

# MONEYCRACY\*

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## Abstract

How do wage and other financial benefits affect the set of candidates for political office? In this theoretical paper, we answer the question by studying self-selection into politics of individuals with heterogeneous skills and heterogeneous motivations. Our predictions are in line with the efficiency wage results proposed by the extant literature when a benchmark model with skills as the sole relevant characteristic of individuals is considered. Welfare is increasing in the politicians' wage since the best, *i.e.*, high-skilled, individuals are attracted to politics only if their remuneration covers their high opportunity costs. Our findings are remarkably different when motivation is also taken into account. Welfare is not likely to be maximized when the politicians' wage is relatively high, for high-skilled individuals with market-oriented rather than public-spirited motivation are attracted. Finally, we provide an overview of the labor market of politicians in Europe and suggest that the Italian Parliament might be representative of our inefficiency wage mechanism, which we call *moneycracy*.

**Keywords:** Politicians' remuneration; Skills; Motivation; Moneycracy.

**JEL Codes:** P16 (Political Economy), J45 (Public Sector Labor Markets), J24 (Human Capital; Skills; Occupational Choice; Labor Productivity), J32 (Nonwage Labor Costs and Benefits; Private Pensions).

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## Introduction

IDEA DUR DELLA RELATIVA ABILITÀ PRIVATO/PUBBLICO? It is widely recognized that good government is a crucial prerequisite for economies to flourish. In turn, the effectiveness of policy-making depends on the quality of the elected officials, *i.e.*, on their ability to maximize welfare by making decisions on behalf of the citizens. Since politicians are chosen within the pool of those willing to serve, finding a convincing answer to the following question is a relevant economic issue: how do wage and other financial benefits affect political self-selection?

Besley (2005) argues that political selection is important because the control of politicians through elections may be limited. Interestingly, he also observes (p. 44): "Much of the modern literature on political economy has not only neglected the problem of political selection, it has been positively hostile to the topic." This is why only recently economists have tackled this issue (see, *e.g.*, Caselli & Morelli, 2004, and Messner & Polborn, 2004, for theoretical analyses; Ferraz & Finan, 2009, and Gagliarducci & Nannicini, 2013, for empirical evidence). The above papers generally measure quality of the political class through one dimension, namely skills. The importance of politicians' competence for government decision-making is indeed axiomatic. Accordingly, a common prediction is provided, which is in line with the adverse selection framework of the efficiency wage theory (see, *e.g.*, Weiss, 1980; and Malcolmson, 1981). Since remuneration is mainly fixed in the public sector, whilst markets reward skills, only low-skilled individuals will run for office. As a result, increasing financial benefits from holding office may attract better candidates and enhance policy outcome.

A possible shortcoming of the above analysis is that it deals with politicians without explicitly taking into account one of the oldest topics discussed by public administration scholars, namely the motivation (see, *e.g.*, Rainey & Steinbauer, 1999). Public service motivation of politicians, or more generally of public servants, is defined as "an individual's predisposition to respond to motives grounded primarily or uniquely in public institutions and organizations" (Perry & Wise, 1990). Put differently, the working activity of politicians is also driven by something else than material incentives such as money or career advancements. This notion has recently been brought into economic thinking. For instance, Besley (2005) argues that motivation of politicians "can be thought of as hard-wired into preferences rather than being dependent on external reinforcement".

Accordingly, the present theoretical paper extends the existing literature by explicitly including the role of politicians' motivation. To be more precise, we examine how the level of politicians' financial remuneration affects self-selection into politics of individuals with *both* heterogeneous skills *and* heterogeneous motivations.

The relevant issue of work motivation has been dealt with by various strands of the economics literature. For instance, Handy & Katz (1998) study the selection of intrinsically motivated managers in the non-profit sector. Heyes (2005) focuses on the nursing labor market. The design of optimal incentives when agents are intrinsically motivated is instead developed by Besley & Ghatak (2005),

Delfgaauw & Dur (2007), and Stowe (2009).

In this paper, we introduce a citizen-candidate model where individuals decide whether to run for office. Only one individual is elected randomly and then provides a public good.<sup>1</sup> The others devote themselves to a private activity in the market sector.<sup>2</sup> Given our focus on self-selection into politics rather than on behavior once in office, we adopt a static framework based on the comparison of the individuals' payoff from one period in office against one period in the market. Accordingly, we disregard the role played by reelection in affecting moral hazard problems (see, *e.g.*, Smart & Sturm, 2004, and Beniers & Dur, 2007).

Motivated, or *public-fit*, individuals are defined as those closely fitting with the public sector environment in terms of value congruence. There are many examples of people whose main work values and goals are public-oriented, *e.g.*, they aim at serving the interests of a community. This type of individuals are supposed to be well fitted with the public sector because it is the environment where they are most likely to achieve their work goals (see Delfgaauw & Dur, 2010, for a similar definition of public service motivated individuals). By contrast, non-motivated, or *market-fit*, individuals have a good fit with the market sector for their main work values are market-oriented, *e.g.*, they enjoy performing business occupations and/or they engage in the pursuit of high monetary incomes. We suppose that, for any given level of skills, (i) public-fit individuals are (weakly) more efficient than market-fit when providing the public good; (ii) market-fit citizens are (weakly) more efficient than public-fit when running the private activity. We also assume that, for any given type of fit, high-skilled individuals are more productive than low-skilled ones in both public and market sectors. Utilitarian welfare is maximum (minimum) in our framework when an individual with both public fit and high skills (market fit and low skills) is in office in that she is able to supply the maximum (minimum) level of public good enjoyed by the whole society.

Theories of person-environment fit, broadly defined as the compatibility between an individual and a work environment that occurs when their characteristics are well matched, have been popular in management literature since Parsons (1909). The idea that the person-environment fit can be a crucial determinant of work motivation is not new in economics literature. Besides Delfgaauw & Dur (2010), Besley & Ghatak (2005) show that motivation of workers is positively affected by the extent to which they agree with the mission being pursued by an organization.

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<sup>1</sup>The assumption of a random election mechanism is aimed at focusing our attention on the effect of financial remuneration on self-selection. We hence disregard the role of political parties, voters, and electoral rules in affecting the quality of the elected politician. In doing so, like Besley (2004), we suppose that each individual knows her own type but ignores the type of the others.

<sup>2</sup>Politics and the private sector are assumed to be mutually exclusive in our framework. This might be considered as a restrictive hypothesis because in some countries members of parliament have the option to keep on working in the market sector while in office, for instance as lawyers, entrepreneurs or consultants. This practice is called moonlighting and it is registered, among other seats of government, in the British House of Commons, in the German Bundestag, in the Italian Parlamento, and in the European Parliament. A recent strand of empirical literature studies the impact of this extra option on political selection (see Geys & Mause, 2013, for a survey of the literature on moonlighting politicians). Accordingly, in Section 5 we allow for politicians' outside employment and show under which conditions our findings are robust to this specification.

Our main findings stand in contrast with the efficiency wage predictions proposed by the aforementioned literature on political selection. We demonstrate that increasing the politician's reward does not have a monotonically positive impact on the expected value of welfare. The reason is twofold. On the one hand, the opportunity costs of entering politics borne by the worst politician, *i.e.*, a market-fit low-skilled individual, are relatively high due to her wrong fit. On the other hand, the top politician, *i.e.*, a public-fit high-skilled individual, incurs relatively low opportunity costs due to her right fit. Accordingly, the worst (best) politician does not demand the lowest (highest) reservation wage. This means that the worst potential candidates are crowded out if a minimum reward is set and that the best ones are attracted even if the reward is not maximum. As a corollary, paying politicians much money attracts high-skilled individuals whose work motivation is yet market oriented, hence poorly fitted with the public sector. This adverse selection effect is referred to as *moneycracy*.<sup>3</sup>

Finally, we provide a descriptive overview of the European politicians' labor market, with a special focus on Italy. The Italian case turns out to be interesting for our theoretical analysis. Italy is home to the highest paid parliamentarians in Europe, whose real wage increased from almost 80,000 euros in 1985 to around 140,000 in 2004. Over the same period, the evolution of high-skilled individuals' proportion in the Italian Parliament was consistent with the Italian population's positive trend. On the contrary, the fraction of public-fit parliamentarians *decreased*, contrary to what occurred in the population. This could suggest that the "moneycratic" mechanism of selection highlighted by our theoretical framework may be in action in the Italian Parliament.

Overall, our analysis might contribute to the lively debate on the politicians' remuneration that is currently taking place in Italy. Given the severe crisis that has been hitting Italy's economy since 2008, the common wisdom is that the parliamentary wage should be reduced for ethical reasons. In their book "The Ruling Class, Management and Politics in Modern Italy", Boeri *et al.* (2010, p. 84) suggest that the same recipe should be advocated also for efficiency reasons:

"[...] We conclude that the sharp increase in the parliamentary wage in Italy has contributed to the decline of the quality of the elected legislators over time."

Similarly, Pirani (2010) comments on the increasing presence of managers in the Lower house of the Italian Parliament and seems to emphasize the existence of a moneycratic mechanism of political selection:

"È probabile trattarsi di persone che perseguono gli interessi aziendali, attraverso

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<sup>3</sup>The more common terms "plutocracy" or "moneyocracy" are related to the concept of government by the rich, with no explanation of why governors are rich. By contrast, we explicitly state that individuals get top income from the private activity thanks to their high skills *and* market-fit (they can be considered self-made persons), rather than because their parents are rich. This makes a crucial difference in our framework, since a rich heir with, *e.g.*, high skills and public fit would raise no concern about selection. In the light of this, moneycracy could be defined as government by the wannabe rich.

la loro posizione politica. Un conflitto di interessi che assume dimensioni macroscopiche quando verificiamo un dato senza precedenti: tra i parlamentari eletti alle ultime politiche (2008) sono i manager a far la parte del leone (un deputato su quattro)."<sup>4</sup>

An analogous opinion can be found in Reggiani & Rizzolli (2012):

"[...] ci hanno illuso che pagando di più i politici avremmo ottenuto politici migliori. Ci sembra invece che, offrendo alte remunerazioni e generosi privilegi, abbiamo attirato in gran numero candidati che ambiscono ad essere eletti solo per poter accedere a questo trattamento privilegiato e non perché motivati dalla missione di poter contribuire genuinamente al bene comune in modo diretto ed attivo."<sup>5</sup>

The remainder of the paper is organized as follows. In Section 1, we review the related literature. In Section 2, we lay out the theoretical framework. In Section 3, we describe a benchmark model where individuals are characterized only by skills. In Section 4, we solve the general model and discuss the main results. In Section 5, we discuss how our results are affected by the moonlighting option and by the hypothesis of a continuum of skill levels, rather than just two values of skills. In Section 6, we give an overview of the labor market of the European politicians. Finally, in Section 7, we draw some conclusions.

