I Edward P. Lazear: 
A Founding Father of Personnel Economics

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The IZA Prize in Labor Economics was awarded to Edward Lazear on October 25, 2004, in Berlin, Germany. The IZA Prize is given annually for outstanding contributions to policy-relevant research and methodological progress in the field of labor economics. Based on nominations submitted by IZA Research Fellows, the Prize Committee including Nobel Laureates George A. Akerlof and Gary S. Becker, as well as Armin Falk, Richard Portes, and Klaus F. Zimmermann, selected Ed Lazear as the third IZA Prize Winner.

In her laudation during the Berlin Prize Ceremony, Uschi Backes-Gellner (University of Zurich) named Ed Lazear the “jack-of-all-trades” of labor economics, alluding to Lazear’s theory that being equipped well with many different skills rather than being a specialist in one particular area constitutes a good entrepreneur (Lazear 2005, see Chapter 16). Indeed, Ed Lazear seems to have many entrepreneurial qualities.

As a founding editor, Lazear has played a major role in successfully establishing the Journal of Labor Economics. Only a few years after its foundation, the journal was widely regarded as the world’s top field journal in labor economics. Since then, the journal—for which Lazear continued to serve as an editor until 2001—has consolidated this role. As a forum for scientific debate among labor economists, the journal has enhanced the visibility and respect for the entire field and thereby fuelled its growth.
Ed Lazear has also proven his talent as an advisor outside the world of academia. Most notably, he served as Chairman of the President’s Council of Economic Advisers from 2006 until 2009. During his time as the chief economic advisor at the White House, he dealt with many important issues in economic policy, most importantly the breakout of the global financial crisis. Previous to his work for the US government, many other countries, such as Czechoslovakia, Georgia, Romania, Russia, and Ukraine, have sought Lazear’s advice for economic policy.

Moreover, Ed Lazear is a role model of an academic who does not lose sight of his students’ needs. According to Lazear, his initial motivation to do research in personnel economics was the fact that his students at the Chicago Graduate School of Business found the traditional topics in labor economics to be lacking in relevance for their future careers (see Part II of this book). He has written several textbooks, both for students and for personnel practitioners. His book on personnel economics (Lazear 1995) has been selected as “Outstanding Book” by MIT Press in 1996 and was named one of the ten most important books in labor economics in the same year. Acknowledging his accomplishments, Stanford University awarded him the “Distinguished Teaching Award” in 1994.

Finally, Ed Lazear is an exceptional scholar. Few other economists have shaped the research agenda in labor economics in a similar manner. It is this domain where the jack-of-all-trades analogy does not completely match Lazear’s record. Rather, he seems to be an example of a rare species that has the skills for being a successful entrepreneur and at the same time has the talents to be an excellent specialist in a certain field. On the one hand, his scientific contributions underline his qualities as a “research entrepreneur”: Lazear has worked on a very diverse set of topics, ranging from labor market institutions such as mandatory retirement or works councils (Chapter 1, Chapter 4), compensation structures and their effects on employee behavior (Chapters 6-9) to cultural assimilation (Chapter 12). However, Lazear also qualifies as a “research specialist”: in all of the mentioned areas, he developed ideas that have profoundly shaped the research agenda for many subsequent researchers.

The IZA Prize 2004 was awarded primarily for Ed Lazear’s contributions to the field of personnel economics. This subfield of labor economics opens the “black box” of the production process and
analyzes what happens inside firms. Most importantly, personnel economics studies the institutions and incentives that shape interactions between employees and employers and those among employees. The questions addressed in personnel economics can be organized according to the different phases of an employment relationship: How should employers select their employees? How do performance incentives influence sorting of workers, i.e., which aspects of a compensation scheme attract a certain “type” of worker? What is it that defines a position or “job” in the first place? How should employers structure their compensation schemes such that employees are motivated to work hard? Why do we observe different compensation schemes in different occupations, and why do different compensation structures sometimes even coexist within the same occupation? How do labor market institutions such as wage bargaining mechanisms or works councils interact with workplace performance? How does the relationship between co-workers impact behavior? For instance, how do the performance and compensation of teammates influence a worker’s motivation and productivity? Finally, how do institutions that govern the termination of an employment relationship, e.g., retirement regulation or employment protection legislation, affect the behavior of employers and employees during the period of employment?

