

Summary of Paper: [Optimal Performance Targets](#)

What is this Study About?

The study delves into executive compensation contracts, particularly focusing on a type of contract where managers receive a bonus if they surpass a predefined performance threshold. These contracts are analyzed in terms of their ability to address the moral hazard problem between firms and managers, under various conditions including risk neutrality and risk aversion. The paper evaluates how these contracts can effectively motivate desired effort levels from managers, considering the complexities introduced by risk and manager risk preferences.

What are the major findings of the study?

Under risk neutrality, performance targets can achieve first-best efficiency, with the optimal bonus increasing in response to risk. When managers exhibit sufficient risk aversion, firms tend to set optimal targets below the equilibrium effort level as a form of insurance, reducing the bonus size as another means of managing risk. Performance targets offer an additional instrument to address managerial effort issues, providing both predictive and normative insights into executive compensation practices. Notably, the study finds that firms prefer low-target contracts as they induce identical efforts at lower costs.

Why is the study important?

This study fills a gap in the theoretical exploration of performance target contracts by closely examining their practical applications and providing normative guidance on their use. It contributes to our understanding of how performance targets can be employed to address managerial incentive problems, especially under different risk conditions. The findings offer firms a nuanced strategy for structuring executive compensation to align managers' efforts with organizational goals, while also considering the implications of risk and manager risk preferences. This research is crucial for practitioners in designing effective compensation schemes that motivate desired managerial behaviors, ensuring that firms can navigate the moral hazard problem more efficiently.