## 1 Related Literature

This paper explicitly introduces motivation into the political selection literature. Accordingly, our contribution is closely connected, in the first place, with the literature on work motivation. The bottom line of economics papers dealing with such a topic is that motivation impacts positively on the individual's productivity and/or utility. Some authors (see, *e.g.*, Heyes, 2005) assume that workers receive a non-pecuniary benefit which increases with their level of motivation. Francois (2000) focuses on the provision of social services and suppose that motivated workers' utility also depends on the level of output produced. Handy & Katz (1998) assume that, for any given level of ability, the more motivated workers are able to produce higher output than their less motivated colleagues. Similarly, Delfgaauw & Dur (2007) and Stowe (2009) suppose that motivation reduces the workers' effort disutility, which is the approach we opt for in this paper.

Our framework is close to Delfgaauw & Dur (2010) and Dal Bó *et al.* (2013) who consider individuals with different market ability and different public service motivation. Delfgaauw & Dur

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<sup>4</sup>"These persons (the managers) are likely to exploit their political position to improve their private business. The deriving conflict of interest is huge as 25% of the deputies elected in 2008 are managers, the highest percentage since the existence of the Italian Republic." English translation by the authors.

<sup>5</sup>"[...] we have been told that we would have attracted better politicians by paying them more. In contrast, it seems that we attracted candidates who run for office only to get money and benefits rather than public-spirited candidates." English translation by the authors.

(2010) study self-selection into public management. Yet their focus is not on potential adverse selection effects caused by high financial remuneration. By contrast, that is precisely the research question of Dal Bó *et al.* (2013). They consider applicants for public sector positions in Mexico and find that higher wages attract more capable applicants as measured by their IQ and proclivity towards public sector work. This stands in contrast to our findings. The reason is that the authors assume market ability of applicants to be increasing with their public service motivation. In our paper we adopt a more general approach by not imposing any functional relation between the two characteristics.

The second strand of literature which we contribute to is on political selection. The basic theoretical framework used to study the decision to enter politics is the citizen-candidate model. This strand, inaugurated by the works of Besley & Coate (1997) and Osborne & Slivinski (1996), removes the artificial distinction between citizens and politicians by recognizing that public officials are selected from those citizens who choose to become candidates. Our paper continues in this tradition.

The two aforementioned seminal papers assume candidates' heterogeneity in preference. Our article is instead closer to a second generation of citizen-candidate models, where agents are supposed to differ with respect to their quality as a politician. Within this framework, Caselli & Morelli (2004) and Messner & Polborn (2004) study how relative salaries in the political and private sectors affect the average ability of elected politicians. In particular, Caselli & Morelli (2004) present an adverse selection model where the population is composed of high and low-ability individuals. High-ability individuals are more productive both in the private sector and in the public sector. Similarly, in Messner & Polborn (2004) the opportunity cost of serving in office is higher for more productive candidates. The main finding of both studies is that increasing the remuneration of elected politicians enhances their average ability.

Comparable results are found by Besley (2004). He describes a political agency model with two types of politicians. He considers the effects of the politicians' wage on both the behavior in office and the decision to run for office. In accordance with the two aforementioned papers, Besley (2004) demonstrates that an increase in wages raises voter welfare. Empirical support to this result comes from Ferraz & Finan (2009). They study salaries of local legislators across Brazil's municipal governments and find that higher wages improve the quality of legislators, as measured by education, type of previous profession, and political experience in office.<sup>6</sup>

Our model introduces an element of novelty within the citizen-candidate framework by allowing for two dimensions of heterogeneity between agents: not only skills, but also motivation. By relying on this richer formulation, we are able to differentiate public sector productivity from market sector productivity and to show that an increase in the politicians' wage can be welfare-reducing.

Two articles in the citizen-candidate literature (Smart & Sturm, 2004, and Poutvaara & Takalo,

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<sup>6</sup> A similar result is found by Gagliarducci & Nannicini (2013) who use data on Italian municipal governments from 1993 to 2001 and conclude that higher wage attracts more educated candidates.

2007) describe circumstances under which raising wage can affect welfare negatively. The main mechanism behind this result is dynamic in Smart & Sturm (2004). Higher remuneration increases the value of being re-elected. Accordingly, politicians are induced to implement policies that guarantee re-election rather than policies aimed at increasing the voters' welfare. Our comparable results depend on selection rather than moral hazard problems. Poutvaara & Takalo (2007) present a model of costly campaigning that produces informative but noisy signals of candidates' abilities. One of their results is that increasing salaries may lower average candidate quality. This is mainly driven by the presence of high campaigning costs, which are instead irrelevant and therefore disregarded in our framework. As illustrated above, our mechanism relies instead on the selection of individuals with a low degree of fit with the public sector.

Interestingly, a bidimensional heterogeneity among agents can be found in the citizen-candidate frameworks proposed by Mattozzi & Merlo (2008) and Beniers & Dur (2007). Mattozzi & Merlo (2008) introduce a dynamic model where politicians display two dimensions of ability, namely political skills and market ability. Whilst skills and fit are independent in our framework, Mattozzi & Merlo (2008) assume that better politicians are more likely to be better managers and viceversa. They find that high-ability citizens are willing to serve for a period (political careers), after which they might leave parliament and capitalize on political experience. In line with the efficiency wage theory, the authors also show that better incumbent politicians are less likely to leave politics when the wage level increases.

Beniers & Dur (2007) study the effect of electoral competition on the behavior of politicians who are heterogeneous in both competence and the extent to which they care about the public interest. In their dynamic framework each incumbent official, before the second-period election, acquires an informational advantage over voters concerning the quality of the policies she has implemented. When a policy turns out to be a failure, it can be reversed before the next elections. This action implies higher welfare for the voters but a reputational loss for the incumbent. Consequently, only those politicians who sufficiently care about the public interest are willing to admit a policy failure and take the risk of losing the re-election. The authors show that politicians are less inclined to admit that a policy has failed when they believe other politicians are more likely to behave opportunistically. Interestingly, the incentives to behave opportunistically increase with the politicians' pay.

## 2 Setup

Consider a society with  $N$  individuals,  $N$  large. We introduce the following three-period citizen-candidate model.

$t = 0$  The level of parameter  $w$  is publicly announced,  $w$  denoting direct remuneration plus any other financial benefits from holding office.

$t = 1$   $N$  individuals decide whether to run for office. Afterward, only one individual is elected randomly among the candidates. Throughout the paper we refer to her as a politician and to individuals who are not elected or decide not to run for office as a citizen.

$t = 2$  The politician exerts an effort level  $e \in [0, \infty)$  to provide a public good, the amount of which is denoted by  $P(e)$ ,  $P' > 0 > P''$  and  $P'(\infty) = 0$ . If no individual run for office, the public good is not supplied. By contrast, each citizen gets income  $M(a)$ ,  $M' > 0 > M''$  and  $M'(\infty) = 0$ , from a productive activity she runs in the market sector, where parameter  $a \in [0, \infty)$  represents the effort level she provides when involved in such a task. Afterward, the politician receives the reward  $w$  which is financed through a lump-sum tax levied on all  $N$  members of the society.

Individuals are endowed with two characteristics chosen by Nature. Parameter  $\gamma_i \in \{\gamma_P, \gamma_M\}$ ,  $\gamma_P \neq \gamma_M$ , represents the degree of fit or compatibility with the working environment, either the public sector or the market one. Parameter  $\theta_j \in \{\theta_L, \theta_H\}$ ,  $\theta_H > \theta_L$ , measures the level of skills.<sup>7</sup> Four types, denoted by  $ij = \{M, P\} \times \{L, H\}$ , are thus present in the society. The proportion of type- $ij$  individuals is  $\lambda_{ij} > 0$ , with  $\sum_{ij} \lambda_{ij} = 1$ . We introduce the following

**Definition 1** *An individual endowed with fit parameter  $\gamma_P$  is referred to as public-fit. An individual endowed with fit parameter  $\gamma_M$  is referred to as market-fit.*

Parameters  $\gamma_i$  and  $\theta_j$  are assumed to affect both type- $ij$  politician's effort disutility function, denoted by

$$c(e, \gamma_i, \theta_j), \quad (1)$$

and the corresponding value of type- $ij$  citizen, indicated by

$$s(a, \gamma_i, \theta_j). \quad (2)$$

Functions (1) and (2) are increasing and convex in  $e$  and  $a$ :  $c_e > 0$ ,  $c_e(0) = 0$ ,  $c_{ee} > 0$ ,  $s_a > 0$ ,  $s_a(0) = 0$ , and  $s_{aa} \geq 0$ , subscripts  $e$ ,  $a$  and  $ee$ ,  $aa$  denoting first and second derivatives, respectively.

We let

$$c(e, \gamma_i, \theta_H) \leq c(e, \gamma_i, \theta_L), \quad (3)$$

$$s(a, \gamma_i, \theta_H) \leq s(a, \gamma_i, \theta_L), \quad (4)$$

$c_e(e, \gamma_i, \theta_H) < c_e(e, \gamma_i, \theta_L)$ , and  $s_a(a, \gamma_i, \theta_H) < s_a(a, \gamma_i, \theta_L)$ . *Ceteris paribus*, an individual with higher skills incurs nonhigher disutility and less marginal disutility both in public and market sectors.

These hypotheses are standard. In addition, we make the following

**Assumption 1**  $c(e, \gamma_P, \theta_j) \leq c(e, \gamma_M, \theta_j)$ ,

<sup>7</sup>In Section 5 we consider a continuum of skill levels.

**Assumption 2**  $s(a, \gamma_P, \theta_j) \geq s(a, \gamma_M, \theta_j)$ .

Assumption 1 states that, *ceteris paribus*, a public-fit individual incurs nonhigher effort disutility than a market-fit one when elected.<sup>8</sup> Assumption 2 states that, *ceteris paribus*, a market-fit individual incurs less effort disutility than a public-fit one when working in the market sector. The two hypotheses capture in a simple way the negative relation between person-environment fit and effort disutility.

Finally, we let the marginal effort disutility in the public sector be nonhigher in case of public fit,

$$c_e(e, \gamma_P, \theta_j) \leq c_e(e, \gamma_M, \theta_j), \quad (5)$$

and that in the market sector be lower in case of market fit,

$$s_a(a, \gamma_P, \theta_j) > s_a(a, \gamma_M, \theta_j). \quad (6)$$

Before proceeding, we remark that the politician receives a reward  $w$  independent of her type, *i.e.* a flat reward. This is a common assumption in the related literature. Besley (2004) points out that "politicians tend to be regulated by career concerns rather than formal incentive contracts". Indeed, it is problematic to link monetary incentives to key observable outcomes in the context of politics. Moreover, politicians are charged with a wide variety of tasks which compete for their attention. Accordingly, the remuneration system for them is generally supposed to be low-powered.<sup>9</sup>

With the aim of a better understanding of the role played by fit in our framework, we first study a benchmark case where effort disutility is affected only by skills.

### 3 A Benchmark Model of Efficiency Wages in Politics

We simplify the set-up of Section 2 by supposing that fit does not appear in the individuals' effort disutility functions. Accordingly just two types of individuals, low-skilled and high-skilled denoted by  $j = \{L, H\}$ , are present in the society. In addition, (1) and (2) rewrite as  $c(e, \theta_j)$  and  $s(a, \theta_j)$ . The model is solved backwards, starting from the third-period politician's choice of effort while in office.