In a relatively short time, personnel economics has become an integral part of research in labor economics. Pioneering articles by Ed Lazear and other early contributors have inspired many other scholars to take up an economic approach for studying human resource questions. Meanwhile, a JEL classification code has been created for the field, and numerous articles on personnel economics appear in high-ranking general interest and field journals. The success of personnel economics is also reflected in the curricula of universities and business schools throughout the world, where a large number of courses on human resource practices or personnel management are now taught by economists.

What explains the success of personnel economics? First, as outlined above, personnel economics studies a multitude of important questions that many practitioners are confronted with in their daily business. Importantly, it does so in the unifying framework of economic theory. In particular, personnel economists can rely on the methodology of non-cooperative game theory and contract theory: in rigorously analyzing the information structures, incen-
tives, and institutions that shape interactions in the workplace, personnel economics has generated a stream of novel—and sometimes surprising—insights on the above questions.

A particularly important finding is that workers’ wages do not necessarily have to coincide with their marginal productivities. As a result of moral hazard problems caused by informational asymmetries (which are the rule rather than the exception in most employment relationships), it can be optimal for firms to implement earnings profiles that do not equalize pay and productivity at every point in time. For instance, simple rank-order based compensation schemes can be equally effective as or sometimes even superior to more elaborate incentive mechanisms (see Chapter 6). In a similar vein, career-based incentives that offer an increasing earnings profile can help to mitigate moral hazard problems, since the prospect of earning future rents gives workers an incentive not to behave opportunistically (see Chapter 1). A further fundamental insight of research in personnel economics is that a firm’s compensation policy and its hiring strategy cannot be regarded as separate systems. Rather, compensation policy affects both workers’ performance incentives and the selection of workers (see Chapter 7 and Chapter 8). Research in personnel economics has also shed new light on the functioning of labor market institutions, showing that these institutions can have important effects on the provision of incentives and, thus, on workplace behavior in general (see Chapters 1-5).

A second reason for the success of personnel economics is that it lends itself to rigorous empirical testing. Though almost a tautology, it is this testing of theories and the identification of causal effects that scientific progress crucially relies on. Again, Ed Lazear has been on the forefront of this development. Not only has he developed some of the most relevant theories, but he has also set standards in the empirical literature on personnel economics. Many of the chapters in this volume start out from an empirical observation, develop a theoretical model to explain the stylized facts, and continue by empirically testing the theory’s implications. Lazear’s work on compensation based on labor input or production output stands exemplary for such fruitful combination of theoretical and empirical analysis. In “Salaries and Piece Rates” (Lazear 1986b, see Chapter 7), he developed the relevant theory, showing that the choice between the two compensation systems has implications for
workers’ performance, but also for the type of workers that are attracted by the firm (in terms of productivity or other personal characteristics). Subsequently, in “Performance Pay and Productivity” (Lazear 2000b, see Chapter 8), he tested the theory’s implications using data from personnel records of a firm that switched from hourly wages to a piece rate incentive scheme.

The theoretical models developed in personnel economics guide empirical researchers to structure their research questions and to identify the key variables needed for testing the theories’ empirical validity. Starting in the 1990s, recent years have shown a rapid increase of empirical research in personnel economics. This is mainly due to the fact that researchers succeeded in gaining access to high-quality micro-level data. Firm-based data sets as well as matched employer-employee data have increasingly become available. These data allow the researcher to observe relevant variables in great detail and therefore make it possible to test numerous theoretical implications, e.g., regarding promotion patterns of employees, compensation schemes in different occupations, turnover rates and composition of the workforce, etc. It can even be speculated that the increased willingness of firms to open their personnel records for researchers is itself the best signal that the research done in personnel economics is considered useful by practitioners.

