ON-THE-JOB SEARCH AND MORAL HAZARD

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Abstract
We analyze the interaction between intertemporal incentive contracts and search frictions associated with on-the-job search. In our model, agency problems call for wage contracts with deferred compensation. At the same time workers do on-the-job search. Deferred compensation improves workers’ incentives to exert effort but distorts their on-the-job search decisions. We show that deferred compensation is less attractive when the value to the worker-firm pair of on-the-job search is high. Moreover, the interplay between search frictions and wage contracts creates feedback effects. If firms in equilibrium use contracts with deferred compensation, fewer firms with vacancies enter the on-the-job search market, and this in turn reduces the distortions created by deferred compensation. These feedback effects between the incentive contracts used and the activity level in the search markets can lead to multiple equilibria: a low-turnover equilibrium where firms use deferred compensation, and a high-turnover equilibrium where they do not. Furthermore, the model predicts that firms are more likely to use deferred compensation when search frictions are high and when the gains from on-the-job search are small. (JEL: J41, J63)