**The Politician.** When a type- $j$  individual is elected her payoff function as a politician is

$$U_j \equiv P(e) - c(e, \theta_j) + w - \frac{w}{N}, \quad (7)$$

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<sup>8</sup> Assumption 1 could be easily reformulated in order to take into account a classical concept in the political economy literature: that of ego rents, defined by Hillman (2003, p.100) as "the emotional or psychic benefits from being an elected politician". Indeed, denoting with  $f(\gamma_i)$  the level of ego rents, Assumption 1 could be rewritten as  $f(\gamma_P) \geq f(\gamma_M)$ .

<sup>9</sup> For example, Mattozzi & Merlo (2008) and Messner & Polborn (2004) consider a fixed salary. Caselli & Morelli (2004), Poutvaara & Takalo (2007), Beniers & Dur (2007) and Besley (2004) introduce flat private rents from holding office, which are defined as the utility value of both financial and psychological rewards from public office. At the best of our knowledge, an exception is Gersbach (2003), who proposes a model where the politicians' pay is made conditional on the realization of macroeconomic events.

where  $P(e)$  is the public good consumption linear utility,  $c(e, \theta_j)$  is the effort disutility,  $w$  is the reward, and, finally,  $\frac{w}{N}$  represents the lump-sum tax.<sup>10</sup>

At  $t = 2$  type- $j$  politician selects the effort level  $e_j^*$  to maximize payoff  $U_j$ . In symbols,

$$e_j^* \equiv \arg \max_e \left[ P(e) - c(e, \theta_j) + w - \frac{w}{N} \right]. \quad (8)$$

F.O.C.  $P'(e) - c_e(e, \theta_j) = 0$  is necessary and sufficient to find a solution to problem (8). We let

$$U_j^* \equiv P(e_j^*) - c(e_j^*, \theta_j) + w - \frac{w}{N} \quad (9)$$

be the payoff obtained by a type- $j$  politician after exerting the optimal effort  $e_j^* > 0$ .

Applying the implicit function theorem to F.O.C. yields  $\partial e / \partial \theta = c_{e\theta} / (P'' - c_{ee})$ , which is positive by assumption. This implies that a politician with higher skills exerts more effort,

$$e_H^* > e_L^*. \quad (10)$$

**Citizens.** We now turn to the citizens' third-period choice of effort in the market sector. When a type- $j$  individual is not elected or does not run for office, her payoff is

$$Z_j \equiv M(a) - s(a, \theta_j) + \bar{P} - \frac{w}{N}, \quad (11)$$

where:  $M(a) - s(a, \theta_j)$  is the market activity income net of the effort disutility;  $\bar{P}$  is the public good consumption linear utility, with  $\bar{P}$  indicating the optimal level of public good provided by the elected politician; finally,  $\frac{w}{N}$  is the lump-sum tax.

At  $t = 2$  a type- $j$  citizen chooses the effort level  $a_j^* > 0$  to maximize payoff  $Z_j$ . F.O.C. is  $M'(a) - s_a(a, \theta_j) = 0$ . We denote by

$$Z_j^* \equiv M(a_j^*) - s(a_j^*, \theta_j) + \bar{P} - \frac{w}{N} \quad (12)$$

the payoff obtained by a type- $j$  citizen after exerting the optimal effort  $a_j^*$ .

Individuals with higher skills exert higher effort in the market sector. To prove it, we apply the implicit function theorem to F.O.C. and get  $\partial a / \partial \theta = s_{a\theta} / (M'' - s_{aa})$ , which is positive by assumption. As a result

$$a_H^* > a_L^*. \quad (13)$$

**Politician's Reservation Reward.** We now go backwards at  $t = 1$ , when all individuals choose whether to run for office. To study such a decision, we introduce the notion of type- $j$  politicians' reservation reward, denoted by  $\underline{w}_j$  and defined as the minimum reward level a type  $j$  is willing to accept to run for office. Individuals are assumed to care just about money when making the entry

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<sup>10</sup>Costs of running for office are assumed to be zero. In the citizen-candidate literature positive costs are often introduced which are equal across individuals. Following this approach would not affect our results.

decision. This amounts to say that they compare reward  $w$ , obtained in case they are elected, to market income  $M(a)$ , earned when they are not elected or do not run for office. Instead, public good consumption utility  $P$  and effort disutilities  $c(\cdot)$  and  $s(\cdot)$  are neglected.<sup>11</sup>

Recalling that the election is random, we let  $p \in (0, 1)$  be a candidate  $j$ 's probability of election. Accordingly, a type- $j$  individual's expected monetary payoff at  $t = 1$  when she runs for office is  $p\left(w - \frac{w}{N}\right) + (1 - p)\left[M\left(a_j^*\right) - \frac{w}{N}\right]$ . With probability  $p$  she is elected and obtains the flat reward net of the lump-sum tax. With probability  $1 - p$  she is not elected and ends up with the net optimal market income. On the contrary,  $M\left(a_j^*\right) - \frac{w}{N}$  is the net monetary return she gets when not running for office. By definition of reservation reward,  $\underline{w}_j$  must solve equality

$$p\left(w - \frac{w}{N}\right) + (1 - p)\left[M\left(a_j^*\right) - \frac{w}{N}\right] = M\left(a_j^*\right) - \frac{w}{N}. \quad (14)$$

As a straightforward result,  $\underline{w}_j$  is equal to type- $j$  individuals' market income, which represents their monetary opportunity cost of becoming a politician. In symbols,

$$\underline{w}_j = M\left(a_j^*\right). \quad (15)$$

Relying on (13) and recalling that  $M'(a) > 0$  we can write

$$\underline{w}_H > \underline{w}_L, \quad (16)$$

according to which a type- $H$  agrees to accept a higher minimum reward than a type- $L$  to run for office for she incurs higher opportunity costs.

**Welfare.** Before proceeding, we are interested in studying how the politician's skills affect welfare of the society. Adopting a utilitarian approach, we define welfare as the sum of utilities of all individuals. Utilitarian welfare when a type- $j$  individual is in office is denoted by  $S_j$  and amounts thus to

$$S_j \equiv U_j + (\lambda_j N - 1) Z_j + \lambda_{-j} N Z_{-j}, \quad (17)$$

where  $\lambda_j > 0$  denotes the proportion of type- $j$  individuals in the society, with  $\sum_j \lambda_j = 1$ , whilst subscript  $-j = L, H$  expresses the citizens' type different from that of the politician. Accordingly,  $\lambda_j N - 1$  indicates the set of type- $j$  citizens but the politician and  $\lambda_{-j} N$  the citizens of the other type. Plugging  $e_j^*$ ,  $a_j^*$  and  $a_{-j}^*$  into (17) and rearranging yields the optimal welfare when type- $j$  is in office,

$$S_j^* = NP\left(e_j^*\right) - c\left(e_j^*, \theta_j\right) + (\lambda_j N - 1)\left[M\left(a_j^*\right) - s\left(a_j^*, \theta_j\right)\right] + \lambda_{-j} N\left[M\left(a_{-j}^*\right) - s\left(a_{-j}^*, \theta_{-j}\right)\right]. \quad (18)$$

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<sup>11</sup>This is a simplifying hypothesis aimed at disregarding strategic interaction among individuals at the entry stage. It is in the spirit of Caselli & Morelli (2004) framework, where each individual candidate does not take into account her potential influence on the average level of the public good when she decides whether to run. If we relax such a simplifying assumption, in line with Messner & Polborn (2004), the results of Proposition 1 are not affected. The two authors show that the expected quality of running candidates increases as the remuneration of the official increases in a setup where candidates consider both their direct remuneration and the possible improvement of the public good level (if they rather than worse candidates serve) as the benefits of running for office.

The first two terms represent the public good consumption utility, enjoyed by all individuals, net of the politician's effort disutility. The last two terms denote the citizens' market activity income net of their effort cost.

The optimal welfare is enhanced when a high-skilled instead of a low-skilled individual is in office,

$$S_H^* > S_L^*, \quad (19)$$

provided that  $N$  is large. To prove this we build upon (18) to rewrite (19) as

$$P(e_H^*) - P(e_L^*) > \frac{(Z_H^* - Z_L^*) - (U_H^* - U_L^*)}{N - 1}. \quad (20)$$

The RHS of (20) is close to zero since  $N$ , which denotes the size of the entire society, is large. In this case (20) is approximately equivalent to  $e_H^* > e_L^*$ , which is fulfilled.

A trade-off is at stake when comparing  $S_H^*$  to  $S_L^*$ . The public sector benefits from the presence of a high-skilled instead of a low-skilled politician. The market sector is penalized by the presence of a low-skilled instead of a high-skilled citizen. Yet, skills are more relevant in the public where the beneficial impact of a type- $H$  individual is spread among all citizens. Put differently, welfare of the society is assumed to be positively affected by quality of the elected official, as measured by skills. Even though identifying positive causality between quality of government and welfare is not straightforward, recent empirical evidence confirms that political leaders play an important role in enacting right policies, which affect significantly the economic performance: see, *e.g.*, Jones & Olken (2005); and Besley *et al.* (2010).

**Efficiency Wages.** The last step of our benchmark analysis studies whether and how the level of remuneration  $w$ , publicly announced at  $t = 0$ , affects welfare of the society. It is worth remarking that  $w$  does not appear in the expression of optimal welfare (18) because  $w$  is transferred from citizens to the politician. Yet, relying on inequality (16), we are able to show that  $w$  can affect welfare through the following selection mechanism.

1. If  $w < \underline{w}_L$ , no individual decides to run for office since reward  $w$  does not satisfy the participation constraint of all individuals. In this case the level of public good is zero, no tax is levied and therefore the welfare equals

$$S_0 \equiv N \sum_j \lambda_j [M(a_j^*) - s(a_j^*, \theta_j)]. \quad (21)$$

2. If  $\underline{w}_L \leq w < \underline{w}_H$ , only type- $L$  individuals run for office. As a result, a type- $L$  will be elected with probability  $p = \lambda_L/\lambda_L = 1$  and the deriving optimal welfare is  $E_L(S) \equiv S_L^*$ , which we assume to be higher than  $S_0$ .<sup>12</sup>

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<sup>12</sup>Note that inequality  $S_L^* > S_0$  is equivalent to  $P(e_L^*) > \{c(e_L^*, \theta_L) + [M(a_L^*) - s(a_L^*, \theta_L)]\}/N$ . In line with condition (20), we assume that welfare is higher when a politician, even if low-skilled, is in office than when nobody is elected, because a positive level of public good is provided which is enjoyed by all citizens.