A second, and complementary, set of empirical studies in personnel economics relies on economic experiments. Experiments are particularly useful to study questions in personnel economics because of two main reasons. First, they give the researcher much tighter control over variables that are crucial for direct tests of theoretical models, such as workers’ effort cost functions, production technologies, or the information structures which employers and employees are assumed to face. In addition, experiments allow the researcher to implement true ceteris paribus variations, which is crucial when one is interested in causal identification, e.g., of the “pure” incentive effect of a change in the compensation system.

The empirical findings in personnel economics have been both reassuring and inspiring for the field. On the one hand, the theories’ most important implications have been confirmed empirically. To say it in Ed Lazear’s (1999) words, many empirical studies have shown that “personnel economics is real”: for instance, workers react to performance incentives largely as predicted by theory (see Prendergast 1999 for an excellent review of early empirical re-
sults), compensation schemes have been shown to affect the composition of the workforce (see, e.g., Chapter 8 or Dohmen and Falk 2010), and many empirical regularities on real-world hierarchies are consistent with the predictions of promotion-based incentive schemes (e.g., Ehrenberg and Bognanno 1990, Eriksson 1999, Bognanno 2001).

On the other hand, empirical studies have also found some interesting departures from theoretical predictions. Probably the most important one is the finding that incentives generated through compensation structures can sometimes have unintended consequences due to employees’ non-pecuniary motives. Examples of such motives that play a role for employee behavior include concerns for distributional fairness or equity (Adams 1963, Fehr and Falk 2002, Abeler et al. 2010), social ties and social comparison (Bandiera, Barankay and Rasul 2009, Fließbach et al. 2007), or the tendency to reciprocate perceived (un)kind treatment even if—from a purely pecuniary viewpoint—this is suboptimal (Fehr, Gächter and Kirchsteiger 1997, Fehr, Klein and Schmidt 2007).

It is important, however, to point out that these findings do not reject the personnel economics approach. Rather, they suggest that the objective function of agents might be more complex than traditionally assumed. This, in turn, has led to the development—and further testing—of new theories that account for these empirical regularities. For instance, models that incorporate employee envy (Grund and Sliwka 2005, Kräkel 2008) or a joy of winning (Parco, Rapoport and Amaldoss 2005, Amaldoss and Rapoport 2009) are consistent with the observation of “dropouts” or excess effort provision that have been documented in experimental studies on tournament incentives (Müller and Schotter 2010; Altmann, Falk and Wibral 2011).

It is nearly impossible to overstate Ed Lazear’s contributions to personnel economics. As one of the founding fathers of personnel economics, his work has profoundly shaped the field. The impact of Ed Lazear on subsequent scholars who study human resources can easily be seen by the fact that the papers in this volume alone have been cited more than 2100 times according to the Social Science Citation Index (SSCI) and more than 8000 times according to Google Scholar. Without Lazear’s impetus, the economics of personnel would probably not exist as a field or, at least, would not be one of the most vital and active fields of research within labor economics today.
IZA follows the tradition of Ed Lazear’s pioneering work in its research program area “Behavioral and Personnel Economics”. Initiated in 2003, the program area mirrors the comprehensiveness of the personnel economics approach: researchers and fellows come from a variety of different backgrounds such as micro theory, empirical labor economics, management and business economics, as well as behavioral and experimental economics. The conferences and workshops organized by IZA in the past years have witnessed a committed scientific community that discusses novel developments in theoretical and empirical research on human resources while keeping closely personnel practitioners and their questions. In his acceptance speech at the 2004 prize ceremony in Berlin, Ed Lazear expressed the belief “that this new research initiative promises to be one of IZA’s most fertile areas for research.” More than five years later this expectation is increasingly becoming reality, both at IZA and in the labor economics profession as a whole.