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Bonding, shirking and adverse selection

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Abstract

The most serious theoretical difficulty regarding shirking-type efficiency wage models is that the introduction of the so-called bonding scheme eliminates involuntary unemployment. This paper develops a shirking-adverse selection model where the resulting key feature is that labor quality within an individual firm negatively depends on the average amount of bonds in the market. Under this situation, a larger bond required by an individual firm will lower the firm's labor quality and will discourage it from bonding its employees to the limit. This adverse selection problem gives rise to the possibility that bonding cannot eventually eliminate involuntary unemployment. Moreover, a larger bond required by a firm also worsens the labor quality within all other firms (negative externalities). The presence of these negative externalities implies that the profit-maximizing size of bonds required by individual firms in the market may be too large from the viewpoint of social welfare. This opens a possible role for bonding legislation to achieve an equilibrium Pareto superior to the competitive equilibrium.
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1. Introduction

One of the well-received theories explaining the existence of involuntary unemployment is the efficiency wage hypothesis. Among the various versions of such a hypothesis, the most popular and controversial development is the shirking view-

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point. The key idea behind shirking models is the existence of asymmetric information with regard to the worker's effort. This asymmetric information forces the manager to pay a wage that exceeds the worker's opportunity cost so as to prevent the worker from shirking, thereby giving rise to a difference between the utilities of the employed and unemployed. Such a difference makes the equilibrium unemployment 'involuntary'.[1]

All these shirking models suffer from a similar theoretical criticism, as pointed out by Akerlof and Yellen (1986, pp. 3–4): 'Employment contracts that are more ingenious than the simple wage schemes considered, can reduce or eliminate involuntary unemployment'.[2] The most famous example is the so-called bonding scheme: workers post bonds when initially hired and these are forfeited if the workers are caught shirking. Since paying premium wages is costly and bonding is costless to the firm, the threat of forfeiting the posted bonds then substitutes for paying efficiency wages in terms of creating work incentives. The competition among workers for jobs thus allows firms to charge an amount for the bonds until there is no difference between employment and unemployment, and so there will be no involuntary unemployment.

Devices that function in similar ways as with bonding include employment fees, deferred wage payments, and tournaments. Carmichael (1985) suggests that unemployed workers would be willing to pay a fee to gain employment, and that the competition among workers for jobs raises such fees until all involuntary unemployment disappears. Lazear (1981) demonstrates that workers can be paid a wage less than their marginal productivity when they are first hired with a promise that their earnings will later exceed their marginal productivity. This upward wage profile provides a penalty for shirking and eliminates involuntary unemployment. Lin and Yang (2001a) explore the macroeconomic implications of tournaments as a worker discipline device in the vein of shirking models. It is shown that tournaments can act as a bonding scheme, and if the full exploitation of tournaments is feasible, then there will be no involuntary unemployment.

The introduction of a bonding scheme or other such devices can eliminate involuntary unemployment, making obsolete unemployment as a worker discipline device. It is no wonder that the bonding issue has been emphasized as *the most serious theoretical difficulty regarding efficiency wage models* (Akerlof and Yellen, 1986, p. 8).

In response to the critics, Dickens et al. (1989, 1990) argue that by requiring workers to post large bonds or submit to other forms of punishment, firms could virtually eliminate monitoring expenditures. The empirical evidence, however, shows that a sizeable fraction of the monitoring of employees by employers is directed at deterring worker malfeasance. The pervasiveness of monitoring outlays makes it apparent that some consideration of fundamental importance is omitted from the formation of the existing models. *What are the limitations that constrain the ability*

[1] A canonical shirking model is provided by Shapiro and Stiglitz (1984).

[2] The origin of this critique can be stretched back to Becker and Stigler (1974) and Salop and Salop (1976). The same theoretical objection to the prediction of involuntary unemployment can also be applied to the labor turnover model of Salop (1979).

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