3. If  $w \geq \underline{w}_H$ , all individuals run for office. Since the election is random and  $\lambda_L(1 - \lambda_L)$  is the proportion of type- $L$  (type- $H$ ) individuals in the society, the elected politician will be type- $L$  with probability  $p = \lambda_L/(\lambda_L + 1 - \lambda_L) = \lambda_L$  and type- $H$  with probability  $1 - p = (1 - \lambda_L)/(\lambda_L + 1 - \lambda_L) = 1 - \lambda_L$ . As a result, the expected optimal welfare, *i.e.*, the welfare before the election takes place, is  $E_H(S) \equiv \lambda_L S_L^* + (1 - \lambda_L) S_H^*$ . It is easy to check that  $E_H(S) > E_L(S)$  under condition (19).

We sum up our findings in the following

**Proposition 1** *When only skills affect the individuals' effort disutility, the expected value of welfare of the society is increasing in the politician's reward.*

Conditions (16) and (19) ensure that both reservation reward and welfare are increasing in skills. As a consequence, the efficiency wage theory applies when just skills matter. Setting a relatively high remuneration for politicians,  $w \geq \underline{w}_H$ , is the only way to attract good candidates and enhance the expected value of welfare. This policy recommendation is in line with some early results concerning the effect of wages on political selection (Caselli & Morelli, 2004; Messner & Polborn, 2004; and Besley, 2004). Yet, in the remainder of the paper we show that the prediction of Proposition 1 is dramatically modified when the notion of fit comes onto the stage.

## 4 The Importance of Motivation

In this section we solve backwards the model laid out in Section 2, where the individuals' effort disutility depends on skills and fit.

### 4.1 The Politician

When a type- $ij$  individual is elected her payoff function as a politician at  $t = 2$  is

$$U_{ij} \equiv P(e) - c(e, \gamma_i, \theta_j) + w - \frac{w}{N}, \quad (22)$$

where effort disutility  $c(e, \gamma_i, \theta_j)$  depends now on both the skill and the fit parameters,  $\gamma$  and  $\theta$ . We denote by

$$U_{ij}^* \equiv P(e_{ij}^*) - c(e_{ij}^*, \gamma_i, \theta_j) + w - \frac{w}{N} \quad (23)$$

the payoff obtained by type- $ij$  politician after exerting the optimal effort  $e_{ij}^* > 0$ .

We know from the above analysis that, for any given type of fit, a politician with higher skills exerts higher optimal effort,  $e_{iH}^* > e_{iL}^*$ . Similarly, condition (5) along with our assumptions on  $P(e)$  and  $c(e, \gamma_i, \theta_j)$  ensure that, for any given level of skills, a politician with public fit exerts nonlower optimal effort,  $e_{Pj}^* \geq e_{Mj}^*$ .

## 4.2 Citizens

When a type- $ij$  individual is not elected or does not run for office, her payoff function as a citizen at  $t = 2$  is

$$Z_{ij} \equiv M(a) - s(a, \gamma_i, \theta_j) + \bar{P} - \frac{w}{N}. \quad (24)$$

We recall that  $\bar{P}$  is public good consumption utility, with  $\bar{P}$  denoting the optimal level of public good provided by the elected politician. We indicate by

$$Z_{ij}^* \equiv M(a_{ij}^*) - s(a_{ij}^*, \gamma_i, \theta_j) + \bar{P} - \frac{w}{N} \quad (25)$$

the payoff obtained by a type- $ij$  citizen when she exerts the optimal effort  $a_{ij}^* > 0$ .

Relying on the above analysis we can demonstrate that, for any given type of fit, a citizen with higher skills exerts higher optimal effort,  $a_{iH}^* > a_{iL}^*$ . Similarly, condition (6) along with our assumptions on  $M(a)$  and  $s(a, \gamma_i, \theta_j)$  ensure that, for any given level of skills, a citizen with market fit exerts higher optimal effort,  $a_{Mj}^* > a_{Pj}^*$ .

## 4.3 Politician's Reservation Reward

We now go backwards at  $t = 1$ , to study the individuals' choice to run for office. The key concept is type- $ij$  politician's reservation reward, denoted by  $\underline{w}_{ij}$ . As shown in Section 3,  $\underline{w}_{ij}$  equals the type- $ij$  individuals' market income,

$$\underline{w}_{ij} = M(a_{ij}^*). \quad (26)$$

The reservation reward increases with the market income, which represent type- $ij$  individual's opportunity cost of becoming a politician.

It is worth studying how  $\underline{w}_{ij}$  is affected by fit and skills. First notice that inequality

$$\underline{w}_{Pj} < \underline{w}_{Mj} \quad (27)$$

is equivalent to  $M(a_{Pj}^*) < M(a_{Mj}^*)$  which holds true since  $a_{Mj}^* > a_{Pj}^*$  and  $M'(a) > 0$ . As a result, for any given level of skills a politician with public fit demands a lower reservation reward. The reason is that she incurs lower opportunity costs of entering politics because of a wrong fit with the market sector. Similarly, inequality

$$\underline{w}_{iH} > \underline{w}_{iL} \quad (28)$$

can be rewritten as  $M(a_{iH}^*) > M(a_{iL}^*)$ , which is fulfilled since  $a_{iH}^* > a_{iL}^*$  and  $M'(a) > 0$ . The reservation reward increases thus with skills.

We study the ranking of reservation wages in the following

**Lemma 1** (i) *A public-fit low-skilled politician requires the minimum reservation reward.* (ii) *A market-fit high-skilled politician demands the maximum reservation reward.* In symbols,

$$\begin{aligned} \underline{w}_{PL} < \underline{w}_{PH} < \underline{w}_{ML} < \underline{w}_{MH} & \text{ iff } a_{PH}^* < a_{ML}^*, & (a) \\ \underline{w}_{PL} < \underline{w}_{ML} < \underline{w}_{PH} < \underline{w}_{MH} & \text{ iff } a_{PH}^* > a_{ML}^*. & (b) \end{aligned} \quad (29)$$

Public fit affects negatively the politician's reservation reward according to (27). By contrast, skills have a positive impact given (28). As a result, a politician with public fit and worse skills (market fit and better skills) requires the lowest (highest) reservation reward. In addition, a type-*PH* politician demands a lower reservation reward than a type-*ML* iff  $M(a_{PH}^*) < M(a_{ML}^*)$ , or equivalently  $a_{PH}^* < a_{ML}^*$ , in which case she incurs lower opportunity costs of entering politics. When the opposite occurs,  $a_{PH}^* > a_{ML}^*$ , it is instead a type-*ML* who requires a lower reservation reward than a type-*PH*.

#### 4.4 Welfare

In this subsection we are interested in studying how fit and skills of the politician affects welfare of the society. Following the approach of Section 3, utilitarian welfare when type-*ij* individual is in office is denoted by  $S_{ij}$  and amounts to

$$S_{ij} \equiv U_{ij} + (\lambda_{ij}N - 1) Z_{ij} + \sum_{fk} \lambda_{fk} N Z_{fk}. \quad (30)$$

Recall that parameter  $\lambda_{ij} > 0$ , with  $\sum_{ij} \lambda_{ij} = 1$ , denotes the proportion of type-*ij* individuals in the society, whilst subscript  $fk \neq ij$ ,  $f = P, M$  and  $k = H, L$ , expresses the three citizens' types that differ from politician's type. For instance, if  $ij = PH$  then  $fk = PL, ML, MH$ . Accordingly,  $\lambda_{ij}N - 1$  indicates the set of type-*ij* citizens but the politician and  $\sum_{fk} \lambda_{fk} N$  are all the other citizens in the society. Plugging  $e_{ij}^*$ ,  $a_{ij}^*$  and  $a_{fk}^*$  into (30) and rearranging yields the optimal welfare when a type-*ij* is in office

$$S_{ij}^* = NP \left( e_{ij}^* \right) - c \left( e_{ij}^*, \gamma_i, \theta_j \right) + (\lambda_{ij}N - 1) \left[ M \left( a_{ij}^* \right) - s \left( a_{ij}^*, \gamma_i, \theta_j \right) \right] + \sum_{fk} \lambda_{fk} N \left[ M \left( a_{fk}^* \right) - s \left( a_{fk}^*, \gamma_f, \theta_k \right) \right]. \quad (31)$$

We first show that the optimal welfare is enhanced when, *ceteris paribus*, a public-fit instead of a market-fit individual is in office,

$$S_{Pj}^* > S_{Mj}^*. \quad (32)$$

Indeed, inequality (32) can be rewritten as<sup>13</sup>

$$(N - 1) \left[ P \left( e_{Pj}^* \right) - P \left( e_{Mj}^* \right) \right] + \left( U_{Pj}^* - U_{Mj}^* \right) > Z_{Pj}^* - Z_{Mj}^*. \quad (33)$$

The LHS is positive. Indeed,  $e_{Pj}^* \geq e_{Mj}^*$  and  $P' > 0$ , and  $U_{Pj}^* > U_{Mj}^*$  by Assumption 1.<sup>14</sup> The RHS is instead negative because  $Z_{Mj}^* > Z_{Pj}^*$  is implied by Assumption 2. As a result, inequality (33) is fulfilled. The reason is twofold. On one hand, a public-fit instead of a market-fit politician does not decrease the level of public good, thus not deteriorating the payoff of all citizens, and increases her own payoff. On the other hand, the market sector benefits from the presence of a market-fit instead of a public-fit citizen.

<sup>13</sup>See Appendix A.1 for computations.

<sup>14</sup>See Appendix A.2 for computations.

In line with condition (19), we can show that

$$S_{iH}^* > S_{iL}^* \quad (34)$$

is approximately equivalent to  $e_{iH}^* > e_{iL}^*$ , which is fulfilled. The positive impact of a high-skilled politician is spread among all citizens, thus outdoing the negative effect in the market sector due to the presence of a low-skilled citizen.

Taking into account (32) and (34), we are able to state the following

**Lemma 2** (i) *Welfare is maximum when a public-fit high-skilled individual is in office.* (ii) *Welfare is minimum when a market-fit low-skilled individual is in office.* In symbols,

$$\begin{aligned} S_{ML}^* < S_{MH}^* < S_{PL}^* < S_{PH}^* & \text{ iff } P(e_{PL}^*) - P(e_{MH}^*) > \frac{(Z_{PL}^* - Z_{MH}^*) - (U_{PL}^* - U_{MH}^*)}{N-1}, & (a) \\ S_{ML}^* < S_{PL}^* < S_{MH}^* < S_{PH}^* & \text{ iff } P(e_{MH}^*) - P(e_{PL}^*) > -\frac{(Z_{PL}^* - Z_{MH}^*) - (U_{PL}^* - U_{MH}^*)}{N-1}. & (b) \end{aligned} \quad (35)$$

Both public fit and skills have a positive impact on welfare. Accordingly, welfare is maximum (minimum) when the elected official is type-*PH* (-*ML*). In addition, expressions

$$\pm \frac{(Z_{PL}^* - Z_{MH}^*) - (U_{PL}^* - U_{MH}^*)}{N-1} \quad (36)$$

are close to zero since  $N$  is large. Accordingly (35-*a*) is approximately equivalent to  $e_{PL}^* > e_{MH}^*$  and (35-*b*) to  $e_{MH}^* > e_{PL}^*$ . Two conclusions can be drawn. (i) A type-*PL* producing a higher level of public good than a type-*MH*,

$$e_{PL}^* > e_{MH}^*, \quad (37)$$

is (almost) a necessary and sufficient condition for welfare to be higher when a public-fit individual instead of a market-fit one is in office for any level of skills. (ii) A type-*MH* producing a higher level of public good than a type-*PL*

$$e_{MH}^* > e_{PL}^*, \quad (38)$$

is (almost) a necessary and sufficient condition for welfare to be higher when a high-skilled individual instead of a low-skilled one is in office for any type of fit.

