



Can you teach old dogs new tricks? On complementarity of human capital and incentives

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Abstract

Contract theory suggests that firm performance can be improved by appointing new managers and/or by introducing better incentives. Furthermore, these two changes should be complementary – their effects reinforce each other. Using data on privatized firms in the Czech Republic, this paper presents results that suggest complementarity between the appointment of new managers and introduction of incentives in a transition economy. The results also show that ignoring the complementarity may lead to the wrong conclusion that the effect of incentives is weak. Managerial incentives seem to work only after the new post-privatization managers are appointed.

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JEL classification: G34; L29; M51; P31

Keywords: Contract theory; Incentives; Managerial change; Privatization; Restructuring

1. Introduction

This paper analyzes managerial replacement as a tool that new private owners can use to improve firm performance after privatization. In general, firm performance depends on both managerial ability and efforts (Laffont and Tirole, 1986). To induce the manager to increase effort, the owner (the principal) can introduce incentives such as performance-dependent

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pay/bonuses, promotion/reappointment if performance is good and demotion/dismissal if it is bad. Thus, theory predicts that firm performance can be improved in two ways: by appointment of more capable managers or by introduction of stronger incentives. However, McAfee and McMillan (1987) argue that these two instruments are in fact complementary so that new managers and better incentives reinforce each other. The complementarity of human capital and incentives plays an especially important role during the post-communist transition:

“Reforms are interlinked. The various incentive mechanisms that constitute a market system can complement or substitute for each other. ... [S]tronger incentives and better managers are complementary changes. They might be so complementary that neither change would be effective by itself. Some managers might be so inadequate as to be unable to respond to new incentives, no matter how well designed. Good managers might not work well under badly structured incentives. If so, restructuring is effective only if both changes – new managers and new incentives – are introduced together.” (McMillan, 1997, pp. 210 and 215)

Managerial incompetence and lack of motivation constitute two important sources of inefficiency of state firms in a planned economy. Thus, firm restructuring should focus both on the introduction of stronger incentives and on appointment of competent managers (McMillan, 1997; Roland, 2000). But which one of the two should receive priority? So far, empirical evidence on restructuring in transition is predominantly in favor of the view that the new human capital is more important than incentives.¹ Often, introduction of new managers is associated with better firm performance whereas the evidence for incentives is weak. However, failure to account for the complementarity between human capital and incentives may lead to misleading conclusion that better incentives do not work and that the appointment of new managers is more important.

Our paper sheds some new light on the relative roles of human capital and incentives and interactions between them in firm restructuring. Compared to the previous literature,² we employ an approach often used in the finance literature that examines the sensitivity of managerial change to past firm performance (see, for example, Denis and Denis, 1995).³ This methodology addresses the impact of negative incentives embodied in high sensitivity of managerial change to poor past performance. We find that the negative managerial incentives start working only after the incumbent pre-privatization manager has been replaced by a new, presumably more competent manager. In particular, our analysis shows that the first post-privatization managerial change is not sensitive to poor past performance. In contrast, poor past performance significantly increases the probability of manager's dismissal for the second and subsequent changes of the top manager (in firms where the new private owners had already introduced a new manager). This indicates that the new incentives kick in only after the first post-privatization managerial change, which suggests that human capital and incentives are indeed complementary.

¹ See, for example, Barberis et al. (1996), Claessens and Djankov (1999), Djankov and Murrell (2002), Warzynski (2003) and Fidrmuc and Fidrmuc (2004).

² Claessens and Djankov (1999) and Groves et al. (1995), for example, explore the impact of managerial changes on future firm performance.

³ Other papers include, for example, Weisbach (1988) and Warner et al. (1988); for a review of empirical papers see Hermalin and Weisbach (2003) and John and Senbet (1998).

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