncorrelated with competition, but there exists an upper threshold for the number of competing firms, over which profits collapse to zero. Moreover, if information about firms' misbehaviour in paying bonuses flows in the labour market at a low rate, there is the possibility for firms to make higher profits by paying efficiency wages instead of bonuses.

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