#### 4.5 Inefficiency Wages?

In this subsection we go backwards at  $t = 0$  and study how the level of  $w$  affects welfare through the selection of candidates.

According to Lemmata 1 and 2, two alternative orderings of both the reservation reward and the optimal welfare might arise. Four different combinations must then be taken into account, which we sum up in Table 1.

We arrange the reservation rewards of Lemma 1 in ascending order,

$$\underline{w}_1 \equiv \underline{w}_{PL}, \underline{w}_2 \equiv \min \{ \underline{w}_{ML}, \underline{w}_{PH} \}, \underline{w}_3 \equiv \max \{ \underline{w}_{ML}, \underline{w}_{PH} \}, \underline{w}_4 \equiv \underline{w}_{MH}. \quad (39)$$

We also rewrite the optimal welfare in the following manner,

$$S_1^* \equiv S_{PL}^*, S_2^* \equiv \min \{S_{ML}^*, S_{PH}^*\}, S_3^* \equiv \max \{S_{ML}^*, S_{PH}^*\}, S_4^* \equiv S_{MH}^*, \quad (40)$$

so that  $S_n^*$ ,  $n = 1, 2, 3, 4$ , denotes welfare of the society when the individual in office demands the  $n$ -th smallest reservation reward. By doing so, we are able to simplify the analysis of the reward level effects on the individuals' self-selection choices and, in turn, on the optimal expected value of welfare.

Reservation rewards/Welfare	Ranking (35-a): $S_{ML}^* < S_{MH}^* < S_{PL}^* < S_{PH}^*$	Ranking (35-b): $S_{ML}^* < S_{PL}^* < S_{MH}^* < S_{PH}^*$
Ranking (29-a): $\underline{w}_{PL} < \underline{w}_{PH} < \underline{w}_{ML} < \underline{w}_{MH}$	<b>Scenario (i):</b> public-fit enter first and enhance the welfare	<b>Scenario (ii):</b> public-fit enter first; high-skilled enhance the welfare
Ranking (29-b): $\underline{w}_{PL} < \underline{w}_{ML} < \underline{w}_{PH} < \underline{w}_{MH}$	<b>Scenario (iii):</b> low-skilled enter first; public-fit enhance the welfare	<b>Scenario (iv):</b> low-skilled enter first and worsen the welfare

Table 1: ORDERINGS OF RESERVATION REWARDS AND WELFARE

1. If  $w < \underline{w}_1$ , no individual decides to run for office. The public good is not supplied, no tax is levied and welfare is

$$\underline{S} \equiv N \sum_{ij} \lambda_{ij} [M(a_{ij}^*) - s(a_{ij}^*, \theta_{ij})]. \quad (41)$$

In line with the benchmark analysis (see Footnote 12), we let  $\underline{S}$  be lower than  $S_{ML}^*$ , the welfare level associated to the worst politician, type- $ML$  according to Lemma 2.

2. If  $\underline{w}_1 \leq w < \underline{w}_2$ , only type-1 individuals, *i.e.* those requiring the smallest reservation reward, run for office. As a result, a type-1 will be elected with probability  $p = \lambda_1/\lambda_1 = 1$ , where  $\lambda_1$  is the proportion of type-1 individuals. The deriving optimal welfare is

$$E_1(S) \equiv S_1^*. \quad (42)$$

3. If  $\underline{w}_2 \leq w < \underline{w}_3$  type-1 and type-2 individuals run for office. Given that the election is random, the elected politician will be type-1 with probability  $p = \lambda_1/(\lambda_1 + \lambda_2)$  and type-2 with probability  $1 - p = \lambda_2/(\lambda_1 + \lambda_2)$ , where  $\lambda_1$  ( $\lambda_2$ ) is the proportion of type-1 (type-2) individuals in the society and  $\lambda_1 + \lambda_2$  is the proportion of candidates. As a result, the expected optimal welfare, *i.e.* welfare before the election takes place, is

$$E_2(S) \equiv \frac{\lambda_1}{\lambda_1 + \lambda_2} S_1^* + \frac{\lambda_2}{\lambda_1 + \lambda_2} S_2^*. \quad (43)$$

4. If  $\underline{w}_3 \leq w < \underline{w}_4$  type-1, -2, and -3 individuals run for office. The expected optimal welfare is therefore

$$E_3(S) \equiv \frac{\lambda_1}{\lambda_1 + \lambda_2 + \lambda_3} S_1^* + \frac{\lambda_2}{\lambda_1 + \lambda_2 + \lambda_3} S_2^* + \frac{\lambda_3}{\lambda_1 + \lambda_2 + \lambda_3} S_3^*. \quad (44)$$

5. Finally, if  $w \geq \underline{w}_4$  all individuals run for office. This means that the expected value of welfare is

$$E_4(S) \equiv \lambda_1 S_1^* + \lambda_2 S_2^* + \lambda_3 S_3^* + \lambda_4 S_4^*. \quad (45)$$

First, in Appendix A.3 we verify that the expected value of welfare increases with the politician's reward,  $E_{n+1}(S) > E_n(S)$ , iff

$$S_{n+1}^* > E_n(S), \quad (46)$$

for any given  $n = 1, 2, 3$ . Taking into account that  $E_n(S)$  is a convex combination of values  $S_n^*$ , condition (46) has an intuitive explanation. The expected value of welfare increases with the politician's reward iff the welfare level attached to the new type entering as  $w$  rises,  $S_{n+1}^*$ , is higher than the expected value of welfare before her entry,  $E_n(S)$ . Obviously, the expected value of welfare decreases with the politician's reward iff

$$S_{n+1}^* < E_n(S). \quad (47)$$

It is worth observing that the worst politician, type-*ML*, demands the third smallest reservation reward in Scenarios (i) and (ii) and the second smallest in Scenarios (iii) and (iv). Taking into account (39) and (40), this amounts to say that  $S_3^*$  represents the minimum welfare level in Scenarios (i) and (ii) and  $S_2^*$  in Scenarios (iii) and (iv). By contrast, the best politician, type-*PH*, demands the second smallest reservation reward in Scenarios (i) and (ii) and the third smallest in Scenarios (iii) and (iv). This means that  $S_2^*$  is the maximum welfare level in Scenarios (i) and (ii) and  $S_3^*$  in Scenarios (iii) and (iv). As a result, neither (46) nor (47) are fulfilled for any  $n$ , *i.e.*, increasing the politician's reward has not a monotonically positive impact on the expected value of welfare. Indeed, in the first two scenarios,  $S_3^* < E_2(S)$  and  $S_2^* > E_1(S)$ . In the last two,  $S_2^* < E_1(S)$  and  $S_3^* > E_2(S)$ .

The above finding, which stands in contrast to Proposition 1, is summed up in the following

**Proposition 2** *When both skills and fit affect the individuals' effort disutility, the expected value of welfare of the society fluctuates in the politician's reward.*

The reason for this result is twofold. On one hand, the opportunity costs of entering politics borne by the worst politician, type-*ML*, are relatively high due to her market fit. On the other hand, the top politician, type-*PH*, incurs relatively low opportunity costs due to her public fit. Accordingly, the worst (best) politician does not demand the lowest (highest) reservation reward.<sup>15</sup>

<sup>15</sup> A similar result is found by Barigozzi & Turati (2012) in the case of the nursing labor market.

In what follows we are interested in deriving the parametric conditions under which  $E_4(S)$ , the expected value of welfare when the politician's reward is at its highest,  $w \geq \underline{w}_4$ , is not maximum. We study separately the four scenarios.

(i) In Scenario (i), the ordering of reservation rewards is given by (29-a) and that of welfare by (35-a): see Table 1. Relying on (39) and (40) we can rewrite (35-a) as

$$S_2^* > S_1^* > S_4^* > S_3^*. \quad (48)$$

It is easy to check that  $E_2(S)$  is the maximum expected level of welfare. Indeed, inequality  $E_2(S) > E_1(S)$  is implied by  $S_2^* > S_1^*$ ;  $E_2(S) > E_3(S)$  by  $\min\{S_1^*, S_2^*\} > S_3^*$ ; and  $E_2(S) > E_4(S)$  by  $\min\{S_1^*, S_2^*\} > \max\{S_3^*, S_4^*\}$ . Scenario (i) is characterized by two aspects. For any level of skills, public-fit politicians are cheaper than market-fit and welfare is higher when a public-fit individual, rather than a market-fit, is in office. Setting a relatively low reward which attracts only public-fit,  $w \in [\underline{w}_2 \equiv \underline{w}_{PH}, \underline{w}_3 \equiv \underline{w}_{ML})$ , is hence welfare-maximizing. At lower rewards,  $w \in [\underline{w}_1 \equiv \underline{w}_{PL}, \underline{w}_2 \equiv \underline{w}_{PH})$ , only low-skilled individuals enter within the group of public-fit. At higher rewards,  $w \geq \underline{w}_3 \equiv \underline{w}_{ML}$ , also market-fit individuals are attracted but they worsen the welfare.

(ii) In Scenario (ii) for any level of skills public-fit politicians are cheaper than market-fit and for any type of fit welfare is higher when a high-skilled individual, instead of a low-skilled one, is in office. In symbols, rankings (29-a) and (35-b) are fulfilled. The latter ranking can be rewritten as

$$S_2^* > S_4^* > S_1^* > S_3^*. \quad (49)$$

$E_2(S) > \max\{E_1(S), E_3(S)\}$  is implied by  $\min\{S_1^*, S_2^*\} > S_3^*$ . Yet, condition  $\min\{S_1^*, S_2^*\} > \max\{S_3^*, S_4^*\}$  does not hold here. The sign of  $E_2(S) - E_4(S)$  is hence undecidable without further investigation. According to (49), the *ex-post* first-best situation here is to have a type-2 ( $\equiv$  type-*PH*) in office. Any other type would generate a welfare loss. Inequality  $E_2(S) > E_4(S)$  can be reduced to

$$\left( \frac{\lambda_{PL}}{\lambda_{PL} + \lambda_{PH}} - \lambda_{PL} \right) (S_{PH}^* - S_{PL}^*) < \lambda_{ML} (S_{PH}^* - S_{ML}^*) + \lambda_{MH} (S_{PH}^* - S_{MH}^*). \quad (50)$$

When setting a relatively low remuneration  $w \in [\underline{w}_2 \equiv \underline{w}_{PH}, \underline{w}_3 \equiv \underline{w}_{ML})$  instead of fixing  $w \geq \underline{w}_4 \equiv \underline{w}_{MH}$ , the society incurs the expected costs given by the LHS of (50). Paying less augments from  $\lambda_{PL}$  to  $\lambda_{PL}/(\lambda_{PL} + \lambda_{PH})$  the probability of electing a type-*PL*, who brings about the welfare loss  $S_{PH}^* - S_{PL}^*$ . At the same time, the society avoids the expected costs denoted by the RHS of (50) because it eliminates the probability of electing both a type-*ML*, who causes the welfare loss  $S_{PH}^* - S_{ML}^*$ , and a type-*MH*, who generate the loss  $S_{PH}^* - S_{MH}^*$ . Therefore  $E_4(W)$  is not the maximum expected value of welfare if (50) is fulfilled. In turn this is likely to occur when the expected welfare loss  $\lambda_{ML} (S_{PH}^* - S_{ML}^*)$  caused by type-*ML* is relatively high.

(iii) In Scenario (iii) the ordering of reservation rewards is given by (29-*b*) and that of welfare by (35-*a*). The welfare ranking can be rewritten as

$$S_3^* > S_1^* > S_4^* > S_2^*. \quad (51)$$

First notice that  $S_2^* < \min\{S_1^*, S_3^*\}$  implies  $E_2(S) < \min\{E_1(S), E_3(S)\}$ . In Appendix A.3 we show that  $S_1^* > S_4^*$  implies  $\max\{E_1(S), E_3(S)\} > E_4(S)$ . Accordingly,  $E_4(S)$  is never the maximum expected level of welfare. The intuition is simple. Relying on (39) and (40),  $S_1^* > S_4^*$  can be rewritten as  $S_{PL}^* > S_{MH}^*$ . In this case setting the maximum reward  $w \geq \underline{w}_4 \equiv \underline{w}_{MH}$  is welfare-reducing since it attracts also high-skilled market-fit individuals who give a worse contribution than public-fit, both high- and low-skilled.

(iv) Low-skilled politicians are cheaper than high-skilled but they give a worse contribution to the society in Scenario (iv). In symbols, rankings (29-*b*) and (35-*b*) hold true, hence the welfare ordering is

$$S_3^* > S_4^* > S_1^* > S_2^*. \quad (52)$$

The minimum expected value of welfare is  $E_2(S)$ . Unlike in Scenario (iii),  $S_1^*$  is lower than  $S_4^*$  here so we cannot rule out the situation where  $E_4(S)$  is maximum. Ranking (52) ensures that the *ex-post* first-best picture here is to have a type-3 ( $\equiv$  type-*PH*) in office. One can check that  $E_1(S) > E_4(S)$  and  $E_3(S) > E_4(S)$  are equivalent to

$$(1 - \lambda_{PL})(S_{PH}^* - S_{PL}^*) < \lambda_{ML} \underset{\text{and}}{(S_{PH}^* - S_{ML}^*)} + \lambda_{MH}(S_{PH}^* - S_{MH}^*) \quad (a)$$

$$\left(\frac{\lambda_{PL}}{\lambda_{PL} + \lambda_{ML} + \lambda_{PH}} - \lambda_{PL}\right)(S_{PH}^* - S_{PL}^*) + \left(\frac{\lambda_{ML}}{\lambda_{PL} + \lambda_{ML} + \lambda_{PH}} - \lambda_{ML}\right)(S_{PH}^* - S_{ML}^*) < \lambda_{MH}(S_{PH}^* - S_{MH}^*), \quad (b)$$

respectively. This scenario is similar to the benchmark case described by Proposition 1. Still, setting the maximum reward  $w \geq \underline{w}_{MH}$  is not welfare-maximizing if (53) holds true. Note that, *mutatis mutandis*, inequalities (53) can be read as (50). Focus first on (53-*a*), which is likely to be fulfilled when the expected welfare loss  $\lambda_{ML}(S_{PH}^* - S_{ML}^*)$  caused by type-*ML* is relatively high. In this case  $E_1(S) > E_4(S)$  because setting the minimum reward  $w \in [\underline{w}_1 \equiv \underline{w}_{PL}, \underline{w}_2 \equiv \underline{w}_{ML}]$  has the virtue of crowding out the worst candidates. Consider now (53-*b*), which is likely to hold true when the two terms of the LHS are relatively low. This occurs in turn if fraction  $\lambda_{PH}$  of the best potential politicians is significant with respect to  $\lambda_{PL}$  and  $\lambda_{ML}$ . Setting  $w \in [\underline{w}_3 \equiv \underline{w}_{PH}, \underline{w}_4 \equiv \underline{w}_{MH}]$  instead of  $w \geq \underline{w}_4 \equiv \underline{w}_{MH}$  increases then the probability of electing a top politician and  $E_3(S)$  turns out to be higher than  $E_4(S)$ .

We sum up our findings in the following

**Proposition 3** (a) *If for any level of skills the welfare is enhanced when a public-fit politician rather than a market-fit one is in office ( $S_{PL}^* > S_{MH}^*$ ), the expected value of welfare is not maximum when*

the politician's reward is maximum ( $w \geq \underline{w}_{MH}$ ). (b) If for any type of fit the welfare is enhanced when a high-skilled politician rather than a low-skilled one is in office ( $S_{MH}^* > S_{PL}^*$ ), the expected value of welfare is not maximum when the politician's reward is maximum, provided that conditions (50) or (53) are fulfilled.

Inequality  $S_{PL}^* > S_{MH}^*$  is a sufficient condition for  $E_4(S)$  not to be maximum. Lemma 2 ensures that  $S_{PL}^* > S_{MH}^*$  is (almost) implied by  $e_{PL}^* > e_{MH}^*$ . The latter condition holds true when a right fit is more important than higher skills in enhancing the effort level of the politician. In this context, public-fit individuals are better politicians. Setting a relatively low remuneration is welfare-maximizing since it prevents market-fit individuals from running for office.

By contrast, inequality  $S_{MH}^* > S_{PL}^*$  states that high-skilled individuals are better politicians. Still  $E_4(S)$  might not be maximum since the politician requiring the maximum reservation reward, type  $MH$ , is not the best politician due to her wrong fit.

In line with the efficiency wage theory, Proposition 1 asserts that as long as skills are the sole determinant of individuals' effort disutility expected value of welfare is maximum when the politician's reward is maximum, *i.e.*,  $w \geq \underline{w}_H$ . This is not likely to occur in our richer framework according to Proposition 3, since the wrong fit of the most expensive class of politicians, type- $MH$ , makes them relatively little productive. As mentioned in the introduction, this potential adverse selection mechanism is referred to as moneyocracy since people whose work motivation is well fitted with the market rather than the public sector are attracted to politics.

## 5 Discussion of the results

With the aim of testing the robustness of our theoretical findings, we discuss two possible extensions of our analysis, the moonlighting option and a continuum of skill levels.

**Moonlighting.** We relax the assumption that politics and the market sector are mutually exclusive. Accordingly, a type- $ij$  individual may work in the market sector while in office and get an extra-income  $m \left[ M(a_{ij}^*) - s(a_{ij}^*, \gamma_i, \theta_j) \right]$ , where  $m \in (0, 1)$  measures the moonlighting activity. A regulated moonlighting is considered, *i.e.*  $m$  is assumed to be sufficiently low so that the outside employment does not affect a type- $ij$  politician's effort. Accordingly, the payoff obtained by a type- $ij$  politician after exerting the optimal public effort  $e_{ij}^*$  and market effort  $a_{ij}^*$  is given by

$$U_{ij}^m \equiv U_{ij}^* + m \left[ M(a_{ij}^*) - s(a_{ij}^*, \gamma_i, \theta_j) \right]. \quad (54)$$

Her reservation reward reduces to

$$\underline{w}_{ij}^m = (1 - m) \underline{w}_{ij} \quad (55)$$

because politics becomes more attractive. Finally, welfare increases to

$$W_{ij}^m = W_{ij}^* + m \left[ M(a_{ij}^*) - s(a_{ij}^*, \gamma_i, \theta_j) \right]. \quad (56)$$

First notice that the positive effect on welfare is small because it concerns only the politician’s payoff. As a result Lemma 2 is approximately unaffected by the moonlighting option. Second, it is easy to check that Lemma 1 is unaffected as long as  $m$  does not depend on the politician’s type. We can conclude that introducing the option of a regulated moonlighting activity for the politician does not affect our results.

**Continuum of skill levels.** We consider a continuum of skill levels within the interval  $[\underline{\theta}, \bar{\theta}]$ , where  $\underline{\theta}$  ( $\bar{\theta}$ ) denotes the minimum (maximum) level of skills, instead of focusing on just two values. As a result, the minimum (maximum) reservation reward must be rewritten as  $\underline{w}_{P\underline{\theta}}$  ( $\underline{w}_{M\bar{\theta}}$ ). Similarly, the ranking in Lemma 1 becomes

$$\underline{w}_{P\underline{\theta}} < \min \{ \underline{w}_{P\bar{\theta}}, \underline{w}_{M\underline{\theta}} \} \leq \max \{ \underline{w}_{P\bar{\theta}}, \underline{w}_{M\underline{\theta}} \} < \underline{w}_{M\bar{\theta}}. \quad (57)$$

Under this new formulation the worst politician is type- $M\underline{\theta}$ , with wrong fit and minimum skills, whilst the top one is type- $P\bar{\theta}$ , with right fit and maximum skills. Interestingly, inequalities (57) ensure that the worst (best) politician does not demand the lowest (highest) reservation reward. This is exactly the intuition driving the results of Propositions 2 and 3, which are thus not altered by the introduction of a continuum of skill levels.

## 6 Parliamentary Reward and Selection into the Italian Parliament

In this section we rely on different sources to provide a brief overview of the labour market of politicians in Europe. Our aim is twofold. First, we compare the Italian legislators’ pay to that of their foreign colleagues. Second, we study the correlation, if any, between the evolution of such pay over the last decades and the quality of individuals selected into the Italian Parliament.

Figure 1 illustrates the parliamentarians’ net annual rewards in EU.<sup>16</sup> The total amount is given by the basic salary plus additional allowances and benefits, such as per-diem reimbursements, the level of which can differ across individuals according to seniority, different duties, and residence.<sup>17</sup> Consequently, Figure 1 reports an average value of parliamentarians’ remuneration in 25 European countries. It is interesting to observe that the top level is reached by the Italians.<sup>18</sup>

In order to compare different pays relying on the same typology of duties, Figure 2 contains a list of rewards of the Members of European Parliament (MEPs) prior to July 2009 (Latza Nadeau, 2012).<sup>19</sup> Again, Italian MEPs’ reward turns out to be the highest. It is, for instance, two times

<sup>16</sup>Corriere della Sera, 2005 June 9th.

<sup>17</sup>For instance, Stella & Rizzo (2007) report that “the basic salary for Italian senators is 5,235 euros a month, but on top of that they claim daily expenses, which on average amount to an extra 4,000 euros a month. When you factor in the average phone bill - 340 euros a month - the real monthly income is nearer to 12,000 euros a month”.

<sup>18</sup>The wage levels in Figure 1 are not based on the PPP. Giommoni & Scrutinio (2013) show that the difference between the Italian parliamentarians and their European colleagues is still significant when the PPP is taken into account.

<sup>19</sup>Starting in July 2009, the salary of MEPs is paid by the EU and pegged to 38.5% of a European Court judge’s earning. This eliminated the substantial disparities among parliamentarians from different EU countries.

Average rewards of parliamentarians				
1 Italy 144.084,36	6 UK 81.600,00	11 France 62.779,44	16 Portugal 41.387,64	21 Malta 15.768,00
2 Austria 106.583,40	7 Belgium 72.017,52	12 Finland 59.640,00	17 Spain 35.051,90	22 Lithuania 14.196,00
3 Netherlands 86.125,56	8 Denmark 69.264,00	13 Sweden 57.000,00	18 Slovakia 25.920,00	23 Latvia 12.900,00
4 Germany 84.108,00	9 Greece 68.575,00	14 Slovenia 50.400,00	19 Czech Rep 24.180,00	24 Hungary 9.132,00
5 Ireland 82.065,96	10 LUX 66.432,60	15 Cyprus 48.960,00	20 Estonia 23.064,00	25 Poland 7.369,70

Figure 1: AVERAGE WAGE OF PARLIAMETARIANS IN EUROPE

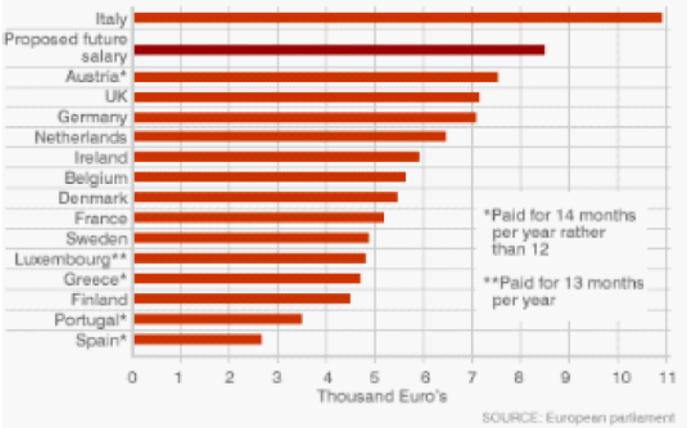


Figure 2: MEPs' SALARIES

that of the Germans and the British, three times that of the Portuguese, and four times that of the Spanish.

Additional information is provided by Figure 3, which shows that the parliamentary rewards in the European countries are generally commensurate with (less than twice as big as) the standard of living, proxied by the GDP per capita. Interestingly, the only exception is given by Italy, where the level of politicians' pay is four times as big as the GDP per capita (Pelagatti, 2011).

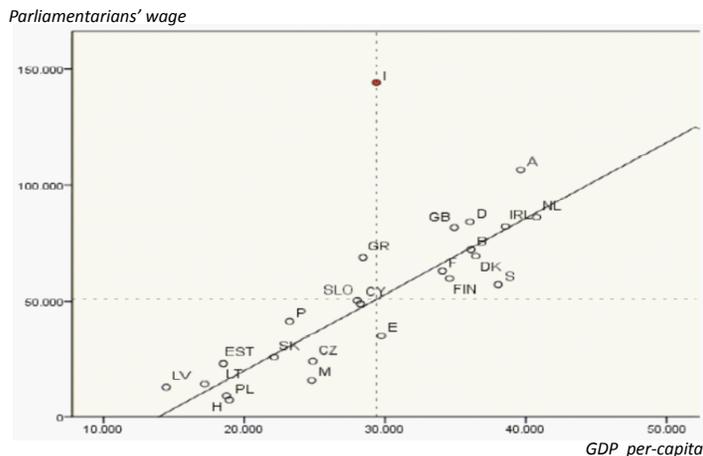


Figure 3: PARLIAMENTARIANS' REWARD AND GDP PER CAPITA IN EUROPE

On top of that, Italian legislators are allowed to keep their regular jobs outside Parliament. Consequently, working in the Italian Parliament implies a substantial pecuniary gain for a large majority of legislators. For example, in 2004 an Italian legislator earned an annual parliamentary wage of 146,533 euros plus another 56,335 euros on average from additional sources. To have an order of magnitude, the total amount was 1.8 times larger than the average earnings of an Italian manager (Merlo *et al.*, 2009).

We also have a look at the evolution over time of Italian legislators' remuneration (Boeri *et al.*, 2010). Figure 4 compares the real average annual income of Italian managers in the private sectors, which increased by 69.2% between 1985 and 2004, with the real average annual income of Italian legislators, which instead grew by 96.7%.<sup>20</sup>

Summing up, three interesting aspects concerning the Italian legislators' wage emerge from the data. (i) It is the highest in Europe. (ii) It is higher than the average income of Italian managers. (iii) Its real value increased significantly over the last decades.

Let us go back to our theoretical setup, where the highest reservation wage is  $w_{MH}$  according to Lemma 1. When  $w$  goes beyond such a cut-off - this was likely to occur in Italy where the legislators'

<sup>20</sup>Further evidence is given by the comparison between the Italian legislators and the US counterpart. In Italy, the before-tax real annual parliamentary wage (in 2005 Euros) increased from 10,712 euros in 1948 to 137,691 euros in 2006, an overall growth of 1,185.4%. In the US, the before-tax real annual congressional wage (in 2005 Dollars) increased from 101,297 dollars in 1948 to 160,038 dollars in 2006, an overall growth of 58%. Interestingly, Italy's real GDP per capita grew by 449.5% over the same period, whilst the US one grew by 241.7% (Boeri *et al.*, 2010).

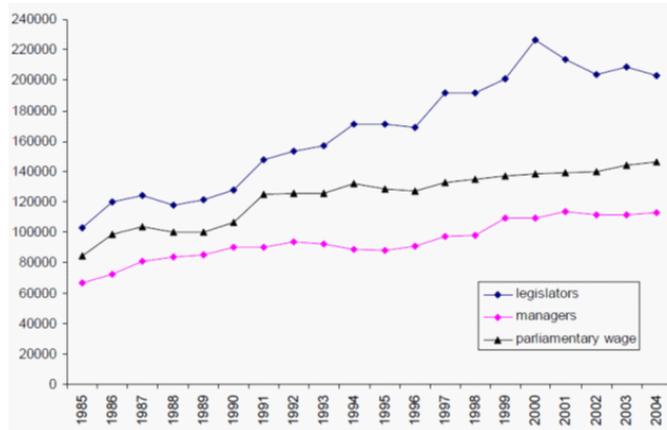


Figure 4: REAL AVERAGE ANNUAL INCOME 1985-2004, ITALIAN LEGISLATORS AND MANAGERS, 2005 EUROS

pay increased from almost 80,000 euros in 1985 to around 140,000 in 2004 (see Figure 4) - high-skilled individuals with market-oriented work motivation are predicted to enter the pool of candidates. With the aim of verifying whether the Italian Parliament might be home to this selection mechanism, we present some descriptive statistics on the types of parliamentarians since 1987.

Figure 5 illustrates the percentage of high-skilled individuals, defined as those with (at least) tertiary education, in the Italian population (OECD Factbook, 2011-2012) and in the Italian parliament over the last decades.<sup>21</sup> The trend concerning the Italian population (dotted line) is slightly positive in the period 1998-2006, the initial value being 8.6% and the final one 12.9%. Similarly, the proportion of high-skilled parliamentarians is not decreasing (upper solid line), from 63.97% in 1987 to 67.65% in 2006.

Figure 6 illustrates instead the fraction of public-fit individuals in the Italian population (World Values Surveys) and in the Italian parliament. Public-fit citizens are defined as those interested in politics.<sup>22</sup> Public-fit parliamentarians are instead defined in two different ways. Individuals with (i) both party affiliation and institutional appointments (*e.g.*, major or counsellor of a municipality, president or counselor of a region/province, member of the European parliament) before entering the parliament; (ii) party affiliation but no institutional appointments before entering the parliament.<sup>23</sup> Interestingly, the fraction of public-fit individuals in the Italian population (solid line) is clearly increasing, from 26.7% in 1981 to 37.4% in 2005, whilst that of parliamentarians is generally declining

<sup>21</sup>Information on Italian parliamentarians derives from a unique database covering the period 1987-2006 (Legislatures X to XV) and collected by Gagliarducci *et al.* (2010).

<sup>22</sup>More exactly, the questions analysed in the World Values Survey are: (i) Which of these statements comes nearest to describing your interest in politics? a) Active interest; b) interest but inactive; c) not greater than other (interests); d) not at all interested (sample 1981). (ii) How interested would you say you are in politics? a) Very interested; b) somewhat interested; c) not very interested; d) not at all interested (samples 1991, 1999, 2005). We define as public-fit individuals those who answered a) or b).

<sup>23</sup>For further details on the empirical definition of public fit, see Fedele & Naticchioni (2013), who rely on the same dataset as Gagliarducci *et al.* (2010) and analyze the effect of person-environment fit on choices of self-selection into politics and effort once in office in presence of moonlighting.

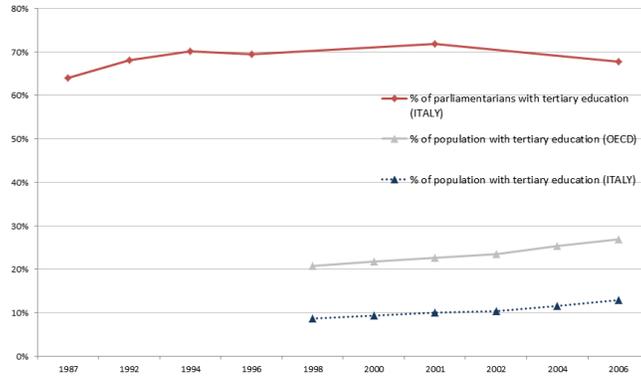


Figure 5: HIGH-SKILLED CITIZENS AND PARLIAMENTARIANS IN ITALY (1987-2006)

under both definitions (dashed and dotted lines): from 36.34% in 1987 to 26.16% in 2006 for definition (i); from 15.86% to 10.50% for definition (ii).

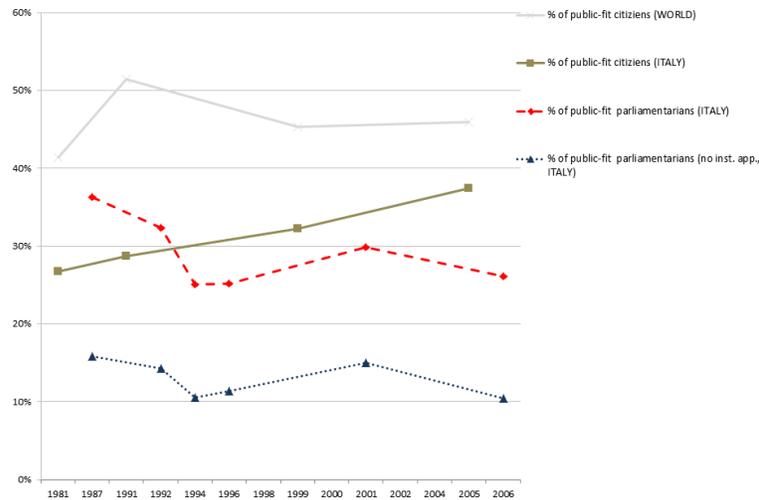


Figure 6: PUBLIC-FIT CITIZENS AND PARLIAMENTARIANS IN ITALY (1981-2006)

Obviously, the above descriptive evidence cannot be used to draw any convincing conclusion on the role played by politicians' wage on self-selection into politics. Still, it is evocative of the fact that the Italian case is definitely peculiar and could represent an example of the inefficiency wage mechanism predicted by our theoretical framework. Indeed, Italy experienced an important rise of the legislators' real wage. At the same time, the evolution of the proportion of high-skilled individuals in the Italian Parliament is consistent with the Italian population's trend; by contrast, the fraction

of public-fit parliamentarians decreased, contrary to what occurred in the population.

## 7 Concluding Remarks

In this paper we investigated the decision to enter politics by individuals with both heterogeneous skills and heterogeneous motivations. We first considered a benchmark model where skills are the sole determinant of individuals' effort disutility. In this context, welfare increases with the politicians' wage since best (*i.e.*, high-skilled) individuals are attracted to politics only if remuneration covers their high opportunity costs. Our findings are remarkably different when motivation is also taken into account. We first demonstrated that welfare fluctuates with the politicians' wage. We then derived conditions under which welfare is not maximized when the politicians' wage is relatively high. The key aspect is that paying politicians more than  $\underline{w}_{MH}$  attracts people whose work motivation is well fitted with the market rather than the public sector. This adverse selection mechanism has been called moneycracy. With the aim of testing the robustness of our theoretical findings, we then enriched our analysis by introducing moonlighting. Finally, we suggested that the Italian parliament can be thought of as being representative of the moneycratic mechanism.

Overall, our analysis suggests that ignoring work motivation when studying choices of self-selection into vocational labor markets, such as politics, might jeopardize the predictive power of the theory.

## A Appendix

### A.1 Inequality $S_{Pj}^* > S_{Mj}^*$

Taking into account (31) and letting

$$\begin{aligned} P_{ij} &\equiv NP \left( e_{ij}^* \right) - c \left( e_{ij}^*, \gamma_i, \theta_j \right), \\ M_{ij} &\equiv M \left( a_{ij}^* \right) - s \left( a_{ij}^*, \gamma_i, \theta_j \right), \end{aligned} \quad (58)$$

inequality  $S_{Pj}^* > S_{Mj}^*$  can be rewritten as

$$\begin{aligned} P_{PH} + (\lambda_{PH}N - 1) M_{PH} + \lambda_{PL}N M_{PL} + \lambda_{MH}N M_{MH} + \lambda_{ML}N M_{ML} &> \\ P_{MH} + (\lambda_{MH}N - 1) M_{MH} + \lambda_{PH}N M_{PH} + \lambda_{PL}N M_{PL} + \lambda_{ML}N M_{ML}, \end{aligned} \quad (59)$$

when  $j = H$  and

$$\begin{aligned} P_{PL} + (\lambda_{PL}N - 1) M_{PL} + \lambda_{PH}N M_{PH} + \lambda_{MH}N M_{MH} + \lambda_{ML}N M_{ML} &> \\ P_{ML} + (\lambda_{ML}N - 1) M_{ML} + \lambda_{PH}N M_{PH} + \lambda_{PL}N M_{PL} + \lambda_{MH}N M_{MH}, \end{aligned} \quad (60)$$

when  $j = L$ . Rearranging (59) gives

$$P_{PH} - M_{PH} > P_{MH} - M_{MH}. \quad (61)$$

Rearranging (60) gives

$$P_{PL} - M_{PL} > P_{ML} - M_{ML}. \quad (62)$$

Summing up,  $S_{Pj}^* > S_{Mj}^*$  can be rewritten as  $P_{Pj} - M_{Pj} > P_{Mj} - M_{Mj}$  which is equivalent to (33) in the text after substituting (58).

## A.2 Inequality $U_{Pj}^* > U_{Mj}^*$

$U_{Pj}^* > U_{Mj}^*$  can be rewritten as

$$P(e_{Pj}^*) - c(e_{Pj}^*, \gamma_P, \theta_j) > P(e_{Mj}^*) - c(e_{Mj}^*, \gamma_M, \theta_j), \quad (63)$$

which holds true since

$$P(e_{Pj}^*) - c(e_{Pj}^*, \gamma_P, \theta_j) > P(e_{Mj}^*) - c(e_{Mj}^*, \gamma_P, \theta_j) \quad (64)$$

by definition of optimal effort and strict concavity of  $P$  and

$$P(e_{Mj}^*) - c(e_{Mj}^*, \gamma_P, \theta_j) \geq P(e_{Mj}^*) - c(e_{Mj}^*, \gamma_M, \theta_j) \quad (65)$$

by Assumption 1. A similar reasoning can be invoked to show that  $Z_{Mj}^* > Z_{Pj}^*$  is implied by Assumption 2.

## A.3 Inefficiency Wages?

**Condition** (46). We study the following three inequalities.

(i)  $E_1(S) < E_2(S)$  is equivalent to

$$S_1^* < \frac{\lambda_1}{\lambda_1 + \lambda_2} S_1^* + \left(1 - \frac{\lambda_1}{\lambda_1 + \lambda_2}\right) S_2^* \Leftrightarrow S_1^* < S_2^* \Leftrightarrow E_1(S) < S_2^*. \quad (66)$$

(ii)  $E_2(S) < E_3(S)$  is equivalent to

$$\begin{aligned} \frac{\lambda_1}{\lambda_1 + \lambda_2} S_1^* + \left(1 - \frac{\lambda_1}{\lambda_1 + \lambda_2}\right) S_2^* &< \frac{\lambda_1}{\lambda_1 + \lambda_2 + \lambda_3} S_1^* + \frac{\lambda_2}{\lambda_1 + \lambda_2 + \lambda_3} S_2^* + \left(1 - \frac{\lambda_1 + \lambda_2}{\lambda_1 + \lambda_2 + \lambda_3}\right) S_3^* \Leftrightarrow \\ \left(\frac{\lambda_1}{\lambda_1 + \lambda_2} - \frac{\lambda_1}{\lambda_1 + \lambda_2 + \lambda_3}\right) S_1^* + \left(1 - \frac{\lambda_1}{\lambda_1 + \lambda_2} - \frac{\lambda_2}{\lambda_1 + \lambda_2 + \lambda_3}\right) S_2^* &< \left(1 - \frac{\lambda_1 + \lambda_2}{\lambda_1 + \lambda_2 + \lambda_3}\right) S_3^* \Leftrightarrow \\ \frac{\frac{\lambda_1}{\lambda_1 + \lambda_2} - \frac{\lambda_1}{\lambda_1 + \lambda_2 + \lambda_3}}{1 - \frac{\lambda_1 + \lambda_2}{\lambda_1 + \lambda_2 + \lambda_3}} S_1^* + \frac{1 - \frac{\lambda_1}{\lambda_1 + \lambda_2} - \frac{\lambda_2}{\lambda_1 + \lambda_2 + \lambda_3}}{1 - \frac{\lambda_1 + \lambda_2}{\lambda_1 + \lambda_2 + \lambda_3}} S_2^* &< S_3^* \Leftrightarrow \\ \frac{\lambda_1}{\lambda_1 + \lambda_2} S_1^* + \left(1 - \frac{\lambda_1}{\lambda_1 + \lambda_2}\right) S_2^* &< S_3^* \Leftrightarrow E_2(S) < S_3^*. \end{aligned} \quad (67)$$

(iii)  $E_3(S) < E_4(S)$ ,

$$\begin{aligned}
& \frac{\lambda_1}{\lambda_1 + \lambda_2 + \lambda_3} S_1^* + \frac{\lambda_2}{\lambda_1 + \lambda_2 + \lambda_3} S_2^* + \left(1 - \frac{\lambda_1 + \lambda_2}{\lambda_1 + \lambda_2 + \lambda_3}\right) S_3^* < \\
& \lambda_1 S_1^* + \lambda_2 S_2^* + \lambda_3 S_3^* + (1 - \lambda_1 - \lambda_2 - \lambda_3) S_4^* \Leftrightarrow \\
& \frac{\frac{\lambda_1}{\lambda_1 + \lambda_2 + \lambda_3} - \lambda_1}{1 - \lambda_1 - \lambda_2 - \lambda_3} S_1^* + \frac{\frac{\lambda_2}{\lambda_1 + \lambda_2 + \lambda_3} - \lambda_2}{1 - \lambda_1 - \lambda_2 - \lambda_3} S_2^* + \frac{1 - \frac{\lambda_1 + \lambda_2}{\lambda_1 + \lambda_2 + \lambda_3} - \lambda_3}{1 - \lambda_1 - \lambda_2 - \lambda_3} S_3^* < S_4^* \Leftrightarrow \\
& \frac{\lambda_1}{\lambda_1 + \lambda_2 + \lambda_3} S_1^* + \frac{\lambda_2}{\lambda_1 + \lambda_2 + \lambda_3} S_2^* + \left(1 - \frac{\lambda_1 + \lambda_2}{\lambda_1 + \lambda_2 + \lambda_3}\right) S_3^* < S_4^* \Leftrightarrow E_3(S) < S_4^*. \quad (68)
\end{aligned}$$

Condition (46) in the text sums up the three above results.

**Scenario (iii).**  $E_3(S)$  can be rewritten as

$$E_3(S) = E_1(S) + \left[ \frac{\lambda_2 (S_2^* - S_1^*) + \lambda_3 (S_3^* - S_1^*)}{\lambda_1 + \lambda_2 + \lambda_3} \right]. \quad (69)$$

$E_1(S) > E_3(S)$  is thus equivalent to

$$\lambda_2 (S_1^* - S_2^*) > \lambda_3 (S_3^* - S_1^*). \quad (70)$$

$E_4(S)$  can be rewritten as

$$E_4(S) = E_1(S) + [\lambda_2 (S_2^* - S_1^*) + \lambda_3 (S_3^* - S_1^*) + \lambda_4 (S_4^* - S_1^*)], \quad (71)$$

$E_1(S) > E_4(S)$  is thus equivalent to

$$\lambda_2 (S_1^* - S_2^*) + \lambda_4 (S_1^* - S_4^*) > \lambda_3 (S_3^* - S_1^*). \quad (72)$$

Since  $S_1^* > S_4^*$ , (70) implies (72) with the effect that  $E_1(S) > E_3(S)$  implies  $E_1(S) > E_4(S)$ . A similar reasoning ensures that  $E_3(S) > E_1(S)$  implies  $E_3(S) > E_4(S)$ .

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